

Cato's Letter

A QUARTERLY MESSAGE ON LIBERTY

Bringing Capitalism to the Masses

Hernando de Soto

The people who opened our intellectual inquiry in Peru as to why things hadn't been working after 12 years of a leftist military government were Rose and Milton Friedman, who were my first guests in 1979.

One of the things Milton taught us when he was in Lima was that there was no free lunch. What he didn't say is that there are free books. About five years after their visit, Milton and Rose sent me a book, called *The Tyranny of the Status Quo*. That book impressed me very much, because by that time our institute had organized hundreds of street vendors and was looking for ways to enact political policies that would make it easier for them to make a living.

The Tyranny of the Status Quo was about—after a few years of Reagan government—how difficult it is to break the Iron Triangle of beneficiaries, politicians, and bureaucrats, which protects the status quo and resists needed change.

We at the Institute for Liberty and Democracy discovered that there was a very large constituency for change in developing countries. Although labeled “the poor,” we under-

*Hernando de Soto is the winner of the 2004 Milton Friedman Prize for Advancing Liberty. This is an excerpt from his acceptance remarks in San Francisco on May 6. De Soto is the founder of the Institute for Liberty and Democracy in Peru and the author of two books, *The Other Path* and *The Mystery of Capital*.*



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stood that those poor wouldn't be surviving if they weren't also entrepreneurs. And while people, as Fareed was pointing out, were saying that a billion people were living on a dollar a day and maybe three billion people were living on \$2 or \$3 a day, nobody said there are four billion people who are poor, who are entrepreneurs, and who are completely excluded from the global economy and even the national economy, because of lack of law.

town, but he and his friends haven't yet been recognized by international financial institutions or by most bilateral programs of developed countries. Even worse, he hasn't really been recognized by most of the people in developing countries who think that street vendors are a problem, that illegal manufacturing creates faulty products.

The more people are aware of the real conditions in developing countries,

“Poor countries need the sorts of solutions that developed countries adopted in the 19th century, not the 21st century.”



It's not the rural 1960s anymore in the Third World. The population of Port-au-Prince is 17 times what it was 35 years ago. The population of Algerian cities is 15 times what it was. Ecuadorian cities, 11 times. And countries that were mostly rural when we started our work are urban today. Those people have moved to become businessmen through the division of labor that cities offer.

THE RISE OF CITIES

Poor countries need the sorts of solutions that developed countries adopted in the 19th century, not the 21st century. What occurred in the West in the 19th century is now occurring in developing countries. “Oliver Twist” has come to

where there are five billion of the world's six billion population, the more politicians are going to find out that their biggest constituency for change is poor businessmen.

THE WEALTH OF NATIONS

My country, Peru, had a president of Japanese origin for 10 years. His name was Alberto Fujimori. The Fujimoris were one of one million families that came from Japan to Peru and Brazil in the 1930s and 1940s.

Now, the fact that the Fujimoris came to Peru and the Yoshiyamas went to Brazil isn't what's important. The more important question is: Why didn't the Toledos and the Lulas go to Japan? They

didn't go to Japan because Peru had a per capita GNP 25 percent above Japan's in 1940, and Brazil had one 50 percent over that. Obviously, Japan did something in the last 50 years that made it 10 times richer than Peru. What happened?

After the Second World War, a plan was implemented that was begun in Honolulu in 1942, under MacArthur's supervision. Like Mao Zedong in China, the Americans basically destroyed the feudal system in Japan, which they thought was at the heart of the problems of Japanese expansionism in Asia. But unlike post-war China, they created the basis of a widespread private property system.

By breaking the feudal system down and creating a large constituency for a market economy, they transformed Japan and its two colonies, Taiwan and South Korea. In 1978, Deng Xiaoping turned around and said, "You know, I don't care what color the cat is as long as it catches mice." And now the giant of Asia is turning around by means of property.

THE "ADOLF BUSCH PHENOMENON"

America has turned countries around and converted feudal economies and patrimonial economies into modern economies through foreign policy before. But there is a tendency, it seems, to forget about those things. It is much easier for a Third Worlder to understand the things I'm saying than it is for a First Worlder, because First Worlders take things for granted.

Karl Popper used to call that phenomenon the Adolf Busch phenomenon. Popper and a friend once went to hear Busch interpreting Vivaldi in Zurich. When he went from the third to the fourth movement, he did it marvelously, in a way

nobody had ever heard. So they visited him afterward in his chambers and asked, "Maestro, how did you go from the third to the fourth movement?" And Adolf Busch said, "Well, it's rather simple." He put the violin to his neck and started playing, and he's never been able to play it again.

TALKING TO THE WRONG PEOPLE

I remember in 1988 I was asked to give a speech at the Secretary of State's Open Forum. The title of the speech was "The United States: Why I Think You're Talking to the Wrong People." In other words most Americans talk to Westernized Third Worlders like me. But most of us have vested interests. We're not really capitalists open to competition, we are mercantilists looking for privileges. The really interesting guys are the real entrepreneurs. But they are poor and small and you haven't made contact with them.

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In Mexico, for example, where we're working with President Fox, we have found out that roughly 80 percent of the Mexican population is in the extralegal economy. They own about 6 million businesses, 134 million hectares of land, and 11 million buildings. And all of them together are worth \$315 billion, which is 7 times the value of Mexican oil reserves and 29 times the value of all foreign direct investments since Spain left.

In other words, pre-capitalist economies, with capitalist orientations, are emerging all over the world. In Egypt, the poor own outside the law 92 percent of all the buildings and 88 percent of all the enterprises, which are worth \$248 billion. That's equivalent to 55 times the value of all foreign direct investment in Egypt since Napoleon left, including the Suez Canal and the Aswan Dam and 70 times all the bilateral aid that they have received.

In other words, the majority of our resources doesn't come from you in the West. Of course, you're very kind, and we accept what you give us, but really it's a drop in the bucket compared to what we already have. Real wealth grows from the efforts of entrepreneurs who can bring resources together and divide labor efficiently to raise productivity.

people violate. Property rights are much more solid, because they're based on a social contract rooted in the reciprocity of one person's interests to another's, not one nation to another."

If you look at maps of Europe over time you find that sovereignty is extremely unstable. Yet if you look at the Alsace-Lorraine, a territory that has been divided up time and again between the French and the Germans, you will find that, no matter who owned it, Monsieur du Pont still lives where he always lived, and Herr Schmidt lives where he always lived. Property rights are the result of a grassroots contract, and they stick even when sovereignty fragments.

PROPERTY AND THE RULE OF LAW

So we are trying to demonstrate that you can break the iron triangle by showing political leaders that they have an enormous constituency for change to a market economy. A market economy is essentially a legal construction and not all those physical things—roads, bridges, airports, and ports—that the West seems to want to give them.

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THE IMPORTANCE OF PROPERTY RIGHTS

We've also been called to places like Ghana. And interestingly enough, not only by President Kufuor, but also by the tribal chiefs. They have read our stuff and said: "we don't want sovereignty anymore; we want property rights. Sovereignty is something all

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If you're poor, and all you've got basically is a piece of land and a place where you work, whether you're street vending or milking a cow, there is nothing more precious to you than your property. But to preserve it without the law you've got to satisfy tribal chiefs, crooked cops, corrupt politicians, bad judges, your difficult neighbors, and even the terrorists.

But if the law comes in and says those rights are now recognized, not only by the neighbors but by the police and the whole nation, now you can trade them nationally and even internationally and the law will protect you, then people become interested in the rule of law.

Soon they'll ask, what happens if they have a dispute and go to court? Then they want a good judiciary system. And eventually they will realize that the laws can be changed, so they'll ask, who makes the laws? And they will care about the political process.

So the origin of the rule of law—which will allow a modern nation to grow and so bring peace, stability, and prosperity to the world—is property rights. And the rule of law will actually generate prosperity.

THE DIVISION OF LABOR

Adam Smith and later Marx would say that the new productivity in Europe was thanks to the division of labor. Smith's example was very simple. He said he saw a couple of people working outside the walls of Glasgow making pins. Taking 18 steps, they were able to make no more than 20 pins each a day. But in another place, he saw 10 people dividing those 18 functions among themselves. One person bought the wire, another one covered it with tin, and then a third one drew the wire, two other people cut the wire, another per-

son put points to the wire, somebody else headed it, and they made 48,000 pins a day.

But if you go to developing countries you will see that you don't really have firms, because the law hasn't reached there. All they've got are families. And families have trouble putting even 10 people to work. They can only put 4. And of those 4, there are your lazy brother and your alcoholic brother-in-law: guys who aren't good at making pins. Anybody who is a manager knows that how you combine resources and who you employ to work are important.

More than four billion people don't have property rights over their assets so they cannot get credit and use collateral and they also cannot create a firm in which they can divide labor. This means they can't efficiently organize inputs or manage the creation of the outputs. They



can't separate the assets of shareholders from the assets of creditors and workers.

With only a few poorly organized people per enterprise, no matter how much microcredit you throw to them, they will never become efficient and so never be able to compete in the global marketplace. Value is not only raw manpower but also the power of man to divide labor. Even though Adam Smith

not believe in the potential of human beings liberated by the rule of law.

The enemies of the Enlightenment are romantics who become the kind of nationalists who don't know how to talk about civilization in the singular, who always believe in many civilizations at the same time. Because they're romantic nationalists, they draw people away from the universal laws of progress. They are



“Property rights are the result of a grassroots contract, and they stick even when sovereignty fragments.”

was a great man, many of these early liberals left us with an inheritance that we'll have to get rid of: the labor theory of value. Value doesn't just come from simple labor. It comes from intelligent political and economic solutions that can raise productivity enormously.

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THE POTENTIAL OF LIBERTY

To build modern nations, we have to learn how the poor work and then structure law to fit their needs. In the end, Peruvians, Chinese, and Americans want essentially the same things: life, liberty, and property. And to get them, you have to build a market economy based on the rule of law. Our real enemies are not Marx and others but the people who do

people like Samuel Huntington, who is really a moderate when compared to our romantics, who believe that we shouldn't follow your model because Max Weber convinced them that it was an Anglo-Saxon model.

So I am here at Cato, proud to be the second foreigner to receive your prize, surrounded by fellow Latinos and introduced by a former citizen of India. You are clearly on the path to enlightenment because you believe in the potentials of all people of the world. So I am proud to receive this prize from Cato, named after the great Milton Friedman. And I am humbled by the honor bestowed upon me, which reflects the work of my colleagues.

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