Book Review of The Mystery of Capital, by Hernando De Soto

“The hour of capitalism’s greatest triumph is its hour of crisis.”¹ So begins Hernando De Soto’s second book, The Mystery of Capital, Why Capitalism Triumphs in the West and Fails Everywhere Else, first published in 2000. At the time he wrote the book, it had been a little more than ten years since the fall of the Berlin Wall in late 1989 and almost twenty since De Soto founded his Institute for Liberty and Democracy (ILD) in 1981. Considering the book’s subtitle, it is not clear whether or not De Soto’s use of the term “triumph” in this first sentence is intended to be ironic. Surely he does not mean capitalism has conquered or been a complete success, but he is dead serious when, without reservation, he says in the first paragraph, “Capitalism stands alone as the only feasible way to rationally organize a modern economy. At this moment in history, no responsible nation has a choice.”²

De Soto was born in Peru, but his family moved to Switzerland when he was seven years old. He received his education in Switzerland and after working as an economist for the General Agreement on Tariffs and Trade (GATT), now the World Trade Organization, and then as an entrepreneur, he returned to live in Peru in 1979. He was thirty-eight years old. According to an advertisement promoting De Soto as a speaker for hire, by that time he had already made enough money in Europe to retire.³ In an interview with Italian journalist Maurizo Steffanini, it is also mentioned that De Soto served as a director of the Banco Central de Reserva in Lima,⁴ and, according to ILD's website, De Soto worked for a time in 1979 “running a group of small Peruvian mining companies” and became frustrated with what he found to be an unduly burdensome regulatory system.⁵

It is in 1979 that De Soto turns his attention to trying to figure out why it seemed so much harder to do business in Peru that it had been for him in Europe. He soon comes to realize that not only does it unnecessarily confound him as an experienced economist and businessman, Peru’s byzantine legal system also excludes a large majority of the country’s citizenry from participation in the legal economic life of society. He discovers that large portions of the population do not have record title to the land they think they own and, because it is next to impossible to obtain title to most land. Also, they do not comply with the numerous and confusing laws for doing business, because following the business laws it is too expensive and time consuming. Things that should take a few days or hours take months and years. Some of the perceived advantages operating a business illegally are no taxes and no regulation, but De Soto says that the advantages to owning property legally and doing business with the benefits of recognition under the law, far outweigh being off the grid. De Soto says that given the choice, most people would prefer to live within the law.

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² Ibid. Emphasis added.
³ http://www.speakers.com/Hernando-de-Soto-speaker-biography
Capitalism, the system that De Soto says all responsible nations must chose, had failed in Peru as it had all failed all over Latin America when De Soto went there to live in 1979. He notes that the perception that capitalism harms rather than helps haunts the whole world. Third World and former communist countries have tried to follow the advice of economists from successful capitalist economies, De Soto says, but most have found that they end up worse off that they were before. He points out that capitalist systems have been tried and rejected several times in many Latin American countries. Even in the developed world De Soto observes anti-globalization political protests are beginning to gain momentum.

Indeed, in a November 6, 2000, cover story, Business Week noted that although generally East Asia saw substantial growth, many areas of the developing world arguably had been damaged by global capitalism, including Latin America where income expanded by 75% during the 1960s and 1970s, when the region's economies were relatively closed, but grew by only 6% from 1980 to 2000, when Latin America was opening up, and, in sub-Saharan Africa and the former Soviet Union where incomes have decreased overall after liberalization. 6

De Soto insists that it is not true that the Third World is not moving ahead, pointing out that the number of people in the world who are living on less than a dollar a day has fallen from 55 percent at the end of World War II to 20 percent. In the same period, life expectancy in India has improved from 27 to 67 years, and infant mortality in the Third World is the same as it was in Europe in 1950, he says.7

He adamantly holds that entrepreneurship and aspiration to ownership of property are inherent in each human being and dismisses the argument of Max Weber, who said that cultural values or tendencies predispose certain groups to fail in implementing capitalism, while others, notably Reformed Protestantism, have led to successful capitalism. Disagreeing with Samuel Huntington 8 on one side and Hugo Chavez 9 on the other, De Soto rejects the argument that capitalism requires cultural values that exist only in the West, and not in the Third World and therefore capitalism is doomed to failure in certain countries. “Think of Bill Gates, the world's most successful and wealthy entrepreneur,” he writes, then asks “Apart from his personal genius, how much of his success is due to his cultural background and his 'Protestant ethic'?"10

Of course, Bill Gates grew up in the culture of the United States, but De Soto's point is that Bill Gates's success would not have been possible without the legal property system of the United States: patent law to protect his inventions, enforceable contracts, limited liability laws and insurance policies, property records that fix and store capital, investment financing arrangements that protected and encouraged others who invested in his enterprise, enforceable employment agreements, the legal foundation to allow Microsoft to issue stock options to its

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6 Pete Engardio and Catherine Belton, “Global Capitalism, Can it be made to work better?” Business Week, November 6, 2000.
8 Samuel P. Huntington (1927–2008). American political scientist who some, including De Soto, believe put too much emphasis on cultural explanations for successful development.
9 Hugo Chávez (b. 1954) Current President of Venezuela, socialist and vocal critic of the United States and capitalism.
10 The Mystery of Capital, pp. 223-224
employees, and the laws that allow him to freely designate to whom his empire should pass after his death without hereditary succession.

The Mystery of Capital is organized into a logical sequence of chapters. The first chapter is an introduction, the second though the sixth each describe one of De Soto's mysteries, and the seventh is a conclusion. The five mysteries are: The Mystery of the Missing Information, The Mystery of Capital, The Mystery of Political Awareness, The Missing Lessons of U.S. History, and the Mystery of Legal Failure.

The in the series of mysteries is called The Mystery of the Missing Information. The information De Soto is talking about here includes: What is the address of a certain piece of property? Who owns it? What are the rules that govern property? What is the address of a certain person? In many developing countries in Africa and Latin America, over 80 percent of the people live outside the law. They have homes, but they have no deed, they have businesses but no legal rights. Many are not desperately poor. Some might even be considered wealthy, but if owning real property means having legal title, they own nothing. However they do have possessions. Many possess real estate, but they do not own it the way, for example, the land and improvements that constitute the Nile Hilton are owned. The big hotels in Cairo would certainly be part of the eight percent of Egyptian city property that is properly titled. De Soto mentions the hotel as an example of a piece of property that exists in world of enforceable transactions, where boundaries are marked with physical evidence which is clearly set forth in instruments of conveyance duly recorded in public land records, allowing for mortgages and other opportunities to generate wealth. In other parts of Egypt, and, indeed, in 92 percent of Cairo, the putative owners do not have title. They have what De Soto calls “dead capital,” assets that cannot be used to their fullest because they are not available to be pledged as security.

De Soto estimates that the value of all dead capital in the world is greater than 9.3 trillion dollars. $9.3 trillion, he says, “is about twice as much as the total circulating US money supply. It is 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.” He adds, “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 times as much as all development assistance from all advanced countries to the Third World in the same period.”

12 According to a Hilton website, the company opened the hotel in 1959. It was Hilton’s first hotel on the African Continent. The hotel site was sold in 2008 to a Ritz-Carton related company and after $64 million in renovations, is scheduled to open under the Ritz-Carton brand in 2012. Surely Ritz Carton has clear record title to the property.
13 The Mystery of Capital, p. 16
14 Ibid., p. 35.
15 Ibid.
Speaking of the poor, he writes, “The words ‘international poverty’ too easily bring to mind images of destitute beggars sleeping on the curbs of Calcutta and hungry African children starving on the sand. These scenes are, of course, real, and millions of our fellow human beings demand and deserve our help. Nevertheless, the grimmest picture of the Third World is not the most accurate. Worse, it draws attention away from the arduous achievements of those small entrepreneurs who have triumphed over every imaginable obstacle to create the greater part of the wealth of their society. A truer image would depict a man and woman who have painstakingly saved to construct a house for themselves and their children, and who are creating enterprises where nobody imagined they could be built. I resent the characterization of such heroic entrepreneurs as contributors to the problem of global poverty. . . . They are not the problem. They are the solution.”

In the chapter called The Mystery of Capital, De Soto starts with a quote from Ludwig Wittgenstein about value. Value for Wittgenstein lies outside of what is happening, that is, it is not accidental, it lies outside the world. De Soto uses this quote to show what he, De Soto, sees as being the essential nature of capital: it exists “outside the physical world.” He distinguishes assets from capital. As they are in the developed world, assets are in use in the Middle East, the former Soviet Union or Latin America. They include the houses people live in, their farm land, their tools and their wares. In the developed world, however, assets lead what De Soto calls a parallel existence outside the world as capital. He asks, “Why can't buildings and land elsewhere in the world also lead this parallel life?” His answer is that “[W]e seem to have forgotten the process that allows us to obtain capital from assets.” As a result, “80 percent of the world is undercapitalized; people cannot draw economic life from their buildings (or any other asset) to generate capital.”

The theme of this chapter is the main theme of the entire book. He marvels so much at the thought of it, he says again: “Why assets can be made to produce abundant capital in the West but very little in the rest of the world is a mystery.”

De Soto begins his solution to this mystery by describing what capital is and how is has been explained defined by those he calls “great classical economists.” They include Adam Smith, Karl Marx, Simonde de Sismondi and Jean Baptiste Say. De Soto says that Smith and Marx believed that capital was the engine that drives the market economy. De Soto is fond of this analogy; he says borrowing money on your house to finance an enterprise is like release of hidden energy that results from an atomic explosion. He credits Smith with the idea that specialization is the “source of increasing productivity and therefore ‘the wealth of nations.’” According to De Soto, Smith defined capital as the “stock of assets used for productivity purposes,” adding that the exchange of products leads to more capital being accumulated, more specialization and higher productivity.

Continuing his consideration of Smith’s ideas about the nature of capital, De Soto takes us a little deeper to what he, De Soto, says is “the very heart of the of the mystery we are trying to

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16 Ibid, pp. 36-37.
18 Ibid.
20 Ibid.
21 Ibid.
22 Ibid, p. 41.
23 Ibid.
solve: For accumulated assets to become active capital and put additional production in motion, they must be \textit{fixed and realized in some particular subject} [De Soto's words, including emphasis, then, quoting Smith] '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.'\textsuperscript{24} Admitting that Smith's meaning is open to various interpretations, De Soto moves on, “What I take from him ... is that capital is not the accumulated stock of assets but the \textit{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 what De Soto refers to as Einstein's brick.”\textsuperscript{25}

Exploring the mystery of capital further, De Soto quotes Swiss economist Simonde de Sismondi who wrote that capital is “‘a permanent value that multiplies and does not perish … . Now this value detaches itself from the product that creates it, it becomes a metaphysical and insubstantial quantity always in the possession of whoever produced it, for whom this value could [be fixed in] different forms.’”\textsuperscript{26} Then he cites another early 19\textsuperscript{th} century economist, Frenchman Jean Baptiste Say, who is quoted as saying that capital is “always immaterial by nature since it is not matter which makes capital but the value of that matter, value has nothing corporeal about it.”\textsuperscript{27}

De Soto tells us Karl Marx agrees with Say and then inserts an odd, even disturbing, quote from Marx's \textit{Das Capital} about a table turning on its head. The table begins as wood, “but so soon as it steps forth as a commodity, it is changed into something transcendent. [So far, so good.] It not only stands with its feet on the ground, but, in relation to all other commodities, it stands on its head, and evolves out of its wooden brain grotesque ideas, far more wonderful than

\begin{itemize}
  \item \textsuperscript{24} Ibid, p. 42; Adam Smith, \textit{The Wealth of Nations} (London: Everyman's Library, 1977), former Vol 1, p. 242
  \item \textsuperscript{25} The Mystery of Capital, p. 42. Emphasis in original.
  \item \textsuperscript{*} To illustrate the essential transcendent nature of capital which separates it from physical things, De Soto uses a rather inelegant analogy he repeatedly refers to as Einstein's brick. According to De Soto, 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.” (The Mystery of Capital, p. 40)
  \item \textsuperscript{26} Ibid, p. 43; Simonde de Sismondi, \textit{Nouveaux principes d'économic politique} (Paris: Calmann-Lévy, 1927) p. 81-82
  \item \textsuperscript{**} Note how nicely the counting analogy works!
\end{itemize}
table turning ever was.”28 Apparently table turning has something to do with seances,29 but the words “it stands on its head, and evolves out of its wooden brain grotesque ideas” had even the likes of Jacques Derrida scratching his head. He wrote 13,000 words about Marx’s famous table, concluding, more or less, “In other words, as soon as there is production, there is fetishism: idealisation, autonomisation and automatisation, dematerialisation and spectral incorporation, mourning work coextensive with all work, and so forth. Marx believes he must limit this coextensivity to commodity production.”30 Is that what De Soto is getting at?

Using another energy analogy, De Soto tells us that hidden value of an asset is like the potential hidden energy of a mountain lake. In the case of the lake, its energy may be exploited by a well known process whereby the pool of elevated water is allowed to flow downhill through electric generating turbines. With the asset, its hidden potential is realized by a process which was not previously known, not even in the west, although the west has exploited and has benefitted greatly from the process.** Simply stated, the process is a western-type system of land titling and registration governed by detailed and precise legal rules. This he calls “the formal property system,” where “capital is born”31 — or waiting to be born in the developing countries of the world. He says 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."32

De Soto asks, “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,” he says, “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 extralegal sector—which is where my colleagues and I do most of our research.”

De Soto is claiming that he has discovered special knowledge about capital, a heretofore

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* It is probably not fair to hold De Soto responsible for explaining what Derrida means by this (Could anyone?), but it would seem reasonable to expect that De Soto would have at least provided his own explanation as to how this cryptic passage from Marx instructs us as to what he, De Soto, means about the transcendent nature of capital. This is a not a book about spirits or fantasy and certainly is not an anti-capitalist work.
** This is an ambitious statement. He is saying that he has discovered something previously unknown, even in the west.
31 *The Mystery of Capital*, p. 47.
hidden dimension, and that formal title registration will open that hidden dimension and allow
the full realization of assets as capital, which itself has special powers or the potential to create
more capital and therefore prosperity. Furthermore, he claims that the most of the world's poor
already have the assets they need to be rescued from poverty. Finally, he is saying that all that is
needed is legal reform bringing the laws of developing countries in line with those that have
benefitted from western capitalism and that will solve the problem of poverty. My version of the
book is decorated with endorsements and praise of De Soto and his writing from Nobel
Laureates in Economics, Milton Friedman and Donald Coase, former U.N. Secretary General
Javier Perez de Cuellar, Francis Fukuyama, former U.K. Prime Minister Margaret Thatcher,
former U.S. Presidents George H.W. Bush and Bill Clinton. Clinton is reported to have declared
at the 2004 annual meeting of the World Economic Forum that de Soto was "probably the world's
most important living economist."

De Soto has his critics. Robert J. Samuelson in his review of Mystery of Capital
complements De Soto for his work in this book and in The Other Path, De Soto's first book, in
identifying and documenting the bureaucratic complexity that prevents the poor from entering
the legal economy, but accuses him of "single bullet approach" oversimplification: "He wants to
make property rights – or their absence – the center of everything," Samuelson says.
Samuelson agrees that "some societies, mainly in the United States and Europe, have indeed
developed workable property rights regimes," but, he says, "others, mainly in Africa and Latin
America, have not. The first group has prospered; the second has floundered." As one might
expect from Samuelson, he is pessimistic about the second group, "The world today lacks a
consensus on how to create economic growth because the proven way – capitalism, even
modified by the welfare state – is a peculiar creation of Western culture. It is an approach that, if
not inherently alien to other cultures, is at least unfamiliar and unnatural."

A more comprehensive mostly negative criticism of the book is that of Ghanaian born
and educated economics professor James C. W. Ahiakpor, now chair of the Department of
Economics at California State University, East Bay. Prof. Ahiakpor advocates free markets and
limited government and is a prolific promoter and def
endorer
of Adam Smith,
whom he says De
Soto has misinterpreted. He says "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. According to Ahiakpor, "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." Ahiakpor also criticizes De Soto's idea that bringing dead capital under the formal

35 Ibid.
36 Ibid, p. 211.
37 A short autobiography of Ahiakpor appears in I Chose Liberty, Autobiographies of Contemporary Libertarians,
38 A hiakpor, James C. W., “Mystifying the Concept of Capital: Hernando de Soto's Misdiagnosis of the Hindrance
property system will raise capital. Ahiakpor’s position is that the only way to raise local capital is to increase savings so that there will be money to lend. Making legal titles more secure, he says, does not result in more money being available. In fact, Ahiakpor says the money available for lending would be the same. He says governments should concentrate on making it easier for people to save and that way provide more capital for development.

In his chapter entitled “The Missing Lessons of U.S. History,” De Soto recounts how titling of land played out in 19th Century America, when “it too was a Third World country,” and much of it was settled by squatters, despite the government’s attempts to prevent squatting by legislation, law enforcement and court actions. He says, “The federal government’s efforts to construct an orderly land system could not overcome the will of the common people to assert their right to the national domain.” De Soto provides a synopsis of the legal and political maneuvers of that century, concluding that the massive migration needs of society overpowered established formal law and, in the end, formal law legitimized itself “by ultimately embracing many of the extralegal arrangements of the settlers.” De Soto says, “For Developing and former communist countries trying to make their own transition to capitalism, the American experience is extremely significant. It was not an easy task or a quick one; nor was it without violence. But the American experience is very much like what is going on in Third World and former communist countries. Official law has not been able keep up with the popular initiative, and government has lost control.”

De Soto notes that all the developing and former communist countries have a formal property system. In effect, however, those systems deny access to all but a small percentage of the population. The problem is legal in nature and he mentions that several international treaties, conventions and agreements, from the Universal Declaration of Human Rights of 1948, to the 169th Covenant of the International Labor Office on Indigenous and Tribal People in Independent Countries of 1989, and even the catechism of the Catholic Church, say that property ownership is a basic human right. De Soto says that good lawyers are essential to the promotion and vindication of these rights: “Although entrepreneurs and ordinary people are builders of capital and capitalism, it is the lawyers who fix property concepts in tangible representative form and define those concepts in statutes. The security of ownership, the accountability of owners, and enforceability of transactions must ultimately be concretized in procedures and rules drafted by lawyers. In fact, it is the legal profession that perfects all the artifacts of formal property: titles, records, trademarks, copyrights, promissory notes, bills of exchange, patent rights, shares of corporate stock. Whether you like lawyers or not, no genuine change in the property regime and the capital formation process will take place without the cooperation of at least some of them.”

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41 Ibid, p. 127.
43 Ibid, pp. 148-149.
44 Ibid, p. 150.
This seems to be a great field to get into for a public minded and well trained lawyer. This book and a television program about the work of Hernando De Soto are why I decided to apply to study in the PROLAW program. For thirty years I practiced as a small town lawyer concentrating on the everyday legal work of small town people, including real estate, wills, small businesses, divorce, bankruptcy and some criminal law. As our children became less dependent on my wife and me, I started to think of ways I might make myself useful in some area of public or social interest. I have always done volunteer work in various capacities, usually teaching, but never thought that my legal career might lead to working as a lawyer in another country. I read this book before ever hearing about the PROLAW program. I had watched a television documentary called “The Power of the Poor” about De Soto’s work, did some research, discovered and bought the book and started reading it right away.

There were some things about the book that I had a hard time understanding. Having completed the first semester in the program, some of De Soto's ideas make more sense to me. I am now more familiar with some of the writers he refers to and the special terminology he uses makes more sense. But, I am also more skeptical. After learning about development architecture, going back to the Paris Peace Conference, then Bretton Woods and the founding of the United Nations and all that followed, and after all the reading we have done in our classes about economics and the theories of development, it seems almost impossible that De Soto could have almost single handedly come up with “The blueprint for a new industrial revolution,” as The Times (London) is quoted on the front cover, or that his work could “the most promising antipoverty initiative in the world,” as former President Bill is quoted on the back cover. Yet, there is something about Mr. De Soto's audacity that still keeps me interested. I still do not understand how people being able to pledge as security their homes and land is going to cause an explosion of energy that will rocket the underground economy into prosperity, but I am still willing to listen and maybe even get involved professionally. De Soto has a new book coming soon, *The Peruvian Amazon is not Avatar*, about documenting property rights along the Peruvian Amazon and I am looking forward to reading it.
"The hour of capitalism's greatest triumph," writes Hernando de Soto, "is, in the eyes of four-fifths of humanity, its hour of crisis." In The Mystery of Capital, the world-famous Peruvian economist takes up the question that, more than any other, is central to one of the most crucial problems the world faces today: Why do some countries succeed at capitalism while others fail? In strong opposition to the popular view that success is determined by cultural differences, de Soto finds that it actually has everything to do with the legal structure of property and property... This persuasive book will revolutionize our understanding of capital and point the way to a major transformation of the world economy.