The Mystery of Capital

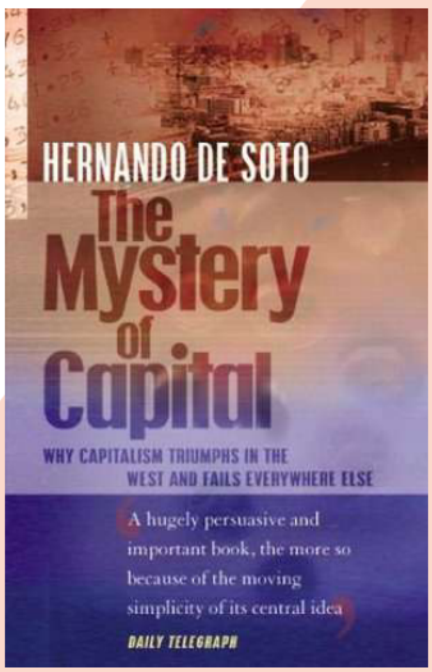
REVIEW BY: BILL BATT

After its winning nine prestigious awards from mainstream economic and public affairs organizations, why have we Georgists not reviewed this book earlier! No book's thesis more directly flies in the face of our own arguments than what Dr. Hernando DeSoto has proposed.

And now, with the rave reviews given to this, his second work, we are compelled to confront what he claims and to demonstrate the sleight-of-hand in his argument. In the absence of more qualified adherents of the Georgist persuasion, I have set myself this task.

DeSoto is president of the Institute for Liberty and Democracy headquartered in Peru. Coming from the global South, he is able to say things that, coming from the World Bank, the International Monetary Fund, or any similar organization, would sound crass and self-serving.

Early on in the book (p. 37), he says that " [l]eaders of the Third World and former Communist nations need not wander the world's foreign ministries and international financial institutions. The key to capital development and economic modernization, he argues, comes from the capacity to leverage what capital assets already exist. And the seeking their fortune. In the midst of their own poorest neighborhoods and shantytowns, there are -- if not acres of diamonds -- trillions of dollars, all ready to be put to use if only the mystery of how assets are transformed into live capital can be unraveled."



The conscience of the global North is thus assuaged: it's not the fault or the insensitivity of the wealthy nations that so many people of the world live in poverty; rather it stems from an inability of impoverished countries themselves to leverage the capital assets that they have. The rest of the book attempts to substantiate this argument, or rather to explain why "the one thing that the poor countries of the world cannot seem to produce for themselves [i.e., investment capital], no matter how eagerly their people engage in all the other activities that characterize a capitalist economy." (p.5.) most commonly and easily leveraged asset is real estate. But because titles in poor nations, to real estate property especially, are not secure and protected in the law, they cannot serve as collateral for further loans. "The result is that most people's resources are commercially and financially invisible. Nobody really knows who owns what and where, who is accountable for the performance of obligations, who is responsible for losses and fraud, or what mechanisms are available to enforce payment for services and goods delivered. Consequently, most potential assets in these countries have not been identified or realized; there is little accessible capital, and the exchange economy is constrained and sluggish." (p.32) He goes on to argue that, "about 85% of urban parcels in these nations, and between 40% and 53% of rural parcels, are held in such a way that they cannot be used to create capital. . . .By our calculations, the total value of the real estate held but not legally owned by the poor of the Third World and former Communist nations is at least $9.3 trillion."

Where is this capital? It lies in every legally-secured asset: "every piece of land, every house, every chattel," all "formally fixed in updated records governed by rules contained in the property system." (p.48) He suggests that in developed economies, "up to 70 percent of the credit new businesses receive comes from using formal titles as collateral for mortgages," (p.84) and that "real estate accounts for some 50 percent of the national wealth of advanced nations." (p.86) Nowhere, however, is this identification of "capital" parsed for what it really is: largely land. As a true neoclassical economist, despite his ritual homage to Adam Smith, everything that the classical economists and we Georgists would call land is conflated into capital. To DeSoto it is the land in almost all instances that provides the leverage for capital equity and accumulation, secured under authorized titles as property. The metaphor that he employs to distinguish land as a capital asset from other forms of capital is revealing. His analogy is a lake, first available only as potential energy, until such time a dam is built to capitalize its kinetic power. The lake's utility as capital is "locked up" until such time as its title makes it securely available for exploitation. "Just as a lake needs a hydroelectric plant to produce usable energy, assets need a formal property system to produce significant surplus value." (p.48) Nowhere does he explore the origins or legitimacy of those titles, how they might have been secured or whether they were fairly gained. It is sufficient, only, that they are guaranteed for current purposes. "Capital is born by representing in writing - in a title, a security, a contract,

(Cont. Next Page)

The Mystery of Capital (Cont.)

and in other such records - the most economically and socially useful qualities about the asset as opposed to the visually more striking aspects of the asset." (p. 49) The moral dimensions of land ownership are totally overlooked. The way to challenge his whole thesis is by asking him to defend the legitimacy of real estate titles - wherever they are.

De Soto spends considerable ink in exploring the history of American economic development, as he sees in its history the key to success elsewhere. Chapter Five is an extended treatment of the "evolution of property" in the USA (p.108), and in believing that the progress making it "open to all" (p.109) is not yet complete. The granting of titles is treated extensively - the eviction of squatters, the reward to soldiers, the surveying and marking of boundaries, and the employment of "cabin rights" and "corn rights." DeSoto notes at one point (p.117) that squatters "were constantly provoking conflict with Native Americans by invading their lands," but the moral questions he never addresses.

His debt to most of the prominent historians on the subject is replete - Gates, Hoffer, and even an Aaron Sokolski book published in 1957 by the Robert Schalkenbach Foundation. There is also an extensive treatment of a controversial 1821 case that attempted to ground the "rules of property" in English common law. One Richard Biddle, a squatter who had settled on land titled to Green, was adjudged liable to pay not merely for the land he occupied but for any improvements that were made. The Court then later reaffirmed that occupancy laws deprived "the rightful owner of the land, of the rents and profits received by the occupants." But the backlash to this decision was so profound that it inspired statutes in rapidly settling western states quickly making Green a nullity. (Green v Biddle, 8 Wheaton 1, 1823) The

sanctity of title in fee simple continues to evolve over the course of the next century. Titles for mining claims came to have the same standing as those for farm lands.

DeSoto accepts the argument of historian Richard White by quoting in part: "[T]hrough occupancy, preemption, homesteading, miners' laws, and such, Americans built a new concept of property, 'one that emphasized its dynamic aspects, associating it with economic growth,' and which replaced a concept 'that emphasized its static character associating it with security from too rapid change.'

American property changed from being means of preserving an old economic order to being, instead, a powerful tool for creating a new one. The result was expanded markets and capital needed to fuel explosive economic growth. This was the momentous' change that still drives U.S. economic growth." (p.149-150) I'm tempted to check White's 1991 book soon, as the title is It's Your Misfortune and None of My Own: A New History of the American West.

Not recognizing land as a separate factor of production, there is of course no further mention of economic rent. One can only wonder how any economic surplus arises - doubtless from labor, even if he provides no indication that workers reap the rewards of their toil. Somehow, rather, capital is transmuted into more capital, simply by virtue of the security of property titles.

Despite our Georgist criticism, DeSoto's thesis is definitely sound in parts: security needs to be granted to its users if improvements are to be tied to locational sites, else the risk to investment will likely be too high to sustain. No homesteader can venture a large stake in a site if he realizes that it may be taken from him. No miner can risk so much transformation of labor to capital, if the land on which he builds may soon be lost. Land titles are important.

DeSoto has a point. But his reliance on freehold property title to land, the birthright of us all, to provide financial collateral is problematic and unjust.

The failure to recognize land rent means that the bases of taxation will necessarily derive from other factors, i.e., labor and capital. By taxing those other factors, the efficiency and productivity of the economy is compromised. DeSoto fails to recognize that the collection of and rent, were it identified, would provide the perfect revenue source. It would not reduce the wealth of societies and the growth of capital one whit; rather it would inspire it. The Georgist point of view is a compelling answer to The Mystery of Capital; it needs only to be told again and again.