

# "Where does the end of poverty begin?" A discussion with Hernando de Soto

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## Moderator

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## Speaker

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## Executive summary

According to **Hernando de Soto**, no nation can have a strong market economy without an adequate public information framework that records all properties and other related economic information. He argues that the primary obstacle most developing countries have to face in their efforts towards economic growth – and reducing poverty – is that most of the economic activity in their countries is informal. As a result, governments do not have in-depth knowledge of their economy. They do not have access to what has been the main driver of economic growth in rich countries for the past 100 years – i.e. a “public memory system” which acts as a databank of a nation’s economic facts.

Why do most poor people in the developing world operate outside the legal system? **Hernando de Soto** argues that they have little choice: the laws in developing countries tend to be costly, burdensome, discriminatory, and just plain bad. Without the legal tools essential to economic success, these “extralegal” entrepreneurs are condemned to poverty. The unrecorded economic activity of these small entrepreneurs, for whom it is virtually impossible to obtain legal ownership and registration of their property, creates a parallel “extralegal” economy.

To survive, to protect their assets and to prosper, “extralegal” entrepreneurs have to set their own rules – what **Hernando de Soto** calls “the law of the people”. This also affects society at large because the rules of “extralegal” economy hinder economic development. In fact, only an elite minority can benefit from the official law and from globalization, while the majority of entrepreneurs are stuck in poverty and their assets (over US\$ 10 billion worldwide) remain some “dead capital” withering out of the legal system. In other words, the country as a whole does not operate at an optimal level.

To reduce poverty, **Hernando de Soto** claims that developing countries’

administrations must reform their flawed legal systems and provide the majority of their citizens with the opportunity to gain a stake in the market. The key to a modern and inclusive market economy is to grant the poor majority access to legal property rights through registered land titles and thus to encourage them to leave the “extralegal” sector and join the legal system. Such documentation accounts for a substantial part of the public memory system that allows society to identify and gain access to information about individuals and assets. It helps to set the limits of businesses’ liability, to monitor their economic situation, to ensure protection against third party claims and to quantify and evaluate their assets and rights. This public memory system also facilitates access to a wider variety of economic opportunities.

**Hernando de Soto** points out that assets held outside the law are “dead capital”, i.e. potential wealth which cannot be leveraged. Through property rights, those are turned into “live capital”, where a single asset may have multiple functions: a house, for instance, is no longer just a shelter but can be used as collateral for a loan or as a verifiable physical address to obtain electricity and other services.

## Synthesis

**How can we fight poverty in the context of the economic crisis and the revolutions in the Arab world? Indeed, the economic crisis increased the number of poor people from 1.4 billion in 2008 to 1.9 billion in 2010. Are freedom and democracy enough to reduce poverty?**

According to **Hernando de Soto**, it depends upon the definition of freedom and democracy that we give. A democracy that only relies on the right to vote is insufficient: voters across the developing world too often elected dictators. Moreover, economic liberty is not enough if it does not come with other forms of liberty. For **Hernando de Soto**, liberty and democracy without property rights are not sufficient to reduce poverty.

The majority of poor people in the developing world does not have easy access to the legal system, which in developed countries and exceptionally for some elites in developing countries is the gateway to economic success. The property documents of the poor need to be legalized so they can have access to the legal system and enjoy the benefits of law and globalization. A property document becomes part of the public memory, which facilitates all the economic activities that drive a modern market economy: banking, system identification processes, credit and insurance information systems, housing and infrastructure supply, equity financing, mortgages, and even efficient governance.

**Which role did the Peruvian State play in the land reform?**

Between 1988 and 1995, **Hernando de Soto** and the Institute for Liberty and Democracy designed the foundations for the administrative reform of Peru's property and business rights systems, which provided more than 1.2 million families with ownership titles and helped 380,000 firms which previously operated on the black market to enter the formal economy. To achieve these reforms, they eliminated bureaucratic and restrictive registrations, licenses and permits that made opening new businesses very time-consuming and costly.

The State's participation is the main driver of the success of land reform, which is a fundamental legal reform: it must guarantee the acknowledgement of land titles by all economic and legal actors and make sure that the link between the property and its owner is clearly established on the local, national and international levels – thus binding economic actors together. Developing that kind of institutions, the costs of operating outside the formal economy will become significantly higher than those of entering and operating within the formal economy. Besides, business profits within the formal economy will obviously overcome those of the extralegal sector.

**The young Tunisian who immolated himself wanted a job, not a property title... Isn't the property rights approach a little simplistic to deal with poverty issues?**

For **Hernando de Soto**, the property rights approach is essential in helping poor entrepreneurs turn their property and business into assets that they can manage and develop to provide for their family and offer jobs to others. This Tunisian man had in fact "a job" – as a typical Third World street merchant from the underground economy. Had he possessed a legal business license, a municipal inspector would have been less likely to humiliate him, leading to this tragic outcome.

**Hernando de Soto** insists that the State must know who owns what in the informal economy before acting for growth or poverty reduction. For instance, before granting land titles, it needs to identify who is holding which land and must obtain information about individuals, assets (including those held in the informal economy), circumstances, and, if need be, about expenses and obligations. The state must also ensure that this information is registered into the public memory system, which facilitates crucial economic functions to be carried out, and helps economic agents to communicate with one another.

To stress how important that information is, **Hernando de Soto** points out the example of the Niger Delta where the ILD has worked: the undocumented population is so abundant that the state estimate ranges "from 15 to 30 million"! **Hernando de Soto** notes that a more accurate figure can be obtained via the information collected through agricultural reforms and land administration.

He also stresses the importance of the "limited liability" status for entrepreneurs set by corporate law, which helps people assess and limit risks in business by comparing how much is invested in the business and how much is saved for the family. In his opinion, the invention of the "limited liability" concept in Europe between 1850 and 1900 was revolutionary: it gave everyone the right to create or invest in a business without risking their own assets. In developing countries where most entrepreneurs do not have access to this legal protection, "unlimited liability" is the norm, and that without a legal property title, there is no way for small entrepreneurs to borrow some money from the bank or raise capital to invest in their business.

**Does the ILD have contacts with countries such as Brazil and China?**

They do, but their heads of State have not yet hired the ILD. However, they have been unofficially using their ideas.

## Questions

**Hernando de Soto** speaks of the difference between “dead capital” – assets that cannot be leveraged because they are held outside the law without access to the legal tools that entrepreneurs in the developed world take for granted, such as property rights or limited liability – and “live capital,” where the same assets acquire numerous functions thanks to property rights. For instance, in the extralegal economy, a building can be used as a shelter or an office; but once a property right is attached to that building, it can have many other purposes – as a collateral to secure a mortgage loan, as an identifiable terminal to get electricity, as real estate rental to make money or even as a way to track a criminal. Turning legal the massive amount of dead capital withering in the extralegal economy of developing countries is mostly a political challenge: the law has to change.

According to **Hernando de Soto**, the revolution in economic development theories is to understand that the actual law in developing countries is the “law of the people” (the norms and customs they use to sign and protect transactions), which has not been recognized nor incorporated into the formal law. Too often, governments preserve a status quo and do not address the problem by implementing the required institutional reforms that would make the legal framework more recognizable and welcoming, so that people in the extralegal sector can enter the legal economy where they could protect and develop their assets to lift themselves out of poverty.

Eventually, the current global financial crisis mainly results from the actions

of financial institutions that ignore what reformers like him have been trying to obtain from the governments of developing countries. He mentions the building of proper procedures in documenting and recording transactions to make sure everyone knows who owns what and under what circumstances. Such economic facts are the basis of the trust that drives economic growth. When banks sold mortgages and distributed credit risk to investors through mortgage-backed securities and collateralized debt obligations, replenishing their funds, they did it in such an opaque and complex way that the link between the property title and the asset was lost – thus undermining general confidence in the financial system.

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