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Special Feature

Securing Property Rights: The Foundation of Markets

THE 1980S WITNESSED a sea change in economic thought and the beginnings of reform in economic policy in countries around the world. In Central and Eastern Europe, shortages of basic goods and economic stagnation hammered home the point that socialism was bankrupt. In developing countries in Africa, Asia and Latin America, policies that echoed socialism—state ownership of enterprises, heavy regulation of markets and economic isolationism—had strangled growth in dozens of promising economies. But while the socialist experiment lay in ruins, no one had yet presented a clear blueprint for market-oriented economic reform.

Peru's Hernando de Soto was one of the first to take up this challenge. In his landmark 1986 book, *The Other Path*, Mr. de Soto identified the barriers to private sector growth that had been invisible to others. The key barrier, he argued, has long been weak institutions. The institutions that make markets function efficiently in the developed world—including contract law, financial markets and respected judicial systems—are too often lacking in countries such as Peru. A casual visitor to Lima can attest to the vibrant markets that exist for local products, but the absence of a solid institutional framework means that the full potential of the

nation's entrepreneurs goes untapped.

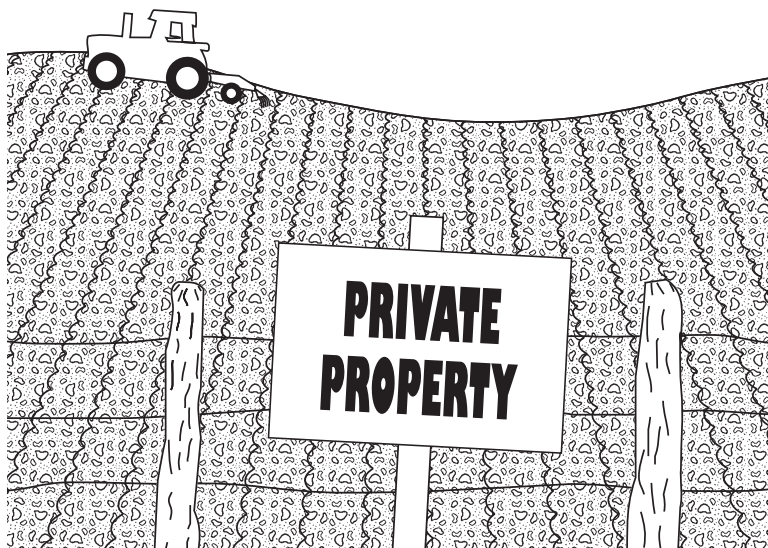
Perhaps the most important—and least noted—of these institutions is property rights. Owners of land, corporate shares and even intellectual property are loath to invest in the upkeep and improvement of their property if their rights as owners are insecure. Just as importantly, if property cannot be bought and sold with the confidence that the authorities will uphold the transaction, the market itself will fail to generate dynamic growth. Indeed, the absence of property rights is one factor that drives people out of formal markets into the informal sector.

The *Other Path* became an international best-seller, and Mr. de Soto's ideas changed the terms of debate on economic policy. In 1987, for instance, CIPE and the US Agency for International Development sponsored a conference focusing on property rights as a necessary condition of economic growth, and representatives from groups in 35 countries attended. By the 1990s, his insights had gained broad acceptance.

Economic Reform Today recently spoke with Mr. de Soto about the institutions policymakers and business leaders have yet to establish to guarantee property rights in the world's emerging markets. As the following interview attests, the labor has just begun.

ERT: When you look at the Western democracies, all of them have strong systems protecting property rights. Is it important for emerging democracies to create such systems?

MR. DE SOTO: I think the first thing that is striking about the Western democracies is that they enjoy property rights. They may have different land-tenure and property rights systems, but they all have one thing in common: they protect the right of people to transact their property rights. It is not only important to



know that if you are the original owner of something, you can enforce this right; but also, that if you decide to sell it, whoever buys it or uses it as collateral for commercial purposes feels secure about the transaction.

In many developing countries or emerging markets, property rights do exist. However, they do not have the complementary legal framework that is present in developed countries and that allows these property rights to become currency. This legal framework provides a kind of scaffolding which allows property to move to its highest valued use with a great deal of security.

In most of the emerging markets from Russia to Latin America, there

are people today who own property that did not before. But the government machinery—the executive, legislative and judicial branches—has not kept up with building the kind of framework and institutions needed to protect property rights.

There is the problem of well-meaning groups who claim property rights do not exist in those countries simply because they aren't there in legal terms. These groups in countries such as yours, which I'm sure have the best intentions, wish to protect indigenous property rights.

However, they do not realize that in many cases what they are talking about is protecting or promoting the sovereignty of a special ethnic group, not property rights. This results in a needless confrontation between the protection of sovereignty of an ethnic group and the property rights of individuals within such a group.

In short, the important thing is whether there will be enough political savvy in emerging markets to create the legal framework that protects private property rights. These do exist in most countries, though maybe to a lesser extent in hunter-gatherer societies. So the first step is one of discovering which property



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rights exist. The second is to learn from the evolution of the various models used in the Western world and how organizations were created so as to best organize and protect these rights legally. Many of these systems were spontaneously generated over many centuries and have existed over the last 50 to 200 years.

ERT: How would you describe the relationship of strong systems of property rights to democratic institutions?

MR. DE SOTO: The relationship between the two is very strong. Democracy has a lot to do with establishing a good system of property rights in the sense that it's not really possible to build such a system unless you know how people think about their relationship to objects, land and assets at the grassroots level. Only after you do this can you incorporate property rights into a body of law that is truly effective.

In the United States, for example, throughout the 19th century and the beginning of the 20th century, there were various mechanisms that recognized the role of pioneers in staking out land claims even though initially the country didn't have a legal framework for them. Instead of keeping with the British tradition which accepted what the king and judge made law, the US government accepted that people on the ground had their own ways of settling many property issues and had effectively built local social contracts. As a result, an effective nationwide property rights system was set up that worked, but not using the law brought over from England. Instead, it was built on a system of grassroots democracy and principles of equity that flowed from the fact that a lot of poor people in the US went out and staked claims which were basically approved by the majority of the population. That's why they stuck.

The preemption acts and occupation of lands via adverse possession

were nothing other than the US government (including the legislative and judicial branches) continually backing away from imported law and recognizing the emerging rights of squatters in Texas and gold-rush miners in California, for example. Yet, these new claims had a legitimacy the old laws didn't have. The preemption acts, in effect, legally recognized that what the people had created was probably stronger than an old parchment title that had been in place before. If democracy is government by the people, it means among other things that people's social conventions are being acknowledged and protected. It means a country is in touch with evolving conventions, and has gradually woven these property rights into a more sophisticated and far-reaching social contract.

That type of democracy doesn't exist in countries like mine. But what may be more instructive for people from emerging markets is to look into the history of the US to understand what state of development they are in, and what democracy means, rather than looking at the US at the end of the 20th century when all the underpinnings for strong property rights and democracy are already in place but are also, unfortunately, invisible.

As for Latin America, for the last 170 years we've been trying to become like the Western democracies, and we've been failing for 170 years. We have systems, for example, to elect a political party, bring a government to power, etc. But our democracies do not have in place mechanisms similar to the US preemption acts, homesteading and recognition of existing arrangements among common people regarding land and assets. What we've done instead is to simply import a legal system that tells us that, regardless of what the existing local conventions are, property rights are determined by prefabricated legal structures from alien social contracts that developed from different realities and contexts.

ERT: Why have past efforts, particularly by international donor agencies, failed to result in broader ownership of land titles in emerging democracies? How can you see future efforts generating a better track record in this regard?

MR. DE SOTO: If you look at the inventory of failures and successes—as ILD has, with a lot of help from CIPE over the years—there are various reasons why international donor agencies have failed to promote broader ownership of land titles.

The first problem is that they have failed to realize that we are not at the same historical point as the US. As a result, when they come to countries such as Peru, they emphasize the role of time-consuming and expensive activities, such as photogrammetry, fine maps and electronic organization of the existing information. All the equipment and detailed maps are useful, but they do not clarify the actual situation of who owns what because who owns what and what rights they have to trade it or use it are basically determined at the grassroots level and not by graphical or computerized documentation. This information can be determined only by political and legal means. Only once these are in place can the equipment be put to good use.

As I said earlier, property is a type of social contract between people, and it is a very political thing. There are places, for example, where people really do have a sense of community regarding grasslands to be used to pasture animals and which can't be parceled off. Other cases may involve public grounds in towns and cities to which people may have accepted temporary usage rights. By contrast, most of the projects done by international donor agencies emphasize the technically-driven aspects of making boundaries more precise rather than finding out what the existing social contracts regarding land ownership are. Too many experts forget that before the West

had computers and photogrammetry, people had already agreed on property rights.

A second problem is the tendency of many donor agencies to work directly with existing property registries which don't reflect what's actually happening. In Peru, for example, you will find a total mess if you look only at the registries. Many of the registered titles are not valid because the country has been titled and re-titled (with and without foreign assistance) over forty times. As a result, there are sometimes dozens of titles per parcel of land, and the question remains, Which of these titles are the ones that really count? This is especially true when someone inadvertently wakes up a dormant title, which is what happens when some so-called experts unwittingly trigger expectations by breathing life into ignored statutes, which may be perfectly legal on paper, but have been effectively substituted by much stronger conventions.

In short, property means not simply honoring pieces of paper just because they exist. First, law changes over time, and the genius in creating property rights lies in determining the current social contract regarding rights to a particular asset, then building on that reality. This is what happened in Japan after the Second World War when the American occupation forces respected the rights determined at the grassroots level by the Japanese themselves as the source of law.

In short, the problem with many donor agencies is that they have missed the point altogether: that property is a living thing, and is incorporated in social conventions that have a lot to do with democracy. This is not to say we don't need surveying, mapping and computers that enable us to process data better. The problem in Latin American countries and the former Soviet Union, for example, is that the machinery may be in place, but they lack the mecha-



Hernando de Soto

Hernando de Soto is president of the Institute for Liberty and Democracy in Lima and director of several Peruvian companies. He has worked as managing director of Universal Engineering Corporation, as a member of the Swiss Bank Corporation Consultant Group, and as a director of Peru's Central Reserve Bank. He was also President Alberto Fujimori's personal representative and principal advisor, and as such initiated Peru's reinsertion into the international economic system and its macroeconomic reform programs in June 1990.

nisms required to locate, decode and systematize the crucial information people at the grassroots level have about who owns what and what their basic rights are. The only good solution is to be able to pick up on what people have already spontaneously created.

ERT: *Would it be possible to repackage the type of work that different donor groups have done, or is this too complicated a process to put it on the right track?*

MR. DE SOTO: First, as I said before, donors must recognize that in our countries, aside from the written law, there is often unwritten law which is much stronger because it is recognized by most of the population. If the advisors are helping to write new laws, they must make sure these laws actually reflect what people believe. They must structure the laws

on the basis of the existing social contract so that people obey them and they thus become enforceable. Otherwise, what you are doing is simply strengthening the paper rights of those people who have political power or privileged access to the judicial system versus the rights of those people who actually own the land and whose ownership is generally respected.

Every time a donor comes in and decides to fight for what's on paper because that's what he finds when he opens the books, he may be bringing back to life outdated political charters which, in many of our countries, no longer reflect who are the real owners of land and other assets. For example, if the US had sent in a technical mission to Japan after the Second World War whose only task was to modernize the system of land record keeping, surveying and mapping, the end result would have been to reaffirm the rights of feudal lords over the land when, in fact, during the previous four hundred years, the real rights over land were held for all practical purposes by small farmers, although their feudal lords taxed them heavily.

I'm rather pessimistic as to just how much can actually be done unless donors become fully aware that one of the most marvelous things that occurred in most of the European countries and the US during the 19th century was a huge property revolution. What used to be patrimony—that is, assets that belonged to only a few families—was converted into a modern property rights system where assets became accessible to everyone and easy to transact.

For the moment, of course, the big issue in most emerging markets is that the majority of people live, work and use land for which they have no legal title even though their neighbors recognize it is theirs, and governments wouldn't even dream of tampering with that land. Without such a title, however, there is no way to build a system of securitization

that gives them access to credit or water, telephones or electricity. Private companies can provide these services only as long as the fundamental risks of doing so can be largely controlled.

That is the key problem for us today. However, many of the experts who work with the donor agencies instead transferred to our countries issues that are not the most important to our countries—at least not for the moment. Take the case of intellectual property rights. How can you explain to someone who has no legal property rights over something as tangible as his home that he cannot replicate a brand-name watch in his workshop or that if he creates a song, he has exclusive rights to it and that it can't be duplicated or plagiarized? Intellectual property rights are crucial, but unless they are brought about in a context meaningful to the majority, they will be very difficult to enforce.

So I would recommend that donors accept they may have lots more to learn about what's happening in our countries at the grassroots level before some of their assistance may be useful. They also must accept that many convoluted political processes in Latin America, Asia or the former Soviet Union occur because some state organizations are way behind the reality at the grassroots level.

ERT: You have worked for many years trying to make it easier for informal sector businesses to register their enterprises and become legitimate. How successful have your efforts been in lifting the standard of living of people in the informal sector, and what needs to happen to push that process forward?

MR. DE SOTO: The first thing to remember is that the projects we did with CIPE had very low budgets if you think in terms of what other countries have spent and yet have few results to show for them.

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Second, these programs were really private ones, and the results have been impressive.

During President Fujimori's administration, registered titles to over 300,000 plots of land have been awarded. Production on these titled properties has risen by about 40% compared to properties which were not titled and registered. About 25% of the owners now have access to bank credit since they can use the titles to guarantee their bank loans. Although some of them had access to credit before from microenterprise organizations and small banks, most had to rely on loan sharks who charged them extremely high interest and other charges. Meanwhile, the value of homes in urban areas has increased by an average of 200% since they were titled and registered three years ago, and their value will continue growing.

We have brought over 276,000 enterprises from the informal sector to the formal one. This was done by re-engineering the whole process and cutting the delays and red tape for

entrepreneurs to legally register a business from about 300 days to less than a day. The weight of the process is now on the bureaucracy rather than on the business owners. Now that these enterprises are in the formal sector, the government is collecting hundreds of millions of dollars more in taxes than before. These enterprises are also employing more people. Over 500,000 new jobs have been created just with this process because now that people own legal businesses, they can advertise and don't have to pay bribes for protection.

The land titling and business registration process has been so successful that the Fujimori government has decided to expand it since it has helped Peru achieve one of the highest growth rates in the world. These programs, which were carried out largely in the Lima area, are to be reinforced and adequately financed so they can cover the whole national territory by the year 2000 or thereabouts.

ERT: In the last issue of ERT we explored the impact of privatization in emerging markets and the work that remains to be done. Do you see a way that stronger property rights and privatizations can be accomplished in tandem?

MR. DE SOTO: I don't see privatization schemes actually working unless you finally settle the property rights issue. There are several reasons for that, as the experience of Latin America shows. We began privatization a long time ago. Even our railroads used to be privately owned by the British, and we had seven consecutive waves of privatization efforts between the 1820s and the 1990s. But we always swung back to renationalize the assets that were privatized.

Today, many people in the region accept, sometimes very grudgingly, that our governments have to privatize because they are broke and must reduce the public deficit because it

produces unbridled inflation and debt. But the whole process hurts the people after a while if they don't understand what's going on. Giving away property to Enron, General Electric, British Gas, or whatever other company may just look to them like handing over sovereignty or creating a foreign enclave. For a person to understand that private property is a good thing and that a foreign company can get rights to it, he must have an opportunity to get private property as well.

The first thing then is to formalize the social contract at the grassroots level so that everybody can understand what property rights are about, and then to understand the distinction between sovereignty and property rights. Governments have to show that they are not giving up sovereignty, but only rights to companies to run enterprises and services privately in everyone's best interest.

The next thing, of course, is to ensure that everyone benefits from privatization. In other words, if I see a private company coming in, having access to credit, electricity and clean water while I'm not getting any, I will resent that situation unless I too have private property that I can use to get the same things. Once I too have a chance to own private property or know that I have a possibility of acquiring it, I will not resent privatization because I'm basically part of the process. We have already seen the connecting links between property rights programs for the majority and successful private investment in infrastructure projects whether they be independent power producers and/or utilities involved in the distribution of energy and water.

In short, I don't think many privatization programs are durable unless property rights or access to property rights are available to everyone in countries such as mine. If they are not, there will be nationalist backlashes, and politicians who depend on the public's vote will be tempted

not to respect privatization contracts they have signed. Unfortunately, there are many examples from history to buttress my point of view.

ERT: Recognition of collateral is at the root of the financial system of every country in the West. How do you see better recognition of property rights in this regard dovetailing with efforts to bolster financial systems in emerging democracies?

MR. DE SOTO: Clear-cut property rights are indeed essential since you can only pledge collateral if you own something. If you give somebody a valid, respected, secure property title, it's really the first step in the securitization process. Let's take the US as an example. I understand that asset-based securities account for about \$4 trillion of the \$13 trillion in its financial markets. These asset-based securities in the end all rest on mortgages and the rediscounting of mortgages. There are other mechanisms that make this whole system more secure, including national mortgage intermediaries like Ginnie Mae, Fannie Mae, Freddie Mac and others that help create secondary markets. But what is at the bottom of these mechanisms is the fact that somebody who owns land or other private property can pledge it as collateral. This engenders a great deal of the capital markets in the US and even anchors the rest of its financial system.

By contrast, in countries such as Peru and probably most of the former Soviet Union, over 70% or 80% of the people cannot be linked legally to a piece of land or real estate. Therefore, the first stages of what you can call securitization—turning illiquid assets into liquid ones—is the process of formalization, which in turn leads to the creation of collateral essential to establishing large financial markets.

The US began moving in this direction in the 19th century by first creating county land registries. It then compensated for deficiencies in the regis-

ters through the creation of title insurance companies and legal conveyances in titles which guaranteed there were no defects in the title, thereby making unmarketable property marketable. As a result, in the US today a house is shelter, land can produce agricultural goods, and a tractor allows its owner to reap the wealth of the land. But these assets are also capital because one can use them as collateral to obtain and create capital, and that's because title to them can be clearly determined. The property title reflects a social contract that is respected by everyone.

While real estate accounts for some 45% of the assets of families in the US, it represents anywhere from 70% to 80% of the assets of Peruvians. But since it is not duly securitized in Peru by a good property formalization system, there is no way a country like Peru can build a mortgage market or a capital market that will allow it to prosper. This also is the reason why the country continually has to obtain international financing.

ERT: What can businesses in the US and other Western countries do to help establish stronger mechanisms for protecting property rights in emerging democracies?

MR. DE SOTO: There are many Western businesses that have the know-how to be able to do this. I just don't think they've become aware of the opportunities in emerging markets, and how to take advantage of them. The market for their services, however, could be equivalent to over 40% of the GDP of countries that don't belong to the OECD. These companies could also enjoy higher profits in emerging markets than those they typically earn in the industrial nations.

Again, the US is a good example since the consumer credit revolution and the so-called non-bank banking started there. It began first with the establishment by the large manufacturers, such as General Electric and General Motors, of basically their own

financial affiliates to extend credit to cash-poor consumers in order to sell more dishwashers, refrigerators, cars, etc. These affiliates created mechanisms to collect credit more effectively and also to securitize it. More recently, the credit revolution has gotten a major boost with the establishment of credit-rating systems such as TRW that use information technology and automated systems to facilitate a person's ability to obtain financing. Poor people can even go to companies such as The Money Store to obtain credit, and this credit revolution has now reached the point where experts such as Robert Litan, now at the US Office of Management and Budget, are documenting how these new credit organizations are starting to displace the traditional big banks or forcing them to merge.

All of these kinds of second-tier providers of consumer credit have developed numerous mechanisms to mobilize the assets of relatively poor people and bring them into the financial markets. Some of these institutions also are able to buy small debts, consolidate them and thus convert them into solid paper that can be traded in the financial markets.

The problem with these consumer credit institutions is that most of them are not internationally oriented. The traditional bankers also must reorient their activities not only to serve governments and their usual wealthy private customers, but also to get to know and service the average consumer as they have learned to do so well in the US.

ERT: Do you see a role as well in this process for the whole title insurance industry and other institutions in the US

The property title reflects a social contract that is respected by everyone.

that are involved in helping people obtain secure titles to their property?

MR. DE SOTO: Definitely. These kinds of organizations and the bankers that are familiar with their techniques can indeed play an important part in emerging economies. One of the reasons is that many of the conditions in these economies today are more similar than they think to the environment in which these institutions were born in the US. I don't know of other organizations which are more aware and have more tools to assist emerging markets in this effort than those in the US. I would include in this not only title insurance companies but also mortgage and commercial banks, insurance

companies and other businesses that help build a country's infrastructure.

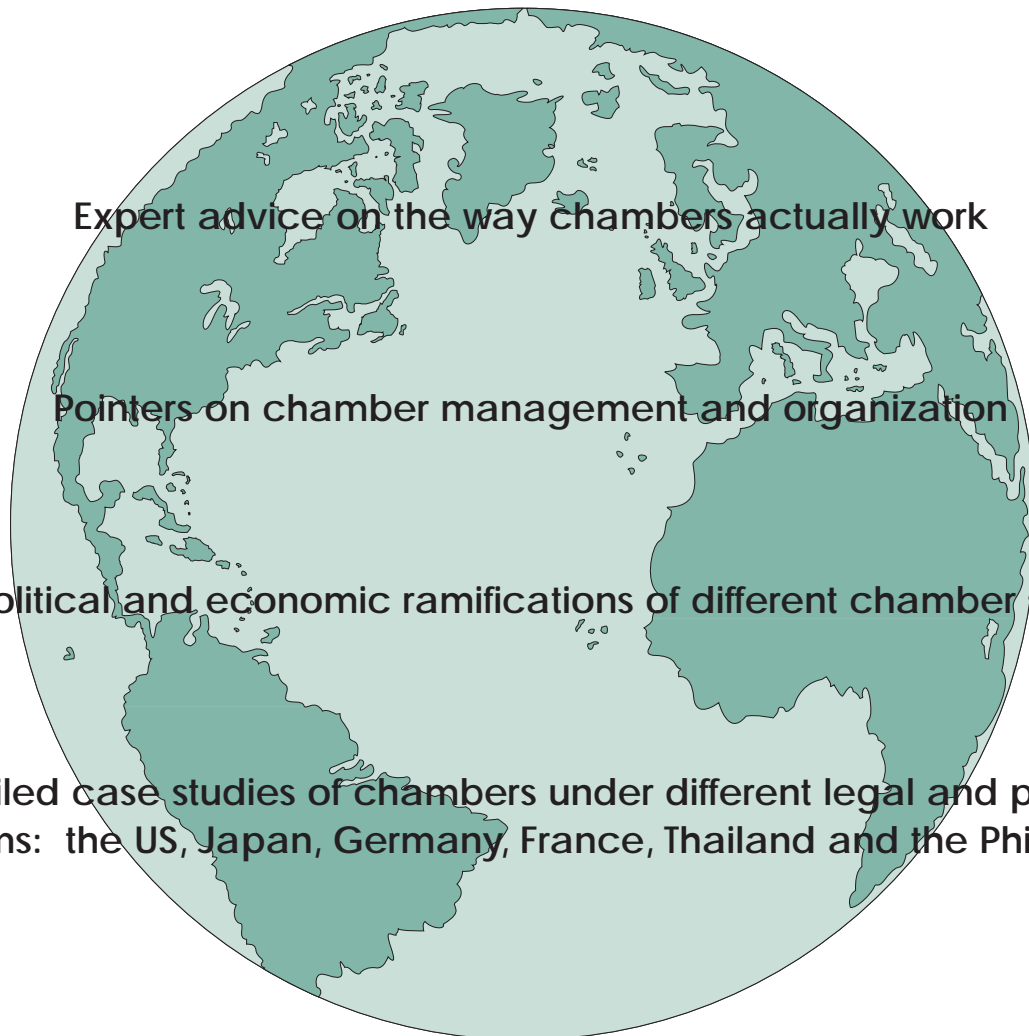
The challenge they face is not a small one, however. One of the main reasons is that generally most of these companies have not yet seen the connecting links between property rights and their businesses nor where the cash collection points are. Moreover, they tend to be very domestically oriented and rely on fuzzy criteria for risk analysis in foreign markets and Power Purchase Agreements that are totally oblivious to the necessary association of their rights to those of the final consumers who, after all, will always be the primary concern of the governments they contract with.

It also takes time because you must first understand what formalization is about (converting the informal into the formal). But if these US industries don't internationalize, other organizations that may not have their know-how and expertise will move in and take away from them the opportunities opening up in emerging markets.

Another thing to remember is that the whole US economy would also benefit if its insurance and credit companies worked in these areas abroad. They would not only help enormously with what the emerging markets need to do in terms of property rights, they also would do wonders for US business working in these markets. Insurance firms as well as consumer-credit organizations would be able to make the process of investing and making money overseas a much more secure and fruitful endeavor than it is today for many other kinds of US companies, especially in infrastructure. 🌐🌐

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