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Economic Insights is a publication of the Colorado Council on Economic Education, a not-for-profit organization founded in 1974 to promote and improve economic literacy in Colorado schools.

We feel that an understanding of key economic concepts is vital for all citizens in order to live, work and make informed decisions in our modern economy. We present high-quality graduate courses designed to provide an understanding of important economic concepts to Colorado K-12 teachers, so they can then bring these concepts to their classrooms. Topics covered include monetary policy, taxation, spending, inflation, the environment, growth, conservation, trade and energy, to name a few.

The Evolution of Poverty

By Hernando de Soto

Since *The Mystery of Capital* came out, the Institute for Liberty and Democracy (ILD) has been called in by 32 heads of state, and is working to bring into these countries the tools of freedom: markets, property rights and business organizations. However, even though there is now no competing model to the market economy—since the fall of the Berlin Wall, it's the only game in town—advocates of markets in the developing world still face difficulties because the pro-market message is hard to get across.

ILD has come to the conclusion that the message of how you start off a market economy, how you start off freedom, isn't that clear. In other words, when you're substituting a new order for an old one, you've got to start thinking genesis: how to begin.

One of the things that captured our imagination was the question, "Where did organic evolution begin?" That opened our eyes to a variety of things that we found useful for thinking about the evolution of markets, because, essentially, what Charles Darwin has told us is that the universe can be very overwhelming. The only places where you can get complexity into place, Darwin said, were small places. He talked about "warm little ponds." The idea, discussed by other thinkers as well, was that the beginning of life requires small spaces. This inspired us to think of the origins of markets differently, that you catch the market from a smaller enclosure, from something more encapsulated.

That is why ILD has been, in recent years, exploring the role of enterprise—a cell in the economy. We find that the business organization or enterprise is essential for understanding the market, for examining an enormous amount of apparently disorderly information and selecting from it what is needed to produce prosperity.

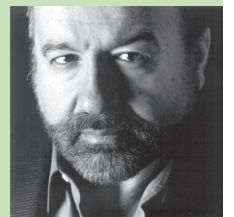
In elementary biology, we learn that as cells become more complex, they absorb information from a huge, swirling environment—a larger "market." Most of the information that actually gets to cells is the result of a discriminatory process—what is relevant and what is irrelevant. Given how biological cells function, it's important to ask of economically advanced countries, "Isn't there something that you are doing with your companies, with your firms that we may not be doing in developing countries and that we have to do?"

When we examine the history of economics, we find that Adam Smith was fascinated by the division of labor. You will remember that he begins *The Wealth of Nations* discussing what it takes to produce a simple pin. As he said, by dividing labor among its 10 workers, one small factory produced 48,000 pins a day versus only as many as 20 if each worker individually manufactured an entire pin. This added productivity explains prosperity.

But Smith didn't really address much about the organizations which, like living entities that were studied by Darwin, were going to put all of this

About the Author

Hernando de Soto is President of the Institute for Liberty and Democracy (ILD, www.ild.org), based in Lima, Peru, which is regarded by *The Economist* as the second most important think tank in the world. He was recently named one of the five leading Latin American innovators of the century by *Time*. As Principal Advisor to the President of Peru, he initiated that country's economic and political reforms. He is the author of *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*. Mr. de Soto was the featured speaker for the Colorado Council's 2004 Annual Lecture.



productivity into place. That in itself was a huge revolution: the creation of the firm as a “legal person.” Up until the 19th century, forming a company was very difficult if not impossible—in the UK, you needed a charter of the king.

In the United States, the revolution began somewhere about 1811, creating the wider possibility of having business organizations. By 1860, about 14 states had general incorporation acts, but it wasn’t until the end of the 19th century that anybody could form a company and get people together in a productive enterprise.

The ability to form companies was absolutely crucial to the great U.S. economic success story. If you do not have companies—that is to say, the possibility of associating people with different specialties that may not be part of your family—you’re not going to be able to produce those 48,000 pins of Adam Smith. You’re going to be forced to work within your family. So if you open up the market, but you’re not given the legal tools to organize and cope with the information that comes from the market, the market’s going to overwhelm you.

This is what’s happening today in developing countries and many countries of the former Soviet Union, where most people are not organized to create a complex organization that allows them to discriminate this enormous amount of information and expand into wider markets beyond family and acquaintances.

In the middle of the 19th century, French Libertarians, led by Charles Coquelin, advised, “Look at what the Americans have been doing. We’ve got to follow.” The main characteristic of the advent of the market is the downfall of the traditional patrimonial institutions, which were like a rope pulling us in one direction—the state and the people. We’re now realizing that to be able to honor the division of labor, we don’t need a rope but fine threads that unite us not to government, but to the rest of society. Those fine threads are legal instruments—such as contracts, property rights, and especially the means to create more productive business organizations.

The French liberal reform movement confronted much resistance where the argument against those who wanted everybody to have the right to get into enterprise was: What you are in effect proposing is the creation of states in miniature. Government, these critics of legal reform argued, has got to be reserved for the public sector for which we can all vote. If you start allowing the formation of little governments by little people, one day those little governments will take over.

What was very important is that in about 1863 Coquelin managed to start creating the first laws to allow the French government to grant people the right to have a company. In Britain, where there was similar resistance to these small governments, the legal revolution occurred in the period between 1840 and 1860.

This fight against little states is actually very much what we’re facing in developing countries. The whole idea—careful of those multinationals, which my friend Jagdish Bhagwati calls the B-52s of globalization—is the fear of what people you didn’t vote for are going to do to your life.

Evidence that this legal revolution has not yet reached developing countries is the tendency of people who are interested in helping countries in Africa to say, “But they’re from different cultures. These guys aren’t built for joint stock companies. They like being in tribes. That makes them feel warm and fuzzy.” On the other hand, here’s a market. It’s like telling everybody to go out into outer space, but without an encapsulated area where you can organize the information and convert

energy into something that can actually be metabolized for growth.

So markets, yes. We Third Worlders already decided that we believed in markets with the fall of the Berlin Wall. We’ve got market economies, and we also have enterprises. But our enterprises are not of a form that allows people to organize different specialties to be able to deal with that swirling mass of information.

ILD, in cooperation with the Inter-American Development Bank, investigated various Latin American countries to determine whether they have what is crucial for the success of enterprises. Looking at 12 countries, from Mexico to Argentina, we learned that people are in business organizations. Most of these enterprises, however, are what we call the “extra-legal sector.”

The question then to be asked is: Have Latin American democracies given enterprises all the legal devices that rich nations have been fine-tuning over the last 120 years—things that companies should have to become information-sensitive agents that allow entrepreneurs to filter information so that they can get what they need?

The first thing needed is an organization separate from family. It doesn’t mean that people can’t own enterprises. It just means that when you do business, you do it according to rules that are different from how a family operates.

In the Third World, the tendency of government has been to protect the family and say, “Just stay there. We’re going to let your family

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buy and sell. We're going to call that a micro enterprise." But by doing so, these countries have essentially created families taking care of their own survival needs with hierarchies that have nothing to do with what you need to succeed in the market.

You go to a small little micro enterprise in Peru and say, "Who runs this place?" And a good-looking Peruvian comes out and says, "I do." You know he's the head of the family. But you look over his shoulder and see his wife, who's a pretty imposing lady, and you realize that really she may be the one that runs the place. You don't really know. When you deal with a company in the United States, it's all determined by law: This is the CEO and you know who's accountable.

When you do not give these other organizations a separate rule, you have not created the first indispensable structure whose purpose is to make money and be profitable. And you have also not created the vehicle that will allow your society to pass from uniqueness to individuality, because the characteristic of all pre-market societies is uniqueness.

When markets came to the West, you had to destroy that order to create one based on meritocracy and individuals. You lost the comfort of belonging to a specific organization. You could now belong anywhere. You could be today in The Colorado Council on Economic Education; you could be tomorrow at McDonald's. You're an individual. You can move around. And the thing that allows you to convert yourself from a unique person within a strict society is an institution that is separate from the church, the family, and the tribe—an institution dedicated to business.

The second thing you need is an identity that is not just your personal identity. You need to be able to describe your wealth in documents. You've got to also be able to have property because we know that in the majority of cases, you're going to need property to get a track record or use the property itself to collateralize the loan. Otherwise, how are you going to achieve the credibility that is necessary to get credit?

How many Latin American companies have all of these qualities: the property rights, the

capacity to issue shares, etc.? It turns out only about 8 percent—the other 92 percent don't understand how to access the market, because they don't have the legal tools with which you can actually globalize.

The first thing you have to do if you are going to get into international trade is to fill in a bill of lading on an airway bill. First is your name. I'm going to say "de Soto." What's your address? Well, what happens if most of us Latin Americans don't have official addresses? We can't even fill in the second line. It's a totally alien world. In a wonderful example Leonard Read tells us that it takes about 1,600 companies to produce a simple wooden pencil—to be productive in today's world, you simply can't do without other businesses.

In the country of Tanzania, we did find evidence of private property ownership—in every village we went into, ninety percent of the land is privately owned. Tanzanians have titles, although very simple ones. Every area that we've gone we see a pattern of social practices created by the people themselves for themselves. We started seeing documents that effectively indicate that land and assets can be traded for money—of course, within very restricted and small groups because there's not one standard document. There are many kinds of documents, but at least they have local value in a way similar to the United States in the 18th and 19th centuries.

While Tanzania's progress is encouraging, the basic problem is that all emerging economies have not developed legal institutions to the same degree because legal institutions haven't connected with the social order. Basically, what we've done are legal transplants. The real problem is to figure out how we mesh legal institutions with people's beliefs. What adjustment has to be made so that a good rule becomes applicable and culturally recognizable in a country? What's really important in a market economy is how things are actually brought together, and the tools to bring things together are essentially the law. To be able to catch the kind of information you need on an everyday basis, you need companies, associations of people that will get that information which is indispensable, and if they don't get it, they will fail.

In effect, when the United States and other Western European countries began creating companies, they were creating the devices that process information and make sense out of huge, unruly markets. What brings the rules into place is essentially what companies have got, which is business law and property law. Thus, by connecting law to local customs, which ILD thinks is the missing link to make markets work and to make a Western-type order available to all countries, we will be closer to success.

[Editor's note: This article is based on a *Thatcher Freedom Lecture: Is Economic Freedom for Everyone?*, delivered at The Heritage Foundation (Sept. 29, 2006). It has been edited for length and is reprinted with permission. The entire lecture can be found at: www.heritage.org/research/world_wide_freedom/h1977.cfm.]

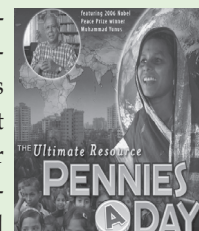
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