

# The Influence of de Soto's *The Mystery of Capital*

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**T**he proliferation of informal and illegal forms of access to urban land and housing has been one of the main consequences of the processes of social exclusion and spatial segregation that have characterized intensive urban growth in developing countries. Given the absence of adequate housing policies and the failure of the land market to offer sufficient, suitable and accessible housing options, millions of urban poor have to create their own shelter, either by invading private or public land or by buying land illegally and constructing their own housing. This phenomenon has attracted the attention of many researchers, policy makers and others worried about the grave socioeconomic, environmental and political implications for the urban poor and society at large.

Peruvian economist Hernando de Soto is one of the most influential contemporary ideologues addressing this complex issue. His ideas and proposals regarding large-scale regularization programs, most recently presented in his book, *The Mystery of Capital*, have received extensive media coverage and have raised the level of public debate. His influence can be measured by the fact that an increasing number of countries and cities, in Latin America and elsewhere, have introduced regularization policies based on his ideas, and these programs have already had a significant impact on international and institutional approaches to property reform and good governance. In many countries, politicians who were never particularly interested in urban development concerns have now become vigorous defenders of de Soto's ideas. Why?

## A Review of Urban Settlement Trends

Before addressing de Soto's work directly, a brief summary of the current situation is in order. In Latin America, the urbanization



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**Sprawling informal settlements like this one outside Campinas, Brazil, are common around most Latin American cities as illegal tenure arrangements have become the main form of urban land development.**

process has been especially significant: 380 million people, some 75 percent of the total population, lived in urban areas in 2000, making it the most urbanized region in the world. While the globalization of urban land markets has intensified in Latin America, the region has also seen poverty escalate. It is estimated that between 40 and 80 percent of the population lives illegally because they can neither afford nor gain legal access to land near employment centers. As a result, illegal tenure arrangements have become the main form of urban land development.

The violent evictions and forced removals of the 1970s have been gradually replaced by a relative tolerance of illegal occupations, culminating in some cases with the official recognition of such settlements. Responding to growing social mobilization, public administrators and policy makers in several countries have struggled to formulate regularization programs aimed at both upgrading informal areas and recognizing the land and housing rights of the dwellers, thus legalizing their status.

Most land tenure regularization programs have been structured around two intertwined objectives: to recognize security of tenure and to promote the sociospatial

integration of informal communities within the broader urban structure and society. The definition of what constitutes security of tenure has varied in both theory and practice. The UN Global Campaign for Securing Tenure for the Urban Poor, for example, seeks to protect dwellers against eviction and achieve other basic objectives, such as contributing to sustainable livelihoods; improving access to basic services; securing urban citizenship; producing certainty and incentives for investment; mobilizing disparate communities; and empowering women.

Generally speaking, regularization programs in Latin America have been more successful in upgrading settlements through public investments in urban infrastructure and service provision than in legalization programs. The definition of the nature of the rights to be attributed to dwellers has varied greatly, ranging from titles (such as freehold and leasehold) to contracts (such as social rent and other rental mechanisms) and precarious administrative permits (such as temporary licenses and certificates of occupancy). Experiences based on the transfer of individual freehold titles have been largely unsuccessful, given the many existing legal, technical and financial obstacles.

### de Soto's Contributions to the Debate

Although he has claimed that he initiated the debate, de Soto instead has made an undeniably important contribution to a long-standing discussion of the need to confront the phenomenon of urban informality and illegality through public policies aimed at legalizing informal settlements and other extralegal economic activities. Since the 1970s, this debate increasingly has involved planners and policy makers, but de Soto has repackaged the discussion and, to some extent, contributed to widening its scope and reach.

What makes de Soto's ideas so appealing is that, perhaps better than anyone else, he has been able to emphasize the economic dimension and implications of urban illegality. Most of the academic research, social mobilization and policy-making on the matter of informal settlements and land regularization have been supported by a combination of humanitarian, ethical, religious, sociopolitical and environmental arguments. de Soto's approach, on the other hand, has stressed the significant impact that comprehensive regularization programs could have on the overall urban economy by linking the growing informal extralegal economy into the formal economy. Moreover, he has argued that such public policies can be instrumental in reducing social poverty.

In his view, small informal businesses and precarious shanty homes are essentially economic assets, "dead capital," that should be revived by the official legal system and turned into liquid capital so people could gain access to formal credit, invest in their homes and businesses, and thus reinvigorate the economy as a whole. He has estimated the amount of dead capital in the developing world at about US\$9.3 trillion, a staggering figure that has drawn the attention of many influential politicians, land developers, government officials and financial organizations (Bourbeau 2001). His argument has been summarized as follows:

"Most of the poor already possess the assets they need to make a success of capitalism.... But they hold these resources in defective forms.... They lack the process to represent their property and create capital ...They have houses, but not titles.... It is

the representation of assets in legal property documents that gives them the power to create surplus value" (Mammen 2001).

In his first book, *The Other Path*, de Soto advocated the formalization of informal settlements. In his new book, *The Mystery of Capital*, he has taken this argument one step further, advocating that property ownership is the reason "why capitalism triumphs in the West and fails everywhere else," which is also the subtitle of the book. de Soto offers a three-part argument:

- People need to feel secure of their legal tenure status so they can start investing in housing and business improvements;
- Security of tenure and resulting access to credit can only be provided by the legalization of informal settlements and businesses;
- The way to proceed is to provide universal title ownership through individual freehold titles, with clear titles and enforceable rights, to enable third world countries to leverage themselves and thus eradicate poverty.

The recognition of property ownership in de Soto's proposal is important because it would entail access to credit and finance. He argues that European countries and the U.S. improved their property systems, allowing economic actors to discover and realize the potential of their assets and thus to be in a position to produce the kind of noninflationary money necessary to finance and generate production. Following that logic, national and international organizations have proposed, and even imposed, the full legalization of businesses and the unqualified recognition of individual freehold titles for urban dwellers in some informal settlements as the "radical" way to transform decaying urban economies.

### Critiques of de Soto's Assumptions

Appealing as his ideas are, there are many flaws in de Soto's arguments. Now that the dust raised by the initial media attention to his book has started to settle down, the debate has become increasingly critical. Such an appraisal is especially important because the regularization programs inspired by his ideas have had a significant impact on the daily lives of millions of people.

To begin with, there has been increasing criticism of de Soto's methodological approach that led to the highly unlikely estimated figure of existing dead capital. Some analysts have pointed out that his grasp of the role and social construction of individual property ownership in European and U.S. economic history is not entirely correct (Payne 2001). Others have criticized de Soto for oversimplifying, if not totally misunderstanding, the complex dynamics of both informal and formal urban land markets (Bourbeau 2001). I have stressed the specific, perhaps unique, role of land ownership in developing countries, especially in Latin America, where historically the combination of weak capital markets, highly inflationary economies and deficient social security systems has turned land value appreciation into a fundamental capitalization mechanism, thus generating a culture of speculation that has long supported a heritage of patrimonialism and political clientelism. This process has, in its turn, deeply affected the conditions of access to urban land and housing and the spatial distribution of public equipment and services, as well as generating urban illegality.

Another related critical argument is that de Soto has failed to recognize that the poor, despite their poverty, have already amassed assets through access to credit, albeit not from formal institutions. In fact, de Soto has failed to provide evidence that banks and other official financial and credit institutions would be prepared to give systematic credit to the poor, even though there is historical evidence to the contrary. For example, in de Soto's country of Peru very few people have been able to access official credit following a massive regularization program (Riofrio 1998; Calderon 2001). Moreover, existing research in Colombia and other Latin American countries has indicated that the poor would not even be interested or willing to obtain official credit, given the socioeconomic and fiscal implications of this process (Gilbert 2001). Recent studies also have questioned the urban and socioeconomic sustainability of settlements in Mexico, Peru, El Salvador and elsewhere that have been legalized by programs inspired by de Soto's ideas (Duhau 2001; Kagawa

2001; Zeledon 2001). Such programs have focused exclusively, and artificially, on the formal legalization of informal settlements and have not included adequate upgrading and other socioeconomic programs, thus failing to promote any sociospatial integration.

From my perspective as a legal scholar, I see three main flaws in de Soto's argument. First, while discussing the importance of legalizing informal settlements, he has failed to question the very nature of the legal system that has generated urban illegality in the first place. I believe that the discussion of laws and legal institutions has to be supported by a critical understanding of the nature of the law-making process, the conditions for law enforcement, and the dynamics of the process of social construction of urban illegality. In particular, I have argued that the legal treatment of property rights should be taken out of the narrow, individualistic context of civil law so the matter can be interpreted from the socially oriented criteria of redefined public urban law (Fernandes 2001).

In this context, far from being radical, de Soto's argument is a very conservative one. His work has failed to qualify the discussion on property rights, and he seems to assume that there is a universal, a-historical, "natural" legal definition of such rights. However, in Latin American countries and elsewhere in the developing world, the state has treated differently the different forms of property rights (financial, industrial, intellectual, etc.) and the social relations around them, allowing for varying degrees of state intervention in the domain of economic property relations. It is only for a very specific form of property rights, land and real estate, that the state has failed to affirm the notion of the social function of property versus the dominant individualistic approach given to such rights by anachronistic civil legislation (Fernandes 1999). The historical and political factors that have allowed classical legal liberalism to survive in Latin America have to be addressed before any comprehensive legal reform, such as that proposed by de Soto, can be implemented. The intimate though dialectically contradictory relationship between legality and illegality cannot be ignored (Fernandes



**This private housing development for low-income residents in rural El Salvador is built on inexpensive land that is not easily accessible to urban services and employment centers, creating a hardship for potential residents.**

and Varley 1998). Such a critical approach to law would certainly serve to dismiss de Soto's claim that formal, unqualified individual ownership can be used against crime and terrorism.

A second flaw is that research in many developing countries has indicated that, given a combination of certain social, political and institutional conditions, residents in informal settlements can share an effective perception of security of tenure, have access to informal (and sometimes formal) credit and public services, and invest in housing improvement, even without having legal titles (Payne et al. forthcoming).

Third, and more important, existing research has shown that while the recognition of individual freehold titles can promote individual security of legal tenure it does not necessarily entail sociospatial integration. Unless titling is undertaken within the context of a broader set of public policies that address urban, politico-institutional and socioeconomic conditions, legalization programs may actually aggravate the processes of exclusion and segregation. As a result, the original beneficiaries of the programs might not be able to remain on the legalized land, although that should be the ultimate objective of regularization programs, especially on public land.

Moreover, regularization programs have had little impact on social poverty, in part

because the traditional banking and financial mechanisms have not embraced them, as de Soto has claimed. The root of the problem runs deeper because regularization programs have a remedial nature. They can only have a more direct impact on urban poverty if they are part of a broader set of preventive public policies aimed at promoting overall urban reform and supported by socioeconomic policies aimed at generating job opportunities and income. There is a fundamental role for the market economy in this process, but it requires systematic intergovernmental relations, public-private partnerships and renewed social mobilization. Furthermore, de Soto has failed to consider the essential gender and environmental implications of land legalization.

To prevent the production of these perverse effects, we must identify and understand the factors that have contributed to the phenomenon of urban illegality. These include not only the combination of land markets and political systems but also the elitist and exclusionary legal systems still prevailing in Latin America. To legalize the illegal requires the introduction of innovative legal-political strategies to promote the articulation of individual land tenure with the recognition of social housing rights compatible with keeping dwellers in their existing settlements. Housing rights cannot be reduced to individual property rights.

New tenure policies need to integrate four main factors: legal instruments that create effective rights; socially oriented urban planning laws; political-institutional agencies and mechanisms for democratic urban management; and inclusionary macro-socioeconomic policies. The search for innovative legal-political solutions also includes the incorporation of a long-neglected gender dimension and a clear attempt to minimize the impacts such policies have on the land market. The benefits of public investment should be captured by the urban poor, not by traditional and new private land developers, as has happened frequently in settlements regularized according to de Soto's proposals.

In conclusion, I would argue that regularization programs should be group specific, taking into account the local historical, cultural and political contexts as well as the existing forms of tenure arrangements, both legal and customary and formal and informal. Public administrators and lawmakers should refuse the pressure to homogenize land and property laws. Individual property ownership will always be an attractive option that should be considered, but there are many other legal-political alternatives.

Hernando de Soto is absolutely right when he questions the legitimacy of exclusionary legal systems. However, while he has uncritically assumed that legitimacy would result from the widespread recognition of individual ownership, other research has proved that this is not necessarily the case. He is generally right when he says that lawyers lack an understanding of the economic process. However, many observers believe that his own understanding of the economic process may be deeply flawed, and that he could also learn a thing or two about the legal process. **L**

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## Latin America Network on Property Taxation

The Lincoln Institute has recently formed informational networks of scholars and policy makers focused on several key issues in land and tax policy in Latin America. Led by Martim Smolka, senior fellow and director of the Lincoln Institute's Program on Latin America and the Caribbean, the first meeting of the property taxation network took place in conjunction with the seminar in Porto Alegre in April 2001 (see page 9). Network representatives came from Argentine (Hector Serravalle), Brazil (Claudia M. De Cesare, Cintia E. Fernandes, Mauro Lunardi and Sol G. Pinto), Chile (Carlos Acuña), Colombia (Maria Camila Uribe and Claudia Puentes), Ecuador (Mario R. Maldonado), El Salvador (Roberto Cañas) and Mexico (Sergio Flores).

The network's mission is to pursue more effective property tax systems in Latin America and to reinforce the role of the property tax as an alternative for local government revenue. The network will promote professional development, identify relevant themes for comparative research and educational programs, and disseminate information and experiences. The members of the network have prioritized the following projects:

- property tax indicators;
- annotated bibliography;
- database on institutions, permanent courses and educational programs;
- development of curriculum; and
- exchanges for professional learning.

Although isolated initiatives at national or state levels have improved cadastral systems, valuation procedures and communication skills in some countries, the network members agree there is still great potential for improving efficiency and equity in current tax systems. The members also wanted more accessible information and better communication on property tax issues in Latin America. Innovative experiences and lessons like those cited in the following article can be shared within the group. Future educational programs may be a source of inspiration for other municipalities, like Porto Alegre, facing challenges in property tax administration.

The next property tax program is scheduled for April 15–19 at the Lincoln Institute in Cambridge, Massachusetts. For more information, see page 18 or contact Alejandra Mortarini at [alejandra@lincolninst.edu](mailto:alejandra@lincolninst.edu).

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