EXCERPTS FROM *THE MYSTERY OF CAPITAL*

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CHAPTER ONE

The Five Mysteries of Capital

> *The key problem is to find out why that sector of society of the past, which I would not hesitate to call capitalist, should have lived as if in a bell jar, cut off from the rest; why was it not able to expand and conquer the whole of society? . . . [Why was it that] a significant rate of capital formation was possible only in certain sectors and not in the whole market economy of the time?*
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> —Fernand Braudel, *The Wheels of Commerce*

The hour of capitalism's greatest triumph is its hour of crisis.

The fall of the Berlin Wall ended more than a century of political competition between capitalism and communism. 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. As a result, with varying degrees of enthusiasm, Third World and former communist nations have balanced their budgets, cut subsidies, welcomed foreign investment, and dropped their tariff barriers.

Their efforts have been repaid with bitter disappointment. From Russia to Venezuela, the past half-decade has been a time of economic suffering, tumbling incomes, anxiety and resentment; of "starving, rioting and looting," in the stinging words of Malaysian Prime Minister Mahathir Mohamad. In a recent editorial, the *New York Times* said: "For much of the world, the marketplace extolled by the West in the afterglow of victory in the Cold War has been supplanted by the cruelty of markets, wariness towards capitalism and dangers of

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instability." The triumph of capitalism only in the West could be a recipe for economic and political disaster.

For Americans enjoying both peace and prosperity, it has been all too easy to ignore the turmoil elsewhere. How can capitalism be in trouble when the Dow Jones Industrial average is climbing higher than Sir Edmund Hillary? Americans look at other nations and see progress, even if it is slow and uneven. Can't you eat a Big Mac in Moscow, rent a Blockbuster video in Shanghai, and reach the Internet in Caracas?

Even in the United States, however, the foreboding cannot be completely stifled. Americans see Colombia poised on the brink of a major civil war between drug-trafficking guerillas and repressive militias; an intractable insurgency in the south of Mexico; an important part of Asia's force-fed economic growth draining away into corruption and chaos. In Latin America, sympathy for free markets is dwindling: Support for privatization has dropped from 46 percent of the population to 36 in May 2000. Most ominously of all, in the former communist nations capitalism has been found wanting, and men associated with old regimes stand poised to resume power. Some Americans sense too that one reason for their decade-long boom is that the more precarious the rest of the world looks, the more attractive American stocks and bonds become as a haven for international money.

In the business community of the West, there is a growing concern that the failure of most of the rest of the world to implement capitalism will eventually drive the rich economies into recession. As millions of investors have painfully learned from the evaporation of their emerging market funds, globalization is a two-way street: If the Third World and former communist nations cannot escape the influence of the West, neither can the West disentangle itself from them. Adverse reactions to capitalism have also been growing stronger within rich countries themselves. The rioting in Seattle at the meeting of the World Trade Organization in December 1999 and a few months later at the IMF/World Bank meeting in Washington, D.C., regardless of the diversity of the grievances, highlighted the anger that spreading capitalism inspires. Many have begun recalling the economic historian Karl Polanyi's warnings that free markets can collide with society and lead to fascism. Japan is struggling through its most prolonged slump since the Great Depression. Western

Europeans vote for politicians who promise them a "third way" that rejects what a French bestseller has labeled *L'horreur économique*.

These whispers of alarm, disturbing though they are, have thus far only prompted American and European leaders to repeat to the rest of the world the same wearisome lectures: Stabilize your currencies, hang tough, ignore the food riots, and wait patiently for the foreign investors to return.

Foreign investment is of course a very good thing. The more of it, the better. Stable currencies are good too, as are free trade and transparent banking practices and the privatization of state-owned industries and every other remedy in the Western pharmacopeia. Yet we continually forget global capitalism has been tried before. In Latin America, for example, reforms directed at creating capitalist systems have been tried at least four times since independence from Spain in the 1820s. Each time, after the initial euphoria, Latin Americans swung back from capitalist and market economy policies. These remedies are clearly not enough. Indeed, they fall so far short as to be almost irrelevant.

When these remedies fail, Westerners all too often respond not by questioning the adequacy of the remedies but by blaming Third World peoples for their lack of entrepreneurial spirit or market orientation. If they have failed to prosper despite all the excellent advice, it is because something is the matter with them: They missed the Protestant Reformation, or they are crippled by the disabling legacy of colonial Europe, or their IQs are too low on the Bell Curve. But the suggestion that it is culture that explains the success of such diverse places as Japan, Switzerland, and California, and culture again that explains the relative poverty of such equally diverse places as China, Estonia, and Baja California, is worse than inhumane; it is unconvincing. The disparity of wealth between the West and rest of the world is far too great to be explained by culture alone. Most people want the fruits of capital—so much so that many, from the children of Sanchez to Khruschev's son, are flocking to Western nations.

The cities of the Third World and the former communist countries are teeming with entrepreneurs. You cannot walk through a Middle Eastern market, hike up to a Latin American village, or climb into a taxicab in Moscow without someone trying to make a deal with you. The inhabitants of these countries possess talent, enthusiasm, and an astonishing ability to wring a profit out of practically nothing. They can grasp and use modern technology. Otherwise, American businesses would not be struggling to control the unauthorized use of their patents abroad, nor would the U.S. government be striving so desperately to keep modern weapons technology out of the hands of Third World countries. Markets are an ancient and universal tradition: Christ drove the merchants out of the temple 2,000 years ago, and Mexicans were taking their products to market long before Columbus reached America.

But if people in countries making the transition to capitalism are not pitiful beggars, are not helplessly trapped in obsolete ways, and are not the uncritical prisoners of dysfunctional cultures, what is it that prevents capitalism from delivering to them the same wealth it has delivered to the West? Why does capitalism thrive only in the West, as if enclosed in a bell jar?

In this book I intend to demonstrate that the major stumbling block that keeps the rest of the world from benefiting from capitalism is its inability to produce capital. Capital is the force that raises the productivity of labor and creates the wealth of nations. It is the lifeblood of the capitalist system, the foundation of progress, and the one thing that the poor countries of the world cannot seem to produce for themselves, no matter how eagerly their people engage in all the other activities that characterize a capitalist economy.

I will also show, with the help of facts and figures that my research team and I have collected, block by block and farm by farm in Asia, Africa, the Middle East, and Latin America, that most of the poor already possess the assets they need to make a success of capitalism. Even in the poorest countries, the poor save. The value of savings among the poor is, in fact, immense: forty times all the foreign aid received throughout the world since 1945. In Egypt, for instance, the wealth that the poor have accumulated is worth fifty-five times as much as the sum of all direct foreign investment ever recorded there, including the Suez Canal and the Aswan Dam. In Haiti, the poorest nation in Latin America, the total assets of the poor are more than one hundred fifty times greater than all the foreign investment received since Haiti's independence from France in 1804. If the United States were to hike its foreign-aid budget to the level recommended by the United Nations—0.7 percent of national income—it would take the richest country on earth more than 150 years to transfer to the world's poor resources equal to what they already possess.

But they hold these resources in defective forms: houses built on land whose ownership rights are not adequately recorded, unincorporated businesses with undefined liability, industries located where financiers and investors cannot see them. Because the rights to these possessions are not adequately documented, these assets cannot readily be turned into capital, cannot be traded outside of narrow local circles where people know and trust each other, cannot be used as collateral for a loan, and cannot be used as a share against an investment.

In the West, by contrast, every parcel of land, every building, every piece of equipment, or store of inventories is represented in a property document that is the visible sign of a vast hidden process that connects all these assets to the rest of the economy. Thanks to this representational process, assets can lead an invisible, parallel life alongside their material existence. They can be used as collateral for credit. The single most important source of funds for new businesses in the United States is a mortgage on the entrepreneur's house. These assets can also provide a link to the owner's credit history, an accountable address for the collection of debts and taxes, the basis for the creation of reliable and universal public utilities, and a foundation for the creation of securities (like mortgage-backed bonds) that can then be rediscounted and sold in secondary markets. By this process the West injects life into assets and makes them generate capital.

Third World and former communist nations do not have this representational process. As a result, most of them are undercapitalized, in the same way that a firm is undercapitalized when it issues fewer securities than its income and assets would justify. The enterprises of the poor are very much like corporations that cannot issue shares or bonds to obtain new investment and finance. Without representations, their assets are dead capital.

The poor inhabitants of these nations—five-sixths of humanity—do have things, but they lack the process to represent their property and create capital. They have houses but not titles; crops but not deeds; businesses but not statutes of incorporation. It is the unavailability of these essential representations that explains why people who have adapted every other Western invention, from the paper clip to the nuclear reactor, have not been able to produce sufficient capital to make their domestic capitalism work.

This is the mystery of capital. Solving it requires understanding why Westerners, by representing assets with titles, are able to see and draw out capital from them. One of the greatest challenges to the human mind is to understand and gain access to those things we know exist but cannot see. Not everything that is real and useful is tangible and visible. Time, for example, is real, but it can only be efficiently managed when it is represented by a clock or a calendar. Throughout history, human beings have invented representational systems—writing, musical notation, double-entry bookkeeping—to grasp with the mind what human hands could never touch. In the same way, the great practitioners of capitalism, from the creators of integrated title systems and corporate stock to Michael Milken, were able to reveal and extract capital where others saw just junk by devising new ways to represent the invisible potential that is locked up in the assets we accumulate.

At this very moment, you are surrounded by waves of Ukrainian, Chinese, and Brazilian television that you cannot see. So, too, are you surrounded by assets that invisibly harbor capital. Just as the waves of Ukrainian television are far too weak for you to sense them directly but can, with the help of a television set, be decoded to be seen and heard, so can capital be extracted and processed from assets. But only the West has the conversion process required to transform the invisible to the visible. It is *this* disparity that explains why Western nations can create capital and the Third World and former communist nations cannot.

The absence of this process in the poorer regions of the world—where two-thirds of humanity lives—is not the consequence of some Western monopolistic conspiracy. It is rather that Westerners take this mechanism so completely for granted that they have lost all awareness of its existence. Although it is huge, nobody sees it, including the Americans, Europeans and Japanese who owe all their wealth to their ability to use it. It is an implicit legal infrastructure hidden deep within their property systems—of which ownership is but the tip of the iceberg. The rest of the iceberg is an intricate man-made process that can transform assets and labor into capital. This process was not created from a blueprint and is not described in a glossy brochure. Its origins are obscure and its significance buried in the economic subconscious of Western capitalist nations.

How could something so important have slipped our minds? It is not uncommon for us to know *how* to do things without understanding *why* they work. Sailors used magnetic compasses long before there was a satisfactory theory of magnetism. Animal breeders had a working knowledge of genetics long before Gregor Mendel explained genetic principles. Even as the West prospers from abundant capital, do people really understand the origin of capital? If they don't, there always remains the possibility that the West might damage the source of its own strength. Being clear about the source of capital will also prepare the West to protect itself and the rest of the world as soon as the prosperity of the moment yields to the crisis that is sure to come. Then the question that always arises in international crises will be heard again: Whose money will pay to solve these problems?

So far, Western countries have been happy to take their system for producing capital entirely for granted and to leave its history undocumented. That history must be recovered. This book is an effort to reopen the exploration of the source of capital and thus explain how to correct the economic failures of poor countries. These failures have nothing to do with deficiencies in cultural or genetic heritage. Would anyone suggest "cultural" commonalities between Latin Americans and Russians? Yet in the last decade, ever since both regions began to build capitalism without capital, they have shared the same political, social, and economic problems: glaring inequality, underground economies, pervasive mafias, political instability, capital flight, flagrant disregard for the law. These troubles did not originate in the monasteries of the Orthodox Church or along the pathways of the Incas.

But it is not only former communist and Third World countries that have suffered all of these problems. The same was true of the United States in 1783, when President George Washington complained about "banditti . . . skimming and disposing of the cream of the country at the expense of the many." These "banditti" were squatters and small illegal entrepreneurs occupying lands they did not own. For the next one hundred years, such squatters battled for legal rights to their land and miners warred over their claims because ownership laws differed from town to town and camp to camp. Enforcing property rights created such a quagmire of social unrest and antagonism throughout the young United States that the Chief Justice of the Supreme Court, Joseph Story, wondered in 1820 whether lawyers would ever be able to settle them.

Do squatters, banditti, and flagrant disregard of the law sound familiar? Americans and Europeans have been telling the other countries of the world "You have to be more like us." In fact, they are very much like the United States of a century ago when it too was an undeveloped country. Western politicians once faced the same dramatic challenges that leaders of the developing and former communist countries are facing today. But their successors have lost contact with the days when the pioneers who opened the American West were undercapitalized because they seldom possessed title to the lands they settled and the goods they owned; when Adam Smith did his shopping in black markets and English street urchins plucked pennies cast by laughing tourists into the mud banks of the Thames; when Jean-Baptiste Colbert's technocrats executed 16,000 small entrepreneurs whose only crime was manufacturing and importing cotton cloth in violation of France's industrial codes.

That past is many nations' present. The Western nations have so successfully integrated their poor into their economies that they have lost even the memory of how it was done, how the creation of capital began back when, as the American historian Gordon Wood has written, "something momentous was happening in the society and culture that released the aspirations and energies of common people as never before in American history."[1] The "something momentous" was that Americans and Europeans were on the verge of establishing widespread formal property law and inventing the conversion process in that law that allowed them to create capital. This was the moment when the West crossed the demarcation point that led to successful capitalism—when it ceased being a private club and became a popular culture, when George Washington's

1. Gordon S. Wood, "Inventing American Capitalism," *The New York Review of Books* (June 9, 1994), p. 49.

dreaded "banditti" were transformed into the beloved pioneers that American culture now venerates.

* * *

The paradox is as clear as it is unsettling: capital, the most essential component of Western economic advance, is the one that has received the least attention. Neglect has shrouded it in mystery—in fact, a series of five mysteries.

The Mystery of the Missing Information

Charitable organizations have so emphasized the miseries and helplessness of the world's poor that no one has properly documented their capacity for accumulating assets. Over the past five years, I and a hundred colleagues from six different nations have closed our books and opened our eyes—and gone out into the streets and countrysides of four continents to count how much the poorest sectors of society have saved. The quantity is enormous. But most of it is dead capital.

The Mystery of Capital

This is the key mystery and the centerpiece of this book. Capital is a subject that has fascinated thinkers for the last three centuries: Marx said that you needed to go beyond physics to touch "the hen that lays the golden eggs"; Adam Smith felt you had to create "a sort of waggon-way through the air" to reach that same hen. But no one has told us where the hen hides. What is capital, how is it produced, and how is it related to money?

The Mystery of Political Awareness

If there is so much dead capital in the world, and in the hands of so many poor people, why haven't governments tried to tap into this potential wealth? Simply because the evidence they needed has only become available in the past forty years as billions of people throughout the world have moved from life organized on a small scale to life on a large scale. This migration to the cities has rapidly divided labor and spawned in poorer countries a huge industrial-commercial revolution—one that, incredibly, has been virtually ignored.

The Missing Lessons of U.S. History

What is going on in the Third World and the former communist countries has happened before, in Europe and North America. Unfortunately, we have been so mesmerized by the failure of so many nations to make the transition to capitalism that we have forgotten how the successful capitalist nations actually did it. For years, I visited technocrats and politicians in advanced nations, from Alaska to Tokyo, but they had no answers. It was a mystery. I finally found the answer in their history books, the most pertinent example being that of U.S. history.

The Mystery of Legal Failure: Why Property Law Does Not Work Outside the West

Since the nineteenth century, nations have been copying the laws of the West to give their citizens the institutional framework to produce wealth. They continue copying such laws today, and, obviously it doesn't work. Most citizens still cannot use the law to convert their savings into capital. Why this is so and what is needed to make the law work remains a mystery.

The solution to each of these mysteries is the subject of a chapter in this book.

* * *

The moment is ripe to solve the problems of why capitalism is triumphant in the West and stalling practically everywhere else. As all plausible alternatives to capitalism have now evaporated, we are finally in a position to study capital, dispassionately and carefully.

CHAPTER THREE

The Mystery of Capital

> *The sense of the world must lie outside the world. In the world everything is as it is and happens as it does happen. In it there is no value—and if there were, it would be of no value.*
>
> *If there is a value which is of value, it must lie outside all happening and being-so. For all happening and being-so is accidental.*
>
> *What makes it non-accidental cannot lie* in *the world, for otherwise this would again be accidental.*
>
> *It must lie outside the world.*
>
> —Ludwig Wittgenstein, *Tractatus Logico-Philosophicus*

Walk down most roads in the Middle East, the former Soviet Union or Latin America, and you will see many things: houses used for shelter, parcels of land being tilled, sowed and harvested, merchandise being bought and sold. Assets in developing and former communist countries primarily serve these immediate physical purposes. In the West, however, the same assets also lead a parallel life as capital outside the physical world. They can be used to put in motion more production by securing the interests of other parties as "collateral" for a mortgage, for example, or by assuring the supply of other forms of credit and public utilities.

Why can't buildings and land elsewhere in the world also lead this parallel life? Why can't the enormous resources we discussed in Chapter 2—$9.3 trillion of dead capital—produce value beyond their "natural" state? My reply is: Dead capital exists because we have forgotten (or perhaps never realized) that converting a physical asset to generate capital—using your house to borrow money to finance an enterprise, for example—requires a very complex process. It is not unlike the process that Einstein taught us whereby a single brick can be made to release a huge amount of energy in the form of an atomic explosion. By analogy, capital is the result of discovering and unleashing potential energy from the trillions of bricks that the poor have accumulated in their buildings.

There is, however, one crucial difference between unleashing energy from a brick and unleashing capital from brick buildings: Although humanity (or at least a large group of scientists) has mastered the process of obtaining energy from matter, we seem to have forgotten the process that allows us to obtain capital from assets. The result is that 80 percent of the world is undercapitalized; people cannot draw economic life from their buildings (or any other asset) to generate capital. Worse, the advanced nations seem unable to teach them. Why assets can be made to produce abundant capital in the West but very little in the rest of the world has become a mystery.

Clues from the Past (from Smith to Marx)

To unravel the mystery of capital, we have to go back to the seminal meaning of the word. In Medieval Latin, "capital" appears to have denoted a head of cattle or other livestock, which have always been important sources of wealth beyond the basic meat they provide. Livestock are low-maintenance possessions; they are mobile and can be moved away from danger; they are also easy to count and measure. But most important, from livestock you can obtain additional wealth, or surplus value, by setting in motion other industries, including milk, hides, wool, meat, and fuel. Livestock also have the useful attribute of being able to reproduce themselves. Thus the term "capital" begins to do two jobs simultaneously, capturing the physical dimension of assets (livestock) as well as their potential to generate surplus value. From the barnyard, it was only a short step to the desks of the inventors of economics, who generally defined "capital" as that part of a country's assets that initiates surplus production and increases productivity.

Great classical economists such as Adam Smith and Karl Marx believed that capital was the engine that powered the market economy. Capital was considered to be the principal part of the economic whole—the preeminent factor (as the capital issues in such phrases as *capital* issues, *capital* punishment, the *capital* city of a country). What they wanted to understand was what capital is and how it is produced and accumulated. Whether you agree with the classical economists or not, or perhaps view them as irrelevant (maybe Smith never understood that the Industrial Revolution was under way; maybe

Marx's labor theory of value has no practical application), there is no doubt that these thinkers built the towering edifices of thought on which we can now stand and try to find out what capital is, what produces it, and why non-Western nations generate so little of it.

For Smith, economic specialization—the division of labor and the subsequent exchange of products in the market—was the source of increasing productivity and therefore "the wealth of nations." What made this specialization and exchange possible was capital, which Smith defined as the stock of assets accumulated for productive purposes. Entrepreneurs could use their accumulated resources to support specialized enterprises until they could exchange their products for the other things they needed. The more capital was accumulated, the more specialization became possible, and the higher society's productivity would be. Marx agreed; for him, the wealth capitalism produces presents itself as an immense pile of commodities.

Smith believed that the phenomenon of capital was a consequence of man's natural progression from a hunting, pastoral, and agricultural society to a commercial one where, through mutual interdependence, specialization and trade, he could increase his productive powers immensely. Capital was to be the magic that would enhance productivity and create surplus value. "The quantity of industry," Smith wrote, "not only increases in every country with the increase of the stock [capital] which employs it, but, in consequence of that increase, the same quantity of industry produces a much greater quantity of work."[1]

Smith emphasized one point that is at the very heart of the mystery we are trying to solve: For accumulated assets to become active capital and put additional production in motion, they must be *fixed and realized in some particular subject* "which lasts for some time at least after that labour is past. It is, as it were, a certain quantity of labour stocked and stored up to be employed, if necessary, upon some other occasion."[2] Smith warned that labor invested in the production of assets would not leave any trace or value if not properly *fixed*.

1. Adam Smith, *The Wealth of Nations* (London: Everyman's Library, 1977), former Volume 1, p. 242.

2. Ibid., p.295.

What Smith really meant may be the subject of legitimate debate. What I take from him, however, is that capital is not the accumulated stock of assets but the *potential* it holds to deploy new production. This potential is, of course, abstract. It must be processed and fixed into a tangible form before we can release it—just like the potential nuclear energy in Einstein's brick. Without a conversion process—one that draws out and fixes the potential energy contained in the brick—there is no explosion; a brick is just a brick. Creating capital also requires a conversion process.

This notion—that capital is first an abstract concept and must be given a fixed, tangible form to be useful—was familiar to other classical economists. Simonde de Sismondi, the nineteenth-century Swiss economist, wrote that capital was "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."[3] The great French economist Jean Baptiste Say believed 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."[4] Marx agreed; for him, a table could be made of something material, like wood "but so soon as it steps forth as a commodity, it is changed into something transcendent. 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 table-turning ever was."[5]

This essential meaning of capital has been lost to history. Capital is now confused with money, which is only one of the many forms in which it travels. It is always easier to remember a difficult concept in one of its tangible manifestations than in its essence. The mind wraps itself around "money" more easily than "capital." But it is a mistake to assume that money is what finally fixes capital. As Adam Smith pointed out, money is the "great wheel of circulation," but it

3. Simonde de Sismondi, *Nouveaux principes d'économic politique* (Paris: Calmann-Lévy, 1827), pp. 81–82.

4. Jean Baptiste Say, *Traité d'économie politique* (Paris: Deterville, 1819), Vol. 2, p. 429.

5. Karl Marx, Frederick Engels, *Collected Works,* (New York: International Publishers, 1996), Vol. 35, p. 82.

is *not* capital because value "cannot consist in those metal pieces."[6] In other words, money facilitates transactions, allowing us to buy and sell things, but it is not itself the progenitor of additional production. As Smith insisted, "the gold and silver money, which circulates in any country, may very properly be compared to a highway, which, while it circulates and carries to market all the grass and corn of the country, produces itself not a single pile of either."[7]

Much of the mystery of capital dissipates as soon as you stop thinking of "capital" as a synonym for "money saved and invested." The misapprehension that it is money that fixes capital comes about, I suspect, because modern business expresses the value of capital in terms of money. In fact, it is hard to estimate the total value of a collection of assets of very different types, such as machinery, buildings, and land, without resorting to money. After all, that is why money was invented; it provides a standard index to measure the value of things so that we may exchange dissimilar assets. But as useful as it is, money cannot fix in any way the abstract potential of a particular asset in order to convert it into capital. Third World and former communist nations are infamous for inflating their economies with money—without being able to generate much capital.

The Potential Energy in Assets

What is it that fixes the potential of an asset so that it can put additional production into motion? What detaches value from a simple house and fixes it in a way that allows us to realize it as capital?

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

6. Smith, *The Wealth of Nations*, former Volume 1, p. 242.
7. Ibid., p. 286.

lake, that process is contained in a hydroelectric plant that allows the lake water to move rapidly downward with the force of gravity, thereby transforming the placid lake's energy potential into the kinetic energy of tumbling water. This new kinetic energy can then rotate turbines creating mechanical energy that can be used to turn electromagnets that further convert it into electrical energy. As electricity, the potential energy of the placid lake is now fixed in the form necessary to produce controllable current that can be further transmitted through wire conductors to faraway places to deploy new production.

Thus an apparently placid lake can be used to light up your room and power the machinery in a factory. What was required was an external man-made process, which allowed us, first, to identify the potential of the weight of the water to do additional work and second, to convert this potential energy into electricity, which can be used to create surplus value. The additional value we obtain from the lake is not a value of the lake itself (like a precious ore intrinsic to the earth) but rather a value of the man-made process *extrinsic* to the lake. It is this process that allows us to transform the lake from a fishing and canoeing kind of place into an energy-producing kind of place.

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

Although the process that converts the potential energy in the water into electricity is well known, the one that gives assets the form required to put in motion more production is not known. In other words, while we know that it is the penstock, turbines, generators, transformers, and wires of the hydroelectric energy system that convert the potential energy of the lake until it is fixed in an accessible form, we do not know where to find the key process that converts the economic potential of a house into capital.

This is because that key process was not deliberately set up to create capital but for the more mundane purpose of protecting property ownership. As the property systems of Western nations grew, they developed, imperceptibly, a variety of mechanisms that gradually combined into a process that churned out capital as never before. Although we use these mechanisms all the time, we do not realize that they have capital generating functions because they do not wear that label. We view them as parts of the system that protects property, not as interlocking mechanisms for fixing the economic potential of an asset in such a way that it can be converted to capital. What creates capital in the West, in other words, is an implicit process buried in the intricacies of its formal property systems.

The Hidden Conversion Process of the West

This may sound too simple or too complex. But consider whether it is possible for assets to be used productively if they do not belong to something or someone. Where do we confirm the existence of these assets and the transactions that transform them and raise their productivity, if not in the context of a formal property system? Where do we record the relevant economic features of assets, if not in the records and titles that formal property systems provide? Where are the codes of conduct that govern the use and transfer of assets, if not in the framework of formal property systems? It is formal property that provides the process, the forms, and the rules that fix assets in a condition that allows us to realize them as active capital.

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

Any asset whose economic and social aspects are not fixed in a formal property system is extremely hard to move in the market. How can the huge amounts of assets changing hands in a modern market economy be controlled, if not through a formal property process? Without such a system, any trade of an asset, say a piece of real estate, requires an enormous effort just to determine the basics of the transaction: Does the seller own the real estate and have the right to transfer it? Can he pledge it? Will the new owner be accepted as such by those who enforce property rights? What are the effective means to exclude other claimants? In developing and former communist nations, such questions are difficult to answer. For most goods, there is no place where the answers are reliably fixed. That is why the sale or lease of a house can involve lengthy and cumbersome procedures of approval involving all the neighbors. This is often the only way to verify that the owner actually owns the house and there are no other claims on it. It is also why the exchange of most assets outside the West is restricted to local circles of trading partners.

As we saw in the previous chapter, these countries' principal problem is not the lack of entrepreneurship: The poor have accumulated trillions of dollars of real estate during the last forty years. What the poor lack is easy access to the property mechanisms that could legally fix the economic potential of their assets so that they can be used to produce, secure, or guarantee greater value in the expanded market. In the West, every asset—every piece of land, every house, every chattel—is formally fixed in updated records governed by rules contained in the property system. Every increment in production, every new building, product, or commercially valuable thing is someone's formal property. Even if assets belong to a corporation, real people still own them indirectly, through titles certifying that they own the corporation as "shareholders."

Like electric power, capital will not be generated if the single key facility that produces and fixes it is not in place. Just as a lake needs a hydroelectric plant to produce usable energy, assets need a formal property system to produce significant surplus value. Without formal property to extract their economic potential and convert it into a form that can be easily transported and controlled, the assets of developing and former communist countries are like water in a lake high in the Andes—an untapped stock of potential energy.

Why has the genesis of capital become such a mystery? Why have the rich nations of the world, so quick with their economic advice, not explained how indispensable formal property is to capital formation? The answer is that the process within the formal property system that breaks down assets into capital is extremely difficult to visualize. It is hidden in thousands of pieces of legislation, statutes, regulations, and institutions that govern the system. Anyone trapped in such a legal morass would be hard-pressed to figure out how the process 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 work.

For some time now I have been looking at the law from an extralegal point of view, to better understand how it functions and what effects it produces. This is not as crazy as it seems. As the French philosopher Michel Foucault has argued, it may be easier to discover what something means by looking at it from the opposite side of the bridge. "To find out what our society means by sanity," Foucault has written, "perhaps we should investigate what is happening in the field of insanity. And what we mean by legality in the field of illegality."[8] Moreover, property, like energy, is a concept; it cannot be experienced directly. Pure energy has never been seen or touched. And no one can see property. One can only experience energy and property by their effects.

From my viewpoint in the extralegal sector, I have seen that the formal property systems of the West produce six effects that allow their citizens to generate capital. The incapacity elsewhere in the world to deploy capital stems from the fact that most of the people in Third World and former communist countries are cut off from these essential effects.

Property Effect No. 1: Fixing the Economic Potential of Assets

The potential value locked up in a house can be revealed and transformed into active capital in the same way that potential energy is identified in a mountain lake and then transformed into actual energy. In both cases, the transition from one state to another requires a process that transposes the physical object into a man-made representative universe where we can disengage the

8. Herbert L. Dreyfus and Paul Rabinow, *Michel Foucault: Beyond Structuralism and Hermeneutics* (Chicago: Harvester, University of Chicago, 1982), p. 211.

resource from its burdensome material constraints and concentrate on its potential.

Capital is born by representing in writing—in a title, a security, a contract, and in other such records—the most economically and socially useful qualities *about* the asset as opposed to the visually more striking aspects *of* the asset. This is where potential value is first described and registered. The moment you focus your attention on the title of a house, for example, and not the house itself, you have automatically stepped from the material world into the conceptual universe where capital lives. You are reading a representation that focuses your attention on the economic potential of the house by filtering out all the confusing lights and shadows of its physical aspects and its local surroundings. Formal property forces you to think about the house as an economic and social concept. It invites you to go beyond viewing the house as mere shelter—and thus a dead asset—and to see it as live capital.

The proof that property is pure concept comes when a house changes hands; nothing physically changes. Looking at a house will not tell you who owns it. A house that is yours today looks exactly as it did yesterday when it was mine. It looks the same whether I own it, rent it, or sell it to you. Property is not the house itself but an economic concept *about* the house, embodied in a legal representation. This means that a formal property representation is something separate from the asset it represents.

What do formal property representations have that allows them to do additional work? Are they not just simple stand-ins for the assets? No. I repeat: A formal property representation such as a title is not a reproduction *of* the house, like a photograph, but a representation of our concepts *about* the house. Specifically, it represents the nonvisible qualities that have potential for producing value. These are not physical qualities of the house itself but rather economically and socially meaningful qualities we humans have attributed to the house (such as the ability to use it for a variety of purposes that can be secured by liens, mortgages, easements, and other covenants).

In advanced nations, this formal property representation functions as the means to secure the interests of other parties and to create accountability by providing all the information, references, rules, and enforcement mechanisms required to do so. In the West, for example, most formal property can be easily used as collateral for a loan; as equity exchanged for investment; as an address for collecting debts, rates, and taxes; as a locus point for the identification of individuals for commercial, judicial, or civic purposes; or as a liable terminal for receiving public utility services, such as energy, water, sewage, telephone, or cable services. While houses in advanced nations are acting as shelters or workplaces, their representations are leading a parallel life, carrying out a variety of additional functions to secure the interests of other parties.

Legal property thus gave the West the tools to produce surplus value over and above its physical assets. Property representations enabled people to think about assets not only through physical acquaintance but also through the description of their latent economic and social qualities. Whether anyone intended it or not, the legal property system became the staircase that took these nations from the universe of assets in their natural state to the conceptual universe of capital where assets can be viewed in their full productive potential.

With legal property, the advanced nations of 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. As Aristotle discovered 2,300 years ago, what you can do with things increases infinitely when you focus your thinking on their potential. By learning to fix the economic potential of their assets through property records, Westerners created a fast track to explore the most productive aspects of their possessions. Formal property became the staircase to the conceptual realm where the economic meaning of things can be discovered and where capital is born.

Property Effect No. 2: Integrating Dispersed Information into One System

As we saw in the previous chapter, most people in developing and former communist nations cannot get into the legal property system, such as it is, no matter how hard they try. Because they cannot insert their assets into the legal property system, they end up holding them extralegally. The reason capitalism has triumphed in the West and sputtered in the rest of the world is because most of the assets in Western nations have been integrated into one formal representational system.

This integration did not happen casually. Over decades in the nineteenth century, politicians, legislators, and judges pulled together the scattered facts and rules that had governed property throughout cities, villages, buildings, and farms and integrated them into one system. This "pulling together" of property representations, a revolutionary moment in the history of developed nations, deposited all the information and rules governing the accumulated wealth of their citizens into one knowledge base. Before that moment, information about assets was far less accessible. Every farm or settlement recorded its assets and the rules governing them in rudimentary ledgers, symbols, or oral testimony. But the information was atomized, dispersed, and not available to any one agent at any given moment. As we know too well today, an abundance of facts is not necessarily an abundance of knowledge. For knowledge to be functional, advanced nations had to integrate into one comprehensive system all their loose and isolated data about property.

Developing and former communist nations have not done this. In all the countries I have studied, I have never found just one legal system but dozens or even hundreds, managed by all sorts of organizations, some legal, others extralegal, ranging from small entrepreneurial groups to housing organizations. Consequently, what people in those countries can do with their property is limited to the imagination of the owners and their acquaintances. In Western countries, where property information is standardized and universally available, what owners can do with their assets benefits from the collective imagination of a larger network of people.

It may surprise the Western reader that most of the world's nations have yet to integrate extralegal property agreements into one formal legal system. For Westerners, there supposedly is only one law—the official one. Yet the West's reliance on integrated property systems is a phenomenon of at most the last two hundred years. In fact, in most Western countries, integrated property systems appeared only about a hundred years ago; Japan's integration happened a little more than fifty years ago. As we shall see in detail later, diverse informal property arrangements were once the norm in every nation. Legal pluralism was the standard in continental Europe until

Roman law was rediscovered in the fourteenth century and governments assembled all currents of law into one coordinated system.

In California just after the gold rush of 1849, there were some eight hundred separate property jurisdictions, each with its own records and individual regulations established by local consensus. Throughout the United States, from California to Florida, claim associations agreed on their own rules and elected their own officers. It took more than one hundred years, well into the late nineteenth century, for the U.S. government to pass special statutes that integrated and formalized U.S. assets. By enacting more than thirty-five preemption and mining statutes, Congress gradually managed to integrate into one system the informal property rules created by millions of immigrants and squatters. The result was an integrated property market that fueled the United States' explosive economic growth thereafter.

The reason it is so hard to follow this history of the integration of widespread property systems is that the process took place over a very long time. Formal property registries began to appear in Germany, for example, in the twelfth century but were not fully integrated until 1896, when the *Grundbuch* system for recording land transactions began operating on a national scale. In Japan, the national campaign to formalize the property of farmers began in the late nineteenth century and ended only in the late 1940s. Switzerland's extraordinary efforts to bring together the disparate systems that protected property and transactions at the turn of the twentieth century are still not well known, even to many Swiss.

As a result of integration, citizens in advanced nations can obtain descriptions of the economic and social qualities of any available asset without having to see the asset itself. They no longer need to travel around the country to visit each and every owner and their neighbors; the formal property system lets them know what assets are available and what opportunities exist to create surplus value. Consequently, an asset's potential has become easier to evaluate and exchange, enhancing the production of capital.

Property Effect No. 3: Making People Accountable

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

By transforming people with property interests into accountable individuals, formal property created individuals from masses. People no longer needed to rely on neighborhood relationships or make local arrangements to protect their rights to assets. Freed from primitive economic activities and burdensome parochial constraints, they could explore how to generate surplus value from their own assets. But there was a price to pay: Once inside a formal property system, owners lost their anonymity. By becoming inextricably linked to real estate and businesses that could be easily identified and located, people forfeited the ability to lose themselves in the masses. This option has practically disappeared in the West, while individual accountability has been reinforced. People who do not pay for goods or services they have consumed can be identified, charged interest penalties, fined, embargoed, and have their credit ratings downgraded. Authorities are able to learn about legal infractions and dishonored contracts; they can suspend services, place liens against property, and withdraw some or all of the privileges of legal property.

Respect in Western nations for property and transactions is hardly encoded in their citizens' DNA; it is rather the result of having enforceable formal property systems. Formal property's role in protecting not only ownership but the security of transactions encourages citizens in advanced countries to respect titles, honor contracts, and obey the law. When any citizen fails to act honorably, his breach is recorded in the system, jeopardizing his reputation as a trustworthy party to his neighbors, utilities, banks, telephone companies, insurance firms, and the rest of the network that property ties him to.

Thus the formal property systems of the West have bestowed mixed blessings. While they provided hundreds of millions of citizens with a stake in the capitalist game, what made this stake meaningful was that it could be lost. A great part of the potential value of legal property is derived from the possibility of forfeiture. Consequently, a great deal of its power comes from the accountability it creates, from the constraints it imposes, the rules it spawns, and the sanctions it can apply. In allowing people to see the economic and social potential of assets, formal property changed the perception in advanced societies of not only the potential rewards of using assets but also the dangers. Legal property invited commitment.

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

Meanwhile, citizens of advanced nations can contract for practically anything that is reasonable, but the entry price is commitment. And commitment is better understood when backed up by a pledge of property, whether a mortgage, a lien, or any other form of security that protects the other contracting party.

Property Effect No. 4: Making Assets Fungible

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

By describing all assets in standard categories, an integrated formal property system enables the comparison of two architecturally different buildings constructed for the same purpose. This allows one to discriminate quickly and inexpensively between similarities and differences in assets without having to deal with each asset as if it were unique.

Standard property descriptions in the West are also written to facilitate the combination of assets. Formal property rules require assets to be described and characterized in a way that not only outlines their singularity but also points out their similarity to other assets, thus making potential combinations more obvious. Through the use of standardized records, one can determine (on the basis of zoning restrictions, who the neighbors are and what they are doing, the square footage of the buildings, whether they can be joined, etc.) how to exploit a particular piece of real estate most profitably, whether as office space, hotel rooms, a bookshop, or racquetball courts and a sauna.

Representations also enable the division of assets without touching them. While an asset such as a factory may be an indivisible unit in the real world, in the conceptual universe of formal property representation it can be subdivided into any number of portions. Citizens of advanced nations are thus able to split most of their assets into shares, each of which can be owned by different persons, with different rights, to carry out different functions. Thanks to formal property, a single factory can be held by countless investors, who can divest themselves of their property without affecting the integrity of the physical asset.

Similarly, in a developed country, the farmer's son who wishes to follow in his father's footsteps can keep the farm by buying out his more commercially minded siblings. Farmers in many developing countries have no such option and must continually subdivide their farms for each generation until the parcels are too small to farm profitably, leaving the descendants with two alternatives: starving or stealing.

Formal property representations can also serve as moveable stand-ins for physical assets, enabling owners and entrepreneurs to simulate hypothetical situations in order to explore other profitable uses of their assets—much as military officers plan their strategy for a battle by moving symbols of their troops and weapons around a map. If you think about it, it is property representations that allow entrepreneurs to simulate business strategies to grow their companies and build capital.

In addition, all standard formal property documents are crafted in such a way as to facilitate the easy measurement of an asset's attributes. If standard descriptions of assets were not readily available, anyone who wanted to buy, rent, or give credit against an asset would have to expend enormous resources comparing and evaluating it against other assets—which also would lack standard descriptions. By providing standards, Western formal property systems have reduced significantly the transaction costs of mobilizing and using assets.

Once assets are in a formal property system, they endow their owners with an enormous advantage in that they can be split up and combined in more ways than an Erector set. Westerners can adapt their assets to any economic circumstance to produce continually higher valued mixtures, while their Third World counterparts remain trapped in the physical world of rigid, nonfungible forms.

Property Effect No. 5: Networking People

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

This explains how legal property encourages the suppliers of such utilities as electricity and water to invest in production and distribution facilities to service buildings. By legally attaching the buildings where the services will be delivered to their owners, who will be using and paying for the services, a formal property system reduces the risks of theft of services. It also reduces the financial losses from bill collecting among people hard to locate, as well as technical losses from incorrectly estimating the electricity needs of areas where businesses and residents are clandestine and not recorded. Without knowing who has the rights to what, and without an integrated legal system where the ability to enforce obligations has been transferred from extralegal groups to government, utilities would be hard-pressed to deliver services profitably. On what other basis could they identify subscribers, create utility subscription contracts, establish service connections, and ensure access to parcels and buildings? How would they implement billing systems, meter reading, collection mechanisms, loss control, fraud control, delinquent charging procedures, and enforcement services such as meter shutoffs?

Buildings are always the terminals of public utilities. What transforms them into *accountable* and *responsible* terminals is legal property. Anyone who doubts this need only look at the utility situation outside the West, where technical and financial losses plus theft of services account for 30 to 50 percent of all available utilities.

Western legal property also provides businesses with information about assets and their owners, verifiable addresses, and objective records of property value, all of which lead to credit records. This information and the existence of integrated law make risk more manageable by spreading it through insurance-type devices as well as by pooling property to secure debts.

Few seem to have noticed that the legal property system of an advanced nation is the center of a complex web of connections that equips ordinary citizens to form ties with both the government and the private sector, and so to obtain additional goods and services. Without the tools of formal property, it is hard to see how assets could be used for everything they accomplish in the West. How else could financial organizations identify trustworthy potential borrowers on a massive scale? How could physical objects, like timber in Oregon, secure an industrial investment in Chicago? How could insurance companies find and contract customers who will pay their bills? How could information brokerage or inspection and verification services be provided efficiently and cheaply? How could tax collection work?

It is the property system that draws out the abstract potential from buildings and fixes it in representations that allow us to go beyond passively using the buildings only as shelters. Many title systems in developing nations fail to produce capital because they do not acknowledge that property can go way beyond ownership. These systems function purely as an ownership inventory of deeds and maps standing in for assets, without allowing for the additional mechanisms required to create a network where assets can lead a parallel life as capital. Formal property should not be confused with such massive inventory systems as the English Domesday Book of nine hundred years ago or a luggage check operation in an international airport. Properly understood and designed, a property system creates a network through which people can assemble their assets into more valuable combinations.

Property Effect No. 6: Protecting Transactions

One important reason why the Western formal property system works like a network is that all the property records (titles, deeds, securities, and contracts that describe the economically significant aspects of assets) are continually tracked and protected as they travel through time and space. Their first stop is the public agencies that are the stewards of an advanced nation's representations. Public record keepers administer the files that contain all the economically useful descriptions of assets, whether land, buildings, chattel, ships, industries, mines, or airplanes. These files will alert anyone eager to use an asset about things that may restrict or enhance its realization, such as encumbrances, easements, leases, arrears, bankruptcies, and mortgages. The agencies also ensure that assets are adequately and accurately represented in appropriate formats that can be updated and easily accessed.

In addition to public record-keeping systems, many other private services have evolved to assist parties in fixing, moving, and tracking representations so that they can easily and securely produce surplus value. These include private entities that record transactions, escrow and closings organizations, abstractors, appraisers, title and fidelity insurance firms, mortgage brokers, trust services, and private custodians of documents. In the United States, title insurance companies further help the mobilization of representations by issuing policies to cover parties for specified risks, ranging from defects on titles to unenforceability on mortgages and unmarketability of title. By law, all these entities have to follow strict operating standards that govern their document-tracking capabilities, physical storage facilities, and staffing.

Although they are established to protect both the security of ownership and that of transactions, it is obvious that Western systems emphasize the latter. Security is principally focused on producing trust in transactions so that people can more easily make their assets lead a parallel life as capital.

In most developing countries, by contrast, the law and official agencies are trapped by early colonial and Roman law, which tilt toward protecting ownership. They have become custodians of the wishes of the dead. This may explain why the creation of capital in Western property happens so easily, and why most of the assets in developing and former communist countries have slipped out of the formal legal system in search of mobility.

The Western emphasis on the security of transactions allows citizens to move large amounts of assets with very few transactions. How else can we explain that in developing and former communist nations people are still taking their pigs to market and trading them one at a time, as they have done for thousands of years, whereas in the West, traders take representations of their rights over pigs to the market? Traders at the Chicago commodities exchange, for example, deal through representations, which give them more information about the pigs they are trading than if they could physically examine each pig. They are able to make deals for huge quantities of pigs with little concern about the security of transactions.

Capital and Money

The six effects of an integrated property process mean that Westerners' houses no longer merely keep the rain and cold out. Endowed with representational existence, these houses can now lead a parallel life, doing *economic* things they could not have done before. A well-integrated legal property system in essence does two things: First, it tremendously reduces the costs of knowing the economic qualities of assets by representing them in a way that our senses can pick up quickly; and second, it facilitates the capacity to agree on how to use assets to create further production and increase the division of labor. The genius of the West was to have created a system that allowed people to grasp with the mind values that human eyes could never see and to manipulate things that hands could never touch.

Centuries ago, scholars speculated that we use the word "capital" (from the Latin for "head") because the head is where we hold the tools with which we create capital. This suggests that the reason capital has always been shrouded in mystery is because, like energy, it can be discovered and managed only with the mind. The only way to touch capital is if the property system can record its economic aspects on paper and anchor them to a specific location and owner.

Property, then, is not mere paper but a mediating device that captures and stores most of the stuff required to make a market economy run. Property seeds the system by making people accountable and assets fungible, by tracking transactions, and so providing all the mechanisms required for the monetary and banking system to work and for investment to function. The connection between capital and modern money runs through property.

Today it is records of property ownership and transactions that provide monetary authorities with the crucial evidence they need to issue additional legal tender. As cognitive scientists George A. Miller and Philip N. Johnson-Laird wrote back in 1976: "Paper currency owes its origins to the writing of debt notes. [Therefore] money . . . presupposes the institution of property."[9] It is property documentation that fixes the economic characteristics of assets so that they can be used to secure commercial and financial transactions and ultimately provide the justification against which central banks issue money. To create credit and generate investment, what people encumber are not the physical assets themselves, but their property representations—the recorded titles or shares—governed by rules which can be enforced nationwide. Money does not earn money. You need a property right before you can make money. Even if you loan money, the only way you can earn on it is by loaning or investing it against some kind of property document that establishes your rights to principal and interests. To repeat: Money presupposes property.

As the eminent German economists Gunnar Heinsohn and Otto Steiger point out, "Money is *never created ex nihilo* from the point of view of property, which must always exist *before* money can come into existence."[10] Recognizing similarities between their work and mine, they brought to my attention an unpublished draft of an article stating "that interest and money cannot be understood without the institution of property."[11] This relationship is obscured, they maintain,

9. George A. Miller and Philip N. Johnson-Laird, *Language and Perception* (Cambridge: Harvard University Press, 1976), p. 578.

10. Gunnar Heinsohn and Otto Steiger, "The Property Theory of Interest and Money," unpublished manuscript, second draft, October 1998, p. 22.

11. Ibid., p. 43.

by the common misapprehension that central banks issue notes and support the ability of commercial banks to make payments. In Heinsohn and Steiger's view, what escapes the naked eye is "that all advances are made in good banking against securities,"[12] or in my terms, legal property paper. They agree with Harold Demsetz that the property rights foundation of capitalism has been taken for granted and note that Joseph Schumpeter already had an inkling that it is property rights that secure the creation of money. As Tom Bethell correctly states in his extraordinary book *The Noblest Triumph,* "the many blessings of a private property system have never been properly analyzed."[13]

Capital, as I argued earlier, is therefore not created by money; it is created by people whose property systems help them to cooperate and think about how they can get the assets they accumulate to deploy additional production. The substantial increase of capital in the West over the last two centuries is the consequence of gradually improving property systems, which allowed economic agents to discover and realize the potential in their assets, and thus to be in a position to produce the noninflationary money with which to finance and generate additional production.

So, we are more than squirrels who store food for winter and engage in deferred consumption. We know, through the sophisticated use of property institutions, how to give the things we accumulate a parallel life. When advanced nations pulled together all the information and rules about their known assets and established property systems that tracked their economic evolution, they gathered into one order the whole institutional process that underpins the creation of capital. If capitalism had a mind, it would be located in the legal property system. But like most things pertaining to the mind, much of "capitalism" today operates at a subconscious level.

Why did the classical economists, who knew capital was abstract and had to be fixed, not make the connection between capital and property? One explanation may be that in Adam Smith's or even Marx's day property systems were still restricted and undeveloped, and their importance difficult to gauge. Perhaps more significantly, the battle for the future of capitalism shifted from the book-lined

12. Ibid., p. 38.
13. Tom Bethell, *The Noblest Triumph* (New York: St. Martin's Press, 1998), p. 9.

studies of theoreticians into a vast web of entrepreneurs, financiers, politicians, and jurists. The attention of the world turned from theories to the real deals being made on the ground, day by day, fiscal year after fiscal year.

Once the vast machine of capitalism was firmly in place and its masters were busy creating wealth, the question of how it all came to be lost its urgency. Like people living in the rich and fertile delta of a long river, the advocates of capitalism had no pressing need to explore upstream for the source of their prosperity. Why bother? With the end of the Cold War, however, capitalism became the only serious option for development. So the rest of the world turned to the West for help and was advised to imitate the conditions of life on the delta: stable currencies, open markets, and private businesses, the objective of so-called macroeconomic and structural adjustment reforms. Everyone forgot that the reason for the delta's rich life lay far upriver, in its unexplored headwaters. Widely accessible legal property systems are the silt from upriver that permits modern capital to flourish.

This is one of the principal reasons macroeconomic reforms are not working. Imitating capitalism at the level of the delta, by importing McDonald's and Blockbuster franchises, is not enough to create wealth. What is needed is capital, and this requires a complex and mighty system of legal property that we have all taken for granted.

Braudel's Bell Jar

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

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

> The key problem is to find out why that sector of society of the past, which I would not hesitate to call capitalist, should have lived as if in a bell jar, cut off from the rest; why was it not able to expand and conquer the whole of society? . . . [Why was it that] a significant rate of capital formation was possible only in certain sectors and not in the whole market economy of the time? . . . It would perhaps be teasingly paradoxical to say that whatever else was in short supply, money certainly was not . . . so this was an age where poor land was bought up and magnificent country residences built, great monuments erected and cultural extravagance financed. . . . [How do we] resolve the contradiction . . . between the depressed economic climate and the splendors of Florence under Lorenzo the Magnificent?[14]

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

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

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

But before we answer that question, we have to solve the rest of the mystery of why governments have been so slow to realize a bell jar exists.

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14. Fernand Braudel, *The Wheels of Commerce* (New York: Harper and Row, 1982) p. 248.

CHAPTER FOUR

The Mystery of Political Awareness

Hark, hark! the dogs do bark,
The beggars are coming to town;
Some in rags and some in jags,
And some in silken gown.

—English Nursery Rhyme

The breakdown of population patterns and mandatory law has been an unmistakable trend in developing countries for the past forty years and in former communist countries for the past ten. Since Deng Xiaoping's economic reforms began in 1979, 100 million Chinese have left their official homes in search of extralegal jobs. Three million illegal migrants besieging Beijing have created a jumble of sweatshops on the outskirts of the city. Port-au-Prince has grown fifteen times larger; Guayaquil eleven times larger, and Cairo four times larger. The underground now accounts for 50 percent of GDP in Russia and Ukraine and a whopping 62 percent in Georgia. The International Labor Organization reports that since 1990, 85 percent of all new jobs in Latin America and the Caribbean have been created in the extralegal sector. In Zambia, only 10 percent of the workforce is legally employed.

What are these countries doing about this? Quite a lot. They have rolled up their sleeves and gone to work, addressing each of these problems individually. In August 1999, for example, Bangladesh authorities demolished 50,000 shanties in the capital city of Dhaka. Where demolition is impossible, governments have built schools and sidewalks for the millions of squatters invading public and private lands. At the same time, they have supported microfinance programs to assist the sweatshops that are transforming residential areas into industrial zones throughout the world. They have improved the stalls of sidewalk vendors clogging their streets; removed hordes of drifters from their city squares and planted flowers instead; tightened construction and safety codes to prevent buildings collapsing as they did in Turkey during the 1999 earthquake. Governments have tried to force the independent jitneys and shabby taxis that glut traffic to meet minimum safety standards; they are cracking down on theft and loss of water and electricity and trying to enforce patents and copyrights. They have arrested and killed as many gangsters and drug traffickers as possible (at least the most famous ones) and jailed them (at least for a while); they have tightened security measures to control the influence of extreme political sects among the uprooted and vulnerable multitudes.

Each of these problems has its own academic specialty to study it and its own political program to cope with it. Few seem to realize that what we have here is *one* huge, worldwide industrial revolution: a gigantic movement away from life organized on a small scale to life organized on a large one. For better or for worse, people outside the West are fleeing self-sufficient and isolated societies in an effort to raise their standards of living by becoming interdependent in much larger markets.

What is understood all too rarely is that the Third World and former communist societies are experiencing nearly the same industrial revolution that arrived in the West more than two centuries ago. The difference is that this new revolution is roaring ahead much faster and transforming the lives of many more people. Britain supported just 8 million people when it began its 250-year progression from the farm to the laptop computer. Indonesia is making that same journey in only four decades and carrying a population of more than 200 million. No wonder its institutions have been slow to adapt. But adapt they must. A tide of humanity has moved from isolated communities and households to participate in ever-widening circles of economic and intellectual exchange. It is this tide that has transformed Jakarta, Mexico City, São Paolo, Nairobi, Bombay, Shanghai, and Manila into megacities of 10, 20, 30 million and overwhelmed their political and legal institutions.

The failure of the legal order to keep pace with this astonishing economic and social upheaval has forced the new migrants to invent extralegal substitutes for established law. Whereas all manner of anonymous business transactions are widespread in advanced countries, the migrants in the developing world can deal only with people they know and trust. Such informal, ad hoc business arrangements do not work very well. The wider the market, as Adam Smith pointed out, the more minute the division of labor can be. And as labor grows more specialized, the economy grows more efficient, and wages and capital values rise. A legal failure that prevents enterprising people from negotiating with strangers defeats the division of labor and fastens would-be entrepreneurs to smaller circles of specialization and low productivity.

Entrepreneurship triumphed in the West because the law integrated everyone under one system of property, giving them the means to cooperate and produce large amounts of surplus value in an expanded market. The advances of the West, right up to today's exponential growth of electronic information and telecommunications technology, could happen only because the property rights systems required to make them work were already in place. Integrated legal property systems destroyed most closed groups while inviting the creation of a larger network where the potential to create capital increased substantially. In this sense, property obeys what is known as Metcalfe's Law (named after Bob Metcalfe, the inventor of the Ethernet Standard that commonly networks personal computers). According to Metcalfe's Law,

> The value of a network—defined as its utility to a population—is roughly proportional to the number of users squared. An example is the telephone network. One telephone is useless: whom do you call? Two telephones are better, but not much. It is only when most of the population has a telephone that the power of the network reaches its full potential to change society.[1]

Like computer networks, which had existed for years before anyone thought to link them, property systems become tremendously powerful when they are interconnected in a larger network. Only then is the potential of a particular property right not limited to the imagination of its owner, his neighbors, or his acquaintances, but subject to a larger network of other imaginations. Only then will people subject themselves to obeying one legal code because they will realize that without that code they will cease to prosper. Only then can government begin to administer development instead of heroically rushing to plug each and every leak. A modern government and a market economy are unviable without an integrated formal property system. Many of the problems of non-Western markets today are due mainly to the fragmentation of their property

1. "Survey the Internet," *Economist*, July 1, 1995, pp. 4–5.

arrangements and the unavailability of standard norms that allow assets and economic agents to interact and governments to rule by law.

When migrants move from developing and former communist countries to advanced nations, well-developed institutions eventually absorb them into a networked property system that helps them produce surplus value. The people who migrate within their own countries are not being accommodated in this way—at least not quickly enough. Poorer countries lack the institutions to integrate the migrants into the formal sector, fix their assets into fungible forms, make their owners accountable agents, and provide them with connecting and leveraging devices which allow them to interface productively and generate capital within a large legal market. So the migrants invent, at the expense of the legal order, a variety of extralegal arrangements to substitute for the laws and institutions they need to cooperate in an expanded market.

Political blindness, therefore, consists of being unaware that the growth of the extralegal sector and the breakdown of the existing legal order are ultimately due to a gigantic movement away from life organized on a small scale towards one organized in a larger context. What national leaders are missing is that people are spontaneously organizing themselves into separate, extralegal groups until government can provide them with one legal property system.

The fundamental problem for non-Western nations is not that people are moving to urban centers, that garbage is piling up, that infrastructure is insufficient, or that the countryside is being abandoned. All of that happened in advanced nations. Nor is the problem simply urban growth. Los Angeles has grown faster than Calcutta in this century, and Tokyo is three times bigger than Delhi. The primary problem is the delay in recognizing that most of the disorder occurring outside the West is the result of a revolutionary movement that is more full of promise than of problems. Once the potential value of the movement is harnessed, many of its problems will be easier to resolve. Developing and former communist nations must choose to either create systems that allow their governments to adapt to the continual changes in the revolutionary division of labor or continue to live in extralegal confusion—and that really isn't much of a choice.

Why has everyone missed the real problem? Because there are two blind spots. First, most of us do not see that the surge in the world's extralegal populations over the past forty years has generated a new class of entrepreneurs with their own legal arrangements. Government authorities see only a massive influx of people and illegal workers and the threat of disease and crime. So while the housing ministry deals with its own issues and the ministries of health and justice focus on theirs, no one notices that the real cause of the disorder is not population, or urban growth, or even a poor minority, but an outmoded system of legal property.

Most of us are like the six blind men in the presence of an elephant: One grasps the animal's searching trunk and thinks an elephant is a species of snake; another finds its tail and thinks the elephant is a rope; a third is fascinated by the large, sail-like ears; another embraces its leg and concludes that the elephant is a tree. No one views the elephant in its totality, and thus they cannot come up with a strategy for dealing with the very large problem at hand. As we have seen, the poor in developing and former communist countries constitute two-thirds of the world's population—and they have no alternative but to live outside the law. As we also saw, the poor have plenty of things, but their property rights are not defined by any law. The millions of enterprising people who fill 85 percent of all new jobs in Latin America, those 3 million Chinese outside Beijing operating illegal sweatshops, and those Russians who generate half of their nation's GDP are doing so on the basis of extralegal arrangements. More often than not, these grassroots property arrangements openly contradict the official, written law. That is the elephant before us.

I do not believe the appearance of small enclaves of prosperous economic sectors in the midst of large undeveloped or informal sectors marks the dawn of an uneven but nevertheless inevitable transition to capitalist systems. Rather, the existence of prosperous enclaves in a sea of poverty conceals an abysmal retardation in a nation's capacity to create, respect, and make available formal property rights to the majority of its citizens.

The second blind spot is that few recognize that the problems they face are not new. The migration and extralegality plaguing cities in the developing and former communist world closely resemble what the advanced nations of the West went through during their own industrial revolution. They too focused on trying to solve their problems one by one. The lesson of the West is that piecemeal solutions and stopgap measures to alleviate poverty were not enough. Living standards rose only when governments reformed the law and the property system to facilitate the division of labor. With the ability to increase their productivity through the beneficial effects of integrated property systems, ordinary people were able to specialize in ever-widening markets and to increase capital formation.

Blind Spot I: Life Outside the Bell Jar Today

Why didn't we see this new industrial revolution coming? Back in the 1980s, when my colleagues and I in Peru began our work, most officials assumed that our part of the world was to a great extent controlled by law. Latin America had a long, refined, and well-respected legal tradition. To be sure, there were poor people holding jobs and property outside the law, but this extralegal sector was considered relatively small and thus a "marginal" issue. Advanced nations had their share of poverty, unemployment, and black markets, and we had ours. Dealing with them was a job mainly for the police or the handful of academic sociologists who had devoted their careers to studying homegrown exotica. At best, the poor made good copy for *National Geographic* and the Discovery Channel.

But no one had any exact data. No one even knew how to measure what the poor were actually doing or precisely how much they owned. And so my colleagues and I decided to put away our books and academic journals, not to mention our reams of government statistics and maps, and visit the real experts on this problem: the poor themselves. Once we went into the streets to look around and listen, we began stumbling across surprising facts. For instance: The Peruvian construction industry was in a slump. Building was down, workers were being laid off. Curiously, however, at outlets for construction materials the cash registers were still ringing. In fact, sales of cement were up. *Bags* of cement, that is. After further investigation, we discovered that the poor were buying more cement than ever for their construction projects—houses, buildings, and businesses that were not legally registered or titled and therefore never made it onto the computer screens of the government economists and statisticians. We began to sense a vibrant, independent, officially invisible extralegal economy buzzing in the cities throughout the developing world. In Brazil, for example, the construction industry reported a mere 0.1 percent growth in 1995; yet cement sales during the first six months of 1996 soared by nearly 20 percent. The reason for the apparent anomaly, according to a Deutsche Morgan Grenfell analysis is that 60 to 70 percent of the region's construction never gets into the records.[2]

The extralegal sector, we realized was hardly a small issue. It was *enormous*.

Growing Cities

The movement towards the cities ballooned in the 1960s for most developing countries, and in the 1980s for China. For various reasons, self-reliant communities abandoned their isolation and began trying to integrate in and around cities. Since the 1980s, millions of Chinese peasants have been illegally clustering around cities to the point where the *Beijing Youth Daily* proclaimed that "the management of the migrant population is out of control."[3]

The phenomenon is also familiar to countries around the Mediterranean. According to Henry Boldrick, after World War II, rural immigrants in Turkey headed towards the cities, building their own dwellings on government land. These spontaneous settlements, known as *gecekondus*, now house at least half of Turkey's urban population. Though some *gecekondus* have been at least partly legalized and consequently have been able to gain some municipal services, the majority are still informal.[4]

In the Philippines, the newspaper *Business World* called on the government "to stem the tide of humanity that is congesting our city to bursting point. . . . You see *barong-barongs* made of concrete and hollow blocks—and you begin to wonder. What is the government doing about the growing problem of homelessness, of squatters in our cities?"[5]

In South Africa, some observers (including myself) believe the extralegal real estate sector is on the verge of its second major expansion. In 1998, *Newsweek* reported that "more and more [South

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2. Jeb Blount, "Latin Trade," *News Finance,* January 20, 1997.
3. Tony Emerson and Michael Laris, "Migration," *Newsweek*, December 4 1995.
4. Henry Boldrick, "Reaching Turkey's Spontaneous Settlements," *World Bank Policy,* April–June 1996.
5. "Solving the Squatter Problem," *Business World*, May 10, 1995.

African blacks] are filling the squatter camps and shantytowns that surround every South African city. Under apartheid, racial pass laws confined many blacks to rural areas. Now they travel freely—but hardly in comfort."[6] The *Economist* confirmed the trend: "Though anti-white political violence never really materialized, the end of racial segregation made it easier for poor blacks to wander into rich white areas."[7]

In Egypt, intellectuals and technocrats seem to have been aware of the issue for some time. According to one recent report, between 1947 and 1989 "Egypt's total urban population has . . . increased . . . from 6.2 million to 23.46 million."[8] Figures compiled by Gerard Barthelemy show that the population in the metropolitan area of Port-au-Prince, Haiti, rose from 140,000 in 1950 to 1,550,000 in 1988 and is now approaching 2 million. Barthelemy estimates that about two-thirds of these people live in shantytowns, or what the Haitians call *bidonvilles*.[9]

In Mexico, the private sector has become increasingly conscious of the extralegal phenomenon and actively involved in doing something about it. According to one news report:

> A 1987 study by the Center for Private Sector Economic Studies (CPSEIS) estimated that the extralegal informal sector generated economic activity worth between 28% and 39% of the official Mexican GDP, and a 1993 study . . . put the number of people in the "non-registered informal sector" at 8 million out of a total work force of 23 million. . . . "For every formal business, there are two informal businesses," says Antonio Montiel Guerrero, president of the Mexico City Small Business Chamber of Commerce (CANACOPE), a group representing 167,000 small, registered formal businesses. "In the Federal District (Mexico City) there are about 350,000 small, informal businesses for a total population of roughly 8 million." What that translates into for the whole 20-million-person Mexico City metropolitan area is

6. *Newsweek,* March 23, 1998.

7. *Economist,* June 6, 1998.

8. Manal El-Batran and Ahmed El-Kholei, *Gender and Housing in Egypt* (Cairo: Royal Netherlands Embassy, 1996), p. 24.

9. Gerard Barthelemy, "L'extension des lotissements sauvages à usage populaire en milieu urbain ou Paysans, Villes et Bidonvilles en Haiti: Aperçus et reflexions," June 1996, Port-au-Prince, offprint, June 1996.

> anybody's guess, especially when the unregulated and growing shantytowns are concentrated outside the central core of the city.[10]

Extralegal zones in developing countries are characterized by modest homes cramped together on city perimeters, a myriad of workshops in their midst, armies of vendors hawking their wares on the streets, and countless crisscrossing minibus lines. All seem to have sprung out of nowhere. Steady streams of small crafts workers, tools under their arms, have expanded the range of activities carried out in the city. Ingenious local adaptations add to the production of essential goods and services, dramatically transforming certain areas of manufacturing, retail distribution, building, and transportation. The passive landscapes that once surrounded Third World cities have become the latest extensions of the metropolis, and cities modeled on the European style have yielded to a more noisy, local personality blended with drab imitations of suburban America's commercial strip.

The sheer size of most of these cities creates its own opportunities. New business owners have emerged who, unlike their predecessors, are of very humble origins. Upward mobility has increased. The patterns of consumption and exclusive luxuries of the old urban society have been displaced by other, more widespread ones.

The March to the Cities

Migration is, of course, the key factor in urban growth in most developing and former communist nations. Its causes, however, are hard to pinpoint. Commentators in each country offer various explanations: a war, an agrarian reform program, the lack of agrarian reform, a foreign embargo on international trade, the opening of international trade, terrorism and guerrillas, moral decay, failed capitalism, failed socialism, even bad taste (It is so much prettier in the countryside, why don't they just stay there?).

Lately, however, opinion has been converging around a few general causes. The most visible explanation for the wave in migration throughout the developing world is better roads. The building of roads and bridges and the transformation of unconnected paths into

10. Blount, "Latin Trade.".

proper highways awakened the rural population to the possibility of travel, and they began moving to the cities. New means of communication provided an additional incentive. Radio, in particular, aroused expectations of increased consumption and income. From thousands of miles away came radio broadcasts publicizing the opportunities, amenities, and comforts of urban life. Modernity sounded within reach of anyone with the courage to head down the road after it.

There is also now fairly widespread agreement that agricultural crises in many countries were also decisive factors. The modernization of agriculture and the uncertain market for some traditional crops following World War II triggered massive layoffs of farm laborers on traditional estates and unleashed vast contingents of people prepared to search for new horizons.

There was also the problem of property rights in the countryside. The long, complex process of agrarian reform only compounded—and ultimately exacerbated—the traditional difficulties of acquiring land suitable for farming. Unable to own land or find work in the countryside, many people came to the cities.

Another powerful attraction was the lower infant mortality rate in most principal cities. This gap between infant mortality in the cities and rural areas widened as medical services in the cities began improving after World War II. Better wages were also an important incentive. In Latin America, for example, by 1970, people leaving the countryside to take up semiskilled employment in capital cities could double or triple their monthly income. A salaried job might quadruple their previous income, and professionals or technicians could earn six times as much. Higher pay offset the risk of unemployment: A migrant who had been unemployed for a year could recoup the lost income in two and a half months in the city. Life in the far-off cities not only seemed better; it was better.

Even the growth of national bureaucracies became an incentive for migration. The centralization of power in the hands of government officials meant that most of the government offices competent to provide advice, answer requests, issue permits, or provide jobs were located in the cities. And any migrant seeking a better future for his children knew that the opportunities for education were much better in the cities. To underemployed peasants with little in the way of resources other than their own ingenuity, education was an increasingly valuable and productive investment. Cities contained most of the secondary school graduates as well as students enrolled in vocational training centers, schools and institutes of higher education, and university applicants and entrants.

Migration, therefore, is hardly an irrational act. It has little to do with "herd instinct." Its it the product of a calculated, rational assessment by rural people of their current situation measured against the opportunities open to them elsewhere. Rightly or wrongly, they believed that migrating to larger markets would benefit them. The move, however, was not an easy one.

Poor People Go Home

Migrants to the cities encountered a hostile world. They soon realized that although urban people had a romantic, even tender image of the farmers and were quick to acknowledge that all citizens had a right to happiness, they preferred that the good farmers pursue their happiness at home. Peasants were not supposed to come looking for modernity. To that end, virtually every country in the developing and former communist world maintained development programs to bring modernity to the countryside.

The greatest hostility toward migrants came from the legal system. At first, the system could easily absorb or ignore them because the small groups who had arrived were hardly likely to upset the status quo. As their numbers grew, however, to the point where they could no longer be ignored, newcomers found themselves barred from legally established social and economic activities. It was tremendously difficult for them to get access to housing, enter formal business, or find a legal job. The legal institutions of most Third World countries had been developed over the years to serve the needs and interests of certain urban groups; dealing with the peasants in rural areas was a separate matter. As long as the peasants stayed put, the implicit legal discrimination was not apparent. Once they settled in the cities, however, they experienced the apartheid of formal law. Suddenly, the bell jar was visible.

Some of the nations of the former Soviet Union also face disarray in their property systems, and at least some elites are recognizing the economic benefits of sorting it out. According to a 1996 report,

> Mechanisms . . . to protect land rights are in their infancy in Russia. . . . In many regions land must be registered with an agency distinct from the one that registers buildings. Moreover, the legal protections that registration provides are unclear. . . . Procedures and customs for protection and use of land rights must be created from scratch. . . . Land is probably Russia's most valuable resource, a resource upon which an entire economy and a democratic society can be based.[11]

We have found that throughout the Third World, extralegal activities burgeon whenever the legal system imposes rules that thwart the expectations of those it excludes. As we saw in Chapter 2, many countries make the obstacles to entering the legal property systems so daunting and expensive that few migrants could ever make their way through the red tape—as many as fourteen years and seventy-seven bureaucratic procedures at thirty-one public and private agencies in Egypt, and nineteen years and 176 bureaucratic steps to legalize the purchase of private land in Haiti.

If there are costs to becoming legal, there are also bound to be costs to remaining outside the law. We found that operating outside the world of legal work and business was surprisingly expensive. In Peru, for example, the cost of operating a business extralegally includes paying 10 to 15 percent of its annual income in bribes and commissions to authorities. Add to such payoffs the costs of avoiding penalties, making transfers outside legal channels, and operating from dispersed locations and without credit, and the life of the extralegal entrepreneur turns out to be far more costly and full of daily hassles than that of the legal businessman.

Perhaps the most significant cost was caused by the absence of institutions that create incentives for people to seize economic and social opportunities to specialize within the marketplace. We found that people who could not operate within the law also could not hold property efficiently or enforce contracts through the courts; nor could they reduce uncertainty through limited liability systems and insurance policies or create stock companies to attract additional capital and share risk. Being unable to raise money for investment, they could not achieve economies of scale or protect their innovations through royalties and patents.

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11. Leonard J. Rolfes, Jr., "The Struggle for Private Land Rights in Russia," *Economic Reform Today*, No. 1, 1996.

Blocked from entering the bell jar, the poor could never get close to the legal property mechanisms necessary to generate capital. The disastrous economic effects of this legal apartheid are most strikingly visible in the lack of formal property rights over real estate. In every country we researched, we found that some 80 percent of land parcels were not protected by up-to-date records or held by legally accountable owners. Any exchange of such extralegal property was therefore restricted to closed circles of trading partners, keeping the assets of extralegal owners outside the expanded market.

Extralegal asset owners are thus denied access to the credit that would allow them to expand their operations—an essential step towards starting or growing a business in advanced countries. In the United States, for example, up to 70 percent of the credit new businesses receive comes from using formal titles as collateral for mortgages. Extralegality also means that the incentives for investment provided by legal security are missing.

Cut off from the legal system, the migrants' only guarantee of prosperity lay in their own hands. They had to compete not only against other people but against the system as well. If the legal systems of their own countries were not going to welcome them, they had no alternative but to set up their own extralegal systems. These extralegal systems, in my opinion, constitute the most important rebellion against the status quo in the history of developing countries since their independence, and in the countries of the former Soviet bloc since the collapse of communism.

Growing Extralegality

The populations of most major Third World cities have increased at least fourfold in the past four decades. By 2015, over fifty cities in developing countries will have 5 million or more people,[12] with most living and working extralegally. The extralegal sector is omnipresent in the developing and former communist countries. New activities have emerged and gradually replaced traditional ones. Walk down most streets and you are bound to bump into extralegal shops, currency exchange, transport, and other services. Even many of the books for sale have been printed extralegally.

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12. Official journal of the *National Geographic Society* (Millennium in Maps), No. 4., October 1998.

Entire neighborhoods have been acquired, developed, and built on the fringes of, or in direct opposition to, government regulations by extralegal settlements and businesses. For every one hundred homes built in Peru, only about thirty have legal title; seventy have been built extralegally. Throughout Latin America, we found, at least six out of eight buildings were in the undercapitalized sector and 80 percent of all real estate was held *outside* the law. According to most estimates, the extralegal sectors in the developing world account for 50 percent to 75 percent of all working people and are responsible for one-fifth to more than two-thirds of the total economic output of the Third World.

Consider Brazil: Thirty years ago, more than two-thirds of housing construction was for rent; today rentals constitute scarcely 3 percent of Brazil's construction. Most of that market has moved to the informal parts of Brazilian cities—the *favelas*. According to Donald Stewart,

> People are not conscious of the volume of economic activity that exists in a favela. These informal economies were born of the entrepreneurial spirit of peasants from the North East of Brazil who were attracted by urban centers. They operate outside the highly regulated formal economy and function according to supply and demand. In spite of the apparent lack of resources, this informal economy functions efficiently. In the favelas there are no rent controls, rents are paid in US dollars and renters who do not pay are rapidly evicted. The profitability of investment is good and as a result there is an abundance of supply of housing.[13]

The *Wall Street Journal* reported in 1997 that according to the group Friends of the Land, only 10 percent of land occupied in the Brazilian Amazon jungle is covered by property titles.[14] In other countries, extralegality is on the rise.

Unlike the situation in advanced nations, where the "underclass" represents a small minority living on the margin of society, in some countries extralegality has always been the mainstream. For example, in most countries we have surveyed, the value of extralegal real estate alone is many times greater than total savings and time

13. Donald Stewart, *AIPE*, December 1997.

14. Matt Moffett, "The Amazon Jungle Had an Eager Buyer, but Was It for Sale?" *The Wall Street Journal,* January 30, 1997.

deposits in commercial banks, the value of companies registered in local stock exchanges, all foreign direct investment, and all public enterprises privatized and to be privatized all put together. This should not, on reflection, be surprising. Real estate accounts for some 50 percent of the national wealth of advanced nations; in developing countries, the figure is closer to three-quarters. Extralegal settlements are often the only avenue for investment in developing and former communist countries and therefore represent an important part of the savings and capital formation process. Moreover, the growing contribution of cities to GNP suggests that a great deal of potential capital and technological know-how is being accumulated mainly in urban areas.

The Extralegals Have Come to Stay

This explosion of extralegal activity in the Third World, the massive squatting in rural areas, and the sprawling illegal cities—Peru's *pueblos jóvenes*, Brazil's *favelas*, Venezuela's *ranchos*, Mexico's *barrios marginales*, and the *bidonvilles* of the ex-French colonies as well as the shantytowns of the former British ones—are much more than a surge of population, or poverty, or even illegality. These waves of extralegals crashing up against the bell jars of legal privilege could very well be the most important factor forcing authorities to welcome the industrial and commercial revolution that is upon them.

Most governments in most nations are in no condition to compete with extralegal power. In strictly physical terms, extralegal ventures have already overtaken government efforts to provide housing for migrants and the poor. In Peru until the end of the 1980s, for example, government investment in low-income housing hovered around 2 percent of the housing investment in the extralegal sector. Including middle-class housing raised the government share to only 10 percent of total informal investments. In Haiti in 1995, the value of extralegal real estate was nearly ten times greater than all the holdings of the Haitian government.

This extralegal sector is a gray area that has a long frontier with the legal world, a place where individuals take refuge when the cost of obeying the law outweighs the benefit. The migrants became extralegals to survive: They stepped outside the law because they were not allowed inside. In order to live, trade, manufacture, transport, or even consume, the cities' new inhabitants had to do so extralegally.

The extralegal arrangements they cobbled together are explicit obligations between certain members of society to provide security for their property and activities. They represent combinations of rules selectively borrowed from the official legal system, ad hoc improvisations, and customs brought from their places of origin or locally devised, and they are held together by a social contract supported by the community as a whole and enforced by authorities the community has selected. The disadvantage to extralegal arrangements is that they are not integrated into the formal property system and as a result are not fungible and adaptable to most transactions; they are not connected into the financial and investment circuit; and their members are not accountable to authorities outside their own social contract.

These arrangements are run by a large variety of organizations, including urban development associations, farming conventions, small merchant associations, small business organizations, microentrepreneurial communities, transport federations, miners' claim clubs, agrarian reform beneficiaries, private housing cooperatives, settlement organizations, residential boards, communal committees, beneficiary committees in state-built housing, native communities, small farmers' associations, and village organizations. These organizations also run building extensions on desert land, building extensions on agricultural land, special arrangements for historic parts of the cities, subdivisions of public housing, settlements with private contracts, settlements with public contracts, appropriations through subleasing with owner's consent, state housing with incomplete titling, illegal tenancy contracts declared before a notary and not recorded, settlement contracts recorded but not declared before a notary, settlements recognized by "national peace processes," relocated settlers, and settlements recorded with suppliers of basic services or tax authorities but not recorded with the official property custodians.

Extralegality is rarely antisocial in intent. The "crimes" extralegals commit are designed to achieve such ordinary goals as building a house, providing a service, or developing a business. Far from being the cause of disarray, this system of extralegal law is the only way settlers have to regulate their lives and transactions. As a result, nothing could be more socially relevant to the way the poor live and work. Although their "laws" may be outside formal law, they are, by and large, the only laws with which these people are comfortable. This is the social contract by which they live and work.

The extralegal settlements the migrants inhabit may look like slums, but they are quite different from the inner-city slums of advanced nations. The latter consist of once-decent buildings falling apart from neglect and poverty. In the developing world, the basic shelters of the poor are likely to be improved, built up, and progressively gentrified. Whereas the houses of the poor in advanced nations lose value over time, the buildings in the poor settlements of the developing world become more valuable, evolving within decades into the equivalent of working-class communities in the West.

Above all, the extralegal settlers, contrary to their lawless image, share the desire of civil society to lead peaceful, productive lives. As Simon Fass wrote in the eloquent conclusion of his book about the economy of Haiti,

> These ordinary people are extraordinary in only one respect. Their incomes are very low, so low that one serious error of judgment or one unfortunate act of providence can often threaten survival of a household as a corporate entity, and sometimes also threaten survival of its members as corporeal entities. What is extraordinary is not so much the poverty itself, but rather the ability of these people to survive in spite of it. . . . Nothing they do in this process is anything but a productive contribution to survival and growth, and the simple items they obtain have concrete functions as factor inputs to the production process.[15]

As the economic activities with which they are associated have grown and diversified, these extralegal organizations have also begun to assume the role of government. To varying degrees, they have become responsible for the provision of such basic infrastructure as roads, water supply, sewage systems, electricity, the construction of markets, the provision of transport services, and even the administration of justice and the maintenance of order.

15. Simon Fass, *Political Economy in Haiti: The Drama of Survival* (New Brunswick, N.J.: Transaction Publishers, 1988), pp. xxiv–xxv.

In the face of the extralegals' advance, governments have retreated. But they are inclined to consider each concession temporary "until the crisis has passed." In reality, however, this strategy is only a way of delaying the inevitable defeat. In some cases, governments have created exceptions for some extralegal enterprises, legal enclaves as it were, where originally illegal enterprises can operate without persecution—but without integrating them so that they enjoy the protection and benefits of the entire legal system. These arrangements avoid open confrontation and as such can be considered a sort of transitory legal peace treaty. In Egypt, for example, experts are already talking about "semi-formal housing":

> Such housing not only increases the housing stock within the country and provides relatively cheap housing but also provides a large proportion of the urban population with an asset in which they can invest. This kind of housing does have some degree of illegality. The housing structures are not developed through established, regulated procedures and those who construct them do not use the recognized institutions of housing. They are usually constructed on agricultural areas which were illegally sub-divided into small plots by the private developers. . . .
>
> The government is usually involved in the process of land acquisition within semi-informal housing. In the semi-formal housing areas where the research was undertaken, it was government bodies that initiated their development and this encouraged private developers to sub-divide the land illegally into small plots at a later stage. Land use was changed from agricultural to residential use through a covert role from the government. The inhabitants within such areas usually acquire their land through an informal process of sub-division and informal land commercialization. Hager El Mawatayah, Exbet Abou Soliman, and Ezbet Nadi El Sid are the best examples of such areas in the city of Alexandria.[16]

Even in the most unlikely places, there is evidence that governments are recognizing that their legal institutions have not adapted to today's economic conditions. In 1992, Reuters News Service

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16. Ahmed M. Soliman, "Legitimizing Informal Housing: Accommodating Low-Income Groups in Alexandria, Egypt," *Environment and Urbanization*, Vol. 8, No. 1 (April 1996), pp. 190–191.

reported that Libyan leader Mu'ammar Gadhafi had incinerated Libya's land titles. "All records and documents in the old land register, which showed that a land belonged to this or that tribe, have been burned," Colonel Gadhafi reportedly informed a meeting of his justice ministry. "They were burned because they were based on exploitation, forgery, and looting."[17]

In some countries, the extralegal sector is now at the very root of the social system. The people of Touba, Senegal, who can be seen hawking their wares on the sidewalks of New York and other big U.S. cities, are often part of a sophisticated Islamic-African sect that funnels millions of dollars of profits back to their home city. *Newsweek* describes Touba as

> a state within a state, largely exempt from Senegal's laws, . . . [and] the country's fastest growing city. Entire villages have relocated here, setting up tin shacks among the walled villas of the rich. . . . The duty free city is the hub of Senegal's transportation and real estate empires, the booming informal sector, and the peanut trade, the nation's main source of foreign exchange.[18]

In other parts of the world, extralegals' concerns about losing their property can ignite open conflict. A case in point is Indonesia whose problems have been much in the news in recent years. As far back as six years ago, the *Economist* was warning:

> Poor people are edgy about losing their property because urbanization and industrialization are creating demand for land, in a country in which land ownership is an extremely murky business. Only 7% of the land on the Indonesian archipelago has a clear owner.
>
> Inevitably, there is a large trade in both genuine and forged certificates. People trying to buy parcels of land sometimes find numerous apparent owners. And banks are very wary of accepting land as collateral for loans.[19]

Elsewhere extralegality is closely associated with misery: "In Bombay . . . two-thirds of the city's 10 million residents live in either

17. Reuters, *Financial Review,* May 11, 1992, p. 45.
18. Mavery Zarembo, *Newsweek,* July 7, 1997.
19. *Economist,* March 5, 1994.

one-room shacks or on the pavement."[20] Yet extralegals in other countries are moving up the economic ladder. According to the Technical Evaluations Organization of Peru (Cuerpo Técnico de Tasaciones del Perú), the value of land in the formal sector of Lima averages some US$50 per square meter, whereas in the area of Gamarra, where a great deal of Peru's informal manufacturing sector resides, the value per square meter can go as high as US$3,000. In Aviación, another extralegal center in Lima, land is worth US$1,000 per square meter; and in Chimú of the Zárate section, it is US$400. By contrast, Miraflores and San Isidro, Lima's most prestigious addresses, the value of legal, titled property ranges from US$500 to US$1,000 per square meter.[21]

It Is an Old Story

Once governments understand that the poor have already taken control of vast quantities of real estate and productive economic units, it will become clear that many of the problems they confront are the result of the written law not being in harmony with the way their country actually works. It stands to reason that if the written law is in conflict with the laws citizens live by, discontent, corruption, poverty, and violence are sure to follow.

The only question that remains is how soon governments will begin to legitimate these extralegal holdings by integrating them into an orderly and coherent legal framework. The alternative is perpetuating a legal anarchy in which the existing property rights system continually competes with the extralegal one. If these countries are ever to achieve a single legal system, official law must adapt to the reality of a massive extralegal push toward widespread property rights.

The good news is that legal reformers will not be stepping into an abyss. The challenge they are up against, though enormous, has been met before in many countries. Developing and former communist countries are facing (albeit in much more dramatic proportions) the same challenges the advanced nations dealt with between the eighteenth century and World War II. Massive extralegality is not

20. *Economist,* May 6, 1995.

21. "Terrenos de Gamarra valen tres veces más que en el centro de Lima," *El Comercio,* 25 April 1995.

a new phenomenon. It is what always happens when governments fail to make the law coincide with the way people live and work.

When the Industrial Revolution began in Europe, governments were also plagued with uncontrollable migration, growth of the extralegal sector, urban poverty, and social unrest. They, too, initially addressed these problems piecemeal.

Blind Spot II: Life Outside Yesterday's Bell Jar

The Move to the Cities

Most writers link the coming of the great industrial and commercial revolution in Europe to the mass migrations to its cities, the growth of the population as a result of a decline in plagues, and a reduction in rural incomes compared with urban incomes.[22] In the seventeenth and eighteenth centuries, workers in the cities began to receive higher wages than those in rural areas for carrying out construction projects ordered by the ruling classes. Inevitably, the more ambitious peasants migrated to the cities, enticed by the prospect of higher wages.

In England, the first wave of migration began late in the sixteenth century. Disconcerted by the growing numbers of migrants in the cities and the resulting unrest, authorities tried to keep the peace with various stopgap measures such as distributing food among the poor. There were also persistent measures to persuade people to return to the countryside. A series of laws enacted in 1662, 1685, and 1693 required that citizens return to their place of birth or their previous fixed residence as a condition of receiving relief. The aim was to prevent more families and laborers from migrating to the cities in search of employment. In 1697, a law was passed allowing migrants to move about England only if they obtained a certificate of settlement from the authorities in their new place of residence. Although these laws did discourage migration among families and the infirm, young, able-bodied, and ambitious unmarried men devised

22. Jan De Vries, *Economy of Europe in an Age of Crisis, 1600–1750* (Cambridge: Cambridge University Press, 1976); D. C. Coleman, *Revisions in Mercantilism* (London: Methuen, 1969); J. H. Clapham, *The Economic Development of France and Germany, 1815–1914* (Cambridge: Cambridge University Press, 1963); Eli Heckscher, *Mercantilism,* ed. E. F. Soderland (London: George Allen & Unwin, 1934).

ways of returning to the cities. They were also the sort who made successful entrepreneurs—or violent revolutionaries.

Most migrants did not find the jobs they expected. Restrictive regulations, particularly difficulties in obtaining permission to expand or diversify activities, limited the capacity of formal businesses to grow and provide jobs for new laborers. Some found temporary work or entered domestic service.[23] Many were forced to settle precariously on the outskirts of Europe's cities, in "suburbs," the extralegal settlements of the day, awaiting admission to a guild or a job in a legal business.

Social unrest was inevitable. No sooner did the migration to the cities begin than the existing political institutions fell behind a rapidly changing reality. The rigidity of mercantilist law and custom prevented migrants from realizing their full economic potential. The overcrowding of an increasing urban population, disease, and the inevitable difficulties of country people adapting to life in the city further aggravated social conflict. D. C. Coleman observes that as early as the sixteenth century there were complaints in the English Parliament about the "multitude of beggars" and the great increase in "rogues, vagabonds, and thieves" in the cities.[24]

Instead of adapting to this new urban reality, governments created more laws and regulations to try to stamp it out. More regulations brought more infringements—and soon new laws were passed to prosecute those who broke the old ones. Lawsuits proliferated; smuggling and counterfeiting were widespread. Governments resorted to violent repression.

The Emergence of Extralegality

Gradually, European migrants who did not find legal employment began to open illegal workshops in their homes. Much of this work "consisted of the direct processing, with little capital equipment beyond simple hand tools."[25] Longtime city dwellers despised the work done outside the guilds and the official industrial system.

23. Joseph Reid, *Respuestas al primer cuestionario del ILD* (Lima: Meca, 1985).
24. D.C. Coleman, *The Economy of England, 1450–1750* (London: Oxford University Press, 1977), pp. 18–19.
25. Ibid., pp. 58–59.

The migrants, of course, could not afford to be choosy; extralegal work was their only source of income, and the extralegal sector of the economy began spreading rapidly. Eli Heckscher quotes a comment by Oliver Goldsmith in 1762: "There is scarcely an Englishman who does not almost every day of his life offend with impunity some express law . . . and none but the venal and the mercenary attempt to enforce them."[26] Two French decrees (of 1687 and 1693), also cited by Heckscher, recognized that one reason why production specifications were not being complied with was that the workers, then even more illiterate than in developing countries today, could not meet even the simple legal requirement that textile manufacturers put their names on the fore-pieces of their cloth. Still, these migrant workers were efficient. Adam Smith once remarked, "If you would have your work tolerably executed, it must be done in the suburbs where the workmen, having no exclusive privilege, have nothing but their character to depend on, and you must then smuggle it into the town as well as you can."[27]

Authorities and legal businessmen were not as impressed with the competition as Adam Smith. In England, during the decades following the restoration of the monarchy in 1660, some traditionalists began to complain about the growing numbers of peddlers and street vendors, the disturbances that took place in front of established shops, and the appearance of new shopkeepers in many small cities. Formal traders tried in vain to get rid of the newcomers. In Paris, the legal battle between tailors and secondhand-clothes dealers went on for more than three hundred years. It was stopped only by the French Revolution.

The preambles to laws and ordinances of this era frequently refer to noncompliance with previous laws and regulations. According to Heckscher, printed calicoes imported from India were prohibited in 1700 in order to protect England's woolen industry. Enterprising English manufacturers produced their own calicoes, always managing to find exceptions or loopholes in the law. One way around the ban on printing cotton-based fabrics was to use fustians—English calicoes made with a linen warp. Spain also prosecuted and punished its extralegal entrepreneurs. In 1549, Emperor Charles I promulgated twenty-five ordinances aimed at extralegal businesses.

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26. Heckscher, *Mercantilism,* Vol. 1, p. 323.
27. Ibid., p. 241.

One law called for authorities to mutilate fabric samples by cutting off the selvedges containing the manufacturer's mark so that buyers would know they were purchasing extralegal goods. This was intended to humiliate distributors.

Government repression of extralegals was plentiful, harsh, and, in France, deadly. In the mid-eighteenth century, laws prohibiting the French public from manufacturing, importing, or selling cotton prints carried penalties ranging from slavery and imprisonment to death. The extralegals remained undeterred. Heckscher estimates that within one ten-year period in the eighteenth century the French executed more than 16,000 smugglers and clandestine manufacturers for the illegal manufacture or import of printed calicoes. An even larger number were sentenced to the galleys or punished in other ways. In the town of Valence alone, 77 extralegal entrepreneurs were hanged, 58 were broken on the wheel, and 631 were sentenced to the galleys. Authorities found it in their hearts to set free only one extralegal.

According to Robert Ekelund and Robert Tollison, the reason the authorities prosecuted extralegals so harshly was not only because they wanted to protect established industries; multicolored prints also made taxes more difficult to collect.[28] Although it was easy to identify manufacturers of single-colored textiles and thus verify whether they were paying all their taxes, calicoes, due to a new printing system, could be made with a variety of colors, making it much more difficult to identify their origin.

The state relied heavily on the guilds—whose main function was to control access to legal enterprise—to help identify lawbreakers. But by making the laws more stringent instead of adjusting them to include extralegal manufacturing, the authorities simply forced entrepreneurs to the extralegal suburbs. When the English Statute of Artificers and Apprentices of 1563 fixed wage rates for workers and required that they be adjusted annually according to the prices of certain basic necessities, many of the earliest extralegals moved their businesses to outlying towns or established new suburbs where state supervision was less strict and regulations more lax or simply inapplicable. Retreating to the suburbs also allowed extralegals to

28. Robert B. Ekelund, Jr. and Robert Tollison, *Mercantilism as a Rent-Seeking Society* (College Station: Texas A&M University Press, 1981), Chapter 1.

escape the watchful eye of the guilds, whose jurisdiction extended only to city boundaries.

Eventually, extralegal competition increased to the point that formal business owners had no alternative but to subcontract part of their production to suburban workshops—narrowing the tax base and causing taxes to rise. A vicious circle set in: Higher taxes exacerbated unemployment and unrest, prompting greater migration to the suburbs and more subcontracting to extralegal manufacturers. Some extralegals did so well that they won the right to enter formal business—though not without paying their share of bribes and applying political pressure.

The guilds fought back. Under the Tudors, numerous laws in England prohibited extralegal workshops and services in the suburbs. But the sheer number of extralegals and their skill at avoiding detection thwarted these efforts. Among the most notable failures were the hat and coverlet makers' guilds in Norwich, which, after a protracted and highly publicized campaign against extralegal operators, were unable to enforce their exclusive legal right to manufacture hats and coverlets.[29] Competition had left the guilds reeling. Coleman attributes their decline to the "increasing labor supply, changing patterns of demand, and expanding trade; [and] the growth of new industries and the considerable extension of rural industry organized on the putting-out system."[30]

The Breaking Down of the Old Order

European governments were gradually forced to retreat in the face of growing extralegality—as governments in developing and former communists countries are doing today. In Sweden, unable to stop the establishment of extralegal settlements, King Gustavus Adolphus had to visit each settlement and give it his blessing to maintain an appearance of government control. In England, the state was forced to recognize that new industries were developing primarily in places where there were no guilds or legal restrictions; indeed, extralegals had created their own suburbs and towns specifically to avoid control by the state and the guilds. Moreover, the extralegal

29. Heckscher, *Mercantilism*, Vol. 1, pp. 239–244.
30. Coleman, *The Economy of England,* p. 74.

industries were more efficient and successful. It was widely acknowledged that the cotton textile industry had boomed because it was not regulated as strictly as the woolen industry. People soon began noticing that the extralegal settlements were producing better goods and services than their legal competitors inside the bell jars. In 1588, a report to Lord Cecil, minister to Queen Elizabeth I, described the citizens of Halifax, one of the new extralegal settlements:

> They excel the rest in policy and industry, for the use of their trade and grounds and, after the rude and arrogant manner of their wild country, they surpass the rest in wisdom and wealth. They despise their old fashions if they can hear of a new, more commodious, rather affecting novelties than allied to old ceremonies. . . . [They have] a natural ardency of new inventions annexed to an unyielding industry.[31]

Extralegals also began building within the cities. In Germany, where it was necessary to pass a test and obtain legal approval in order to build, according to one historian, "whole districts could be found in which plenty of houses were being built, though there was no one in the district legally qualified to build them."[32]

The extralegals' numbers, persistence, and success began to undermine the very foundations of the mercantilist order. Whatever success they had, it was won in spite of the state, and they were bound to view the authorities as their enemies. In those countries where the state outlawed and prosecuted extralegal entrepreneurs instead of adjusting the system to absorb their enterprise, not only was economic progress delayed, but unrest increased, spilling into violence. The best-known manifestations were the French and Russian revolutions.

Those countries that adapted quickly, however, made a relatively peaceful transition to a market economy. As soon as the state realized that a working extralegal sector was socially, politically, and economically preferable to a growing number of unemployed migrants, authorities began withdrawing support from the guilds. The result in England was that fewer and fewer people applied for admission to the guilds, thereby setting the stage for the state to alter drastically the way in which business was conducted.

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31. Heckscher, *Mercantilism,* Vol. 1, p. 244.
32. Clapham, *Economic Development of France and Germany,* pp. 323–325.

The power of the state also declined. Any legal system as rigid as the one that preceded the Industrial Revolution was bound to be rife with corruption. A 1692 ordinance in England stated that tax inspectors in many areas visited workshops and factories merely to collect agreed-upon tax payments without ever examining the goods to see how much the producers really owed. Most production supervisors, whether they belonged to the guilds or were appointed by the state, were continually accused of corruption and neglect of duties, a situation that was attributed to lack of civic respect for the law.

Even members of Parliament, which by the end of the seventeenth century had the power to authorize the establishment of businesses, were known to receive bribes for special favors. Local authorities were worse. In 1601, a speaker in the House of Commons defined a justice of the peace as "a living Creature that for half a Dozen of Chickens will Dispense with a whole Dozen of Penal Statutes." Public officials sought to blame legislative failures not on bad laws but on inadequate enforcement. "I conclude better laws in these points cannot be made, only there wants execution," concluded one pamphlet in 1577. Joseph Reid argues that the old order broke down because widespread corruption permeated all its institutions and divided the population into those who could outwit the system and those who could not. He also notes that a legal system that encouraged some people to break the law and made others suffer from it would inevitably lose prestige among both constituencies.[33] Suburban justices of the peace had little incentive to enforce laws that had been drafted in the cities and were unacceptable to suburban residents. By the end of the eighteenth century, the entire legal apparatus had been weakened and in some countries was completely corrupt.

At a time when government controlled everything, people placed all their economic expectations in the state. This gave rise to a pattern typical of precapitalism: When wages went up faster than food prices, merchants called for wage ceilings; when food prices went up faster than wages, workers demanded a minimum wage and a price ceiling on foodstuffs. Prices, incomes, and wages were fixed by political pressure and action, a situation that discouraged

33. Joseph Reid responds to the second questionnaire submitted by the Institute of Liberty and Democracy. Typewritten memoranda, ILD Library, 1985; Heckscher, *Mercantilism,* Vol. 1, pp. 247, 251.

industrial and agricultural production and hiring. Neither minimum nor maximum prices, therefore, could solve the problems of scarcity, food shortages, and unemployment. "The age," writes Charles Wilson, "was one of violence, when the pursuit of economic ends constantly demanded the backing of force."[34] It was a time ripe for ideological and partisan battle, in parliaments and in the streets.

As early as 1680, a kind of fatalism had emerged in the face of the apparent impossibility of substantial economic progress: "The generality of poor manufacturers believe they shall never be worth ten pounds . . .; and if it so be they can provide for themselves sufficient to maintain their manner of living by working only three days in the week, they will never work four days."[35]

Amidst such economic crises and social unrest, the strongest and most self-confident people chose to emigrate or join revolutionary movements. Between the seventeen and nineteenth centuries, hundreds of thousands of Italians, Spaniards, French, and other Europeans emigrated to other lands in search of a better future. In France, the persecution of the Huguenots and the extralegals in the textile sector prompted many entrepreneurs and skilled workmen to leave, mainly for England and Holland, where they and their hosts managed to prosper.

Finally—After Three Hundred Years

As badly structured regulations stifled formal businesses and as extralegals openly defied the law and voiced their dissatisfaction at being pushed to the margins, the stage was set for politicians to adapt to the facts on the ground. The law had ossified at about the same rate as the migrant settlements encircled the cities. And as peddlers, beggars, and thieves invaded the streets, as extralegally manufactured or smuggled goods glutted the markets, official corruption became rampant, and violence disrupted civil society.

Law began adapting to the needs of common people, including their expectations about property rights, in most West European countries during the nineteenth and early twentieth centuries. By that time, the Europeans had concluded that it was impossible to

34. Charles Wilson, *Mercantilism* (London: Routledge & Kegan Paul, 1963), p. 27.
35. Coleman, *The Economy* of *England,* p. 105.

govern the Industrial Revolution and the presence of massive extralegality through minor ad hoc adjustments. Politicians finally understood that the problem was not people but the law, which was discouraging and preventing people from being more productive.

Although the picture of precapitalist society and the circumstances of its decline are quite similar in most European countries, the outcome was not always the same. Countries that made legal efforts to integrate extralegal enterprise prospered more quickly than the countries that resisted change. By easing access to formal property, reducing the obstacles engendered by obsolete regulations, and allowing existing local arrangements to influence lawmaking, European politicians eliminated the contradictions in their legal and economic systems and allowed their nations to carry the Industrial Revolution to new heights.

The past of Europe strongly resembles the present of developing and former communist countries. The fundamental problem that the latter face is not that people are invading and clogging the cities, that public services are inadequate, that garbage is piling up, that ragged children beg in the streets, or even that the benefits of macroeconomic reform programs are not reaching the majority. Many of these difficulties existed in Europe (and also the United States) and were eventually overcome. The real problem is that we have still not recognized that all these difficulties constitute a sea change in expectations: As the poor flow into cities and create extralegal social contracts, they are forcing a major redistribution of power. Once the governments of developing and former communist countries accept that, they can begin to catch the wave instead of being engulfed by it.