Mystifying the Concept of Capital

Hernando de Soto's Misdiagnosis of the Hindrance to Economic Development in the Third World

JAMES C. W. AHIAKPOR

In his well-publicized book *The Mystery of Capital* (2000), Hernando de Soto claims to have discovered the explanation for poverty in countries of the Third World and the former Soviet Communist bloc. He claims it is the inability of the poor people in these countries to convert their "dead capital" into live, functioning "capital" because of a "legal apartheid" their governments have created. He asserts that the conversion of dead capital into live capital explains the rise of capitalism, which he equates with economic development, in the West. Numerous reviewers of the book have praised de Soto's diagnosis of the cause of underdevelopment and his recommendation of the widespread granting of formal titles to properties owned by the poor as a solution to this problem. In academic journals, the positive reviews include those by Libecap (2001), Buch (2002), Rosenberg (2002), and Pal (2003).

In the process of developing his argument, de Soto refers to the well-known explanation that clearly defined and enforceable property rights reduce transactions costs (Coase 1937) and promote investments, thus earning Ronald Coase's endorsement of the book: "A very great book . . . powerful and completely convincing. It will

James C. W. Ahiakpor is a professor of economics at California State University, East Bay.

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have a most salutary effect on the views held on economic development." Similarly, Milton Friedman endorsed the book, noting: "De Soto has demonstrated in practice that titling hitherto untitled assets is an extremely effective way to promote economic development of society as a whole. He offers politicians a project which can contribute to the welfare of their country and at the same time enhance their own political standing, a wonderful combination" (see the book's back dust cover for both quotations).[1] Comparing de Soto's claims with some of the grand development theories of the 1950s and 1960s, Jagdish Bhagwati (Columbia University) also declares that "de Soto is arguably the most interesting intellectual writing on development today. . . . [He] is the man with 'big' ideas. . . . His *Mystery of Capital* will endure as a work of extraordinary importance" (qtd. in Clift 2003, 10). *The Economist* hails the book as "the most intelligent . . . yet written about the current challenge of establishing capitalism in the developing world" (Clift 2003, 8).

Despite these accolades, de Soto is quite mistaken in his diagnosis of the real hindrance to economic development in the Third World and former Soviet bloc countries. Rather than the lack of titles to property, the problem is the inadequacy of their domestic savings to finance investment. Poor people in these countries hardly own assets, the absence of whose formal titles impairs their ability to borrow funds, or "capital," for investment. Thus, de Soto's suggested solution of a massive titling program by the governments of these countries would be a wasteful diversion from what needs to be done in them to promote their economic prosperity. This point is implicit in Culpepper's criticism of de Soto's property-titling project as "flawed" and "inherently biased against the landless and propertyless tenants," although his book "purports to speak on behalf of, and to empower, the poor and disenfranchised" (2002). Because de Soto's book has received numerous endorsements from high-profile figures, the fundamental errors of its premise need wide publicity in order to spare Third World governments from being misled.[2]

1. Among other high-profile endorsers of de Soto's book are Margaret Thatcher, Javier Perez de Cuellar, Francis Fukuyama, and William F. Buckley Jr. Mrs. Thatcher argues that "*The Mystery of Capital* has the potential to create a new, enormously beneficial revolution, for it addresses the single greatest source of failure in the Third World and ex-communist countries—the lack of the rule of law that upholds private property and provides a framework for enterprise. It should be compulsory reading for all those in charge of the 'wealth of nations.'" De Cuellar thinks the book makes "[a] crucial contribution. A new proposal for change that is valid for the whole world." Fukuyama observes that "*The Mystery of Capital* constitutes one of the few and genuinely promising approaches to overcoming poverty to come along in a very long time," and Buckley argues that de Soto's "book changes our understanding of where capital comes from. The consequences could be world-shattering." (All of these quotes are from the book's back or inside dust cover.) Believing de Soto's claims regarding the absence of the rule of law and private-property rights for the poor in the Third World, Sowell also concludes his review of the book by arguing: "This book should be required reading for those—including law professors—who seem to think that property rights are just privileges for the rich. The poor need them most of all, especially if they want to stop being poor" (2000). Former president Bill Clinton is also reported to have declared de Soto "the world's greatest living economist" ("Hernando de Soto" 2007) because of the book.

2. Since the publication of *The Mystery of Capital,* de Soto has received numerous awards (nineteen between 2002 and May 2007), mainly from free-market adherents, including the Adam Smith Award (2002), the Milton Friedman Prize (2004), and the 2006 Innovation Award (Social and Economic Innovation) from *The Economist* magazine. It is unclear how much the selection of him for these awards was influenced by

De Soto appears to have arrived at his fundamental misdiagnosis of the hindrance to economic development primarily from his misconception of "capital" and the source from which it derives. He thinks that "an implicit process buried in the intricacies of [the] formal property systems . . . creates capital in the West" and that "the formal property system is capital's hydroelectric plant . . . the place where capital is born" (2000, 46, 47; hereafter cited by page number only). But this view is incorrect. Rather, it is a community's savings that mainly create the "capital" that may be borrowed by titled or untitled property owners. De Soto compounds his misconception with a confusion between stocks of wealth and the relevant flows of savings, or "capital," to finance investment. He also exaggerates the limited role of titles to property in the economic-development process of the more developed countries and misrepresents the historical causality between economic development and the titling of private property. His misdiagnosis of the principal impediment to economic development also appears to have been driven by his misperceptions of conditions in poor countries, misperceptions that he himself affirms with self-contradictory claims in the book, especially his view that most people there do not have property rights.

Samuelson (2001), Woodruff (2001), Gilbert (2002), and Miranda (2002) have offered criticisms and warnings about the illusions of de Soto's proposal. Woodruff notes that the amount of "capital" that may be "unlocked" from the poor's assets "might be only a small percentage of that suggested by de Soto" (2001, 1221). He also reports from a study of rural Thailand that "owners of untitled land are as likely to receive credit as are farmers with titled land, even from banks," and that "titles have little effect on credit obtained from non-bank sources such as traders" (1219). Samuelson faults de Soto for his neglect of the cultural dimension of the pursuit of economic development, adding: "Property rights are not the be all and end all of progress but a simple reflection of the larger culture. . . . [De Soto's] story of property rights is only an interesting sideshow" (2001, 211).[3] Gilbert reports that the granting of titles in Bogotá, Colombia, has made little difference in people's access to credit, and Miranda notes that "after six years work and more than 1 million registered land titles [in Peru], a very small percentage of the people in the target population have credit, which in most cases is from the Banco de Materiales, a government credit system that provides credit to those with *secure incomes* and which is not based on those who have formal titles" (2002, 263, emphasis added). Miranda's report answers Thomas's query about the outcome of the land-titling project to which de Soto was

the acclaim he received for his earlier book *The Other Path* (1989), arguing the benefits of private enterprise and pointing out the burdens of government bureaucracy, or by his having founded the Institute for Liberty and Development in Lima, Peru. Several governments in the Third World have invited de Soto to advise them on the implementation of his project—that is, to help them to find the key to "unlocking the hidden wealth" that already exists in their countries. He expected in 2003 to be working with twenty-five of these governments "over the next two years" (Clift 2003, 10).

3. De Soto appears to dismiss the relevance of the cultural dimension for explaining differences in the level of economic development, arguing that "one day these cultural arguments will peel away as the hard evidence of the effects of good political institutions and property law sink in" (225).

appointed by President Alberto Fujimori of Peru in the 1990s, but of which de Soto says nothing in the book to explain "why this programme failed to generate credit for those who were registered" (2002, 191). A recent study of a poor suburb of Buenos Aires, Argentina, by Galiani and Schargrodsky also finds "only . . . modest effects on access to credit markets as a result of [property] entitlement" (2005, 3). The land had been bought by the Argentine government and distributed to squatters.

However, the preceding criticisms do not focus on de Soto's misconception of "capital" and of its source—namely, savings—or consider that titles may only increase the demand for loanable savings in the formal credit market without necessarily increasing the total supply.[4] Meanwhile, such notable textbook commentators as Perkins, Radelet, and Lindauer (2006, 85, 414) and Gwartney and colleagues (2006, 38) repeat without criticism de Soto's claims that the absence of formal titles to property is a hindrance to economic development. I here follow up Woodruff's suggestion that "policy makers . . . be alerted to the limitations of de Soto's proposals" (2001, 1223). I also clarify Adam Smith's concept of capital, which de Soto misrepresents.[5]

De Soto is reported to have admitted the insufficiency of his titling project to promote economic development, but insists on its primacy: "I'm not saying that other reforms aren't necessary. I'm simply saying that a property rights system is a principal reform, without which other reforms are difficult to manage. It's quite clear that property law alone does not resolve the other problems. But to me, what is also quite clear is that without property law, you will never be able to accomplish other reforms in a sustainable manner" ("Hernando de Soto" 2007). In view of this insistence, his mistaken diagnosis requires correction, particularly for his free-market admirers who have been touting his program.

Mystifying Capital and Its Source

When a businessperson says he is looking for some "capital" to invest or set up an enterprise, he has in mind a sum of money (funds), typically to be borrowed at interest. Some of the funds may be used to purchase or rent machinery or equipment, rent space for the enterprise, purchase raw materials, and pay for the services of

4. In an attempt to defend de Soto's argument, a referee for this article gave the analogy of a rickshaw driver who might "become financially independent" by pledging his land, if he had title to it, as collateral for a loan to purchase the rickshaw instead of renting the vehicle. But how likely is it that a man so poor as to be only a driver of a rented rickshaw will also own land? The poor in the Third World typically are not property owners.

5. My article is not so much about the effects of land titling on landowners' access to credit as it is about de Soto's misdiagnosis of the principal hindrance to economic development in the Third World and the irrelevance of his suggested remedy. Therefore, I focus on the relevant development literature; readers interested in the literature on land titling and access to credit may see Van Tassel 2004 and Jacoby and Minten 2007. I thank an anonymous referee for bringing these recent publications to my attention. However, these authors do not discuss de Soto's diagnosis of the hindrance to economic development.

workers. Some of the funds will also be kept on hand to pay incidental costs that the enterprise incurs or to provide change to customers before revenues start to flow in. Thus, borrowed "capital" is a larger sum of money than the value of the physical assets an entrepreneur purchases, which modern economists call *capital goods*—machinery, equipment, raw materials, or produced goods yet to be sold. It goes without saying that income earners first must save if businesspersons are to borrow capital. Thus, "capital" is intimately connected with savings and interest rates. The greater the demand for "capital" relative to its supply (savings), the higher the rate of interest, and vice versa.

This meaning of the term *capital* is the one that the classical economists and several early neoclassical economists employed; see, for example, Adam Smith's *Wealth of Nations* ([1776] 1976, 1:294–301); David Ricardo's *Works and Correspondence* (1951–, 1:363, 2:331, 3:89–94); J. S. Mill's *Collected Works* (1963–88, 2:chap. 6, 3:chap. 23); Alfred Marshall's *Principles of Economics* ([1920] 1990, 60–69); A. C. Pigou's *Industrial Fluctuations* (1927, 120–22, 131–34); Frank Knight's essay "Professor Hayek and the Theory of Investment" (1935) and book *The Economic Organization* ([1933] 1967, 113–17); and J. B. Clark's *The Distribution of Wealth* (1938, 116–56). Marshall argues that "economists have no choice but to follow well-established customs as regards the use of the term capital in ordinary business, i.e. trade capital." In his reaction to Böhm-Bawerk's ([1890] 1970) confinement of the term *capital* to only capital goods and thus his failure to interpret correctly the classical "capital" supply-and-demand theory of interest, he urges economists to use "the language of the market-place" ([1920] 1990, 647, 60). However, following J. M. Keynes ([1936] 1976), most modern economists tend not to heed Marshall's advice and attach only the meaning "capital goods" to the term *capital*, qualifying the term with *financial* to refer to its original meaning. In contrast, Austrian economists who adopt the Böhm-Bawerkian analysis of capital and interest and meet with criticism from neoclassical writers would rather the term *capital* were banished from economics. Hayek points out, "The . . . ambiguity of the term capital has been the source of unending confusion, and the suggestion has often been made [for example, by Schumpeter] . . . that the term should be banned entirely from scientific usages" (1941, 9); I elaborate on this point in another article (Ahiakpor 1997).

In *The Mystery of Capital*, de Soto extends the modern confusion over the term *capital* by suggesting that capital has an invisible existence, like television or radio waves that are known to exist but cannot be seen or touched, and is congealed in the residential houses and lands that the poor occupy, although he qualifies this capital as being "dead" (7). Thus, instead of recognizing the paucity of savings or loanable "capital"—that is, unconsumed income devoted to earning interest or profits (dividends), represented in financial assets such as bank deposits, mutual-fund shares, stocks, and bonds—as the principal hindrance to economic development in the Third World, de Soto insists that the "poorest sectors of society have saved. The quantity is enormous" (11).

In de Soto's view, the problem for the Third World is a failure to recognize or understand how to "convert their savings into capital" (12): "This is the mystery of capital. Solving it requires an understanding of why Westerners, by representing assets with titles, are able to see and draw out capital from them. One of the greatest challenges to the human mind is to comprehend and to gain access to those things we know exist but cannot see" (7). He believes that "at least 80 percent of the population in these countries cannot inject life into their assets and make them generate capital because the law keeps them out of the formal property system. They have trillions of dollars in dead capital, but it is as if these were isolated ponds whose waters disappear into a sterile strip of sand, instead of forming a mighty mass of water that can be captured in one unified property system and given the form required to produce capital" (210).

De Soto's conception of capital as being embedded in the dwelling places of the poor in the Third World leads him to urge the governments of these countries to turn inward to find capital for economic development, not by changing policies that have inhibited their citizens' saving, but merely by providing the poor with titles to their properties. Instead of wandering "the world's foreign ministries and international financial institutions seeking their fortune," he argues, the leaders of these nations should recognize that 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" (37).

De Soto's urging of these governments to rely on domestic sources for investment funds is well advised,[6] but the amount that he suggests can be retrieved (if one may grant legitimacy to his vision) merely by providing titles to the poor—who by definition do not own much—is quite misleading.[7] He appears to mistake the possibility of pledging a clearly titled property as collateral for loans for the probability of obtaining such loans. But without adequate savings, the poor still would have little chance of obtaining the "capital" that would be rationed at higher interest rates and obtainable by those with better-quality assets than those of the poor.[8] As

6. Numerous analysts (e.g., Bauer 1981; Easterly 2003) have noted that it is futile for less-developed countries to expect to secure their economic prosperity primarily from reliance on foreign aid, instead of from the creation of conditions to promote domestic savings and investment. Thus, de Soto here strikes a familiar chord with analysts inclined toward free-market, self-reliant policies as well as with those who simply have been disappointed with the poor record of foreign aid in the less-developed countries.

7. Woodruff notes that de Soto's estimates are highly inflated: "Given inevitable slippage in translating collateral into loans, the capital unlocked from these assets might be only a small percentage of that suggested by de Soto" (2001, 1221). Miranda (2002) also notes the exaggeration in de Soto's estimates. But note that the values of collaterals themselves do not generate capital; loanable savings do.

8. At best, one may argue that the newly qualified (property-titled) borrowers might face a lower rate of interest than they did in the informal capital or credit market, and the rate of interest on the informal market might fall because of a reduced demand for loans there. But there is little reason to expect the total amount of loans made on both the formal and informal credit markets to rise simply from the shuffling of borrowers from one market to another.

David Ricardo well makes the point, credit "does not create Capital, it determines only by whom that Capital should be employed" (1951–, 5:436–37). Besides, lending to small-scale businesses in poor countries relies precious little on the ownership of titles to property (see, for example, Perkins, Radelet, and Lindauer 2006, 506–8).

Indeed, lenders are more interested in the likelihood of a borrower's repayment on account of the probable success of the enterprise for which the loans are extended than in the possibility of collecting payment from the sale of pledged assets. Maintenance and selling costs are involved in attempting to recover the loan principal from pledged assets (not to mention the interest that may be forgone). Lenders are also eager to receive their expected repayments of loans in order to meet their own short-term obligations. Furthermore, there hardly are primary, let alone secondary, markets for shacks the poor may build on rural parcels of land in most Third World countries to make property foreclosure sales feasible, be they in Haiti, Egypt, Peru, or the Philippines, the countries de Soto and his group have visited. It also may be against the cultural norms for a lender to sell the dwelling places of borrowers in default, even where the law permits such sales.[9]

De Soto attributes to Adam Smith the view that "capital is not the accumulated stock of assets but the *potential* it holds to deploy new production" (42, emphasis in original). He also attributes to Smith, Sismonde de Sismondi, and Karl Marx the view that capital is "first an abstract concept and must be given a fixed, tangible form to be useful" (42–43). But de Soto's pursuit of the abstract notion of "capital" leads him away from a recognition that Smith clearly defines "capital" first as funds and derives its origin from savings before the borrowed "capital" takes the forms of fixed and circulating capital in the hands of producers:

> Capitals are increased by parsimony and diminished by prodigality and misconduct.
>
> Whatever a person *saves* from his revenue he adds to his *capital,* and either employs it himself in maintaining an additional number of productive hands, or enables some other person to do so, by lending it to him for an interest, that is, for a share of the profits. As the capital of an individual can be increased only by what he saves from his annual revenues or his annual gains, so the *capital of society,* which is the same with that of all the individuals who compose it, can be increased only in the same manner. ([1776] 1976, 1:358–59, emphasis added)

9. In some Third World countries, the law prohibits lenders from selling the land or the houses of borrowers who are in default (see Van Tassel 2004). These restrictions are supposed to protect the poor from lenders, although their operation may appear to affirm de Soto's claim of a legal apartheid against the poor's access to credit. In 2007, even the U.S. government put pressure on banks and some other mortgage lenders not to foreclose on the properties of so-called subprime borrowers in default, but to work with them to keep their homes. Alston (1984) recounts legislation by U.S. states barring farm foreclosures in times of economic distress during the nineteenth and twentieth centuries.

When Smith distinguishes "capital" from money, a point de Soto (43) notes, he is only warning against mistaking the medium (money) through which "capital" (savings) may be conveyed from savers to borrowers for the substance of what is conveyed. Thus, an increase in the quantity of money—specie or, in our time, paper—does not mean that the real purchasing power of savings rises or that the rate of interest at which savings are borrowed falls. For example, between 1988 and 1990, Peru's central bank increased the quantity of currency at an average annual rate of 3,263 percent, but the deposit interest rate averaged 1,246 percent and the rate of inflation averaged 3,849 percent without the economy's experiencing real growth.

Furthermore, Smith talks about the conversion of "dead stock ["capital"] into active and productive stock" through the "judicious operations of banking" when banks keep no more of the community's savings deposited with them than they need "in ready money for answering occasional demands" ([1776] 1976, 1:341, 340). This observation is offered to explain fractional reserve banking's positive contribution to economic growth, not to designate dwelling places as custodians of "dead capital" capable of being converted into active "capital" for production. Thus, de Soto's employment of the term *dead capital* may have been an ingenious borrowing from Smith's language, but the context to which de Soto applies it leads to his failure to recognize that increased loanable savings, not titles to properties owned by the poor, are the source of "live capital" to promote growth. It is misleading to claim that "capital is the result of discovering and unleashing potential energy from the trillions of bricks that the poor have accumulated in their buildings" (40).

Confusing Stocks and Flows

De Soto's view that trillions of dollars worth of "dead capital" exist in the Third World waiting to be turned into productive capital, if only the conversion process were initiated with the granting of legal titles to property, confuses the stock of wealth with the flow of "capital," or savings, needed for investment. His estimates are based only on the perceived market values of the poor's dwellings.

At any point in time, the values of assets owned by the poor may well be enormous, given that to determine this value one is simply estimating the value of the land and dwelling places they inhabit, although in per capita terms the values owned by the middle class and the rich may be significantly greater. However, it is the current or annual additions to stocks, or savings (flows), that matter for the promotion of economic growth. Such flows provide the funds for hiring additional labor, acquiring tools and machinery to assist labor in production, and obtaining the raw materials to be processed. Levine (1997) provides an excellent empirical demonstration of this point, besides summarizing other studies that affirm it. Little of relevance turns on whether de Soto correctly estimates the "dead capital" in land values of Third World and former Communist bloc countries to be worth $9.3 trillion, or

> very nearly as much as the total value of all the companies listed on the main stock exchanges of the world's twenty most developed countries: New York, Tokyo, London, Frankfurt, Toronto, Paris, Milan, the NASDAQ, and a dozen others. It is more than twenty times the total direct foreign investment into all Third World and former communist countries in the ten years after 1989, forty-six times as much as all the World Bank loans of the past three decades, and ninety-three time as much as all development assistance from all advanced countries to the Third World in the same period (35).

The "dead capitals" themselves are of little use in production, but the funds (savings) used to purchase stocks traded on capital markets make increased production possible. The economic functions of the two types of assets must not be confused. The "rural parcels" of land have existed in these countries since their founding, and they cannot to be compared meaningfully with World Bank loans, development assistance, or foreign direct investment over any period of time. Indeed, with economic development made possible by increased savings, the value of other forms of wealth may exceed the value of land.

The Limited Role of Property Titles

De Soto gives the impression that it is primarily, if not only, titles to property that enable people to transform their "dead capital" into the live capital needed for production. But titles only make it easier for the grantor of a loan to seize the property represented by the title in case of default. They do not increase the available loanable funds, or "capital." Given the rate of savings, an increase in the pool of borrowers may only cause lenders to pay closer attention to other discriminating aspects of borrowers. Among these aspects are the borrowers' cash flows, constancy or regularity of employment, and previous repayment history. On these criteria, we can hardly expect the poor in the Third World to outperform the well-to-do who already borrow "capital" in their underdeveloped financial markets for investment.

However, an increased flow of savings may lower interest rates as well as induce lenders to relax their qualifying criteria for potential borrowers. The case of mortgage lenders who extended loans without requiring the traditional 20 percent down payment or carefully verifying potential borrowers' sources of income during the early 2000s in the United States—the so-called subprime lending phenomenon—illustrates the point. In 2001, an 8 percent interest rate on a thirty-year mortgage loan was a good rate, but by 2005 the rate for a similar loan had dropped to 5.5 percent. Funds clearly had moved out of stocks into mutual funds and certificates of deposit, significantly depressing their interest rates. With a lower cost of funds, mortgage lenders too could afford to charge historically low rates to borrowers, even though credit worthiness still may have affected some individual loan rates.

De Soto also draws the wrong inference from the history he recounts of squatting in the United States, particularly by the early settlers in Maryland, Massachusetts, New Hampshire, Vermont, and Pennsylvania. Those who took possession of land as squatters first acquired "capital," or savings, which they used to build the cabins and till the land as required of them. Thus, "under Massachusetts law, a settler's duties included taking actual possession and within three years, building a house of a certain size, usually eighteen or twenty feet square, and clearing five to eight acres for mowing and tilling" (115). In this way, squatters acquired their "cabin," "tomahawk," or "corn" rights, subsequently to be recognized by state or federal governments.

Those squatters were people of considerable means who "did everything they could to secure the [public] land they occupied; some even paid twice for the same parcel, while others paid lawyers enormous fees to help them make their land legal" (135–36). Thus, the positive contemporaneous view of the early settlers that de Soto quotes from Senator Henry Clay hardly applies to the poor squatters of present-day Third World and former Communist countries: '"They [the early settlers] build houses, plant orchards, enclose fields, cultivate the earth, and rear up families around them. Meanwhile, the tide of emigration flows upon them, their improved farms rise in value, a demand for them takes place, they sell to the newcomers at a great advance, and proceed farther west. . . . In this way, thousands and tens of thousands are daily improving their circumstances and bettering their conditions'" (132).

Moreover, Third World squatters are not foreigners or immigrants occupying the lands of dispossessed natives; neither are they people with sufficient means to build appreciable houses, till lands of any significant size, and plant orchards. Rather, they are violators of their fellow citizens' property rights. Respect for the law, which de Soto recognizes as a requirement for the successful building of capitalism, suggests rather that governments enforce the property owners' rights against squatters by guaranteeing the interlopers' eviction. As Adam Smith notes, "Civil government, so far as it is instituted for the security of property, is in reality instituted for the defence of the rich against the poor, or of those who have some property against those who have none at all" ([1776] 1976, 2:236). "Till there be property," he points out, "there can be no government, the very end of which is to secure wealth and to defend the rich from the poor" (from *Lectures,* qtd. in Smith [1776] 1976, 2:236n).[10]

10. John Locke's version of the same point is that "government has no other end but the preservation of property" (qtd. in Smith [1776] 1976, 2:236n).

Other Problems with de Soto's Claims

Several of de Soto's claims are factually incorrect, and others are self-contradictory. About conditions in the Third World, he incorrectly states

- that "nobody can identify who owns what. . . . [P]eople cannot be made to pay their debts. . . . [T]he rules that govern property vary from neighborhood to neighborhood or even from street to street" (15);
- that peasants face "an impenetrable wall of rules that bar . . . them from legally established social and economic activities. It [is] tremendously difficult for these new city people to acquire legal housing, enter formal business, or find a legal job" (18, repeated on 82);
- that "[e]xtralegal asset owners are . . . denied access to credit" (84), and "many statutes . . . wall off the majority of people from capital" (188); and
- that "the sale or lease of a house may involve lengthy and cumbersome procedures of approval involving all the neighbors" (47).

Among other assertions that easily can be shown to be incorrect are:

- "Even as the West prospers from abundant capital, people really [do not] understand the origin of capital" (8), and "ironically, the enemies of capitalism have always seemed more aware of the virtual origin of capital than capitalists [are] themselves" (222);
- "Capital, the most essential component of Western economic advance, is the one that has received the least attention" (10–11);
- "The genius of the West was to have created a system that allowed people to grasp with the mind values that human eyes could never see and to manipulate things that hands could never touch" (63);
- "Money does not earn money. You need a property right before you can make money" (64);
- "the classical economists [including Adam Smith], who knew capital was abstract and had to be fixed, [did] not make the connection between capital and property" (65); and
- "Capitalists generally have no systematic explanation of how the people in the underclass got where they are and how the system could be changed to raise them up" (213).

That "capital" originates in savings has been well known to economists for a long time, and the policies to encourage increased "capital" formation to promote economic growth have been urged since the time of Adam Smith. Even as modern Keynesian macroeconomics has taught the myth that increased saving causes a decline in aggregate demand, hence an economy's decline—as in the "paradox of thrift" proposition (see Ahiakpor 1995)—growth theories, from the Harrod-Domar model to the Solow model, have emphasized the importance of increased savings for promoting economic growth. (See also Goldsmith 1969; McKinnon 1973; Levine 1997; and development economics texts such as Meier and Rauch 2005, esp. chap. 5, and Perkins, Radelet, and Lindauer 2006, esp. chaps. 10 and 13.)

Indeed, modern growth theories may be read as illustrating Smith's explanation that

> [t]he annual produce of the land and labour of any nation can be increased in its value by no other means, but by increasing either the number of its productive labourers, or the productive powers of those labourers who had been employed. The number of its productive labourers, it is evident, can never be much increased, but in consequence of an *increase of capital*, or the *funds destined for maintaining them*. The productive powers of the same number of labourers cannot be increased, but in consequence either of some addition and improvement to those machines and instruments which facilitate and abridge labour; or of a more proper division and distribution of employment. In either case an *additional capital* is almost always required. It is by means of an additional capital only, that the undertaker of any work can either provide his workmen with better machinery, or make a more proper distribution of employment among them. . . . When we compare, therefore, the state of a nation at two different periods, and find, that the annual produce of its land and labour is evidently greater at the latter than at the former, that its lands are better cultivated, its manufactures more numerous and more flourishing, and its trade more extensive, we may be assured that its *capital* must have *increased* during the interval between those two periods, and that more must have been *added* to it by the good conduct of some, than had been taken from it either by the private misconduct of some, or by the public extravagance of government. ([1776] 1976, 1:365, emphasis added)

Ricardo reiterates Smith's point when he observes that

> the wealth of a country may be increased in two ways: it may be increased by employing a greater portion of revenue in the maintenance of productive labour [i.e., increased savings],—which will not only add to the quantity, but to the value of the mass of commodities; or it may be increased, without employing any additional quantity of labour by making the same quantity more productive,—which will add to the abundance, but not to the value of commodities.
>
> In the first case, a country would not only become rich, but the value of its riches would increase. It would become rich by *parsimony;* by diminishing its expenditure on objects of luxury and enjoyment; and employing those *savings* in reproduction. (1951–, 1: 278, emphasis added)

Baumol reproduces, though in a different context, J-B. Say's (1803) restatement of the same classical emphasis on savings as a principal determinant of economic growth:

> As for a nation that does not expend its entire income, and annually augments its capital, that is the one and the only one that provides the greatest annual markets for its product. In effect, each year it experiences growth in the profits from its capital and in the power of its industry and, consequently, in its income; that is to say, its means of consumption either direct or through exchange, in one word, its markets. The public interest is consequently not served by consumption, but it is served and served prodigiously by saving, and though it seems extraordinary to many persons, not being any the less true as a consequence, the labouring class is served by it more than anyone else. (1977, 150)

De Soto's claim that "most people [in the Third World] do not have property rights" (211)—a claim that appears to have significantly influenced the positive evaluations of his book by Sowell (2000), Baetjer and Lineberry (2003), Gwartney and colleagues (2006), and Morris (2007)—is a myth. The right to private property is widely recognized in most non-Communist Third World countries, even where people do not have any government-issued documents attesting their ownership (see, for example, Besley 1995). These countries have notions of theft or violations of property rights, and in traditional or rural settings they have mechanisms for punishing or discouraging theft.

Rental property owners in the urban areas of the Third World do not turn away prospective renters from the rural areas who show financial ability to pay. The problem for migrants from the rural areas may instead be their inability to afford the higher rents in the urban areas. De Soto's notion of a legal apartheid separating people of rural and urban origins in their economic activities is also a myth. The prevalence of lending and borrowing in the informal market also vitiates his claim that nonholders of formal titles to property are denied access to credit in the Third World. It also reveals as incorrect his notion that money "does not earn money" for the nonformal title holder.

De Soto's description of activities in the informal sector as *extralegal,* a term he sometimes equates with illegality, incorrectly tarnishes the legitimate, welfare-improving, economic activities undertaken in the informal sectors of Third World countries. Thus, he compares "the so-called *law abiding* sector on one side [with] the impoverished extralegal sector" (213, emphasis added) and argues that "when people have access to an orderly mechanism to settle land that reflects the social contract, they will take the *legal route,* and only a minority, like anywhere else, will insist on extralegal appropriation" (226, emphasis added). In the informal sector of less-developed countries, production activities common in agriculture, services, and small manufacturing are for the most part not illegal activities. It is also well known that the informal sector's size declines on its own as economic growth occurs (see, for example, Meier and Rauch 2005; Perkins, Radelet, and Lindauer 2006).

I count a number of self-contradictory claims in de Soto's work:

He observes correctly that economic development occurred in the United States at the hands of "immigrants, who settled boundaries, ploughed fields, built homes, transferred land, and established credit" long before governments conferred "on them any right to engage in these acts" (16) through titles. But he also dwells on the primacy of legal titles as a prerequisite for economic development in the Third World.

He describes the vibrancy of the informal or "extralegal" sector, as in the Brazilian *favelas*, where "there are no rent controls . . . ; rents are paid in U.S. dollars, and renters who do not pay are rapidly evacuated" (21), and characterizes this sector as a place where "street-side cottage industries have sprung up . . . , manufacturing anything from clothing and footwear to imitation Cartier watches and Vuitton Bags. There are workshops that build and rebuild machinery, cars, even buses . . . entire industries and neighborhoods that have to operate on clandestine connections to electricity and water. There are even dentists who fill cavities without a license" (28).[11] Yet elsewhere he argues that without integration into the formal or "legal" sector through titles, these economies have little chance for growth or development.

He asserts that "property, like energy, is a concept; it cannot be experienced directly. . . . And no one can see property" (49) even though it is "properly surveyed, mapped, and recorded" (154). Yet he also argues that a title to property enables one "to see it as live capital" (50) or even to "touch [the] capital" (63).

He declares that in the extralegal sector of the less-developed countries "nobody really knows who owns what" (32) and "the poor have plenty of things, but their property rights are not defined by any law" (74). Yet he claims that in these same communities "illegal tenancy contracts [are] declared before a notary"; that "[a]lthough their 'laws' may be outside formal law, they are, by and large, the only laws with which these people are comfortable" (88); that "it is extralegal law that regulates the assets of most citizens" (175); that "asset owners in the extralegal sector are . . . relatively well organized [and] 'law-abiding,' although the laws they abide by are not the government's" (178); that people "in the undercapitalized sector do

11. In fact, besides obtaining a license to operate a commercial vehicle, "private bus, jitney, or taxi," a driver does not need any "official recognition of *his route*" to operate in Third World countries, a recognition de Soto claims can take as many as "twenty-six months of red tape" to obtain (20). Routes are not drivers' monopolies granted by government. Donald Stewart's vivid description of the Brazilian *favelas* as economies "born of the entrepreneurial spirit of peasants" and in which the "profitability of investment [in housing] is good and as a result there is an abundance of supply of housing" (1997, qtd. in de Soto 2000, 85) also contradicts de Soto's dim view of the prospects for economic development without a formal integration of titles to property. An economy may be composed of formal and informal sectors, but the growth of the latter also improves the well-being of the economy's inhabitants.

have . . . strong, clear, and detailed understandings among themselves of who owns what" (182); and that in Haiti he and his group "did not find a single extralegal plot of land, shack, or building whose owner did not have at least one document to defend his right—even his 'squatting rights'" (183).

He argues that "massive extralegality [in the Third World and former Communist countries] is not a new phenomenon. . . . When the Industrial Revolution began in Europe, governments were also plagued with uncontrollable migration, growth of the extralegal sector, urban poverty, and social unrest" (93), and during the settlement of America, "migrants began settling boundaries, plowing fields, building homes, transferring land, and establishing credit long before governments had conferred on them the right to do so" (117). But he fails to see that the evolutionary process in economic development—what he calls capitalism—took place in these countries without there first being a widespread government program of granting titles to property owned by the poor, and that such a program did not precede economic development in today's more-developed countries.

He claims that in the Third World "the rules that govern property vary from neighborhood to neighborhood or even from street to street" (15). But elsewhere he declares that "individual extralegal social contracts in the same country [are] more alike than different" (180).

At numerous places (for example, 30, 67, 82, and 159), he argues that the poor have been excluded from entering the formal sectors of Third World economies by some sort of "legal apartheid" or a "bell jar." Yet he also notes that "governments in developing countries have tried for 180 years to open up their property systems to the poor" (154) and that "programs to endow the poor with property exist in almost all developing and former communist countries" (165).

He observes correctly from the history of some of the more-developed countries that "unconscious evolution" rather than "conscious planning" created the "integrated property systems" in these countries (109) and that the "extralegals [in the less-developed countries] want to come in from the cold," as evidenced by the "engaging and diplomatic leaders they select to negotiate on their behalf [who] hardly fit the stereotype of the street boss" (177–78). Yet in general he sees little prospect of economic development unless Third World governments engage in a massive, conscious, and planned integration of formal titles to property.

Thus, de Soto's path to arriving at his conclusions about the dim prospects for economic development in the Third World and former Communist countries unless they implement his suggested granting of titles to property owned by the poor is littered with misperceptions, inaccuracies, and contradictions.

Further Evaluation and Conclusions

Before Adam Smith elaborated his blueprint for the process of efficient economic development in the *Wealth of Nations*, he argued in 1755: "Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism but peace, easy taxes, and a tolerable administration of justice: all the rest being brought about by the natural course of things. All governments which thwart this natural course, which force things into another channel or which endeavour to arrest the progress of society at a particular point, are unnatural, and to support themselves are obliged to be oppressive and tyrannical" (qtd. in Smith [1776] 1996, xl). Smith's blueprint includes government provision of security for its citizens against external and internal aggression, the administration of justice, and the erection of public works and institutions to facilitate the functioning of markets. De Soto's emphasis on the benefits of clear titles to property and the state's enforcement of owners' property rights may fit under Smith's duty of the sovereign to administer justice, but the massive titling campaign he urges on the governments of Third World and former Communist countries appears to obstruct the "natural course of things" in the process of efficient economic development.

As de Soto himself recounts at numerous points, economic development in the industrialized countries preceded the development of titles to private property. Indeed, private companies now survive there by providing titling services to dealers in real estate. In many Third World countries, government offices register titles to property, although perhaps not as expeditiously as private title companies in the more developed countries (see Atwood 1990; Besley 1995; Jacoby and Minten 2007). Private enterprise in titling services in the less-developed countries hardly exists primarily because the demand for such services is negligible. Their market for real estate, especially dwelling houses, is rather thin. Most people there save over long periods of time, typically during most of their adult working years, to build their own houses and then pass on the dwellings to their heirs. It is thus not uncommon in these countries for several of the builder's adult children to share rooms in the same building or to build additional structures on the same "family compound," which none of them would expose to foreclosure by pledging the property as collateral for a loan. Thus, de Soto's view of houses, including the shacks of the poor, as "dead capital" from which "live capital" can be "unlocked" to finance investment projects in the Third World is quite misleading.

Some investors in the more-developed countries may well acquire funds through a second mortgage on their homes, as de Soto argues, but they are not among the poor. Besides, a second mortgage is tied to the "equity" accumulated in the home—that is, the extent to which the indebtedness on the first mortgage has been reduced, mainly through subsequent repayments (a form of savings accumulation) or through the market-value appreciation of the property (a form of return of the savings). Still, second mortgages are funded by the current flow of loanable savings, not by the qualification to borrow represented by a property's legal title.

The reason we save, as Adam Smith noted, "is the desire of bettering our condition, a desire which, though generally calm and dispassionate, comes with us from the womb, and never leaves us till we go into the grave" ([1776] 1976, 1:362–

Table 1
Economic Performance in Selected Countries, 1975–2003, 2004

Country	GDP/ population 2003 (U.S.$)	Annual Growth Rate (%) 1975–2003	Annual Growth Rate (%) 1990–2003	GNI/ population 2004 (U.S.$)
Hong Kong	22,987	4.3	2.1	26,810
Singapore	21,492	4.9	3.5	24,220
Bahamas	16,571	1.2	0.3	14,920
South Korea	12,634	6.1	4.6	13,980
Barbados	9,708	1.2	1.4	9,270
Antigua and Barbuda	9,629	3.8	1.6	10,000
Seychelles	8,610	2.9	2.2	8,090
Trinidad and Tobago	8,007	—	3.2	8,580
St. Kitts and Nevis	7,397	5.1	3.1	7,600
Mexico	6,121	0.9	1.4	6,770
Chile	4,591	4.0	4.1	4,910
Botswana	4,372	5.1	2.7	4,340
Mauritius	4,274	4.6	4.0	4,540
Malaysia	4,187	3.9	3.4	4,650
Thailand	2,305	5.1	2.8	2,540
China	1,100	8.2	8.5	1,290
Portugal	14,161	2.8	2.2	14,350
Greece	15,608	1.0	2.1	16,610
New Zealand	19,847	1.0	2.1	20,310
Spain	20,404	2.2	2.4	21,210
Canada	27,079	1.6	2.3	28,390
Germany	29,115	2.0	1.3	30,120
France	29,410	1.7	1.6	30,090
United Kingdom	30,253	2.1	2.5	33,940
United States	37,648	2.0	2.1	41,400

Sources: United Nations Development Program 2005, table 14, 266–67. GNI = gross national income, from World Bank 2006, 292–93, 316.

63). Nevertheless, people are less inclined to save if the expected real return in interest is rendered negative by government controls on interest rates or by high and variable rates of inflation.[12] The incentive to save is also diminished by the insecurity of property created by civil wars, political instability, breakdown of law and order, inef-

12. For example, inflation rates in Peru, measured by the consumer price index, were 667 percent, 3,399 percent, and 7,482 percent in 1988, 1989, and 1990, respectively, and deposit interest rates were 162

ficient administration of justice, rampant corruption of public officials, theft, or armed robbery. To the extent that price controls retard producers' income-earning capacity, they also retard the growth of saving in an economy, as do high rates of income taxation. Impediments to foreign enterprises' investments in Third World countries also retard income creation there, hence retarding the rate of domestic savings. These conditions are the more important impediments to economic development in the Third World, which their governments should be advised to remedy.

The governments of the less-developed countries may take many other useful actions to facilitate their economic development, consistent with Adam Smith's elaboration in the *Wealth of Nations*. These actions include adoption of nondiscriminatory tariffs to facilitate free and efficient international trade between their countries and more-developed countries, as well as among themselves; limited government spending, consistent with "easy taxes" and small budget deficits; and the provision of social infrastructure, including roads and bridges, appropriately paid for by user fees.

These prescriptions are well known in the development-economics literature. Their adoption by some countries in the Third World over the past half century or so, particularly in Southeast Asia, has yielded the expected positive results. Indeed, capitalism may be said already to have triumphed in Hong Kong, Singapore, South Korea, Taiwan, and the Bahamas, and may be well under way at various rates of development in such places as mainland China, Botswana, Chile, Malaysia, Mauritius, Seychelles, Thailand, and several island countries in the Caribbean, if we may judge by their levels of GDP or income per capita and their rates of annual growth since the mid-1970s (see table 1). Indeed, the incomes per capita of Singapore and Hong Kong exceed those of Portugal, Greece, New Zealand, and Spain, countries that de Soto would include among the capitalist West. The incomes of the Bahamas and South Korea are not far behind. Thus, the data would appear to negate the subtitle of de Soto's book: *Why Capitalism Triumphs in the West and Fails Everywhere Else*.

Moreover, not everyone welcomes capitalism or private enterprise as an acceptable form of economic organization. Some are strongly averse to the inequality of "income distribution"[13] that may accompany economic development through private enterprise,[14] and others, under the inspiration of Marxist or Maoist philosophy, be-

percent, 1,136 percent, and 2,440 percent, respectively (International Monetary Fund 2001). The rates of inflation fairly closely match the rates of currency creation in Peru for those three years: 568 percent, 1,437 percent, and 7,783 percent, respectively. The negative real interest rates on deposits, roughly amounting to –505 percent, –2,263 percent, and –5,042 percent, respectively, were far more discouraging to saving and capital formation than the lack of titles to anyone's property in Peru in those years.

13. *Income distribution* is a misleading term because no one hands out to individuals their shares of "national income." *Income creation* better describes what goes on: people exercising different capabilities in creating their own incomes.

14. Income inequality has increased in China since the government gave up on Maoist economic organization and opened up the economy to private enterprise, particularly foreign direct investment. China's Gini coefficient is reported to have risen from 28.8 in 1981 to 38.8 in 1995 (World Bank study cited in Meier and Rauch 2005, 473). Although most Chinese have obviously benefited from the new economic

lieve that private property derives from theft and that the capitalist system is a mechanism for the exploitation of the poor in society—views that de Soto himself recounts (212–18). Thus, it is to be expected that different governments around the world may choose different approaches to economic organization, obtaining different results. As Ricardo acutely observes, following J-B. Say, "it is not the province of the Political Economist to advise:—he is to tell you how you may become rich, but he is not to advise you to prefer riches to indolence, or indolence to riches" (1951–, 2:338). Moreover, societies in which the drive to become rich through production is not strong can hardly be expected to choose, individually or generally through their governments, the path to becoming wealthy.

It would have been helpful had de Soto's belief that capitalism is "the only game in town" capable of creating economic prosperity along with "freedom, compassion for the poor, respect for the social contract, and equal opportunity" (228) led him to counter Marxist-inspired misrepresentations of the process of economic development in the Third World, especially of the dependency theory type. Instead, he restates those misrepresentations: "capitalism is a transfer of property from poorer to richer countries and . . . Western private investment in developing nations is nothing short of a massive takeover of their resources by multinationals" (214). In contrast, Joan Robinson aptly declares that "as we see nowadays in South-East Asia or the Caribbean, the misery of being exploited by capitalists is nothing compared to the misery of not being exploited at all" (1962, 46).[15] De Soto might have illustrated Robinson's observation with data showing that since the 1960s countries that have been more open to international trade and foreign direct investment have grown faster and seen a greater reduction in absolute poverty than the socialist ones have. Instead, he treats Marxist-inspired views as though they have validity. He also thinks "Marx's insights into capital, as George Soros recently observed, are often more sophisticated than those of Adam Smith" (214), but his research would have been better served had he consulted Smith's *Wealth of Nations* more carefully or Alfred Marshall's *Principles* on the relative merits of Adam Smith, David Ricardo, and J. S. Mill's definition of "capital," its source, and its role in economic development.

Smith warns about the "knowledge problem," as Hayek (1945) subsequently called it, and urges governments to refrain from attempting to direct private investors in how they should employ their "capitals":

> What is the species of domestic industry which his capital can employ, and of which the produce is likely to be of the greatest value, every individual, it is evident, can, in his local situation, judge much better than any statesman or lawgiver can do for him. The statesman, who should attempt to

framework, and absolute poverty has declined in that country, some may yet be inclined to point to the increased income inequality as an undesirable feature of the new system.

15. Robinson had strong Marxist sympathies, nevertheless. See Ahiakpor 1985 for a counter to dependency theory arguments.

> direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no counsel or senate whatever, and which would no-where be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it. ([1776] 1976, 1:478)

Disregarding the knowledge problem for regulators in a country, George Soros advocates the establishment of a world body to regulate capital investments through a "collective decision-making mechanism": "To put the matter simply, market forces, if they are given complete authority even in the purely economic and financial arenas, produce chaos and could ultimately lead to the downfall of the global capitalist system. This is the most important practical implication of my argument in this book" (1998, xxvii).[16] And de Soto finds no grounds on which to object to Soros's suggested scheme.

Bad policy choices by governments in the less-developed countries certainly explain for the most part the extent of their people's poverty. How the choice of growth-promoting policies has yielded the expected results in the more-developed countries therefore merits constant illustration. Yet such policies do not include massive government programs to hand to the poor paper titles to whatever properties they may own. In any case, those who find the gains of acquiring paper titles to be worth the costs of registering their properties may do so on their own. Although paper titles may facilitate loan applications, they can hardly be the primary source of "capital" for economic development in any country. That source must be increased domestic savings.

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16. Soros apparently has a low opinion of laissez-faire policies, which he calls "market fundamentalism" (1998, xx).

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