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Capital Demystified*

In an important sequel to his earlier work on the role and importance of informal and extralegal economic activity in underdeveloped countries, Hernando de Soto describes the lack of clear titles to the land on which the masses of the urban poor in these places live and work. His assertion that this is the major barrier to broad-based development in such places is convincing.

Economists have long struggled to determine why it has been that some parts of the world have lagged behind others. Many of these explanations, such as endowments of natural resources, the "Protestant ethic," or the simple fact that, in colder climates, people have to save for the winter season, have been controverted by facts or shown to have little practical application. Adam Smith's analysis in *The Wealth of Nations*, which was one of the first, would seem to have withstood the test of time and experience the best.

Indeed, since the collapse of communism there are few who overtly challenge Smith's finding that nations flourish when their citizens are allowed to buy and sell freely with one another. Much of what used to be called the second (the formerly centrally planned economies) and the third world (the underdeveloped countries) have established democratic regimes. These have moved to end price controls, official monopolies, onerous regulations and to open their borders to imports and foreign capital investment.

Yet, in nearly all these places the prescription isn't working very well. Glittering office towers and shopping areas may have appeared, but not far away the hovels of the very poor become ever more crowded and squalid. Harried officials from the IMF and World Bank scurry from financial crisis to financial crisis, meeting in first world surroundings of the luxury hotels and air conditioned offices with little to show for their efforts. Hernando de Soto thinks he knows why.

Mr. de Soto's latest book is subtitled "Why Capitalism Triumphs in the West and Fails Everywhere Else." The author is President of the Institute for Liberty and Democracy, headquartered in his native Peru. In many ways *The Mystery of Capital* builds on his earlier work *The Other Path,* which was an influential best seller in Latin America. In that book, Mr. de Soto concluded that the key to economic growth and to the betterment of the lot of the poor was to accept and even encourage their efforts to make a living in the "informal" sector, and to end the harassment of entrepreneurial efforts with bureaucratic regulations. The following passage is a good example of his approach.

> …my research team and I opened a small garment workshop on the outskirts of Lima, Peru. Our goal was to create a new and perfectly legal business. The team then began filling out the forms, standing in the lines, and making the bus trips to central Lima to get all the certifications required to operate, according to the letter of the law, a small business in Peru. They spent six hours a day at it and finally registered the business—289 days later. Although the garment workshop was geared to operating with only one worker, the cost of legal registration was $1,231—thirty-one times the monthly minimum wage. To obtain legal authorization to build a house on state-owned land took 6 years and eleven months, requiring 207 administrative steps in fifty-two government offices. To obtain legal title for that piece of land took 728 steps. We also found that a private bus, jitney, or taxi driver who wanted to obtain official recognition of his route faced twenty-six months of red tape.
>
> My research team, with the help of local associates repeated similar experiments in other countries. The obstacles were no less formidable than in Peru; often they were even more daunting.

Mr. de Soto, and many others, long ago concluded that "red tape" does not stop people from economic activity, it only drives such activity outside the official purview—rendering it "informal" or "extralegal"—where it is less efficient and results are less assured. The author persuasively argues that those operating in extralegal sectors do not do so to evade taxes but rather because they are shut out from formal legal processes. The costs of doing business in the informal sector, mainly from restricted access to credit and payoffs to criminal elements, may in fact be higher than in the legal sector.

The focus of *The Mystery of Capital* is that the poor in these countries have very uncertain legal title to the real estate where they live and work. This finding is far from unique. There have been many "top down" land reform programs to change this. Land reform has had few successes and many failures. Mr. de Soto concludes that this dismal record reflects the "experts" ignorance and denial of the very real rules and procedures that the poor have developed on their own to provide themselves with some security of tenure. According to the author,

> In Haiti, for instance, no one believed we would find documents fixing representations of property rights. Haiti is one of the world's poorest countries; 55 percent of the population is illiterate. Nevertheless, after an intensive survey of Haiti's urban areas, we did not find a single extralegal plot of land, shack, or building whose owner did not have at least one document to defend his right—even his "squatting rights."

These claims typically parallel the official legal structure, but usually are not

* This article is a review of *The Mystery of Capital,* by Hernando de Soto, New York, 2000, Basic Books, 276 pp. with index, $27.50 hardbound.

recognized beyond a very limited area (i.e. by anyone not residing in the vicinity). Mr. de Soto argues persuasively that they must be made a part of any successful effort at reform. Aerial mapping, and computers and other modern gadgetry can only supplement, not replace, plot by plot determinations of who is occupying and using particular parcels with the general agreement of his immediate neighbors. This process will perforce vitiate some claims and titles that currently are recognized by the official legal system, but not "on the ground."

We *norte americanos* should not be too upset about this, or too smug about our own historical record. The author provides a fairly lengthy description of land tenure disputes in U.S. history. As settlers poured through the Alleghenies "The political and legal establishments were caught between their allegiance to formal law and their sympathy to the settlers." The latter were building homes and farms in the wilderness on public lands and also on lands held by private absentee landowners in large tracts.

Between 1785 and 1890, the United States Congress passed more than five hundred different laws to reform the property system, ostensibly based on the Jeffersonian ideal of putting property into the hands of private citizens. The complicated procedures associated with these laws, however, often hampered this goal. To confuse matters further, individual states developed their own rules of property and land distribution that largely benefited and protected only their own propertied elite. As a result, attempts to reform the property system only served to highlight the nation's land difficulties while making migrants extremely wary about losing what semblance of title they may have possessed.

De Soto mentions the history of "Claim Associations" (and later "Miners Organizations") as extralegal ways that titles and claims were protected by those on the frontier, and finds close parallels with what he has found in his research around the world. In the United States, we eventually found ways to establish clear titles, and these ways usually favored those who were occupying the land. This is what the author is advocating for the countries he has studied.

The author states that "With legal property the West had the key to modern development; their citizens now had the means to discover, with great facility and on an ongoing basis, the most potentially productive qualities of their resources." He identifies five other salutary effects of formal property systems, including integrating dispersed information in one system, making people accountable, making assets fungible, networking people, and protecting transactions. What these appear to boil down to is enabling people to obtain credit on the security of their property, to enforce contracts involving property, and to respect the property rights of others.

Many things have been identified as prerequisites for economic development, and the "rule of law" is on most short lists. De Soto's central assertion, "Respect in Western nations for property and transactions is hardly encoded in their citizen's DNA; it is rather the result of having enforceable formal property systems," may seem a little overblown. However, just as Adam Smith had little to say on monetary issues because he was writing at a time when sound, commodity-based currency was the norm, the development experts of today may well ignore the essential point of a rule of law. We may well be blind to the central significance of the mundane activities of the registrars and clerks, who record property transfers and liens, to the day-to-day functioning or our economic system. We take them for granted. De Soto's book is a welcome and important reminder that this is all too often not the situation around the world. ❑

A Surprise Revolution

Before 1950, most Third World countries were agricultural societies organized in ways that would have made an eighteenth-century European feel right at home. Most people worked on the land, which was owned by a very few big landlords, some of them indigenous oligarchs, others colonial planters. Cities were small and functioned as markets and ports rather than industrial centers; they were dominated by tiny mercantile elites who protected their interests with thick wrappings of rules and regulations.

After 1950, there began in the Third World an economic revolution similar to the social and economic disruptions in Europe in 1800. New machines were reducing the demand for rural labor just as new medicines and public-health methods were cutting the rate of infant mortality and extending life spans. Soon hundreds of thousands of people were trundling down the newly built highways to the cities so alluringly described in the new radio programs.

The population of the cities began to rise rapidly. In China alone, more than 100 million people have moved from the countryside to the cities since 1979. Between 1950 and 1988, the population of metropolitan Port-au-Prince rose from 140,000 to 1,550,000. By 1998, it was approaching 2 million. Almost two thirds of these people live in shantytowns. Experts were already in despair over this surge of new city dwellers as early as 1973, long before the largest influx had taken place. "Everything happens as if the city were falling apart," wrote one urbanist. "Uncontrolled construction, anywhere anyhow. The sewage system is incapable of helping drain rainwater and stuffs up every day. The population concentrates in defined areas where no sanitation infrastructure is provided.... The sidewalks of the Avenue Dessalines are literally occupied by small vendors.... This town has become unlivable."

Few had anticipated this enormous transformation in the way people lived and worked. The fashionable theories of the day about "development" sought to bring modernity to the countryside. Peasants were not supposed to come to the cities looking for the twentieth century. But tens of millions came anyway, despite a backlash of mounting hostility. They faced an impenetrable wall of rules that barred them from legally established social and economic activities. It was tremendously difficult for these new city people to acquire legal housing, enter formal business, or find a legal job.

— from *The Mystery of Capital*

COME A CROPPER

During fiscal year 2000, the U.S. Department of Agriculture (USDA) distributed a record $28 billion in direct payments to farmers and ranchers, accounting for roughly half of U.S. net farm income for the year. The decision to buy land and machinery, hire workers, plant crops, and sell food should be based on economics, not politics.

Most governments around the world intervene in agriculture. The reasons for doing so may differ, but the intent is always the same—to promote one group's interests at the expense of another's.

In many poor countries, for example, it is the urbanized population that the politicians favor and food prices (and farmers' incomes) are kept artificially low. The end result, of course, is that people flee to the cities and too little food is produced. In Africa, where this practice has been common, many countries that were once food exporters have experienced consistently declining per capita food production throughout the post-colonial period. As a result, such countries have often had to import food or endure famines, and their economies have stagnated or declined.

In richer countries, governments have intervened on behalf of farmers at the expense of taxpayers and consumers. One argument usually given in favor of this is that neither the farmer nor the consumer should be subjected to the inherent violent price fluctuations associated with short-run market price adjustments for foodstuffs. It is also commonly argued that market intervention is required to thwart domination of the industry by large monopolistic "agribusiness." Lastly, populist-minded agrarians, who view "family farms" as microcosms of all good things in life, passionately advocate agricultural subsidies in order to keep people "down on the farm."

Farm Program Payments and Distribution

In the United States, direct government payments to farmers and ranchers will reach a record $28 billion this year. This amount was roughly half of the forecasted net cash farm income for the year, but the $28 billion does not include the billions more in indirect assistance delivered in the form of subsidized loans, loan guarantees, subsidized insurance, and various tax breaks. The bulk of direct payments are disbursed through three programs: production flexibility contract payments, loan deficiency payments, and emergency supplemental appropriations. (See Table 1.)

Prior to 1996, farmers who agreed to acreage restrictions could get income support payments when crop prices were low. This policy, however, had a fundamental drawback. Rather than producing for the market, supply management encouraged farmers instead to produce for the program. In order to "decouple" income support to farmers from planting decisions and market prices, the 1996 Farm Bill allowed farmers to sign up for production flexibility contracts whereby producers would receive seven annual fixed but declining payments through 2002. The legislation—dubbed the "Freedom to Farm Act"—was heralded on two counts. Besides eliminating planting restrictions on farmers, total spending for the seven-year program was capped at $35.6 billion. Most notably under the new policy, payments were scheduled to end after 2002, which was supposed to be the start of an era of market-based agriculture.

Loan deficiency payments compensate farmers for the difference between posted county crop prices and government crop loan rates, essentially establishing a minimum per-unit revenue for the commodity. When the posted county price falls below the program loan rate, LDP payments track the decline in cash receipts. Continued low commodity prices pushed 2000 LDP levels to $7.6 billion, an increase of 29 percent from the previous year.

Legislation passed by Congress in June authorized $15.1 billion in additional federal aid to farmers, marking the third consecutive year of emergency supplemental appropriations. Total emergency assistance for the last three years has amounted to $25 billion.

According to the USDA, 41.6 percent of all farms received government payments in 1999—up from 36 percent in 1998. Payments for those operations receiving government support averaged $16,751, amounting to 13 percent of gross cash income earned by these farms.

Although all farm "typology" groups receive government payments, participation rates and the share of program payments vary markedly. For example, as Table 2 shows, less than one-third of "limited-resource farms" with gross sales of less than $100,000, total farm assets of less than $150,000, and operator household income of less than $20,000, received payments. But payments went to four-fifths of farms in the "farming occupation, higher sales" and "large family farm" groups.

In absolute dollar terms, larger operators received far more support than smaller farmers, but payments to smaller farmers represented a greater share of their gross cash farm income. For example, "very large family farms" received an average

Table 1
Direct Government Payments
(Billions)

	1996	*1997*	*1998*	*1999*	*2000*
Production flexiblity	6.0	6.1	6.0	5.0	4.9
Loan deficiency (LDP)	na	na	1.8	5.9	7.7
Conservation Reserve (CRP)	2.1	2.0	1.6	1.9	2.0
Emergency assistance	0.0	0.0	2.8	7.8	8.9
Total	8.1	8.1	12.2	20.6	23.5

Source: *USDA*, 2000.

Table 2
Distribution of Government Payments

Category	*% of Farms*	*% of Sales*	*% Receiving Payments*	*Average Payment*	*% of Gov't Payments*
Small family farms					
Limited resource	6	1	29	$ 3,924	1
Retirement	14	2	33	5,061	3
Residential/lifestyle	43	7	28	5,016	9
Farming occupation					
Lower sales (<$100k)	22	10	52	8,833	15
Higher sales ($100k-250k)	8	17	81	27,022	25
Large family farm ($250k-500k)	4	15	81	50,790	21
Very large family farm (>$500k)	3	35	69	85,208	22
Nonfamily farm	2	13	46	34,128	4

Source: *USDA*, 2000.

payment of $85,208, whereas "limited resource" farms received just under $4,000.

The largest portion of government payments goes to "farming occupation, higher-sales" farms (farms with sales of between $100,000 and $250,000). This outcome is a result of a combination of factors, including the share of all farms in this group (8 percent), the fraction receiving payments (81 percent), and the average payment ($27,022).

Operations specializing in cotton received by far the highest average payment, $78,638, of any commodity specialization. Although cotton producers in northern Texas where particularly hurt by drought, the bulk of support was to shore-up low domestic prices.

What Crisis?

Despite a seemingly endless portrayal in the print and broadcast media of struggling farmers, the farming sector today is financially strong overall. Average farm household income was $64,347 in 1999, slightly greater than nonfarm household income of $56,827 (married-couple family). Like many households, farm households generate income from a variety of sources. Earnings from farming make an important income contribution for households operating larger farms. However, these larger farms make up less than 10 percent of all farms. Farm earnings contribute a small share of household income for a large majority of farm operators. According to the USDA, 85 percent of what it considers to be farm households are not greatly affected by changes in farm sector income. This is not surprising; of "small family farmers," 43 percent reported a major occupation other than farming, and another 14 percent indicated that they were retired.

The USDA currently classifies 4.5 percent of farm businesses as being in a "vulnerable" financial condition based on a combination of income and solvency measures. (A farm is "vulnerable" if it has negative income and a debt-to-asset ratio exceeding 0.4) The share of vulnerable farms has remained in line with the share reported in each year since the 1996 Farm Bill was passed. Moreover, the share of farm businesses considered to be in a "favorable" financial position (positive income and a debt-to-asset ratio below 0.4) reached 68 percent.

Proponents of government support to farmers would argue that the current financial landscape in the agricultural sector would look quite different if not for a strong safety net. Four consecutive years of large harvests and large existing supplies of field crops, along with a high volume of output from foreign competitors, a strong dollar, and weak export demand, have kept prices down. In addition, farmers and ranchers are facing higher interest, labor, and fuel expenses. Without assistance, farm income would have plunged to levels not seen since the farm financial crisis of the 1980s, and thousands of farmers would have been forced out of business.

However, it has never been the prosperous operators that have left agriculture but rather those who were earning less than they could in other pursuits. Increasing productivity has always involved "squeezing out" marginal producers, a process that has been underway for most of U.S. history.

Thus, the major effect of government farm policy has been to perpetuate overcapacity by sustaining farmers who should stop farming. For the 10 years beginning in fiscal 1990, farm revenue and income support mechanisms are estimated to have totaled $100 billion. The record payments to farmers are propping up land values where federal payments constitute a large share of gross cash receipts. Land prices will continue to reflect anticipated benefits from federal subsidies. The decision to buy land and machinery, hire workers, plant crops, and sell food should be based on expected returns from farm production, not in expectation of a windfall from Government nor in anticipation of appreciating land values. In other words, farming, like any commercial activity, should be based on economics, not politics. Expanding or extending the current policies will only come a cropper. ❑

Although it has been argued that subsidies to agriculture in the U.S. are unjustified, these subsidies are quite modest in comparison with subsidy levels in other countries. The table below shows the "Producer Support Estimate" (PSE) and "Consumer Support Estimate" (CSE) for several selected Organization for Economic Co-operation and Development (OECD) countries.

The PSE is the value of gross transfers from domestic consumers and taxpayers to support agricultural producers resulting from a country's agricultural policies. For example, in 1999 Switzerland's amount of public support to agriculture was larger than the amount of value added to the sector by farmers. The CSE is the value of gross transfers to consumers arising from policy measures, which support agriculture. When negative, the CSE is an implicit tax on consumers. For instance, agricultural policies more than double the price of food to Swiss citizens.

Subsidy Equivalents, 1999

Country	*Producer Total (bil. $)*	*Share of Production*	*Consumer Total (bil. $)*	*Share of Consumption*	*Total Support, % of GDP*
Canada	3.9	20	-2.3	-17	0.4
Japan	58.9	65	-67.9	-54	1.6
Mexico	5.7	23	-4.4	-18	1.4
N. Zeal.	0.1	2	-0.1	-6	0.4
Switz.	4.9	73	-3.0	-61	2.4
U.S.	54.0	24	-3.0	-2	1.0
EU-15	114.5	49	-65.8	-36	1.5
OECD	282.8	40	-183.4	-31	1.4

Source: *OECD*, 2000.

PRICE OF GOLD

	1998	*1999*	*—— 2000 ——*	
	Nov. 12	*Nov. 11*	*Nov. 2*	*Nov. 8*
Final fixing in London	$294.45	$296.00	$264.85	$264.100

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