

# Heritage Lectures

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## Is Economic Freedom for Everyone?

*Hernando de Soto*

**DR. KIM R. HOLMES:** I am very pleased indeed to welcome back to The Heritage Foundation one of the world's foremost authorities on property rights and free markets, Hernando de Soto. As many of you know, Hernando is the founder and president of the Institute for Liberty and Democracy, a think tank in Peru that economists have called one of the most important in the world.

Hernando, it is an honor to have you here to deliver this lecture, the second in our Margaret Thatcher Center for Freedom Lecture Series. I cannot think of any economist more widely respected and straight-talking to address the question, "Is Economic Freedom for Everyone?"

I'm pleased also to welcome the Honorable Jorge Valdez, Adviser to Peru's Minister of Foreign Affairs. Welcome to Washington, sir. I also would like to welcome our guests from the diplomatic corps, the United States government, and the others who are here for this important address.

My only wish is that Lady Margaret Thatcher herself could have been here with us today. She visited us just two weeks ago, and we used that occasion to honor her as Patron of The Heritage Foundation and to thank her for choosing us to house the only policy center in the world named after her. Lady Thatcher is one of Hernando de Soto's earliest supporters. She said his book *The Mystery of Capital* could start "a new, enormously beneficial revolution, for it addresses...the lack of a rule of law that upholds private property and provides a framework for enterprise," which, she says, is

### Talking Points

- Are we all ready for freedom? Yes, we are. We just haven't picked up on it. We spend billions of dollars in helping developing countries have institutions, but those institutions haven't connected with the social order.
- 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, which is what's happening today in developing countries and many former Soviet Union countries.
- The main characteristic of the advent of the market is the downfall of traditional institutions, which were like a rope pulling us into one direction. We're now realizing that we don't need a rope but fine threads that unite us 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.

This paper, in its entirety, can be found at:  
[www.heritage.org/research/worldwidefreedom/hl977.qfm](http://www.heritage.org/research/worldwidefreedom/hl977.qfm)

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the single greatest source of failure in the Third World and ex-Communist countries.

Empowering the poor with legal property rights is indeed a revolutionary idea, but as Hernando explains in a chapter in our book, *The Road to Prosperity*, doing it is essential for lasting and real sustainable development. Lady Thatcher and Hernando de Soto understand, as we do at The Heritage Foundation, that economic freedom is the antidote to poverty. It is the antidote to war and terrorism. Freedom to own property gives people the ability to improve their lives and live in dignity.

In the first Thatcher Freedom Lecture, Natan Sharansky answered the question of our day—“Is freedom for everyone?”—with a resounding “Yes.” Today, it is most appropriate that we ask Hernando de Soto a similar question: “Is economic freedom for everyone?”

It is fitting indeed that he tackles this question. Leaders around the world, from Mexico, the Philippines, to Egypt and across Africa, are seeking his help. The president of Peru has tapped him as his special envoy to the United States to help secure a free trade agreement. As governor of Peru’s Central Reserve Bank, he helped implement hundreds of initiatives, laws, and regulations that have modernized Peru’s economy and given legal property rights to millions of poor families. Both of his books, *The Other Path* and *The Mystery of Capital*, are international best sellers. A finalist for the Nobel Prize for Economics in 2002, he has been given many awards, including the Cato Institute’s Milton Friedman Prize for advancing liberty and the Templeton Freedom Prize.

It’s no wonder that *Time* magazine calls him one of the world’s 100 most influential people, that *Forbes* says he is one of the 15 innovators who will “reinvent your future,” or that former Secretary of Housing and Urban Development Jack Kemp believes he should have won the 2004 Nobel Peace Prize. Ladies and gentlemen, please join me in welcoming back to Heritage this noble defender of freedom and our very good friend, Hernando de Soto.

—Kim R. Holmes, Ph.D., is Vice President for Foreign and Defense Policy and Director of the Kathryn and Shelby Cullom Davis Institute for International Studies at The Heritage Foundation.

**HERNANDO DE SOTO:** Thank you very much, Kim, for your very generous words. The first time I came to Heritage was about, I think, 1982 or ’83. We had F. A. Hayek for a conference in Peru, and many of us thought that we had material for creating a think tank or an action tank in our own country, and we said, “Well, how do you fund these things?” We were directed here, and Heritage gave us \$5,000 and gave us an introduction to the U.S. Agency for International Development. So I’m very glad to be here where we got our economic and inspirational start.

Since *The Mystery of Capital* came out, many things have happened to us. Among other things, we’ve been called in by 32 heads of state, and we are working directly with some of them and with others through knowledge and training programs to try to bring into their countries the tools of freedom: to bring in markets where there are no markets, to bring people into property rights and into business organizations.

What I’m going to talk to you about is some of the things that we have learned since the publication of *The Mystery of Capital*, how we go about doing our research and how we go about finding out why, even if there is now no competing model to the market economy—because, since the fall of the Berlin Wall, it’s the only game in town—we advocates of markets in the developing world still face difficulties. We’re in difficulties in Afghanistan. We’re in difficulties in Iraq. We’re in difficulties in Mexico, where the election of people who believe in markets was won by a hair’s breadth. In Peru, again, we’ve grown by a very small margin.

There’s no Moscow, there’s no Beijing centering anti-capitalist activities, and yet the pro-market message is hard to get across. The argument, of course, against the idea of markets is, “Well, if this is what you call freedom, look at the disorder it’s producing. Why does it produce disorder? The whole idea was that we were going to get into an orderly society. Now that you’ve made us drop feudalism, now that you’ve made us drop Communism, now that you’ve made us drop central planning, you’ve now given us freedom, and look what it’s doing to our country.”

So what we try and do at my organization, the Institute for Liberty and Democracy (the ILD), is find out what's going on, and we have come to the conclusion that the message of how you start off a market economy, how you start off freedom, isn't that clear so far. In other words, the genesis, the beginning point. What happens when you're already in a market economy, when your powers are balanced, how you modify it, this is another matter. But when you're substituting a new order for an old one, you've got to start thinking genesis: how to begin.

The way we go about finding how to start up freedom is to try and look at other sources of where freedom could come about. By other sources, I mean not just simply reading the classics, but reading those parts of the classics which you may have to put aside: letters, memoirs, academic journals, political and academic debates of the day, anything that we can associate with the problems of initiating the cause of freedom. That comes from looking at history in a different way.

Second, it means looking at case studies. For example, we have accepted contracts in Africa, and one of the reasons is because we wanted to look at tribes, we wanted to look at clans, we wanted to look at non-market organizations and see why they were a continuing substitute for markets. Why, if we humans are indeed equal, aren't markets taking hold for all of us, since most of the literature says they are now taking hold? So, first of all, is it true? Isn't it true?

Third, it means looking at other disciplines besides economics, because it's also our feeling that a lot of economics has become very number-oriented, very statistically oriented, and other disciplines might give us a lead as to where we could go and where we should go.

One of the things that captured our imagination was the question "Where was life born? Where did organic evolution begin?" That opened our eyes to a variety of things that we found useful for thinking about the origins and evolution of markets, because, essentially, what Einstein and even Darwin have told us is that the universe can be a sort of mindless vacuum. It can be very overwhelming.

The universe itself doesn't produce life—that is essentially what Darwin said; life, on the contrary, is produced in enclosures. The universe is too big. The second law of thermodynamics, which is probably the clearest law in physics, actually says that the universe is gradually deteriorating into disorder; it's decaying.

The only places where you can put life and get organization going, get complexity into place, Darwin said, were small places. He talked about "warm little ponds." Probably life, he said in a letter to a friend, was born in a warm little pond. Somewhere along the line somebody said, "It may have been, actually, not a warm little pond; it could have been an oily bubble on the shallow waters of the ocean." Somebody else says, "No, maybe it could have been cracks in the subterranean rock or geothermal vents on the sea floor." Even Aristotle ventured into that field. He had two hypotheses, which didn't actually work out. He said that fleas were born in accidental pockets of dirty laundry and that mice were born, probably, in little heaps of wheat. But the common idea was that the beginning of life requires small spaces.

In other words, humanity or life requires degrees of concentration. We see it from an enclosure, from a smaller place, and that's how we put it together. This inspired us to think of the origins of markets differently, that you catch the market from a smaller enclosure. You catch the market from something more encapsulated.

That is why we have dedicated a lot of our time in recent years at my organization, the Institute for Liberty and Democracy, to exploring the role of enterprise: What is the role of enterprise for understanding a market, and can you actually understand the market unless you have an enterprise with certain specific characteristics that allow you to bring an enormous amount of apparently disorderly information and be able to select from it what you actually need to be able to use the information in the market adequately and produce prosperity?

We've been studying the sort of things many of you probably learned in school: how cells become more complex, how it is that they get organized, how it is that they absorb information, light sensi-

tivity, sensitivity to heat, sensitivity to humidity, to actually be able to adapt to that huge, swirling environment which is a larger “market” where things are not so clearly discriminated. We have learned that most of the information that actually gets even to cells that become more complex and become more organized is the result of a discriminatory process within the cell. They decide what is relevant and what is irrelevant, because if it’s not relevant, the only thing it does is confuse you, and whatever confuses you produces disorder.

And that kind of research and thinking led us to ask, “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?”

We also saw this in the field of computer sciences, where you deal with artificial intelligence. The whole problem, again, is that you have an enormous amount of information, and then what do you do? Most people encapsulate, and they separate cyberspace from software, and you are able in that way to impose order.

That led us then to look at the history of economics and look at people who were fascinated by the division of labor, with the fact that organizations, business organizations, were finding a way to organize production—and not only Smith and Marx, but also what others after them said about the subject, which has not been as well publicized. Both Marx and Adam Smith were fascinated by the division of labor. You will remember that Adam Smith begins *The Wealth of Nations* discussing what it takes to produce a simple pin: somebody to buy the wire, somebody to stretch it, somebody to cut it into different pieces, another person to put a point at one end, another person to round it off on the other end and put the head on. And all of that, at the end, started raising productivity: 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.

About 80 years later in the 19th century, Marx was also fascinated by what Adam Smith had talked about and said, yes, this is what explains prosperity:

the division of labor, which allows you through specialization to raise productivity. Marx explained how a locomotive is really composed of over 5,000 different parts. He concluded from this the importance of world trade, because it is trade that allows you to assemble inputs from different parts of the world to create something else that has a surplus value, and that surplus value is what wealth is all about.

What bothered Marx, of course, was that that surplus value should be only captured by a certain group of people, which he argued would lead to the concentration of wealth among a few, which would, in turn, necessarily lead eventually to the demise of capitalism. That very kind of concentration of wealth is exactly what we get in Latin America, together with China: Too few people are rich, too many people are poor and on the other side looking in—and thus, as Marx predicted, comes alienation, resentment, and the downfall of the system.

What Marx and Smith, as far as I’ve been able to see, didn’t really get into was what you started doing about those organizations which, like living entities that were being studied by Darwin, were going to put all of these external factors into place. That in itself was a huge revolution: the creation of the firm as a “legal person.” Up until the 19th century, if you were about to form a company, you could only do it through political authorization. In the United Kingdom, you needed a charter of the king; you needed government officials to authorize the specific activity you were in. That’s why you have in many stores in England, for example, products that say “By appointment to Her Majesty the Queen.” Those are the old business organizations that you should look into and not others.

You Americans began your revolution somewhere about 1811, creating the wider possibility of having business organizations—the first one was in New York—formed without authorization of government or Congress if it had to do with wool or with cotton or with other materials. Pennsylvania followed in 1836 and then Connecticut in 1837. In 1860, about 14 states had general incorporation acts, but it was only at the end of the 19th century that in the United States anybody could form a company and get people together in a productive enterprise.

We think that that 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 and there are enormous possibilities 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 former Soviet Union countries, where most people are not organized to create a complex organization that allows them to discriminate this enormous amount of information the market produces and detect just what they need to build a product and then get it all together in one place—a legal company that now has the legal tools to grow productively and expand into wider markets beyond family and acquaintances.

We've also been looking at, for example, the history of the early French Libertarians since 1850, led by Charles Coquelin, who started saying, "Look at what the Americans have been doing. We've got to follow up." The main characteristic of the advent of the market is the downfall of the traditional patrimonial and feudal institutions, which were like a rope pulling us into 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.

By looking at the *Journal des Economistes*, the bastion of French liberal reform, the different acts and proposals that they brought out to make their case for reform, you see how much resistance they met in France where the argument against those who wanted free enterprise and everybody having 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 giving the

rights of forming little governments to little people, one day those governments will take over—probably not such a bad thing, but it seemed a terrible idea at that time.

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.

What was very important is that Coquelin managed about 1863 to start creating the first laws to allow the French government to grant people the right to have a company simply by complying with form requirements and bankruptcy laws, etc. In Britain, where there was similar resistance to these small governments, it began with the Joint Stock Company Act in 1840, which was then perfected again with a Limited Liability Act in 1855 and then again the Joint Stock Company Act in 1856.

These liberal reformers started a major revolution that has not really reached developing countries. The proof of it for us is that the tendency of most people who are interested in helping developing countries like mine or Africa or Asia is 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 you go out into outer space, but you don't have an encapsulated area where you can organize the information of outer space and convert energy into something that can actually be metabolized and allow you to grow.

So markets, yes. We Third Worlders already decided that we believed in markets with the fall of the Berlin Wall. There are only about three countries in the world which would say "markets, no," which would be North Korea, Zimbabwe, Cuba. The Venezuelans are beginning to say something like that, but they're not quite there yet, and the Bolivians are beginning to say something like that, but they're not quite there yet.

The rest of us have got market economies, but we don't have the enterprises that allow people to organize different specialties to be able to deal with

that swirling mass of information in the market. Most of the market produces information that is not reliable. The two sides of mankind are, on the one hand, we have enormous imagination, but the Janus-like side of that is that we also lie a lot.

If you think of all your laws in the U.S., what are they mainly for? They're out there to find out whom you can trust. The moment I land in a U.S. airport, the first thing they try to find out is if I'm really de Soto. This guy goes out, checks all the things to find out if I'm really de Soto, wants to see the facts; and if the immigration people are not quite sure, I'll be put into a back room and checked again. Then, when I cease being confused with a bearded terrorist, I'm finally let out. I go and try to get a little cart to pass my luggage through customs, but I need a credit card, more documentary proof about de Soto—that he's really got the credit to get the cart. All the time, I'm being checked. Why? Because we human beings lie about ourselves, and if the authorities don't have a way of distinguishing the lies from the facts, all the information that's useless from what's essential, the system is not going to work.

And that happens not in the market; it happens in the *enterprise*.

What is crucial about that? In Latin America, we have enterprises. At the ILD, we started doing a very interesting study that began about nine months ago with the Inter-American Development Bank under its new president, Louis Alberto Marino, who said, "I believe in all these things that you people from the Institute for Liberty and Democracy are doing. Let's ask various Latin American countries whether they have what is crucial for the success of their enterprises; let's take 12 countries, going from Mexico down to Argentina, basically the west coast of Latin America, and let's find out how many people are actually working within companies, within business organizations, and let's find out if they've got all the legal tools that are required to move ahead."

What we learned in this recent study confirmed what we had been finding out in the Institute for Liberty and Democracy for more than 20 years: namely, that people all throughout our world are organized in business organizations. Most of these

enterprises, however, are what we call the "extra-legal sector" or the "informal sector." (Some of those businesses are actually formal, which is why we prefer the term "extra-legal.")

The question then to be asked is: If Latin American democracies have been starting to give everybody the capsules or cells or warm little ponds within which to organize themselves, have we really given them all the qualities, all the instruments, all the legal devices that you in the rich nations have been fine-tuning over the last 120 years? Or are we giving them something different? So we made a list of questions.

The first question that we asked was: Why is it important to create companies? Coquelin used to call it a re-adaptation of social intelligence. Before, we got all our information from government and from feudal organizations. Now, by allowing society to disperse itself vis-à-vis this enormous market into different little entities that have to deal with that enormous amount of information outside, we are reorganizing social intelligence so that we're now going to learn from a variety of independent fields and will find ways of putting all that information together, which is what you do at Heritage. It's what you do in your U.S. think tanks. It's what intellectuals do.

And so the next question was: What are, therefore, those kinds of things that companies should have to become information-sensitive agents that allow entrepreneurs to filter information so that they can get what you need? The first thing that you need is an organization that is separate from your family. It doesn't mean that you can't own enterprises. Most enterprises probably in your country are family-owned. It just means that when you do business, you do it according to rules that are different from how you operate in your family.

In our countries, the Third World countries, the tendency of government has been to protect the family and say, "Just stay there. We're going to let your family buy and sell. We're going to call that a micro enterprise, or we're going to call it a social interest enterprise or an Aztec enterprise, an Inca enterprise, a Zulu enterprise. It's going to be there." But by doing so, by not creating the separate space,

we have not encouraged the collection of correct information. We have created what Maturan and Valdez, two brilliant Chilean philosophers who worked at the Santa Fe Institute, would have called an “autopoietic institution.” An autopoietic institution is an organization that is created to deal with the outside, that has a different hierarchical structure. What we have managed is just simply to consolidate autopoietic institutions, which are essentially 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 with a big black mustache 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. And if your eye roves to the other corner, you may find the mother-in-law who really runs the whole thing. 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. This is the CFO. These are their responsibilities, and you know who’s liable and who’s accountable by law.

When you do not give these other organizations a separate rule, you have not created the first indispensable structure to be able to have something that is accountable to business, whose purpose is to make money and be profitable; but 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. In other words, I may not be an individual, but in society, I know what I am. I’m a soldier, or I am a merchant. Or I am in the trade of making shoes, and I belong to this guild. And I feel good because I know what my place in society is. I know who my king is, and I know who my leader is.

When markets came to the West, you had to destroy that order to create one based on meritocracy and individuals. You lost a lot of the comfort of belonging to a specific organization. You could now belong anywhere. You could be today in The Heritage Foundation; you could be tomorrow at Lazard Frères. You could be working 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 where people feel good, where people don’t need psychiatrists as much as individuals do, but where you can’t move around as you can in the market—you need to create an institution that is separate from the church, that is separate from the family, that is separate from the tribe, that is dedicated to business. If you don’t have that, the transition from uniqueness to individuality will be a very tough one, or so we at the ILD think.

The second thing you need is an identity that is not just your personal identity. When I go home to Arequipa, the Peruvian city where my family is from, most people recognize me because they say, “He’s got the de Soto eyes but his mother’s eyebrows.” Identity’s all about redundancy, crossing information. But when you get into the commercial world, you need another type of identity, and for that you need a separate structure.

You need to be able to describe your wealth in documents. You need to be able to divide stock into parts. You may be my brother, but I’m not going to give you more than 20 percent of the company because I thought 80 percent of it up, or I am using my collateral to get it ahead. You’ve got to be able to catch value in property documents that relate to stock. At the same time, if you’re going to look for investment, you’ve got to be able to issue stock or shares. How else are you going to get investment? 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 or the information about 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?

You need asset shielding. Why? Because if everybody supports you with capital, you’ve got to make sure that when you’re dealing with an actual company, that nobody in the company has just decided that they were going to leave the company, taking with them all their assets. You’ve got to have those assets shielded and put into one place. You need to have capital locked in for those same purposes. You need to have going concern value reflected. If I said, “What’s Heritage worth?” and somebody came

around and said, “Well, let’s see what the price of the American flag is, how much textile there is in that, how much there is in the seats, how many computers do you have,” that isn’t the value of Heritage. The value of Heritage is that plus all its knowledge, its capital, its goodwill, its capacity to influence the course of events in the United States and, therefore, history.

It’s the same with a business corporation, but where are all these intangibles reflected? They’re reflected in company documents. There’s no other place. They’re not in the air. They’re in company documents, and that’s where they get captured.

So our question at the Inter-American Development Bank and as we went down the west coast of Latin America from Mexico to Argentina was how many Latin American companies have any of these qualities: the property rights, the asset shielding, the capacity to issue shares, etc.? And the reply is 8 percent. In other words, when we sign a free trade agreement with you or you sign it with anybody in the world, you are signing with 8 percent of the businesses in those countries. The other 92 percent are the people who don’t understand how you get at that large swirling mass of the universe which people call the market, because they don’t have the legal tools to get into the market or the identities or the contracts 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. You’re going to have to fill in the first thing, which 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. You can’t do without the companies. And that means that in the field of research, which is where we’re really at, we have forgotten how important it is to have instruments, *legal* instruments, to allow us to put things together. We’ve lost respect for those things.

There used to be a time when we knew that things which in themselves didn’t look like they had much value but that held things together were extremely important. For example, as I was reading the other day, Thomas Jefferson wrote a letter to a

friend who had asked what he was doing. He said, first of all, I’ve got various family responsibilities. In my family, to begin with, I am the nail maker. In those days, making nails was very important because that’s what held the houses together. That’s what held carriages together. We hadn’t yet learned how to make nails by cutting wire, so nails had to be forged and made right, and they had to have a certain type of sharpness to put things together. They were so valuable, as a matter of fact, that the whole history of your conquest of the West is about people making log cabins, advancing a few miles or a couple hundred miles, and then deciding to move further west—and then they burned down the log cabin just to recuperate the nails.

Things that fasten and bind other things together are always very important things. And all those legal instruments I’m talking about are nails. *Per se*, they’re not particularly dramatic, but they actually help you put things together. They may not give you the shape of things, but without them, you cannot put things together. And if you look around this room, there is not one thing here that has been built by one person. Everything has required thousands of persons.

There is this wonderful Leonard Read example of how many companies it actually takes to put together a simple pencil, which has got wood or cedar from Oregon, which has got graphite from Sri Lanka that’s wedged down with candalia wax from Mexico and sulphuric acid from France. All of that takes about 1,600 companies. Before you were able to put the wood together with the graphite, you had to get the owners or the people who are going to deliver these goods, their hopes, their beliefs, their promises, their statements onto enforceable statements or that wasn’t going to work. The law had to work, and that is essentially business law.

The question, then, would remain: Is the world ready for that? Maybe we have to have massive education programs for which, of course, there’s no money, and everybody will tell you that is not what is happening. So we took with glee the opportunity given to us by President Benjamin Mkapa of Tanzania, who approached us and said, “I believe in the things you’re saying. I can see that what you’re saying is true, but in my country all the books say



we're run by tribes." So we organized in Tanzania a group of 975 Tanzanians to go out in the field and find out what was cooking, what was going on, and these are the things we found.

The first thing we found is that in every village we went into, when we tried to find out whom the land belonged to, we only found that 10 percent of the land is owned by tribes. Ninety percent is privately owned. What happened to the tribes? Somebody is going to have to study that. Was it when the Tanzanians created the republics in the 1960s, the politicians decided to do away with the tribes because they were a parallel structure and they didn't want any competition? I don't know. All I'm telling you is that I found that the tribes, which were mainly the shepherds, were the people that owned about 10 percent of the land. Everything else was private.

What did they have? They had titles, very simple ones. And who created those titles? Adjudication committees. That's the way the Roman Empire started. Nobody began with property rights. What happened is that people wanted to avoid conflicts between themselves, and so there was an adjudication committee of elders which said, all right, the Smiths own this, the Sullivans own that, the Daleys own this, the Valdezes own that. It was essentially a practical move to have peace so that everybody could collaborate. The rights come later when you legislate over adjudications that have already taken place.

In this country of \$270 gross national product per capita, which is a very low gross national product per capita, as is the case in Ethiopia where we're beginning to work as well, which has \$70 gross national product per capita, people are adjudicating all over the place, and that isn't the result of any assistance program, any aid program. When we've gone to Tanzania, what we've seen is that they're adjudicating, and they're documenting their adjudications, so property is being created there without anybody's particular support. For us, that makes property an archetype in Tanzania: a pattern of social practices created by the people themselves for themselves.

Every area that we've gone to is documented. Property rights are established by mutual agreement

and documented. In each case, maps are coming more into place, and when people can sign, they sign, and where they can't sign, they put their fingerprints. So identity is also being established. Every village has got even a small little room where people are doing record-keeping. Sometimes it's really poor. It isn't even color-coded. It isn't done in alphabetical order. But the idea of creating records so that you can then identify yourself and build credibility is there. This is what they're doing, but nobody's writing about it, because to write about it, you have to field 975 people. Otherwise, you get one person's experience of what they thought they lived through when they visited a Third World country.

We started seeing documents that effectively indicate that land and assets are fungible. They 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 the way they did in the United States in the 18th and 19th centuries. They are being used as collateral.

We're seeing testaments. Those are most of the documents that we find in the record-keeping. How can there be a testament if there isn't private property? It's obvious that somebody has decided this land is his land. So you can go to some place, and they tell you, "These are the Bantus, or these are the Shepebos, and they own all of this land, and that's what the records of Spain or France or England say." But inside that so-called sovereign area, people are saying, "This belongs to de Soto, and I want it to belong to my sons, or I don't want it to belong to my sons. I want it to belong to my third wife." So obviously, private property's on the move.

Associations: We haven't found one group of people that are associated that don't have some kind of a document—whether they can read or write doesn't matter; there's always a scribe to do it—that doesn't put the constitution of the company into paper. States in little: We've seen division of labor. We've seen that there's a distinction of documents between management and labor. We've seen that in the different companies, there are people that are the record keepers. They're keeping that memory. They're keeping the information in place that can then be used to start creating a market economy. We haven't

found one bull or one cow in all of Tanzania that doesn't have a private brand on it.

So are we all ready for freedom? The reply is, yes, we are. We just haven't all picked up on it.

That is the basic problem, because it's not as if we're not concerned in the world with institutions. We spend billions of dollars in helping developing countries have institutions, but those institutions haven't connected with the social order. Basically, what we've done are legal transplants. This is where we're very good in Peru. If our lawyers have been trained in Spain, they will photocopy Spanish laws and bring them in. Or if they've been trained in the United States, they'll photocopy your laws. The real problem is how do you actually mesh that with people's beliefs? What adjustment do you have to make so that a good rule becomes applicable and culturally recognizable in your own country?

One of the persons who most taught me about this was my friend John Sullivan, who is here from the Center for International Private Enterprise, who said have a look at the *acquis communautaire*, which is the process that the Europeans have for integrating their larger European economic unity. For example, Spain in 1978 acceded to the *acquis communautaire*, to the European Economic Community. They didn't go in and say, "Okay, these are the laws of Frankfurt; we're going to apply them." They said, "These are the principles of where we want to head. This is how we understand markets and how we understand law in the European Economic Community, so let's take the Spanish laws as they are and combine them in the direction of unity." These are exercises that can take 10 or 15 years, but essentially, the process of the European Economic Community is a process whereby what you do is bring in the rule of law to these countries, and you try and set standards while respecting local culture.

When you deal with developing countries like mine, then it's PL-480, micro enterprise, give them a tractor that will rust in the middle of the field. But it's all about rules. When Europeans deal among themselves, it's rules. When Americans deal among themselves, it's rules. It's about nails. When we deal among ourselves, it's all about logs and things

which are important, to be sure, but what's really important in a market economy is how you actually bring things together, and the tools to bring things together are essentially the law.

I think, to a great extent, that this disorder that we find in the world is actually the opposite of information. Having the right kind of information is what produces order. By definition, disorder is the opposite of information. And 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 allow you to process the information and that allow you to make sense out of huge, unruly markets. What brings the rules into place are essentially what companies have got, which is business law and property law. That's what allows you to pass from a society based on uniqueness to a society based on individuals.

Interestingly enough, we have looked at this with a very recent friend of ours, Ashraf Ghani, who is the Chancellor of Kabul University and before that the Minister of Economy and Finance of Afghanistan. We are trying to form a coalition of Third World universities so that we can figure out how we create a career path for people that are concerned with this eclectic science of connecting law to local customs, which we think is the missing link to make markets work and to make a Western-type order available to all countries. At that time, when we're able to deal with those things, we will then be able to establish a regime of freedom for the world.

So my reply to the question that Heritage asked me—Are we all ready for economic freedom?—is that I'm convinced we are. What happens is that it's more difficult than we thought. It's a very sophisticated process. It has to be documented. It has to be taught. And once we do learn that it's not only about macroeconomic rules, but how people can get organized and are getting organized even in the most backward parts of the world, we will be closer to success.

**DR. HOLMES:** Thank you very much, Hernando. That was absolutely brilliant. Very often in the policy think tank world, we find ourselves repeating things over and over again, and sometimes things start sounding like clichés; but you have broken through the clichés this morning, and we greatly appreciate you coming here. We have some time for questions.

**BOB HERSHEY:** I'm Bob Hershey. I'm a consultant. In some of these projects, have you been able to bring in computers or the Internet to help document things for people?

**MR. DE SOTO:** Yes, we have. Obviously, computers are extremely useful, and some of the people that we have talked to in the West have talked about how to simplify them, adapt them to local circumstances. The important thing to keep in mind is the limitation of computers, because what computers do is collect and process information, but where did you get, for example, all your property and business information in the United States? First of all, you wrote it down, and then you scanned it.

In other words, first you've got to paperize the country. When you paperize the country, then you can digitalize the country. So what we do is not substitute computers, but we try and prepare it in such a way so that the documents that are found on the ground can then be computerized. Part of the activity that we have is trying to get very complex information created by the notarial system, for example, of Latin America and boil it down to very simple form documents that can then be scanned and adapted to computers.

**STEPHEN JOHNSON:** Steve Johnson, The Heritage Foundation. I would like to congratulate you on your new position with the Peruvian government, helping to promote the U.S.–Peru Free Trade Agreement. I would like to know what you think the prospects are and if some of the process of education that you talked about is going to come into play in helping to educate both Peruvian and the U.S. publics.

**MR. DE SOTO:** I don't have a diplomatic passport, and I'm not in the hierarchy, but I'm something that is probably just as good: I'm the personal representative of a president that is essentially a Social

Democrat, Alan Garcia. He only got anointed president on the 28th of July. He was running against a Hugo Chavez ally in our country who nearly won the elections. Garcia won by a hair's breadth.

One of the big issues during the elections there—like the elections in Mexico, like the upcoming elections in Ecuador, like the elections coming up in Nicaragua, like the elections that already took place in Bolivia—has been the issue of trade agreements. Many of these new leaders that are coming up in Latin America are saying this is the market; this is trade agreements. It doesn't suit our culture; it doesn't suit our place. You know the Western system and globalization is the road to go, but what do you do when you're a politician and you find out that the majority of your nation doesn't react to globalization because they don't have the tools with which to access it? Yes, they've got the companies, but companies without limited liability, companies without separate identities from the family, companies that don't allow them to even cross the U.S. border.

So what we have done with the president is talk about doing two things together. One is the free trade agreement with the United States, because it's the symbol of whether you're going to go the populist road in Latin America or you're going to take the globalization road, and we decided to take that one. But we have coupled to it what we call the "internal free trade agreement," which is how do we Peruvians make sure that our people internally can trade, because only when they can trade and have identities that allow them to do business inside the country will they be able to benefit from free trade outside Peru. The result is a treaty that today has a whopping 70 to 80 percent support in Peru because we've connected the globalization agenda with the social agenda.

What I'm trying to do with my colleagues and compatriots now that we've come to Washington is to say this agreement that's up for approval with your Congress is not only about free trade. We are trying to set up a different model for Latin America. That model is essentially a political one because we are pro-market; but we have recognized that if the market doesn't fully work in our countries, it's not because of things that are missing in our treaty. It's

not because of things that haven't been put into the World Trade Organization or the rules for trading worldwide or international transactions. It's because we haven't done the home agenda, the one we're talking about here. We're going to do it.

We're also heading towards a period of elections in Peru. In November this year, we're going to have local elections, and the model we're putting up is going to be voted upon. So what we're trying to get through to your Congress is that we're not just talking about free trade agreements now, whether it's good or bad. We're talking about a model that's going to take hold or not take hold in your Southern Hemisphere.

We are your political allies. We dealt with terrorism, with the Shining Path, from 1980 to 1992, and we dealt with them very effectively not only through military means, but also through political means. We discredited them to the point that they couldn't even be elected dogcatcher in Peru today. So we are your allies, and we're trying to get it across that this isn't just about free trade; we're talking about a political agenda here, and that's what I'm supposed to come and talk about.

**FRED SMITH:** Fred Smith, Competitive Enterprise Institute. "Brilliant" is the term I'd use too.

The idea that a Coasian institutional evolution is critical, the creation of the firm as a cellular entity that in a sense suborganizes the very small part—of course, it rolls back. We see the Bubble Act in England where they took back that freedom for a while. You were very optimistic about the West, but as you must know, in the West, the whole idea of that specialized entity cellular structure is now under attack under the term "corporate social responsibility," which is an attempt to make the little state a replica of the big state run by the NGOs and so forth. Could you comment on the CSR threat to the evolutionary forces you're talking about?

**MR. DE SOTO:** First of all, thank you for mentioning the name of Ronald Coase. I should have done that from the beginning, because if we didn't read Ronald Coase, we wouldn't be here. I wouldn't be here. I wouldn't be talking about these things in the first place. His seminal work on the firm is, of course, outstanding.

I've noticed that many firms in the world do decide to do something for the community on their own, and I have nothing against that if they want to. However, imposing it on them is a mistake. I subscribe to Clive Crook's article in *The Economist*, which said it is not up to business firms to do social responsibility. That is what governments should be about. If they want to, this is absolutely fine. We shouldn't get companies involved in that.

Recently, the case came out in Peru where a mining company has been asked to become socially responsible, and what we've said is responsible to whom? They said to the indigenous people that surround the area where they're obtaining minerals or where they're obtaining oil or whatever it is. And we said it would be so much better if, instead of charity, what you gave these indigenous people would be property rights over the subsoil.

What happens is that since we don't have property rights for the indigenous people because supposedly we've got to leave their order intact in most cases, and they don't have and we don't have property rights over the subsoil, which belongs to government, the moment you bring in a foreign firm or a local firm, it's immediately in social conflict with the neighbors. If they had property rights, the company would have to negotiate with them in the same way you have to negotiate with Eskimos in Alaska, and the people get a lot richer by doing that than by having corporate social responsibility.

**MICHAEL MAYBOCK:** Michael Maybock, European American Business Council. Excellent remarks. Thank you.

The question is the country of Iraq, both the development of democracy and a market there. To the outside observer, it seems like they have three tribes—the Kurds, the Sunnis, the Shiites—and lots of violence. Can you comment on what you see there?

**MR. DE SOTO:** Unfortunately, I know much less about Iraq than you do in the United States since you're involved there. I'm a big admirer of what you did when you got involved in an overseas operation in Japan and with General Douglas MacArthur. One of the first things you did at that time was, with the help of a man called Wolf Ladejinsky from 1942 to 1945 in Honolulu, set up a commis-

sion to study what happens when we do get into Japan, considering that Japan is a feudal state.

We Peruvians know a lot about this, because when Alberto Fujimori, who was our president from 1990 to till 2000, came to Peru or his family came, we knew that they had come from Japan, like a million other families that came to Peru and Brazil, because Japan was poorer than Peru and Brazil in the 1940s. So we knew that the feudal system allows you to build destroyers and airplanes, but that the capitalist sector was only 10 percent, so that would have to, in one form or another, be reformed.

As a result of this plan that you had from Honolulu, right from the beginning, you started bringing business rights and property rights into Japan and helping those Japanese who also wanted to be Westernized in that sense to the point now that the Japanese are no longer poorer than us Peruvians, but are 10 times richer.

When you've been so successful in Japan, so successful in Taiwan, so successful in Korea to the point that 28 years after Mao Tse Tung took power, these three thorns in his side obliged Deng Xiaoping to head toward the market economy that is now even competing with yours, how did you forget that? How did you forget it when you went to Vietnam? How could you have forgotten it in Afghanistan? Why didn't you make it the principal thing?

If I go to Tanzania, there are tribes, and everybody's got even cows and bulls on private property. I don't believe that there can be anything else but that in Iraq or even Afghanistan. With our contra-

dictions or concentrations, you can deal with it through law, and that's what gets you the majority of the people on your side right from the beginning. So I don't know what's going on. It would just be good if, in America, you could remember those things you did correctly when you gained the West and when you had successful wars.

**DR. HOLMES:** Hernando, thank you again for your brilliant lecture in answering the question "Is economic freedom for everyone?" Obviously, you've given us a very profound "yes" in the sense that it's pretty much part of the social fabric of human nature, but we don't always recognize it, and we don't always have the formal legal and even political structures to tap into what's already there and to work with it.

You've given us a lot to think about today. You've gotten us off to a very good start in looking at the economic component of freedom in this lecture series. We are all at The Heritage Foundation very grateful that you came, as I'm sure your audience here is as well.

—*Hernando de Soto is President of the Lima, Peru-based Institute for Liberty and Democracy. A finalist for the Nobel Prize for Economics in 2002, he is the author of The Other Path: The Economic Answer to Terrorism (Basic Books, 1989); The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else (Basic Books, 2000); and a chapter in The Road to Prosperity: The 21st Century Approach to Economic Development (The Heritage Foundation, 2004).*