

HERNANDO
DE SOTO

**The facts are in:
The Arab Spring
is a massive
economic revolution**

Translated from the original French

**An opportunity
for Tunisia**



"The ILD is doing some of the most important work in the world today".

"Hernando de Soto is the world's greatest living economist".

Bill Clinton



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Why is the Tunisian economy breaking down?

The Tunisians are richer than they think

UTICA (Union Tunisienne de l' Industrie, du Commerce et de l'Artisant) is an organization that represents Tunisian employers in the industrial, commercial and artisanal services sectors. Organized regionally and according to sector, UTICA is Tunisia's largest employer organization, acting as the public voice and defender of its members' social and commercial interests.

- The ILD is a Peru-based think and action tank dedicated to understanding through fieldwork the

legal causes of economic exclusion and providing governments and civil institutions the means to build an inclusive rule of law in order to benefit from the positive aspects of globalization– and defend themselves from the negative ones.

Objective of the study

UTICA and ILD have decided to collaborate during the next year on a research project based on their shared beliefs – that during the past two centuries, history has demonstrated throughout the world that entrepreneurship creates wealth; and that the Arab world – and Tunisia in particular – is teeming with ambitious, talented entrepreneurs.

The project will address a nagging question among business leaders in the region: Why are Arab entrepreneurs not meeting their potential for producing prosperity – for themselves and their countries? That’s why the research project has been titled “Why has the Tunisian economy

broken down?”

Based on daily observations and complaints received from formal entrepreneurial leaders in the MENA region and the preliminary results of ongoing ILD field research begun in 2010 soon after the breakout of the “Arab Spring,” we can start off with a quick answer: What is holding Tunisian entrepreneurship back is an excess of business carried out extralegally, outside the rule of law.

The importance of Legality

ILD interviews and analysis carried out over the past 16 months with Tunisian and other MENA entrepreneurs – operating both legally and extralegally – have revealed a strong consensus that what MENA entrepreneurs need most to deliver on their true potential is a legal system that provides them with the standard rules to cooperate with partners, suppliers and clients.

To understand how essential legality is to economic development, all you have to do is look around you and recognize that nothing that you find useful is generally just one thing or manufactured by only one person. Almost everything is

the result of some kind of combination. The reason for this is that the world economy is made up of billions of tiny parts that on their own are of little use and therefore of little value. The role of entrepreneurs is to combine these parts into more complex wholes, until they become more useful to more people. Complexity has its rewards: the more useful these aggregations are, the higher their value; the more value added, the more economic growth you get.

But most of these parts are controlled, owned and processed by different interests; most of the people controlling these interests are not personally known, are far away and sell, dispatch and finance their products in a variety of ways. That is why entrepreneurs need regularly updated information about who owns what, who is accountable, who can deliver and which potential partners, suppliers and clients can be trusted. Such information is what legal systems document and provide. The law also offers entrepreneurs another type of device essential for generating prosperity: “joining mechanisms” (e.g. enforceable contracts, fungible property, and business organization tools) to make sure that the control of all the parts that have to be combined can be transferred and combined into higher valued products.

Indeed, humanity’s greatest achievements—from combining trees, rocks and labor into beautiful cities or 120 pieces of metal into a clock to combining computers and telephones into the Internet— all result from having the shared rules, the joining mechanisms and the recorded information that property and business law provides so that opportunities can be spotted, potential partners and their assets can be identified and tracked, risks can be measured, the terms and conditions of deals are familiar and can easily be sealed and promises can be enforced.

Development does not happen without legality. And Tunisia already has legality. Like just about every nation in the world, Tunisia has a sovereign legal system with its own contracts as well as property and business mechanisms that assist entrepreneurs in making combinations.

According to Tunisian legal codes, all citizens should be able:

- To capture new investment by issuing shares;
- To raise capital by bringing in new partners;
- To raise financing by issuing bills and notes;
- To protect personal, family or communal assets by limiting liability;
- To ensure the survival over time of their reputation, goodwill, brands, and other such intan-

gible values by legally documenting them;

- To pool skills and resources by collaborating within an enterprise with nonfamily members;
- To expand markets beyond family and neighborhood;
- To use reputation and property as information and collateral for credit;
- To enforce public and private commitments over the long term.

This means that the Tunisian legal framework already has sufficient global standard procedures to connect willing and able entrepreneurs to each other and to the rest of the world – despite any specific traits of Tunisian law or an occasional regulation that deals with local issues. Over the ages, but especially after World War II, nearly all nations have shared a coherent body of normative maxims that we dare call “the rule of law.” In spite of political speeches and tirades against globalization, whether driven privately or publicly, no country in the world in this era of global standards and large scales has ignored the benefits of the rule of law and the standard mechanisms it provides so that all its citizens may connect to each other on a national scale and the rest of the world on a global scale.

Unlike legality, extralegality – holding assets outside the law – is not an order. It is the opposite of the rule of law in the sense that it does not connect people on a national scale but divides them. Extralegality is nothing more than a word that describes the anarchic situation in which thousands of disconnected and divisive social arrangements are piled up by those who have found it inconvenient or difficult to be governed by the rule of law. None of these arrangements is large enough to operate on a big scale; none can generate or administrate any of the legal instruments that allow society to combine and thus prosper.

Acces to legality in Tunisia

*(Establishing facts through definitions
and statistics)*

The real question, therefore, is not whether Tunisia has legality but whether that legality is easily accessible to all Tunisians, empowering them to create surplus value, jobs and wealth, as is the case in developed countries.

To answer that question, the ILD carried out a survey in November 2012 aimed not at measuring how many Tunisians had deeds and licenses, or the required rubber stamps, or a small number of employees or family members per business

or household, or if they pay one tax or another. None of that. What we wanted to find out is how many Tunisians – and the things and businesses they own – are extralegal, held outside the law where they have no access to official joining mechanisms that would allow them to cooperate with other Tunisians and create added value by combining talent and resources, generating credit or creating capital; extralegal assets cannot be easily identified and tracked so as to be accountable to any other Tunisian; are restricted to micro territory because they cannot work or be measured on a national or global basis according to official standard rules; cannot create without fear because they are not protected from arbitrary expropriation and unlimited liability

Here follows the results of ILD's first quick, preliminary measurement of the extralegal property and business assets for Grand Tunis.

Tunisia's extralegal assets

The amount of extralegal property and businesses in Tunisia is massive:

- 524,000 of a total of 616,000 enterprises are extralegal (85%).
- The assets of these 525,000 extralegal enterprises are estimated to add up to US\$ 22 billion (34 billion Tunisian Dinars).
- Extralegal real estate property (households, commercial real estate) is estimated to total US\$ 93 billion (146 billion Tunisian Dinars).
- The sum of all extralegal business and real estate assets amounts to US\$ 115 billion (180 billion Tunisian dinars). That is equivalent to:

- » 11 times the capital value of companies quoted on the Bourse de Tunis in the year 2010 (US\$ 10.7 billion).
- » 4 times Foreign Direct Investment in Tunisia since 1976 (US\$ 25.9 billion).

Our experience is that these numbers are likely to change over the next year, as they get cross-examined, debated and refined. Also in our experience, critics will point out that there is more to life than entrepreneurship and business; and other statistics will emerge that measure and reflect alternative values.

None of that, however, will erase the fact that many, if not most, Tunisians today are at an economic disadvantage. This is both bad and good news. The bad news is that, as things stand, no matter how enterprising or talented a Tunisian operating extralegally might be, he or she will not be able to carry out the sophisticated combinations that create employment and add value to the economy.

The very good news is that the number of Tunisians clever and persistent enough to work imaginatively under dire circumstances is huge. The repressed potential value of combining the things they own means that Tunisia's capacity to

grow and employ people could be very significant – if Tunisians in the extralegal economy are legally empowered.

It may not sound serious to attribute such power to legality. It's as if the law has magic power. Well, the law does have power, but there's nothing magic involved. (See page 13 and Annex 1.)

Extralegality in Tunisia and its connection to the Arab Spring

To obtain the bits of information (or, as the philosopher Bertrand Russell would say, “little patches of color”), and use them to paint a realistic picture of the extralegal economy requires talking to the extralegal people themselves. But you have to find those who are willing to talk and motivated to tell the truth about how they live and work at the micro level. Only among them will you locate the leads that gradually take you to the macro world of aggregates. In short: From the bottom up; there is no other way. Only in the

extralegal economy can you get the “little patches of color” for developing the economic criteria and legal categories to understand why people prefer to operate extralegally, and figure out what it takes to bring everyone into the legal system.

This is no small or easy task. For in the extralegal world, where activities are always opaque and rarely visible, where everyone feels vulnerable, prefers to keep a low profile and tends to under-report, finding the right indicators is more about detective work than economics.

In fact, extralegal businessmen will be motivated to talk only in dramatic and extraordinary circumstances. Such dramatic circumstances crashed into our lives at 11:30 am on 17 December 2010 in Sidi Bouzid, when the street vendor Mohammed Bouazizi, self-immolated and sparked the Arab Spring – thus making him the world’s most famous extralegal and providing us with a starting point to access the patches of color.

We know that many of our readers will be skeptical: We are well aware that the promise of the Arab Spring has faded in many places, including the West where it has been re-baptized as “the Arab Winter.” Bouazizi’s image in Tunisia has also deteriorated. What was originally viewed as a heroic act that put Bouazizi’s portrait on post-

age stamps and his name in Paris streets is now perceived as a lonely act of madness, without any positive social significance.

That’s not the way we see it. Bouazizi’s self-immolation was very significant act: Millions of ordinary people do not march in the streets on behalf of anything or anyone unless they are able to identify with a situation that reflects their own ambitions and frustrations. As soon as we at the ILD heard the news from Tunisia that the public suicide of a “street vendor” had sparked a popular uprising, a series of questions occurred to us, given our decades of experience in developing countries: What archetypes did Arabs everywhere identify with? How did Bouazizi’s act get the strength to tumble four strongmen from power in Tunisia, Egypt, Libya and Yemen in no time, and we’re still counting? What whispered order was so authoritative that it mobilized armies of anti-status quo civilians in more than 15 countries?

To find out, we sent ILD researchers to Tunisia to begin at the beginning and try to work our way to getting solid facts about Bouazizi’s life and death – and why his desperate act galvanized millions of people across the diverse MENA region. We interviewed Bouazizi’s family as well as friends in the local extralegal market. We learned

that self-immolation was not a customary form of protest in the Arab world, yet heard of others who had replicated his desperate protest – in Tunisia and elsewhere in the MENA region. We are far from having covered all the territory but so far it would seem that self-immolation embodied the collective frustrations of a massive number of entrepreneurially inclined Arabs also unable to protect their assets with adequate property rights and to use them to create Ras el mel (capital).

Here is a sample of the ILD findings that led to that conclusion:

***Bouazizi was not alone:** Within, 60 days of his immolation, 64 other people throughout all MENA countries also torched themselves. Between December 2010 and February 2011, 29 in Algeria, 5 in Egypt, 4 in Morocco, 1 in Saudi Arabia, 2 in Syria, 22 in Tunisia and 1 in Yemen. Forty percent of them survived, and ILD researchers have interviewed several of them as well as the families of many of those who died.

***All these self-immolators share another thing in common with Bouazizi: they, too, were extralegal entrepreneurs.** They ran businesses as diverse as restaurants, information technology, real estate, eyeglass vending, taxis, wholesale vegetables, etc.

***The chain reaction of initial immolators seems to signal that there were also economic causes for the Arab Spring.** This doesn't deny the enormous role of political leadership. It just confirms that since somewhere between 150 and 200 million Arabs work extralegally, the lack of respect for the labor of small entrepreneurship, THIS may help to explain why the revolt initiated in Tunisia spread so quickly across the otherwise culturally diverse national and traditional boundaries of MENA.

***All the survivors we interviewed or their families said that what finally pushed them to sacrifice their lives was expropriation.** They were acting to get official recognition of their right to property (66% for Business Property and 16% for Real Estate Property). Shortly after their wares were confiscated, or the documentation they needed to operate, use, hold on to land, buildings, machinery or buy and sell were withdrawn, they made the drastic decision to commit suicide in public. One Tunisian survivor actually said, "I have no problem with competition, but expropriation is an indignity. Authorities do not recognize what is ours, and that is not tolerable."

*** Though the visible losses of the martyrs were relatively small, their invisible losses were**

much more consequential. Bouazizi, for example, lost \$225 dollars worth of possessions: two crates of pears (\$15), one crate of bananas (\$9), three crates of apples (\$22) and one electronic weight scale (\$179, second hand). But less obviously he lost the location from which he could sell and be recognized. He knew immediately that from then on he would never be awarded a legal property right (une concession) to put a stall (no bigger than the size of one and half mattresses) in the wholesale market. Nor would he get an Autorisation d'Occupation du Domaine Public, a Carte de Commerçant Détaillant or a Patente (roksa) to park his cart on a fixed point on a sidewalk. He had no way to reduce the cost of the bribes that he paid regularly (El-Makes) to local authorities to purchase his right to buy and sell, which amounted to 17% of his total income.

***No credit for the martyrs.** Bouazizi also realized his chance was now more remote than ever to get credit to buy the truck that would enable him to get fruit directly from the farmers – something that, according to his family, he had long dreamt of; he also knew that hostile authorities would never allow him to convert his deceased father's extralegal right to squat or defend his possession on a piece of land into legal collateral or a

symbol of his rights to facilitate a loan. Nor would he ever be able to afford to record a deed in the property registry (“Conservation de la Propriété Foncière”), an indispensable requirement for using the house as a guarantee – that would involve 499 days of red tape at a cost of \$2,976.

***Too many obstacles to legality.** Perhaps Bouazizi and his colleagues could have been able to do more in their effort to become legal. But in some cases it is impossible. For example, the attempt to legalize street vendors just before the December 2010 Revolution 2010 (Arrêté du Ministre de l'Intérieur et du développement local) contains an inapplicable procedure: the prerequisite for achieving the license for street vending (Carte de commerçant détaillant ambulante) is an official authorization for “setting up in a public place” (Autorisation d'occupation du domaine public) – that, in practice, no one has been able to obtain.

***No division of labor.** Bouazizi's dream of establishing even a small, legal sole proprietorship (Société Unipersonnelle à Responsabilité Limitée - SUARL) as a vehicle to divide labor in-house also faded. Getting the papers takes 55 administrative steps over 142 days, and requires spending \$3,233 (twelve times Bouazizi's monthly net income, not

including maintenance and exit costs).

***Bankruptcy.** Bouazizi's main concern the day he self-immolated was debt. He was accustomed to getting his merchandise on credit. But now that his fruit and scales had been expropriated, he had no revenue, which meant he couldn't pay his debt: he was bankrupt.

***The main objective: Ras-el-mel (Capital).** All the extralegals that we interviewed considered themselves "entrepreneurs," "business people." Bouazizi's family had no doubt: they recalled that he had been an entrepreneur (Isami) since the age of 12. They expressed their pride in the fact that he could keep his own as well as fellow vendors' accounting records (*tenir la table*). When we asked what his main objective was, they clearly stated that it was to accumulate "Ras-el-mel to grow his business." We repeated the same question to all interviewees, and they all agreed - some less emphatically than others, but they all agreed.

***But no Ras-el-mel, only Hogra.** When we asked survivors why they had done so poorly in their efforts to accumulate ras-el-mel, **84%** cited as their main reason for losing hope "hogra" (the contempt that many have for poor business people). Fadoua Laroui, in Souksebt, Morocco, can be heard in the film we have of her suicide

screaming: "I am going to immolate myself. I am doing this to protest against hogra and economic exclusion."

In our attempt to get beyond sentiment, we asked our interviewees a series of questions to find out if they had access to any of the legal mechanisms that we considered crucial to get ras-el-mel. They seemed to understand these business-related questions well enough to say yes or no:

Can you issue shares and stock to capture investment? **No.** Can you bring in new partners to raise capital? **No.** Issue bills to raise financing? **No.** Use limited liability to circumscribe your risks and make it attractive to invest in your business? **No.** Can you transfer the intangible value of your business, such as goodwill, reputation, brand, teamwork, etc., which is also capital, to your successors beyond your death? **No.** Can you share rights to your business outside the confines of your family to raise productivity and create surpluses? **No.** Once you invest and own something, do you feel your property is secure? **No.** Can you convert the things you own into credit or capital? **No.**

Finally, we asked them, why they thought that they didn't have these legal instruments. About

that question, too, their answers were quite clear:
Hogra.

***Extralegality has no ideology.** Not yet. According to our interviews, not one of the self-immolators issued a political statement when they torched themselves. Bouazizi's family, for example, informed us that he had absolutely no ideological interest: "He never paid attention to the news."

The Cost of Extralegality in Tunisia: No Knowledge

The story behind the story of the advantages of legality – whether it is recording assets, issuing shares, creating limited liability companies or capturing value – is that nothing legal can take place unless it is documented in a standard fashion that provides short-cut knowledge about other people's resources, potential and reputation.

At the core of extralegality is the lack of easily accessible knowledge via standard, coherent, documentation, records and written rules. For example, in the town of Sidi Bouzid (40,000 inhabitants), where Mohamed Bouazizi lived and

worked, we have so far identified nine types of extralegal arrangements regarding control over real estate assets: public and private buildings on land under dispute (between different government entities and the municipality); properties legally transferred with scattered cases of joint ownership, informal inheritance and transfers; houses built in illegal subdivision of State-owned farm land formalized with defective contracts issued by the municipality; houses built in illegal subdivision of State-owned farm land in the process of being formalized; recent illegal subdivision of farmland (after 2000); houses built in old squatter settlements (habitat anarchique); invasions of State land after the revolution (new habitat anarchique); formal properties legally adjudicated in Sidi Bouzid's Industrial Zone; and reserved for public housing projects (e.g. Lotissement El Yasmine).

If all Tunisian villages are similar to Sidi Bouzid, Tunisia would have more than 1,000 arrangements regarding property in the whole country. This in turn means Tunisians don't have the standards to obtain knowledge and deal with any situation anywhere in Tunisia using one set of tools. Each time you want to make a deal to buy, sell, borrow or invest, you have to learn new rules,

make new acquaintances. It's a bit like navigating up the Rhine a few hundred years ago, when boat owners had to stop and pay dues to the lords of 65 castles, trying to learn along the way case who controls what and what constitutes correct behavior.

Therefore, no matter how enterprising or talented Tunisians operating extralegally might be, they will not be able to achieve the kind of sophisticated combinations that will add great value to the economy. For extralegal Tunisians to transcend the local realm of face-to-face interactions and connect with larger markets, fragmented and uncertain pieces of information have to be legalized and consolidated in well-documented, regularly updated and publicly available records. Historically, that is how the rule of law gets built – how extralegality as a massive phenomenon disappears and nations develop.

That is the goal of the UTICA-ILD project. And it has been done before: all developed nations built their own rule of law one way or another. The challenge for us Third Worlders is that when legalization took place in what are now developed countries there wasn't much consciousness of what was really happening. There is really no practical understanding in the West that

legalization was in fact triggered by the need to be informed and that when knowledge became available extralegal economies were pretty much wiped out.

How legalization of business and property creates knowledge

It is important for Third Worlders –whether they are Tunisians, Peruvians or citizens of any other developing country– to understand how essential this relationship between legality and knowledge is to economic growth. The West stumbled upon the creation of short-cut knowledge without fully realizing its contribution to the creation of large scale law abiding societies. The discipline of economics, in fact, does little to explain how businesses and people marshal the knowledge they need to trust each other, identify creditworthiness, divide labor productively

among them and make efficient decisions.

The result is that legalization's valuable role in development is tremendously underestimated, though in the past it was a prime concern. Ibn Khaldun, the great Arab thinker of the Medieval era, sensed early on, in the terms of his times, that realism based on facts was crucial, when he wrote that that well organized businesses would eventually surpass those owned by wealthy rulers. Marx wondered where one could find the "essential links and relations" that allow humans to know each other and cooperate on a large scale; the influential Austrian Economist Friedrich von Hayek dedicated an entire book to making the case that the human mind does not have the sensory attributes to access economic reality directly.

With the passing of time, most economists have either assumed the problem away or borrowed from philosophy the logical tools that elucidate collective understanding: the invisible hand, catallaxy, episteme, world three, collective subconscious, knowledge rhizome and lebenswelt –all concepts that boosted the issue of knowledge into the realm of metaphysics.

Once upon a time, however, some economists and jurists did understand the practical things that could be done to overcome ignorance

in an effort to generate trust. They even created the institutions that structured and transmitted knowledge ripe for decision-making. Though the battle to overcome man's economic ignorance began with Aristotle in the Fourth Century B.C., it was initiated in earnest during the second half of the 19th Century when the world's biggest economies experienced an unparalleled series of social revolutions: angry and alienated people unable to benefit from an expanded market economy took to the streets, unsettling and toppling governments –as is happening in the Arab world today.

In old Europe, where economic activity and knowledge –such as feudalism, patrimonialism and tribalism– had been organized on a small scale; the expanding markets of the 19th Century were destroying those face-to-face economies that could only survive on a micro scale.

Masses of disorganized extralegal entrepreneurs appeared in city streets; social upheavals and demonstrations were everyday events. A huge rift was occurring between those who produced according to the written legal order and those who didn't – as in the Arab world today.

In the face of this turbulence, reformers stepped forward concluded that the erratic, segmented and undirected knowledge available was

not enough to allow entrepreneurs and financiers to trust and divide labor on a large scale. Knowledge had to be gathered, organized, recorded, updated and directed so that all players in the widening markets –in the words of the French reformer Charles Coquelin– “could pick up the thousands of filaments that businesses are creating between themselves, and thereby socialize and recombine production in a mobile fashion...so as to readapt the social intelligence of society.”

The result was what today would be called “formalization programs” and the invention of a new kind of legality capable of massively recording and classifying –in rule-bound and publicly accessible registries, titles, balance sheets, and statements of account– all the knowledge available relevant to the economic situation of people and the assets they controlled, whether they were intangible (stocks, commercial paper, deeds, ledgers, contracts, patents, companies and promissory notes), or tangible (land, buildings, boats, machines, animals and books). Knowing who owned and owed what and where and under which circumstances made it possible for investors to infer value and take a risk.

But what does legalization, recording and classifying have to do with economic knowledge?

Plenty. Knowledge is essentially a memory-based process that involves selecting, categorizing and storing the information and facts we need. Knowledge increases incrementally, forcing us to understand and validate each additional input obtained so as to decide which one is important to our welfare and worth remembering, how it should be written up and packaged, in what context it should be described and how it should be stored so as to be easily retrieved. What we know about the economy and the importance of its components is pretty much what we can remember about it, by looking at the records and seeing how various parts relate to one another.

Look at the world’s most prosperous countries: everything of economic value they own is documented and recorded in a legally created or mandated public memory system. They are able to hold, transfer, assess and certify the value of their assets only through documents that have been recorded and legally authenticated by a public system of rules, procedures and standards. Ensuring that the relationship between those documents and the assets and situations they describe is never debased is what produces the trust that allows credit and capital to flow and markets to work.

And thus some 100 years ago legalization precipitated a revolution no less significant than the one set off by the invention of the personal computer. In a world brimming with the jumbled information of isolated extralegal organizations, developed nations and businesses were now obliged to decide what knowledge was important to remember regarding property and transactions; then to assemble, prioritize, and write it up in statements that describe the asset and the economic context in which it finds itself – so what is stated can be measured, compared, certified by an accountable authority and tested for truth. The final product of this revolution was a new form of knowledge – made up of compressed, short-cut, economic facts about every important thing and person, continually updated and thus providing the possibility of dividing labor on a large scale governed by the rule of law.

Organizing the collection of data to build up knowledge so that people and governments could share information in the same language inadvertently launched the West on a huge step towards legality – and simultaneously dealt a big blow to extralegality.

A first step for Tunisia: A strategy for the Legalization Study

The objective of the UTICA - ILD project is to develop a plan that will assist the Tunisian State to create the accessible knowledge and shared rules that will allow all Tunisians to interact with each other and the world as they see fit. This means gathering the information needed to making the rule of law so much more convenient to extralegals that it will inspire their massive migration away from anarchic arrangements to legality.

At the beginning, the main task is getting enough information about extralegal activities to craft a reform proposal that responds so clearly

to the needs and molds so snugly to the culture of extralegal Tunisians that they will voluntarily cross over into legality. On the extralegal side this involves identifying who their real extralegal leaders are; what it takes for them to share knowledge; what they think it takes to understand the benefits of doing business and being credit-worthy in an impersonal, wider and more legal economy; what it will take for them to move into the legal economy. Some of these leaders will be part of the study team.

On the legal side, it involves bringing together the most experienced business and political operators not only to design reforms but to identify what the specific benefits of legalization would be for all important stakeholders (government, private sector, armed forces, foreign trade, security) –so as to lower any resistance there may be to changing rules and opening up society.

Here are the contents of the legalization plan:

Formalization Process

A. The Diagnosis Strategy

Awareness

A.1 Identify, locate and classify extralegal

assets (dead capital)

A.1.1 Develop local recruitment specifications to penetrate extralegal sector (Training and Team Building).

A.1.2 Determine causes for the accumulation of extralegal assets so as to develop workable typologies.

A.1.3 Locate economic sectors and geographic areas where extralegal activities are most prevalent.

A.2 Quantify the actual and potential value of extralegal assets (dead capital)

A.2.1 Develop appropriate methodologies to estimate the value of extralegal assets using existing information and data gathered in the field.

A.2.2 Customize criteria to gather and process information and to confirm results.

A.2.3 Establish the importance of the value of extralegal assets.

A.3 Analyze the interaction of the extralegal sector with the rest of society

A.3.1 Research the relevant links between government and extralegal assets.

A.3.2 Research the relevant links between legal businesses and extralegal assets.

A.3.3 Identify processes where government has already successfully dealt with extralegal assets.

A.4 Identify the extralegal norms that govern extralegal property

A.4.1 Detect and decode the extralegal norms that define the manner in which property rights are held and exercised by the different extralegal communities in the country.

A.5 Determine the costs of extralegality to the country

A.5.1 The costs to the extralegal sector

A.5.2 The costs to the legal business sector

A.5.3 The costs to government

B The Political and Legal Strategy

B.1 Ensure that the highest political level assumes responsibility for capitalization of the poor

B.2 Put into operation agencies that will permit rapid change

B.2.1 Identify and connect with the capitalization process the different institutions that presently govern property rights or impinge upon their ability to generate

surplus value.

B.2.2 Design, obtain approval for, and put into operation agencies that will permit the rapid introduction of changes in the diverse processes required for capitalization. If possible, create a single organization having the sole mandate of capitalizing assets and decentralize offices to provide services throughout the country.

B.2.3 Ensure that the capitalization process both incorporates the political priorities of the government and reflects a consensus within society that makes the process easily enforceable.

B.3 Remove administrative and legal bottlenecks

B.3.1 Calculate the costs of capitalizing extralegal assets, including:

B.3.1.1 Requirements for permits at all levels of government.

B.3.1.2 Requirements for and the amount of payments for these permits.

B.3.1.3 The number of forms and other documents required.

B.3.1.4 Requirements that cannot be met in practice.

B.3.1.5 All other transaction costs, in-

cluding time delays.

B.3.2 Remove administrative and legal bottlenecks by identifying and modifying the institutions, statutes and practices that create unnecessary red tape.

B.4 Build consensus between legal and extra-legal sectors

B.4.1 Determine the points where extra-legal norms coincide with the law so as to be able to draft statutes that recognize acceptable extralegal proofs of ownership with the support of extralegal communities.

B.4.2 Ensure that the draft legal norms that incorporate extralegal property do so without compromising the level of security that the existing legal order now provides property that is duly recorded and effectively controlled so as to obtain acquiescence of the legal sector.

B.5 Draft statutes and procedures that lower the costs of holding assets legally below those of holding them extralegally

B.5.1 Enact the statutes required for all property in a country to be governed by one consistent body of law and set of procedures.

B.5.2 Broaden the definition of proofs of ownership to suit the new process, and consolidate into administratively manageable packages the statutes and procedures that will govern the capitalization process.

B.5.3 Consolidate dispersed legislation into a single law.

B.5.4 Develop institutions and procedures that permit economies of scale for all the activities which constitute the process of capitalization.

B.5.5 Create an expedient and low-cost alternative to squatting and other forms of extralegal appropriation. Consolidate process and respect for the law by establishing incentives and disincentives aimed at encouraging legal and discouraging illegal [extralegal] conveyance.

B.5.6 Design and implement administrative or private processes, to substitute judicial processes, where suitable, so as to encourage settlement of disputes within the law.

B.6 Create mechanisms that will reduce risks associated with private investment, including credibility of titles and non-payment for public services

C The Operational Strategy

C.1 Design and implement field operation strategy, procedures, personnel, equipment, offices, training and manuals that enable government to recognize and process individual property rights in the extralegal sector

C.1.1 Design mechanisms to obtain the massive participation of the members of extralegal settlements for the purpose of reducing the costs of capitalization.

C.1.2 Carry out training courses for the organization of capitalization brigades that reflect the types of extralegality they will encounter.

C.1.3 Develop manuals that explain to the leaders and the people of extralegal settlements the ways in which they can participate in the selection and collection of proofs of ownership.

C.1.4 Prepare for capitalizing extralegal communities

C.1.4.1 Identify and train local promoters within each community

C.1.4.2 Implement a local promotional campaign within each community

C.1.4.3 Educate each community about

the proofs of ownership required

C.1.4.4 Train local leaders to record ownership information on registration forms

C.1.4.5 Identify and train private verifiers to certify information collected by the community.

C.1.5 Gather and process information on physical assets.

C.1.5.1 Obtain or prepare maps showing the boundaries of individual parcels (where necessary prepare digital base maps to record boundary information)

C.1.5.2 Verify that maps showing individual parcels correspond with what is on the ground

C.1.5.3 Enter the maps into the computer system.

C.1.6 Gather and process ownership information.

C.1.6.1 Gather ownership information and record on registration forms

C.1.6.2 Verify that ownership rights are valid under the new law

C.1.6.3 Enter the ownership information into the computer system

C.1.6.4 Officially register the ownership

rights

C.1.6.5 Hand out certificates to the beneficiaries at a public ceremony.

C.2 Implement communications strategies using appropriate media to encourage participation of the extralegal sector, support in the business community and the government sector, and acquiescence among those with vested interests in the status quo

C.2.1 Conduct a campaign for each particular type of community in the extralegal sector to encourage their participation in the process.

C.2.2 Devise mechanisms that show beneficiaries of capitalization process that their assets are protected by the same institutional framework that protects the rights of private investors, both domestic and foreign. This will give these owners a reason to respect contracts governed by the formal legal order.

C.2.3 Conduct a campaign for each legal community that may feel vulnerable.

C.2.4 Design the means of communicating to legal sector the benefits of capitalization, emphasizing the reduction in risks and making it clear that capitaliza-

tion will neither affect existing property rights nor compromise the rights of third parties.

C.2.5 Conduct a campaign for professionals with vested interests in property definition, explaining their future role and increased involvement within an expanded legal sector after capitalization.

C.3 Re-engineer the record keeping organizations and registration processes so that they can pull together all the economically useful descriptions about a country's extralegal assets and integrate them into one data/knowledge based computer system

C.3.1 Structure the organization of the registry and its internal work flows, simplify the registration processes, establish specifications for automating information, design and implement a quality control system, select and train personnel, and establish procedures to ensure that the registry can handle a massive national program of capitalization.

C.3.2 Construct GIS based systems to provide spatial analytical capabilities.

C.3.3 Establish control mechanisms to guarantee that the cost of enrollment and

registration services are sufficiently efficient and cost effective that its users will not be motivated to slip back into extralegality.

C.3.4 Insert descriptions of features of extralegal property holdings into customized, computer-friendly registration forms where they can be differentiated, recorded and managed in one computer environment.

C.3.5 Break down the information that is traditionally contained in deeds into simple categories that can be entered into computer software and be systematized for easy access, after having effected a legally approved streamlining of existing information gathering procedures.

C.3.6 Facilitate the update of computerized property information by placing data input centers close to the beneficiaries. The purpose is to cut down on the transportation and transaction costs of legally registering property and property-related business and keeping their status legal.

D The Commercial Strategy

D.1 Implement the information and enforcement mechanisms that will enable the

provision of:

D.1.1 Banking/Mortgages/Credit

D.1.2 Public Utilities (Energy, water, sewage, telecommunications)

D.1.3 Collection Systems (Credit, rates, taxes)

D.1.4 Databases/Information Services

D.1.5 Insurance products (Property damage, life insurance, credit insurance, liens, title insurance)

D.1.6 National Identification Systems

D.1.7 Housing and Infrastructure

D.1.8 National Security

Summary and Conclusions

The UTICA-ILD research project is ongoing. It is as yet far from complete. But it has produced some interesting findings and reflections which seem to be leading to useful conclusions. Here they are.

1. Formality is another word for the rule of law. It is a universal ordering system that developed spontaneously over time and is the result of hundreds of conventions explicitly approved by governments over time to provide all of humanity the legal tools to combine their talents and resources to produce economic wellbeing.

Since the end of WWII formality, the legal ordering of economic activity, was gradually crafted

to take its present shape basic on legal maxims by all 200 nations of the world (with nearly no exceptions)—each respecting their particular cultures and sovereign prerogatives- to provide their citizens, whether they are organized as private, public, communal, profitable or nonprofit organizations, with the knowledge, fungible property, enforceable contracts and legal business tools so that they can voluntarily cooperate.

In the world of economics –which UTICA and ILD belong to–formality is not only about being tidy, obeying the law and paying taxes. Over and above that the crucial function of formality is allowing humanity to combine resources and talents. Value is created by combinations. The reasoning is as follows: the world economy is made up of billions of tiny parts that on their own are of little use to us. The role of entrepreneurs is to combine these parts into more complex wholes, until they become more useful to more people. Combinations produce humanity’s greatest achievements: a clock can be made up of 120 pieces of metal, a wooden pencil can have inputs from more than 12 countries, and the internet combines thousands of computer and telephone ingredients.

Entrepreneurs cannot put these parts together

without the shared rules, the knowledge that legally sanctioned records provide, the guarantees and the “joining mechanisms” like enforceable contracts, fungible property, and business organization tools that formal law delivers worldwide from Tunisia to Peru. Modern life would not be possible without formality.

2. Informality is the opposite of the rule of law. It is not an order but simply a word that describes economic anarchy understood as being the sum total of disconnected economic arrangements that people who found it impossible, difficult or inconvenient to enter formality have cobbled together to survive until they can get in. None of these arrangements is sophisticated enough to operate on a big scale to offer its constituencies the legal knowledge and joining mechanisms that would allow their entrepreneurs to combine and be wealthy.

Aside from the fact that it doesn't help development –that it's only a palliative to unemployment- it is a serious problem for at least three other reasons. First, it is undocumented and as such a source of ignorance and confusion, quite the opposite of a documented society which produces the knowledge and devices required to understand and renew itself. Second, like all

non-transparent environments where rules are not standard and mechanisms to join forces are unavailable, informality encourages anonymity, discourages trust, hides culprits, masks risks and therefore conspires against significant investment and combinations on a grand scale. Third, those that live in it can't help but compare themselves to those that prosper with formality and this produces an acute sense of being left out: alienation.

3. Informal alienation worldwide. If unattended, and perceived as a manifestation of natural backwardness informals can become extremely alienated. Since it's a feature of most developing and former Soviet nations there are plenty of cases of where alienation is evident. Each case has its own specific cultural traits– whether it's the slumdogs of Mumbai, the Naxalite armies of India, the favelas and drug mafias of Brazil, the coca fields of Peru, the narrow streets of Gaza, the impoverished tribes of the Amazon, the migratory settlements throughout the Third World, the feudal arrangements of Afghanistan, or the oil partitioning arrangements in the Niger Delta.

Even developed countries have experienced informality further back in history when their old structures fell and the need to change and upscale economic institutions became an imperative.

And they all got over it. There doesn't seem to be anything so deeply ethnic about Arab informality that would make it unfathomable and beyond repair.

4. Informal alienation in Tunisia -a first, very preliminary interpretation. At 11:30 am on 17 December 2010 in Sidi Bouzid, street vendor Mohammed Bouazizi, self-immolated because the fruit he sold and his scales were confiscated. The press agrees he sparked the Arab Spring – thus making him the world's most famous informal. Some gave him a hero's status; others said that it was a lonely act of madness without any social significance.

5. Bouazizi was not alone: 64 immolations in 60 days. After researching the subject for more than a year we have now documented that within, 60 days of his immolation, 64 other people throughout all MENA countries also torched themselves. Between December 2010 and February 2011, **29 in Algeria, 5 in Egypt, 4 in Morocco, 1 in Saudi Arabia, 2 in Syria, 22 in Tunisia and 1 in Yemen.**

6. All these self-immolators were extralegal entrepreneurs. They ran businesses as diverse as restaurants, information technology, real estate, eyeglass vending, taxis, wholesale vegetables, etc. When they were asked item by item if they had

the tools to protect the things they owned and bring them together to fetch higher values the reply was negative. Once you invest and own something, do you feel your property is secure? No. Can you convert the things you own into credit or capital? No. Can you issue shares and stock to capture investment? No. Can you bring in new partners to raise capital? No. Issue bills to raise financing? No. Use limited liability to circumscribe your risks and make it attractive to invest in your business? No. Can you transfer the intangible value of your business such as goodwill, reputation, brand, teamwork, etc. to your successors beyond your death? No. Can you share rights to your business outside the confines of your family to raise productivity and create surpluses?

7. All 64 Self-immolators or their surviving families coincided that the tipping point before their suicide was expropriation. 66% percent had their business property confiscated and 16 percent their real estate whether it be in the form of wares, buildings, the right to own land, or machinery.

In Bouazizi's case his stock of fruit and weight scales the immediate cost (\$225): pears (\$1.15), bananas (\$1.09) apples (\$1.22), second-hand weight scales (\$179). But that's only what's visible,

he also lost the invisible and few tools he had to make combinations: The right to continue selling on the street, carte de commercant detaillanta patente (a rokssa) which would have given him legal access to park his cart on a fixed point on the sidewalk according to “arête de Ministre de l’intereir” of 14/12/2010.

- **Thee right to division of labor:** Lost good will to establish a small societe unipersonelle a responsabilite limite-suarl to divide labor with his associates which takes 55 administrative steps over 142 days and requires spending \$3,233 not including maintenance and exit costs.
- **Bankruptcy as a consequence of losing his informal right to the property of his wares:** he had obtained his fruit and scale with informal credit. Expropriation meant he couldn’t sell them to pay his debt. He was bankrupt.
- The possibility of getting property Lost. good will to put a stall in the whole sale market (en consesion)
- Lost good will required to convert his deceased father’s possession of a piece of land he originally squatted on into a deed in the property registry (conversation de la propriete fonciere) which he may have used as collateral

to buy a truck provided he complied with 499 days of red tape at a cost of \$2,979.

8. Informality is not a marginal problem. If further studies confirm that the majority of Arab production units don’t operate under the rule of law, and lack the mechanisms that facilitate entrepreneurship, that economic informality may be an important, but as yet unconscious root of the Arab Spring even if it was not deliberate, it means that is not a marginal problem.

Certainly the very preliminary numbers we have distilled bear that out. 524,000 enterprises of a total of 616,000 (85%) are informal as previously defined: they lack the documented knowledge and joining mechanisms to do profitable combinations. The sum value of both the of all informal businesses and real estate in Tunisia would be about US\$115 billion which is 11 times the capital value of companies quoted in the Bourse de Tunis in the year 2010.

9. The Positive side of informality and the research proposal. The dark cloud of informality shows a huge silver lining: indisputable evidence that the entrepreneurial spirit is prevalent even among the poorest Tunisians who have gone to dramatic extremes to show that they do not have access to the kind of law that would allow them

to build *ras el mel*.

It is evident that informals want to get ahead – so much so that some 23 Tunisians have laid their lives on the line in the defense of property rights—and hundreds of thousands of people went into the streets in support of Bouazizi. That is why a first UTICA-ILD proposal to formalize the informals is essentially about finding ways of legally empowering the poor. This proposal embodies our belief that the poor are not the cause of their own poverty; nor are the poor the problem standing between Tunisia and economic growth; they may just be part of the solution.



The Mystery of Capital

Hernando de Soto

Chapter 3: The Mystery of Capital

Why has the genesis of capital become such a mystery? And why have the rich nations of the world not explained to other nations how indispensable a formal property system is to capital formation?

Walk down most roads in the Middle East, the former Soviet Union, or Latin America, and you will see many things: houses used for shelter;

parcels of land being tilled, sowed, and harvested; merchandise being bought and sold. Assets in developing and former communist countries primarily serve these immediate physical purposes. In the West, however, the same assets also lead a parallel life as capital outside the physical world. They can be used to put in motion more production by securing the interests of other parties as “collateral” for a mortgage, for example, or by assuring the supply of other forms of credit and public utilities.

Why can't buildings and land elsewhere in the world also lead this parallel life? Why can't the enormous resources in developing and former communist countries, which my colleagues at the Institute for Liberty and Democracy (Lima) and I estimate at \$9.3 trillion of dead capital, produce value beyond their “natural” state? My reply is, dead capital exists because we have forgotten (or perhaps never realized) that converting a physical asset to generate capital—using your house to borrow money to finance an enterprise, for example—requires a very complex process. It is not unlike the process that Albert Einstein taught us whereby a single brick can be made to release a huge amount of energy in the form of an atomic explosion. By analogy, capital is the result of dis-

covering and unleashing potential energy from the trillions of bricks that the poor have accumulated in their buildings.

Clues from the past

To unravel the mystery of capital, we have to go back to the seminal meaning of the word. In medieval Latin, “capital” appears to have denoted head of cattle or other livestock, which have always been important sources of wealth beyond the basic meat, milk, hides, wool, and fuel they provide. Livestock can also reproduce themselves. Thus, the term “capital” begins to do two jobs simultaneously, capturing the physical dimension of assets (livestock) as well as their potential to generate surplus value. From the barnyard, it was only a short step to the desks of the inventors of economics, who generally defined “capital” as that part of a country's assets that initiates surplus production and increases productivity.

Great classical economists such as Adam Smith and, later, Karl Marx believed that capital was the engine that powered the market economy. In *The Wealth of Nations*, Smith emphasized one point that is at the very heart of the mystery we are trying to solve: for accumulated assets to become active capital and put additional pro-

duction in motion, they must be fixed and realized in some particular subject “which lasts for some time at least after that labour is past. It is, as it were, a certain quantity of labour stocked and stored up to be employed, if necessary, upon some other occasion.” What I take from Smith is that capital is not the accumulated stock of assets but the potential it holds to deploy new production. This potential is, of course, abstract. It must be processed and fixed into a tangible form before we can release it—just like the potential nuclear energy in Einstein’s brick.

This essential meaning of capital has been lost to history. Capital is now confused with money, which is only one of the many forms in which it travels. It is always easier to remember a difficult concept in one of its tangible manifestations than in its essence. The mind wraps itself around “money” more easily than “capital.” But it is a mistake to assume that money is what finally fixes capital. Money facilitates transactions, allowing us to buy and sell things, but it is not itself the progenitor of additional production.

Potential energy in assets

What is it that fixes the potential of an asset so that it can put additional production into mo-

tion? What detaches value from a simple house and fixes it in a way that allows us to realize it as capital?

We can begin to find an answer by using our energy analogy. Consider a mountain lake. We can think about this lake in its immediate physical context and see some primary uses for it, such as canoeing and fishing. But when we think about this same lake as an engineer would by focusing on its capacity to generate electrical energy, by means of a hydroelectric plant, as an additional value beyond the lake’s natural state as a body of water, we suddenly see the potential created by the lake’s elevated position. The challenge for the engineer is finding out how he can create a process that allows him to convert and fix this potential into a form that can be used to do additional work.

Capital, like energy, is a dormant value. Bringing it to life requires us to go beyond looking at our assets as they are to actively thinking about them as they could be. It requires a process for fixing an asset’s economic potential into a form that can be used to initiate additional production.

Although the process that converts the potential energy in the water into electricity is well known, the one that gives assets the form required

to put in motion more production is not known. This is so because that key process was not deliberately set up to create capital but for the more mundane purpose of protecting property ownership. As the property systems of Western nations grew, they developed, imperceptibly, a variety of mechanisms that gradually combined into a process that churned out capital as never before.

Hidden conversion process of the west

In the West, this formal property system begins to process assets into capital by describing and organizing the most economically and socially useful aspects about assets, preserving this information in a recording system—as insertions in a written ledger or a blip on a computer disk—and then embodying it in a title. A set of detailed and precise legal rules governs this entire process. Formal property records and titles thus represent our shared concept of what is economically meaningful about any asset. They capture and organize all the relevant information required to conceptualize the potential value of an asset and so allow us to control it.

Any asset whose economic and social aspects are not fixed in a formal property system is extremely hard to move in the market. How can

the huge amounts of assets changing hands in a modern market economy be controlled, if not through a formal property process? Without such a system, any trade of an asset, say a piece of real estate, requires an enormous effort just to determine the basics of the transaction: Does the seller own the real estate and have the right to transfer it? Can he pledge it? Will the new owner be accepted as such by those who enforce property rights? What are the effective means to exclude other claimants? This is why the exchange of most assets outside the West is restricted to local circles of trading partners.

Developing and former communist countries' principal problem is clearly not the lack of entrepreneurship: the poor have accumulated trillions of dollars of real estate during the past forty years. What the poor lack is easy access to the property mechanisms that could legally fix the economic potential of their assets so that they could be used to produce, secure, or guarantee greater value in the expanded market.

Why has the genesis of capital become such a mystery? Why have the rich nations of the world, so quick with their economic advice, not explained how indispensable formal property is to capital formation? The answer is that the process

within the formal property system that breaks down assets into capital is extremely difficult to visualize. It is hidden in thousands of pieces of legislation, statutes, regulations, and institutions that govern the system. Anyone trapped in such a legal morass would be hard-pressed to figure out how the system actually works. The only way to see it is from outside the system—from the extra-legal sector—which is where my colleagues and I do most of our research.

The formal property systems of the West produce six effects that allow their citizens to generate capital.

(1) Fixing the economic potential of assets

Capital is born by representing in writing—in a title, a security, a contract, and other such records—the most economically and socially useful qualities about the asset as opposed to the visually more striking aspects of the asset. This is where potential value is first described and registered. The moment you focus your attention on the title of a house, for example, and not on the house itself, you have automatically stepped from the material world into the conceptual universe where capital lives.

The proof that formal property is pure concept comes when a house changes hands: noth-

ing physically changes. Property is not the house itself but an economic concept about the house, embodied in a legal representation that describes not its physical qualities but rather economically and socially meaningful qualities we humans have attributed to the house (such as the ability to use it for a variety of purposes—for example, to generate funds for investment in a business without having to sell the house—by providing security to lenders in the form of liens, mortgages, easements, or other covenants). In advanced nations, this formal property representation functions as the means to secure the interests of other parties and to create accountability by providing all the information, references, rules, and enforcement mechanisms required to do so.

Legal property thus gave the West the tools to produce surplus value over and above its physical assets. Whether anyone intended it or not, the legal property system became the staircase that took these nations from the universe of assets in their natural state to the conceptual universe of capital where assets can be viewed in their full productive potential.

(2) Integrating dispersed information into one system The reason capitalism has triumphed in the West and sputtered in the rest of the world

is because most of the assets in Western nations have been integrated into one formal representational system. This integration did not happen casually. Over decades in the nineteenth century, politicians, legislators, and judges pulled together the scattered facts and rules that had governed property throughout cities, villages, buildings, and farms and integrated them into one system. This “pulling together” of property representations, a revolutionary moment in the history of developed nations, deposited all the information and rules governing the accumulated wealth of their citizens into one knowledge base. Before that moment, information about assets was far less accessible. Every farm or settlement recorded its assets and the rules governing them in rudimentary ledgers, symbols, or oral testimony. But the information was atomized, dispersed, and not available to any one agent at any given moment.

Developing and former communist nations have not created unified formal property systems. In all of these countries I have studied, I have never found just one legal system but instead dozens and hundreds, managed by all sorts of organizations, some legal, others extralegal, ranging from small entrepreneurial groups to housing organizations. Consequently, what people

in those countries can do with their property is limited to the imagination of the owners and their acquaintances. In Western countries, where property information is standardized and universally available, what owners can do with their assets benefits from the collective imagination of a larger network of people.

It may surprise the Western reader that most of the world’s nations have yet to integrate extralegal property agreements into one formal legal system. For Westerners today, there supposedly is only one law—the official one. Diverse informal property arrangements, however, were once the norm in every nation—the West’s reliance on integrated property systems is a phenomenon of at most the last two hundred years. The reason it is so hard to follow the history of the integration of widespread property systems is that the process took place over a very long time.

(3) Making people accountable The integration of all property systems under one formal property law shifted the legitimacy of the rights of owners from the political context of local communities to the impersonal context of law. Releasing owners from restrictive local arrangements and bringing them into a more integrated legal system facilitated their accountability.

By transforming people with real property interests into accountable individuals, formal property created individuals from masses. People no longer needed to rely on neighborhood relationships or make local arrangements to protect their rights to assets. They were thus freed to explore how to generate surplus value from their own assets. But there was a price to pay: once inside a formal property system, owners lost their anonymity while their individual accountability was reinforced. People who do not pay for goods or services they have consumed can be identified, charged interest penalties, fined, and embargoed, and can have their credit ratings downgraded. Authorities are able to learn about legal infractions and dishonored contracts; they can suspend services, place liens against property, and withdraw some or all of the privileges of legal property.

Respect in Western nations for property and transactions is hardly encoded in their citizens' DNA; it is rather the result of having enforceable formal property systems. Formal property's role in protecting not only ownership but also the security of transactions strongly encourages citizens in advanced countries to respect titles, honor contracts, and obey the law. Legal property thus

invites commitment.

The lack of legal property thus explains why citizens in developing and former communist nations cannot make profitable contracts with strangers and cannot get credit, insurance, or utilities services: they have no property to lose. Because they have no legal property, they are taken seriously as contracting parties only by their immediate family and neighbors. People with nothing to lose are trapped in the grubby basement of the precapitalist world.

(4) Making assets fungible One of the most important things a formal property system does is transform assets from a less accessible condition to a more accessible condition, so that they can do additional work. Unlike physical assets, representations of assets are easily combined, divided, mobilized, and used to stimulate business deals. By uncoupling the economic features of an asset from its rigid, physical state, a representation makes the asset “fungible”—able to be fashioned to suit practically any transaction.

By describing all assets in standard categories, an integrated formal property system enables the comparison of two architecturally different buildings constructed for the same purpose. This allows one to discriminate quickly and inexpen-

sively between similarities and differences in assets without having to deal with each asset as if it were unique.

Standard property descriptions in the West are also written to facilitate the combination of assets. Formal property rules require assets to be described and characterized in a way that not only outlines their singularities but also points out their similarities to other assets, thus making potential combinations more obvious. Through the use of standardized records, one can determine how to exploit a particular asset most profitably.

Representations also enable one to divide assets without touching them. Whereas an asset such as a factory may be an indivisible unit in the real world, in the conceptual universe of formal property representation it can be subdivided into any number of portions. Citizens of advanced nations are thus able to split most of their assets into shares, each of which can be owned by different persons, with different rights, to carry out different functions.

Formal property representations can also serve as movable stand-ins for physical assets, enabling owners and entrepreneurs to simulate hypothetical situations in order to explore other profitable uses of their assets. In addition, all standard for-

mal property documents are crafted in such a way as to facilitate the easy measurement of an asset's attributes. By providing standards, Western formal property systems have significantly reduced the transaction costs of mobilizing and using assets.

(5) Networking people By making assets fungible, by attaching owners to assets, assets to addresses, and ownership to enforcement, and by making information on the history of assets and owners easily accessible, formal property systems converted the citizens of the West into a network of individually identifiable and accountable business agents. The formal property process created a whole infrastructure of connecting devices that, like a railway switchyard, allowed the assets (trains) to run safely between people (stations). Formal property's contribution to mankind is not the protection of ownership: squatters, housing organizations, mafias, and even primitive tribes manage to protect their assets quite efficiently. The property system's real breakthrough is that it radically improved the flow of communications about assets and their potential. It also enhanced the status of their owners.

Western legal property also provides businesses with information about assets and their own-

ers, verifiable addresses, and objective records of property values, all of which lead to credit records. This information and the existence of integrated law make risk more manageable by spreading it through insurance-type devices as well as by pooling property to secure debts.

Few seem to have noticed that the legal property system of an advanced nation is the center of a complex web of connections that equips ordinary citizens to form ties with both the government and the private sector, and so to obtain additional goods and services. Without the tools of formal property, it is hard to see how assets could be used for everything they accomplish in the West.

(6) Protecting transactions. One important reason why the Western formal property system works like a network is that all the property records (titles, deeds, securities, and contracts that describe the economically significant aspects of assets) are continually tracked and protected as they travel through time and space. Public agencies are the stewards of an advanced nation's representations. They administer the files that contain all the economically useful descriptions of assets, whether land, buildings, chattels, ships, industries, mines, or airplanes. These files will

alert anyone eager to use an asset about things that may restrict or enhance its utilization, such as encumbrances, easements, leases, arrears, bankruptcies, or mortgages. In addition to public record-keeping systems, many other private services (escrow and closing organizations, appraisers, etc.) have evolved to assist parties in fixing, moving, and tracking representations so they can easily and securely produce surplus value.

Although they are established to protect the security of both ownership and transactions, it is obvious that Western systems emphasize the latter. Security is principally focused on producing trust in transactions so that people can more easily make their assets lead a parallel life as capital. The Western emphasis on the security of transactions allows citizens to move large amounts of assets with very few transactions. In most developing countries, by contrast, the law and official agencies are trapped by early colonial and Roman law, which tilt toward protecting ownership. They have become the custodians of the wishes of the dead.

Conclusion

Much of the marginalization of the poor in developing and former communist nations comes from their inability to benefit from the six effects that formal property provides. The challenge these countries face is not whether they should produce or receive more money but whether they can understand the legal institutions and summon the political will necessary to build a property system that is easily accessible to the poor

The French historian Fernand Braudel found it a great mystery that at the inception of Western capitalism, it served only a privileged few, just as it does elsewhere in the world today:

The key problem is to find out why that sector

of society of the past, which I would not hesitate to call capitalist, should have lived as if in a bell jar, cut off from the rest; why was it not able to expand and conquer the whole of society? . . . [Why was it that] a significant rate of capital formation was possible only in certain sectors and not in the whole market economy of the time?

I believe the answer to Braudel's question lies in restricted access to formal property, both in the West's past and in developing and former communist countries today. Local and foreign investors do have capital; their assets are more or less integrated, fungible, networked, and protected by formal property systems. But they are only a tiny minority—those who can afford the expert lawyers, insider connections, and patience required to navigate the red tape of their property systems. The great majority of people, who cannot get the fruits of their labor represented by the formal property system, live outside Braudel's bell jar.

The bell jar makes capitalism a private club, open only to a privileged few, and enrages the billions standing outside looking in. This capitalist apartheid will inevitably continue until we all come to terms with the critical flaw in many countries' legal and political systems that prevents the majority from entering the formal property

system.

The time is right to find out why most countries have not been able to create open formal property systems. This is the moment, as Third World and former communist nations are living through their most ambitious attempts to implement capitalist systems, to lift the bell jar.

This article, which was published in the IMF's March 2001 issue of Finance & Development, is derived from Chapter 3 of the author's book, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books and London: Bantam Press/Random House, 2000).

The Sherlock Holmes image is by Massoud Etemadi - IMF graphics artist.

References: Fernand Braudel, *The Wheels of Commerce* (New York: Harper and Row, 1982). Adam Smith, *The Wealth of Nations* (1776; reprint, London: Everyman's Library, 1977).

Condensed version of Chapter 3 of "The Mystery of Capital"

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This first UTICA-ILD project proposal aims to allow informals to enjoy the benefits of formality. It is essentially a search for solutions that will allow the excluded to prosper by putting the law at their service. This proposal reflects our belief that the poor are not the cause of their poverty and not the problem that prevents Tunisia from achieving economic growth. They are the solution.

The book is based on the research conducted by Gustavo Marini and Aline Millet.