STREAM READINGS

IGL&P

INSTITUTE FOR GLOBAL LAW & POLICY

HARVARD LAW SCHOOL

Law and Development

IGLP ASIAN REGIONAL WORKSHOP

BANGKOK, THAILAND

JANUARY 6 - 11, 2017

Law and Development

Faculty

- **Scott Newton** (United States) SOAS, University of London
- **Alvaro Santos** (Mexico) Georgetown Law

Description

This stream will investigate legal reform strategies geared towards inducing economic growth and social welfare in developing countries. We will consider a range of approaches to government and markets and the influence of international legal regimes for trade, investment and human rights. We will explore the role of law in economic and social theories of development, the global and intellectual context that channels the range of development reform, and recent shifts in development theory and state practice. We will focus particular attention on choices: alternate legal arrangements which may open alternate trajectories for development with different patterns of inequality or social justice.

Stream Session

Law and Development

Arrighi, G. (2010). T*he long twentieth century : Money, power, and the origins of our times* (New and updated ed.] ed.). London ; New York: Verso. Pages 1-3

Soto, H. (2000). *The mystery of capital : Why capitalism triumphs in the West and fails everywhere else* (1st pbk. ed.). New York: Basic Books. Pages 4-19

Griffin, E. (2010). A short history of the British industrial revolution. Houndmills, Basingstoke, Hampshire ; New York: Palgrave Macmillan. Pages 20-22

Hirschman, A. (1988). The strategy of economic development. Boulder: Westview Press. Pages 23-28

Kennedy, D. (2011). Some Caution about Property Rights as a Recipe for Economic Development. Accounting, Economics, and Law, 1(1), Accounting, Economics, and Law, 01/31/2011, Vol.1(1). Pages 29-34

Santos, A., Case study: Illegal Drug Markets and Development in Mexico Pages 35-38

In short, just as the Great Depression of 1873–96 had been primarily a malady of businessmen depressed by "excessive" competition and "unreasonably" low profits, so the "beautiful times" of 1896–1914 were first and foremost a recovery from this malady following the dampening of inter-enterprise competition and a consequent upturn in profitability. But in so far as the expansion of trade, production, and working-class incomes were concerned, we can hardly speak of an upturn. Like all the wonderful moments that had characterized the closing phases of previous cycles of accumulation, the moment was wonderful only for a minority, and even for that minority it was short-lived. Within a few years, the "rattling of arms" – which was music to the ears of the European bourgeoisie as long as it inflated profitability by intensifying interstate competition for mobile capital – turned into a catastrophe from which nineteenth-century capitalism would never recover.

In this respect, Edwardian Britain reproduced in highly compressed form and under radically different world-historical circumstances some of the tendencies that had already been at work in Florence during the very first financial expansion of the European world-economy. In both situations, the massive relocation of surplus capital from industry to finance resulted in unprecedented prosperity for the bourgeoisie, partly at the expense of the working class. In early modern Florence, the tendency eventually resulted in the takeover of the government by finance capital; in twentieth-century Britain, it eventually resulted in the takeover of the government by labor. But in both situations the beautiful times of the bourgeoisie were a sign of the supersession of existing capitalism.

Even closer is the resemblance between the Edwardian era and what is known as the "periwig period" of Dutch history – a period that broadly corresponds to the phase of financial expansion of the Dutch cycle of accumulation, particularly to the closing two or three decades of the expansion. As in Florence 400 years earlier and in Britain 125 years later, the financial expansion of the latter half of the eighteenth century was associated in Holland with widespread processes of "deindustrialization" (most clearly reflected in shipbuilding) and with a contraction in working-class incomes. "The merchant-bankers and the wealthy rentiers might never have 'had it so good,' " notes Charles Boxer (1965: 293–4), but as an eyewitness reported at the end of the period, " 'the well-being of that class of people who lead a working life [was] steadily declining.' " And as in Renaissance Florence or in Edwardian Britain, or for that matter in Reaganite America, the capitalists-turned-rentiers of periwig Holland

were only concerned with the very short run. "Each one says," wrote the periodical *De Borger* in 1778, " 'it will last my time and after me the deluge!' as our [French] neighbors' proverb has it, which we have taken over in deeds if not in words" (quoted in Boxer 1965: 291).

The "deluge" for the Dutch republic came soon afterwards with the Patriots' Revolution of the early to mid-1780s – "insufficiently recognized for what it was, the first revolution on the European mainland, the forerunner of the French Revolution" (Braudel 1984: 275) – with the subsequent Orangist counter-revolution, and with the final demise of the republic under Napoleon. Nothing of the sort happened, of course, in Britain after the Edwardian *belle époque*. On the contrary, victory in the First World War translated into a further expansion of Britain's territorial empire. Nevertheless, the costs of empire had begun exceeding its benefits by a good margin, thereby preparing the ground for its dismantling by the Labour government after the Second World War. But even before the empire was dismantled, the collapse of the British pound's gold standard in 1931 marked the terminal crisis of British rule over the world's money. As Polanyi (1957: 27) put it, "the snapping of the golden thread was the signal for a world revolution."

The Dialectic of Capitalism and Territorialism

As Geoffrey Ingham has pointed out, if the promoters of the reforms that led after the end of the Napoleonic Wars to the establishment of the free trade/gold standard regime had any specific economic interests in mind, it was the interests of British entrepôt trade, which had grown and prospered through the capture of Dutch and French commerce:

> Huskisson [President of the Board of Trade] believed that such policies would make Britain the Venice of the nineteenth century. Ironically, critics of Britain's entrepôt roles invoked the same comparison at a later date. At the end of the nineteenth century, many observers pointed out that the Venetian decline was the result of having based wealth and power on such insecure and uncontrollable mercantile activities. It was far better, they argued, to build a strong domestic productive base. (Ingham 1984: 9)

Both before and after the great mid-nineteenth-century trade expansion, British capitalism thus appeared to its contemporaries as a new variant of older forms of entrepôt capitalism. This indeed was the main similarity between the British and the earlier Dutch regime of accumulation. Like the Dutch, the British regime was still based on the principle of commercial and financial intermediation – the principle, that is, of buying in order

to resell, of taking in in order to send out, of being supplied by the whole world in order to be able to supply the whole world again.

England's role as the clearing-house of the world-economy preceded and outlasted its role as the "workshop of the world" (Rubinstein 1977: 112–13). The industrial revolution and the defeat of Napoleon's imperial bid simply consolidated and expanded the scope of British entrepôt capitalism:

> [The] combination of the Industrial Revolution at home and the destruction after Waterloo of any barrier or competition to English global hegemony overseas brought into being a quite new form of world economy, in which British manufacturers possessed overwhelming preponderance amid generalized international free trade. As the density of commercial exchanges multiplied between ever more states and regions drawn into a common network, the functional necessity for a central switchboard to direct its flows grew steadily. The regular reproduction of multilateral transactions, in a world economic space segmented into independent political units, depended on the existence of at least one major clearing-house of universal scope. English industry and the English navy ensured that there would be *only* one. Amsterdam, isolated and sidelined by the Continental System, never recovered from the war-time blockade. With the submergence of Holland and the defeat of France, London had no possible rivals after 1815. (Anderson 1987: 33; emphasis in the original)

Taking issue with Ingham's and Anderson's characterization of nineteenth-century British capitalism as primarily commercial and financial in structure and orientation, Michael Barrat Brown has underscored its imperial and agro-industrial foundations. By the time the great mid-century expansion of British and world trade took off, Britain had already conquered a territorial empire of unprecedented and unparalleled scale and scope:

> [Contrary] to the views equally of Lenin and of Gallagher, Robinson and Fieldhouse, now repeated by Ingham and Anderson, most of the British Empire had already been established by 1850 – not only in Canada, and the Caribbean, Madras, Bombay and the Cape Coast from the seventeenth century, but in Gibraltar, Bengal, Ceylon, the Cape, Botany Bay, Penang, Guiana and Trinidad by the end of the eighteenth; and to these were added by 1850 virtually the whole of India, plus Hong Kong, Australia, New Zealand, Natal. Further increments, then, were almost entirely on the African continent. (Barrat Brown 1988: 32; see also Barrat Brown 1974: 109–10, 187)

Moreover, this far-flung territorial empire was primarily an agro-industrial rather than a commercial-financial complex:

> To believe that British capital had basically a banking and merchanting role in the Empire would require us to suppose that there had been in the Empire no sugar and cotton plantations, no tea and rubber estates, no gold, silver, copper and tin mines, no Lever Brothers, no oil companies, no Chartered Company, no Dalgety, no British-owned railways and other utilities or mills and factories overseas. (Barrat Brown 1988: 31)

From the perspective adopted in this study, there is no real contradiction between the views of Ingham and Anderson on the one side, and Barrat Brown on the other. As we have underscored in chapter 1, and again in sketching the third (British) systemic cycle of accumulation, Britain in the nineteenth century did follow the developmental path of Venice and of the United Provinces; but it also followed the developmental path of Imperial Spain or, more precisely, of the Genoese-Iberian capitalist–territorialist complex. Once we acknowledge this hybrid structure of the developmental path of nineteenth-century British capitalism, the thesis of the "nightwatchman state" as applied to Victorian England does indeed become untenable. "What sort of nightwatchman was this who prepared the ground for every single activity of the building's occupants and not only watched against unfriendly acts from outside but effectively ruled the seven seas and established colonial outposts in every continent?" (Barrat Brown 1988: 35). Nevertheless, the "industrialism" and "imperialism" of nineteenth-century Britain were integral aspects of its *enlarged* reproduction of the strategies and structures of Venetian and Dutch entrepôt capitalism. It was precisely by being industrial and imperial in ways that neither Venice nor the United Provinces had ever been that Britain could exercise the functions of world commercial and financial entrepôt on a much grander scale than its predecessor ever dreamt of doing.

For the "industrialism" and "imperialism" of the British regime of accumulation in comparison with the preceding Dutch regime were expressions of a double movement – forward and backward at the same time – analogous to the one that had characterized the transition from the first (Genoese) to the second (Dutch) systemic cycle of accumulation. Just as in the late sixteenth and early seventeenth centuries the Dutch regime of capital accumulation on a world scale superseded the Genoese regime through a forward movement consisting of an internalization of protection costs, so in the late eighteenth and early nineteenth centuries the British regime superseded the Dutch through an internalization of production costs, of which industrialism was the main expression. And just as the Dutch regime had internalized protection costs through a backward movement consisting of a revival of the organizational structures of Venetian state monopoly capitalism, which the Genoese

regime had superseded, so the British regime internalized production costs through a revival of the organizational structures of Iberian imperialism and Genoese cosmopolitan finance capitalism, both of which the Dutch regime had superseded.

By "internalization of production costs" we shall understand the process through which production activities were brought within the organizational domain of capitalist enterprises and subjected to the economizing tendencies typical of these enterprises. To be sure, capitalist enterprises specializing in production activities had existed long before the British cycle of accumulation took off. But this kind of enterprise had played either no role or only a secondary and subordinate role in the formation of the Genoese and Dutch regimes of accumulation. The leading capitalist enterprises of the Genoese and Dutch cycles were typically engaged in long-distance trade and high finance – the activities which Braudel (1982: ch. 4) calls the "home grounds" of capitalism – and as far as possible kept production activities outside their organizational domains. In the British cycle, in contrast, the accumulation of capital came to be based on capitalist enterprises that were heavily involved in the organization and rationalization of production processes.

In assessing the nature and extent of this new "organizational revolution" of the capitalist world-economy, it is important to bear in mind that the distinction between "trade" and "production" is not as clear-cut as it is often assumed to be. The reshuffling of goods in space and time, which is what trade is all about, can involve as much human effort and can add as much use-value ("utility") to the goods so reshuffled as does extracting them from nature and changing their form and substance, which is what we understand by production in a narrow sense. As Abbé Galiani once wrote, "[t]ransport . . . is a kind of manufacture" (quoted in Dockés 1969: 321). But so is storage and all other trade-related activities that require human effort and make the goods reshuffled in space and time more useful to potential buyers than they would have been otherwise. Almost no trade activity can be undertaken except in conjunction with some kind of production in this broader sense, or even in the narrower sense mentioned above.

The capitalist organizations that specialized in long-distance trade were always involved in some kind of production activity. Besides storage and transport, they often engaged in some processing of the goods they bought and sold, and in the construction of at least some of the means and facilities required by the storage, transport, and processing of commodities. Shipbuilding was probably the most important of these activities, particularly for capitalist organizations like Venice and the United Provinces which were self-sufficient in "producing" the protection required by their traffics. In addition, capitalist organizations

that specialized in long-distance trade engaged in, or closely supervised, the manufacture of goods (such as jewels and coins, high quality textile products and other luxuries, works of art, etc.) which were particularly suitable either as exclusive means of trade or as "stores" of the surplus capital that accrued to their members. But apart from these activities, the leading capitalist organizations of the Genoese and Dutch cycles avoided production as much as they could:

> Venice, Genoa and Amsterdam consumed grain, oil, salt, meat, etc., acquired through foreign trading: they received from the outside world the wood, raw materials and even a number of the manufactured products they used. It was of little concern to them by whom, or by what methods, archaic or modern, these goods were produced: they were content simply to accept them at the end of the trade circuit, wherever agents or local merchants had stocked them on their behalf. Most if not all of the primary sector on which such cities' subsistence and even their luxuries depended lay well outside their walls, and labored on their behalf without their needing to be concerned in the economic and social problems of production. (Braudel 1984: 295)

In partial qualification of this claim, Braudel immediately adds that these cities were often more conscious of the drawbacks than of the advantages of such an externalization of production: "obsessed with their dependence on foreign countries (although in reality such was the power of money that this was reduced to nothing), all leading cities desperately tried to expand their territory and to develop their agriculture and industry." As a result, the Italian city-states, and Holland later, came to be characterized by "1) a very 'modern' relationship between their rural and urban population; 2) an agricultural sector, where it existed, which tended to go in for cash crops and was a natural focus for capitalist investment . . . [and] 3) a number of luxury industries, so often the most profitable" (Braudel 1984: 295–6).

There is in fact no need to assume that the Italian city-states or Holland were obsessed with dependence on foreign countries to account for this kind of involvement in domestic production. In the case of luxury industries, their profitability and the lack of social problems associated with their development were in themselves good enough reasons for the involvement. As for cash crops, it was only natural that the massive wealth that accumulated in the capitalist cities would bring into existence in contiguous rural areas a commercial agriculture oriented towards the production of food for the urban population. And it was equally natural that the capitalist centers would sooner or later incorporate these contiguous rural spaces within their political jurisdictions either for strategic or for economic reasons, and so promote their further commercialization and modernization.

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 is 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 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* importance, *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 that 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," wrote Smith, "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*.

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 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 can 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—while not 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 lake, that process is contained in a hydroelec-

tric 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 your room and power the machinery in a factory. What was required was an external man-made process that 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 then 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 that 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 into 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 may 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 past 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 could 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 electrical energy, 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 the Third World and in 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 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 on 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; and 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 most Western countries, integrated property systems appeared only about a hundred years ago; Japan's integration happened 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 anonymity 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. Although 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 it be 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. Whereas 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 movable 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 significantly reduced 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, whereas 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 risk 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, chattels, 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 why 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 tende

Why have they failed? The reason is that they usually operate under five basic misconceptions:

- all people who take cover in the extralegal or underground sectors do so to avoid paying taxes;
- real estate assets are not held legally because they have not been properly surveyed, mapped, and recorded;
- enacting mandatory law on property is sufficient, and governments can ignore the costs of compliance with that law;
- existing extralegal arrangements or "social contracts" can be ignored;
- you can change something as fundamental as people's conventions on how they can hold their assets, both legal and extralegal, without high-level political leadership.

To explain these countries' underground economies, in which typically 50 to 80 percent of the people operate, in terms of tax evasion is partially incorrect at best. Most people do not resort to the extralegal sector because it is a tax haven but because existing law, however elegantly written, does not address their needs or aspirations. In Peru, where my team designed the program for bringing small extralegal entrepreneurs into the legal system, some 276,000 of those entrepreneurs recorded their businesses *voluntarily* in new registry offices we set up to accommodate them—with no promise of tax reductions. Their underground businesses had paid no taxes at all. Four years later, tax revenues from formerly extralegal businesses totaled US$1.2 billion.

We were successful because we modified company and property law to adapt to the needs of entrepreneurs accustomed to extralegal rules. We also cut dramatically the costs of the red tape to enroll businesses. This is not to say that people do not care about their tax bill. But extralegal manufacturers and shopkeepers—who

operate on razor-thin profit margins, in cents rather than dollars—know basic arithmetic. All we had to do was make sure the costs of operating legally were below those of surviving in the extralegal sector, facilitate the paperwork for legalization, make a strong effort to communicate the advantages of the program, and then watch hundreds of thousands of entrepreneurs happily quit the underground.

Contrary to popular wisdom, operating in the underground is hardly cost-free. Extralegal businesses are taxed by the lack of good property law and continually having to hide their operations from the authorities. Because they are not incorporated, extralegal entrepreneurs cannot lure investors by selling shares; they cannot secure low-interest formal credit because they do not even have legal addresses. They cannot reduce risks by declaring limited liability or obtaining insurance coverage. The only "insurance" available to them is that provided by their neighbors and the protection that local bullies or mafias are willing to sell them. Moreover, because extralegal entrepreneurs live in constant fear of government detection and extortion from corrupt officials, they are forced to split and compartmentalize their production facilities between many locations, thereby rarely achieving important economies of scale. In Peru, 15 percent of gross income from manufacturing in the extralegal sector is paid out in bribes, ranging from "free samples" and special "gifts" of merchandise to outright cash. With one eye always on the lookout for the police, underground entrepreneurs cannot openly advertise to build up their clientele or make less costly bulk deliveries to customers.

Our research in the countries we have worked with has confirmed that being free from the costs and nuisance of the extralegal sector generally compensates for paying taxes. Whether you are inside the bell jar or outside, you will be taxed. What determines whether you remain outside is the relative cost of being legal.

Another prime misconception is that real estate assets cannot be legally registered unless they have been surveyed, mapped, and recorded with state-of-the-art geographic information technology. This, too, is at best partially true. Europeans and Americans managed to record all their real estate assets decades before computers and geographical information systems were invented. As we saw in the last chapter, throughout the nineteenth century the surveying of newly settled land in the United States lagged many years behind the conveyance of property rights. In Japan, I examined the documentation available in registry offices and saw how some land assets had been recorded after World War II using maps from the Edo period—three to four centuries before the invention of aerial photography and global positioning systems.

This does not mean that state-of-the-art computing and geographical information systems are not extremely important to any government's efforts to open up its property system to the poor. What it does mean is that the widespread undercapitalization, informal squatting, and illegal housing throughout the non-Western world are hardly caused by a lack of advanced information and mapping technology.

Braudel's bell jar is made not of taxes, maps, and computers but of laws. What keeps most people in developing and former communist nations from using modern formal property to create capital is a bad legal and administrative system. Inside the bell jar are elites who hold property using codified law borrowed from the West. Outside the bell jar, where most people live, property is used and protected by all sorts of extralegal arrangements firmly rooted in informal consensus dispersed through large areas. These local social contracts represent collective understandings of how things are owned and how owners relate to each other. Creating one national social contract on property involves understanding the psychological and social processes—the beliefs, desires, intentions,

customs, and rules—that are contained in these local social contracts and then using the tools that professional law provides to weave them into one formal national social contract. This is what Western nations achieved not so long ago.

The crucial point to understand is that property is not a physical thing that can be photographed or mapped. Property is not a primary quality *of* assets but the legal expression of an economically meaningful consensus *about* assets. Law is the instrument that fixes and realizes capital. In the West, the law is less concerned with representing the physical reality of buildings or real estate than with providing a process or rules that will allow society to extract potential surplus value from those assets. Property is not the assets themselves but a consensus between people as to how those assets should be held, used, and exchanged. The challenge today in most non-Western countries is not to put all the nation's land and buildings into the same map (which has probably already been done) but to integrate the formal legal conventions inside the bell jar with the extralegal ones outside it.

No amount of surveying and mapping will accomplish this. No amount of computerizing will convert assets into a form that allows them to enter expanded markets and become capital. As we saw in Chapter 3, assets themselves have no effect on social behavior: They do not produce incentives, they make no person accountable, no contract enforceable. Assets are not intrinsically "fungible"—capable of being divided, combined, or mobilized to suit any transaction. All of these qualities grow out of modern property law. It is law that detaches and fixes the economic potential of assets as a value separate from the material assets themselves and allows humans to discover and realize that potential. It is law that connects assets into financial and investment circuits. And it is the representation of assets fixed in legal property documents that gives them the power to create surplus value.

Part I: The Legal Challenge

As things stand, the creation of one integrated property system in non-Western nations is impossible. Extralegal property arrangements are dispersed among dozens, sometimes hundreds, of communities; rights and other information are known only to insiders or neighbors. All the separate, loose extralegal property arrangements characteristic of most Third World and former communist nations must be woven into a single system from which general principles of law can be drawn. In short, the many social contracts "out there" must be integrated into one, all-encompassing social contract.

How can this be accomplished? How can governments find out what the extralegal property arrangements are? That was precisely the question put to me by five members of the Indonesian cabinet. I was in Indonesia to launch the translation of my previous book into Bahasa Indonesian, and they took that opportunity to invite me to talk about how they could find out who owns what among the 90 percent of Indonesians who live in the extralegal sector. Fearing that I would lose my audience if I went into a drawn-out technical explanation on how to structure a bridge between the extralegal and legal sectors, I came up with another way, an Indonesian way, to answer their question. During my book tour, I

had taken a few days off to visit Bali, one of the most beautiful places on earth. As I strolled through rice fields, I had no idea where the property boundaries were. But the dogs knew. Every time I crossed from one farm to another, a different dog barked. Those Indonesian dogs may have been ignorant of formal law, but they were positive about which assets their masters controlled.

I told the ministers that Indonesian dogs had the basic information they needed to set up a formal property system. By traveling their city streets and countryside and listening to the barking dogs, they could gradually work upward, through the vine of extralegal representations dispersed throughout their country, until they made contact with the ruling social contract. "Ah," responded one of the ministers, "Jukum Adat (the people's law)!"

Discovering "the people's law" is how Western nations built their formal property systems. Any government that is serious about reengineering the ruling informal agreements into one national formal property social contract needs to listen to its barking dogs. To integrate all forms of property into a unified system, governments must find out how and why the local conventions work and how strong they actually are.

The failure to do so explains why past attempts at legal change in developing and former communist countries have not worked. People tend to look upon the "social contract" as an invisible, godlike abstraction that resides only in the minds of visionaries like Locke, Hume, and Rousseau. But my colleagues and I have discovered that the social contracts of the extralegal sector are not merely implied social obligations that can be inferred from societal behavior; they are also arrangements that are explicitly documented by real people. As a result, these extralegal social contracts can actually be touched, and they can also be assembled to build a property and capital formation system that will be recognized and enforced by society itself.

Chapter 6 . . . . . .

The 'Mechanical Age': Technology, Innovation and Industrialisation

> Were we required to characterise this age of ours by any single epithet, we should be tempted to call it, not an Heroical, Devotional, Philosophical, or Moral Age, but, above all others, the Mechanical Age. It is the Age of Machinery.
>
> (Carlyle, 'Signs of the times', 1829)[1]

> It is upon the excellency of machinery that the superiority of British manufactures chiefly depends. In other countries labour may be cheaper, and in some the raw material may be more easily obtained, but as yet no country can equal Great Britain in the speed and perfection of machinery.
>
> (Lawson, *Geography of the British Empire*, 1861)[2]

For many Victorians, rapid advances in technology, in particular the use of machines to perform work that had previously been done by hand, were the most striking developments of the age. The mechanisation of the cotton industry, the invention of the steam engine and a myriad other contrivances and innovations in many branches of industry were taken as emblematic of nineteenth-century economic progress.

This emphasis on technology and machines has also continued throughout much of the twentieth century. In the late 1940s, for example, the economic historian T. S. Ashton spoke of a cadre of 'Inventors, contrivers, industrialists, and entrepreneurs . . . from every social class and from all parts of the country' busy at work fashioning the inventions that were to drive the industrial revolution. He continued, 'It was not only gadgets, however, but innovations of various kinds – in agriculture, transport, manufacture, trade, and finance – that surged up with a suddenness for which it is difficult to find a parallel at any other time or place.'[3] While not everybody shared Ashton's generally rather rosy interpretation of the industrial revolution, his emphasis on the transformative role of new technologies continued to resonate throughout the second half of the twentieth century. In the *Cambridge Economic History of Europe*, published in 1965, David

Landes offered a broad definition of the industrial revolution based upon a number of technical advances, encompassing the substitution of human strength with machines; new sources of power (fossil fuels and the steam engine); and new materials (iron and minerals).[4] More recently still, Joel Mokyr has argued that if 'European technology had stopped dead in its tracks – as Islam's had by about 1200, China's had by 1450, and Japan's had by 1600 – then Europe would not have continued down its path of industrialisation in the two centuries following 1750.' Britain's industries, he adds, 'displayed an unprecedented technological creativity that lay at the foundation of the British Industrial Revolution'.[5] For many, both contemporaries and historians, the rapid pace of technological change after 1750 is not simply a colourful historical curiosity; it is the key to understanding the world's first industrial revolution. This amounts to a large claim for the significance of technology, and in this chapter we shall consider whether inventions and technology do indeed deserve a place at the centre of our definitions of the industrial revolution.

It should immediately be clear that this account of pervasive and transformative technological change has been seriously challenged by the recent, and hugely influential, macroeconomic analyses of British industrialisation that we considered in Chapter 2. Crafts and Harley's estimates of national economic growth suggested that productivity growth was heavily localised in two 'modern' industries – cotton and, to a lesser extent, iron – with only meagre productivity gains elsewhere.[6] The poor productivity gains in industries outside the two modern sectors led them to infer that most 'other industries remained largely unchanged' and, therefore, to reject accounts stressing widespread technological change.[7]

We have already reviewed a number of criticisms of macroeconomic approaches to British industrialisation and cautioned that in the absence of reliable data to measure the various elements of economic growth the results must be viewed as subject to a sizeable margin of error. There are a number of further reasons why their description of a languishing manufacturing sector, if not incorrect, might be misleading. In the first instance, Crafts and Harley's estimates for industrial productivity were never based upon a complete analysis of the manufacturing sector. Their indices of industrial production were initially based upon a sample of around a dozen different industries, though the size of the sample was slightly extended in subsequent revisions.[8] Nonetheless, a recent study of industrial output for 26 industries for the period from 1815 to 1850 acknowledges that these industries amount to only about 60 per cent of total industrial production – still leaving fully 40 per cent entirely out of the account.[9] Most of those excluded were relatively small industries, and it has even been suggested that it was in precisely some of these small, dynamic industries that technological innovation was most pervasive – a claim that Crafts and Harley, unsurprisingly, dispute.[10] At any rate, our current macroeconomic estimates do not measure the productivity of these smaller industries, and the absence of such measurement should force us to pause before deciding whether

change in manufacturing was localised in the 'modern' industries or was in fact more widely spread throughout the sector.

Peter Temin has turned to import and export data as an alternative way of gauging the extent and significance of technological change in some of the smaller industries not included in the Crafts-Harley analysis.[11] Between a quarter and a half of all manufacturing exports between the late eighteenth and mid-nineteenth centuries were of goods other than textiles and iron: they included items such as cutlery, pottery, clothing, glassware, books, umbrellas, hats and fishing tackles. If the manufacture of these items was undergoing improvements in productivity, one should expect their export to expand: without these improvements, exports should stagnate or be replaced by imports. Temin's analysis indicates that exports in such industries were keeping pace with exports in cotton, and he infers from this that technological progress must have occurred within them. This, it should be stressed, is not direct evidence for technological improvements in these smaller, older, industries, any more than Crafts or Harley ever provided direct evidence for its absence. Trade data reveal that Britain enjoyed a comparative advantage in these industries relative to her foreign neighbours, but does not indicate what underpinned this comparative advantage. Nonetheless, the existence of a buoyant export market in so many items outside the lead sectors of cotton and iron sits rather uneasily with the Crafts-Harley account of a stagnant traditional manufacturing sector.[12]

The evidence from patenting also paints a rather different picture of manufacturing progress to that depicted by Crafts and Harley. A patent is a grant by the state of exclusive rights for the use of a new invention for a defined period of time (during this period it was set at 14 years), and the granting of patents has been used by historians as a crude yardstick of inventive activity.[13] Care must be exercised in linking the patent series to technical and industrial change. A patent was expensive and difficult to obtain and some of the industrial revolution's most significant inventions – James Hargreaves' spinning jenny and Samuel Crompton's mule, for example – were never successfully patented, though the omission of major innovations from the patent series was in fact a rather unusual occurrence.[14] At the same time as some major inventions slipped through the patenting system, not every invention that was patented signified a fundamental technological breakthrough: while a handful were obtained for a radical new invention, many others were obtained for relatively minor improvements to existing techniques, or even simply in an attempt to evade the restrictions of existing patents.[15] Furthermore, the mere existence of a patent does not provide evidence that the patented device was ever produced and marketed successfully. More than one patented idea has failed to make the transition from inventor's workshop to commercially viable product. It is little wonder, therefore, that the historian of patents Christine MacLeod has cautioned that the patent series 'related to technological change in an erratic and tangential manner'.[16]

Despite these caveats, however, a number of clear and very interesting trends emerge from the patenting record. In the first instance, the scale and extent of patenting activity expanded considerably during this period, particularly in the years following 1750. The rate of change accelerated so sharply after 1762 that one historian has suggested that England 'entered her "Age of Invention"' at this time, defined as a period of self-sustaining growth in technology.[17] Given the great variety of inventions that underlie the patent series, it is helpful to break it down further, and consider which sectors of the economy were patenting new ideas, and what kinds of inventions they were seeking to protect. An analysis of the series by Richard Sullivan indicates the particular importance of machinery and motive power inventions (steam engines and other devices for transmitting power). Between 1750 and 1850, about a third of all patents concerned machinery and machine parts, while motive power accounted for about 7 per cent in the first 50 years rising to 14 per cent in the 50 years thereafter.[18] And while some of this machinery was for use in the textile industry, taken as a whole, the patent series is not dominated by the cotton industry in the way that productivity figures might suggest. Around 15 per cent of patents for capital goods between 1750 and 1800 were for textile machines (106 patents in all), and textile machines made up no more than 6 per cent of all patents issued.[19] This left over 1500 patents taken out on a very wide range of inventions and innovations spread across the economy – agriculture, ship-building, canals and chemical equipment, to name a few.

Once again, the evidence from patents does not fit with the claim that there was little technological change outside the cotton industry prior to 1850. The error lies in assuming that measures of productivity are a good indicator of the industrial processes at work in the economy. New technology is expensive to purchase, often prone to failure, and requires new workers to be trained to its use. All these factors mean that manufacturers are often slow to purchase new equipment and are likely to wait a considerable period before seeing much return on their outlay. To give one example, James Watt's separate condenser undeniably improved the fuel efficiency of existing steam engines, yet many manufacturers preferred to continue with their fuel-hungry Newcomen engines, as the cost of purchasing a Watt engine and paying his annual premiums outweighed any fuel savings that could be made, at least before his patent expired in 1800.[20]

Despite the fact that productivity gains were highly localised in two sectors of the manufacturing economy, the evidence from exports and patenting suggests that technological change was occurring on a much wider basis in the century following 1750. New inventions can be slow to diffuse and measurements of changes in the rate of productivity are unlikely to reflect the underlying changes in industrial techniques. It is one thing, however, to demonstrate that technological change was pervasive and quite another to evaluate its significance in powering the industrial revolution. As the history of earlier great civilisations demonstrates, it is possible to have extensive, and even revolutionary, technological change, without having an

industrial revolution. In the case of Britain, industrialisation appeared to turn a switch, marking the end of a period of limited population growth and limited economic expansion and the beginning of an era in which both population and the economy appeared able to grow without limits. Our question concerns the role played by new technologies in turning that switch. Let us turn, then, from assessing the extent of inventive activity to evaluating its wider impact on the British economy.

Ever since Toynbee's popularisation of the term 'industrial revolution' in the late nineteenth century, the mechanisation of the cotton industry, and of cotton spinning in particular, has lain at the heart of historical accounts of British industrialisation. It is not difficult to understand why so much significance has been placed on this one industry. In the period 1772–74, England imported 4.2 million lb of raw cotton. By 1839–41, the annual average had risen by an astonishing one hundredfold to 452 million lb.[21] Over roughly the same period, the price of cotton cloth dropped by 85 per cent.[22] In fact, as this period also witnessed the rapid growth of muslins and fine cotton cloths, requiring less raw cotton to produce, it is likely that cotton output actually increased yet more rapidly than the figures for raw cotton imports suggest. Certainly, by any measure, the manufacture of cotton textiles underwent an extraordinary expansion in the century following 1750, experiencing an acceleration of growth that was unmatched in Britain's earlier industrial history. It is clear that something exceptional was happening in the cotton industry in the late eighteenth and early nineteenth centuries, and there can be no better starting point for considering the importance of technological change to Britain's industrial revolution.

While the myriad changes at work in the cotton industry escape simple classification, we must look to a series of major technological breakthroughs in the eighteenth century, causing the mechanisation of work that had previously been done by hand (and the subsequent movement of work out of the home into the factory), in order to understand the historical development of this one particular industry. Before cotton cloth can be woven, the yarn has to be spun into thread, and it was in this branch of the industry – the spinning industry – that some of the most significant advances were made. During most of the eighteenth century and earlier, cotton yarn had been spun by hand, between thumb and forefinger, at a small wheel turned by hand: it was women's work, and it was usually performed at home. It was a labour-intensive process, and so, despite the low wages generally paid to women, a relatively costly task. In the 1760s and 1770s, the process of spinning was revolutionised by a series of inventions: the spinning jenny, the water frame and the mule, which together replaced the work performed by women's hands with various mechanical devices.[23]

James Hargreaves' spinning jenny replaced the spinner's one spindle with several (initially 8 or 16), enabling the machine operator to spin the yarn onto several spindles at the one time, thereby considerably increasing the quantity of yarn that could be spun in a given period of time. Richard Arkwright's 'frame' (or 'throstle') produced a stronger thread by using three sets of paired rollers to produce yarn and a set of spindles to twist the fibres

together; it was too large to be operated by hand, and after some experimentation was powered by a waterwheel instead, thereafter becoming known as the 'water frame'. Samuel Crompton's mule combined elements of both the jenny and the water frame to spin strong and good-quality cotton thread, which in turn facilitated the weaving of fine cotton cloth on a large scale. The mule required a skilled operator, but Richard Roberts' 'self-acting' mule, patented nearly 50 years later in 1825, made the operator unnecessary, and ushered in the first truly automatic machine. The mechanisation of elements of the process of cotton manufacture that had traditionally been performed by hand enabled industrialists to replace human skill and effort with machines and vastly increased the productivity of the industry within a matter of decades. Whereas a worker spinning cotton on a hand-operated wheel in the middle of the eighteenth century might take more than 50,000 hours to spin 100 lb of cotton, by the 1790s the same quantity of cotton might be spun in just 300 hours by mule, and the self-acting mule reduced the figure to 135 hours.[24] Illustrations 6.1–6.3 show the changing spinning technology and Figure 6.1 shows imports rising over the century 1750–1850 and clearly illustrates the great expansion of the industry that occurred during this period of rapid technological change.

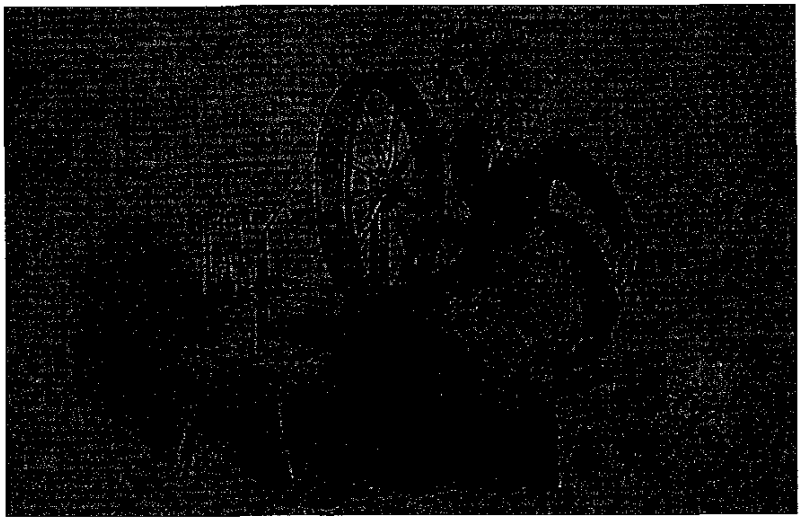

Illustration 6.1 Woman Spinning on the One Thread Wheel. Baines, *Cotton Manufacture in Great Britain.*

A woman using a hand-operated spinning wheel could only spin one thread of yarn at a time. It was a labour intensive, and therefore relatively costly, procedure.

Albert O. Hirschman
The Strategy of Economic Development

CHAPTER 1

Preliminary Explorations

The Search for the Primum Mobile

THE INTENSIVE STUDY of the problem of economic development has had one discouraging result: it has produced an ever lengthening list of factors and conditions, of obstacles and prerequisites. The direction of the inquiry has proceeded from thoroughly objective, tangible, and quantitative phenomena to more and more subjective, intangible, and unmeasurable ones. For a long time, certainly until 1914 and perhaps until 1929, natural resources held the center of the stage when the chances of a country's development were considered. Later on capital, a man-made and quantifiable entity, came to be considered the principal agent of development. The view is still widespread that if only the underdeveloped countries could obtain, through their own efforts or through outside assistance, sufficient amounts of capital, they would be able to "finish the job." But this belief in the strategic importance of capital has itself been increasingly challenged. Among the proximate causes of economic development, the supply of entrepreneurial and managerial abilities now occupies in official documents a position of pre-eminence at least equal to that of capital.[1] The contribution to be derived from "nonconventional inputs" such as investment in people as productive agents and the introduction of improved techniques not embodied in physical capital goods has also been stressed.[2]

If one turns to the conditions that indirectly determine development by their influence on the supply of capital, entrepreneurship,

1. See, e.g., United Nations, *Processes and Problems of Industrialization in Underdeveloped Countries* (New York, 1955), pp. 30–8.

2. Theodore W. Schultz, *The Economic Test in Latin America*, New York State School of Industrial and Labor Relations, Cornell University, Bulletin 35 (Aug. 1956).

and skills, the spectacle becomes far more bewildering. It is usual at this point to list the need for minimum standards in public order, law enforcement, and public administration. In attempts to dig more deeply, economic historians and sociologists, starting with Max Weber, have identified a number of beliefs, attitudes, value systems, climates of opinion, and propensities which they have found to exert a favorable influence on the generation of enterprise and of developmental initiative. They have also stressed the role of minorities and of deviant behavior in the formation of entrepreneurial groups. Joining in the search for the *primum mobile,* psychologists have recently undertaken to establish the dependence of development and of entrepreneurial activity on the presence of achievement motivation, as measured by experimental tests.[3]

In spite of the many valuable insights gained from these theories, their cumulative impact on the unwary reader could well raise serious doubts about the possibility of any economic development at all. For how can any stagnating country ever hope to fulfill simultaneously so many necessary conditions?

Fortunately, the very multiplicity of attempts at explanation can be made to yield another and radically different conclusion. As one explanation is proposed, a previous one is disputed. This is usually done by demonstrating that if only factor *B* can be generated, and development thereby got under way, then factor *A*, hitherto regarded as so important, will be forthcoming without much trouble. This process began when experience demonstrated conclusively that, under appropriate conditions, industrial skills can be learned by any people, race, or human group, and that countries poorly endowed with natural resources can achieve high levels of per capita output and income.

With respect to savings and capital, anthropologists have long known that primitive people who, by Western standards, live "on the margin of subsistence" insist nevertheless on devoting a considerable portion of their time, energies, and resources to ceremonial purposes, gift-making, and other activities not directly related to consumption. In recent years, increasing numbers of economists have also come to doubt that insufficiency of savings is the most important factor hold-

3. I am referring to the work of David C. McClelland and his associates; cf. also Everett E. Hagen, "The Process of Economic Development," *Economic Development and Cultural Change, 5* (April 1957), 202–4.

ing back development. For one thing, they have noticed, in addition to the above phenomena, the luxury consumption of the rich, the widespread hoarding, and the ubiquitous instances of misdirected and unproductive investment. For another, they have realized that savings and productive investment are as much a result as a cause of development.[4] For once the latter is under way windfall profits are realized at many points in a developing economy; more important, when economic opportunity is perceived, consumption-savings and work-leisure patterns are drastically readjusted. That the supply of capital is remarkably elastic to improved profit expectations has been brought out particularly with respect to capital formation in agriculture in underdeveloped areas. The expansion in the cultivation of slow-yielding tropical tree crops such as coffee, cocoa, and rubber by independent peasant producers is a case in point.[5] But in manufacturing also, shortage of capital is seldom found to hold back the fruition of projects that have been carefully planned and give promise of being competently managed.[6]

The initiatory role of capital is usually belittled by those who stress the importance of entrepreneurship and of technical and managerial knowledge. But again it has been convincingly shown that entrepreneurial ability as such is not usually lacking in underdeveloped countries, but that, because of a foreshortened time-horizon and insufficient knowledge and experience, it is often deflected from the promotion of industry to other more familiar pursuits in trade and real estate.[7] It has even been asserted that enterprise, just as capital, is a "by-product of the process of economic development, and has seldom been found wanting in a society favorable to its exercise."[8] The sud-

4. A. K. Cairncross, "The Place of Capital in Economic Progress," in *Economic Progress,* ed. L. H. Dupriez, Louvain, 1955; see also his review of W. A. Lewis' *The Theory of Economic Growth* in *The Economic Journal, 66* (Dec. 1956), 694–7.

5. P. T. Bauer and B. S. Yamey, *The Economics of Underdeveloped Countries* (Chicago, 1957), pp. 29–31.

6. C. Wolf, Jr. and S. C. Sufrin, *Capital Formation and Foreign Investment in Underdeveloped Areas* (Syracuse, 1955), pp. 11–29; and William Diamond, *Development Banks* (Baltimore, 1957), pp. 7–13.

7. Henry G. Aubrey, "Industrial Investment Decisions: A Comparative Analysis," *Journal of Economic History, 15* (Dec. 1955), 333–51.

8. James Baster in the discussion on Aubrey's article, ibid., p. 355.

den outbreak of industrial entrepreneurship in Pakistan after the partition, in the Middle East during World War II, and again in Latin America since the thirties confirms the view that underdeveloped countries may harbor a "reserve army" of entrepreneurs that are as achievement-motivated as any Puritan ever was. Similarly, it is hard to argue that there are some countries whose citizens are basically corrupt or unable to keep law and order.

The discovery that the ability to tend a machine and the propensity to invest or to act as entrepreneur are widely spread over the globe and only need suitable occasions to manifest themselves is in line with recent trends in anthropology. Thus Kluckhohn writes: "The anthropologist for two generations has been obsessed with the differences between peoples, neglecting the equally real similarities upon which the 'universal culture pattern' as well as the psychological uniformities are clearly built." [9]

When it was increasingly realized that economic backwardness cannot be explained in terms of any outright *absence* or *scarcity* of this or that human type or factor of production, attention turned to the attitudes and value systems that may favor or inhibit the emergence of the required activities and personalities. To some extent we shall ourselves be concerned with this line of inquiry. But whenever any theory was propounded that considered a given value system a *prerequisite* of development, it could usually be effectively contradicted on empirical grounds: development had actually taken place somewhere without the benefit of the "prerequisite." Moreover, here again different theories neutralize one another. For instance, it seems difficult to argue at one and the same time that the general climate of opinion must be favorable to industrial progress *and* that a strategic factor of particular importance is the presence of minority groups or of individuals with deviant, i.e., socially disapproved, behavior. One rather suspects that when economic opportunity arises it will be perceived and exploited primarily by native entrepreneurs or by deviant minorities, depending on whether or not the traditional values of the society are favorable to change.

9. Clyde Kluckhohn, "Universal Categories of Culture" in *Anthropology Today*, ed. A. L. Kroeber (Chicago, Univ. of Chicago Press, 1953), p. 515. See also G. P. Murdock, "The Common Denominator of Cultures" in *The Science of Man in the World Crisis*, ed. Ralph Linton (New York, 1946), pp. 123–40.

Thus, while we were at first discouraged by the long list of resources and circumstances whose presence has been shown to be needed for economic development, we now find that these resources and circumstances are not so scarce or so difficult to realize, *provided, however, that economic development itself first raises its head.* This is of course only a positive way of stating the well-known proposition that economic development is held back by a series of "interlocking vicious circles." [10] Before it starts, economic development is hard to visualize, not only because so many different conditions must be fulfilled simultaneously but above all because of the vicious circles: generally the realization of these conditions depends in turn on economic development. But this means also that once development has started, the circle is likely to become an upward spiral as all the prerequisites and conditions for development are brought into being.

This approach permits us to focus on a characteristic of the process of economic development that is fundamental for both analysis and strategy: development depends not so much on finding optimal combinations for given resources and factors of production as on calling forth and enlisting for development purposes resources and abilities that are hidden, scattered, or badly utilized.[11] Economists have long realized this situation with respect to labor and have coined the term "disguised unemployment" to describe it. But just as an underdeveloped economy can mobilize vast hidden reserves of unskilled labor from its redundant peasantry, so it is able to make capital, entrepreneurship, and all the other "prerequisites" climb unexpectedly on the bandwagon of economic development once it has started to roll.

If this is correct, then too much has perhaps been made of the difference between a situation of cyclical unemployment in a developed economy and the problem of development in an underdeveloped coun-

10. H. W. Singer, "Economic Progress in Underdeveloped Countries," *Social Research, 16* (March 1949), 5.

11. A recent contribution makes the same point: "There are always and everywhere potential surpluses available. What counts is the institutional means for bringing them to life. . . . for calling forth the special effort, setting aside the extra amount, devising the surplus." Harry W. Pearson, "The Economy Has No Surplus: Critique of a Theory of Development," in *Trade and Markets in the Early Empires*, ed. K. Polanyi, C. M. Arensberg, and H. W. Pearson (Glencoe, Ill., Free Press, 1957), p. 339.

try. It has often been said that the two situations have nothing in common and demand therefore totally different cures: during the typical depression in a developed country unemployed labor exists side by side with unutilized plant and equipment and all that needs to be done is to "reunite what should never have been parted"; whereas, so it is pointed out, in an underdeveloped economy we have at best disguised unemployment but no other unutilized factors of production, so that the problem is "structural" rather than "cyclical." True, in an underdeveloped economy we have no idle capital or trained labor resources that cry out to be utilized; but we do have not only underutilized labor in agriculture but unutilized ability to save, latent or misdirected entrepreneurship, and a wide variety of usable skills, not to mention the modern industrial techniques that are waiting to be transferred from the advanced countries. The task here is to *combine* all these ingredients, a task far more difficult than, but not entirely different from, the *recombining* of idle factors of production that must be accomplished to end a depression.

In both situations the need is for a binding agent. The difference is that in a situation of underdevelopment a far stronger agent is required than deficit spending or similar Keynesian remedies for unemployment. But, as we shall see, the way in which these remedies are expected to perform is not entirely devoid of lessons for the problem of development.

What is gained by considering resources and production factors latent and conditionally available rather than outright absent or scarce? The advantage appears to be that in this way attention is properly focused on the essential dynamic and strategic aspects of the development process. Instead of concentrating exclusively on the husbanding of scarce resources such as capital and entrepreneurship, our approach leads us to look for "pressures" and "inducement mechanisms" that will elicit and mobilize the largest possible amounts of these resources. To consider them as irremediably scarce and to plan the allocation of resources on that basis may mean bottling up development, just as a child's mental growth will be badly stunted if an attempt is made to obtain the maximum yield from its manifest abilities at a given point of time rather than to call forth its potential endowments. In this view, then, planning for development consists primarily in the systematic setting up of a series of *pacing devices*.

The formulation of the development problem which is here proposed calls particular attention to the fact that the use of different economic resources has very different repercussions or "feedback" effects on the available stocks of these resources. In the case of some natural resources such as mineral deposits there is no feedback at all: the resources become depleted. In the case of capital, on the other hand, a well-known feedback operates: by generating income and then savings, the capital that is used up in the production process is ordinarily more than replenished.[12] More directly, the use of capital in one venture may lead to complementary capital formation in another. Finally, in the exercise of entrepreneurial and managerial ability the feedback is so immediate that it is hard to recognize it as such: these are resources that increase directly with and through use (much as the ability to play the piano or to speak a foreign language improves with exercise) while more indirect effects similar to those characteristic of capital are also at work. Thus, the latter resources which are probably the scarcest at the beginning of the development process are those that may show the fastest increase because of the directness and strength of the feedback effect and because their expansion is limited only by learning ability.

The Importance of Being a Latecomer

To view development as a process of drawing together a variety of conditionally available resources and latent abilities may seem to make light of the task. This is by no means the intention. On the contrary, the approach is motivated by the conviction that development is much more difficult than is often realized. As long as one thinks in terms of a missing component, be it capital, entrepreneurship, or technical knowledge, he is likely to believe that the problem can be solved by injecting that component from the outside or by looking for ways and means of producing it within the country. If one concentrates instead on the need for a "binding agent" which is to bring together various scattered or hidden elements, the task becomes vaguer, to say the least, and may well turn out to be more complex. We may even be considered to be guilty of a fairly meaningless, almost

12. See the formulation of the Harrod-Domar model as a feedback in R. G. D. Allen, *Mathematical Economics* (London, 1956), p. 282.

tautological diagnosis. Are we not simply saying that development depends on the ability and determination of a nation and its citizens to organize themselves for development?

Perhaps this is not as tautological and vague as it sounds. By focusing on determination, for instance, we are taking hold of one of the specific characteristics of the development process in today's underdeveloped countries, namely, the fact that they are latecomers. This condition is bound to make their development into a less spontaneous and more deliberate process than was the case in the countries where the process first occurred.

Some theories of development fail to include in their structures this fundamental fact of *contact* between the advanced and backward countries. The question they ask: why have some countries developed while others have failed to do so? [13] seems to us relevant primarily to the inquiry why the Industrial Revolution took place in England rather than elsewhere. Once economic progress in the pioneer countries is a visible reality, the strength of the desire to imitate, to follow suit, to catch up obviously becomes an important determinant of what will happen among the nonpioneers.

A comprehensive account of the development process as a deliberate attempt at catching up on the part of various groups of economic operators is given by Gerschenkron. In his view, the intensity and other specific characteristics of the developmental efforts of the principal Continental European countries in the nineteenth century were conditioned by the *relative degree of backwardness* vis-à-vis the industrial leaders that was exhibited by each of these countries when it started its industrialization in earnest. The delay in starting the process and its sudden inception are explained by the consideration that "a point will be reached at which the advantages implied in rapid economic development will more than offset those obstacles to economic progress which are inherent in the state of economic backwardness." [14] This theory clearly implies that the development of the

13. This question is, for example, the starting point of the inquiries of T. Haavelmo, *A Study in the Theory of Economic Evolution*, Amsterdam, 1954.

14. Alexander Gerschenkron, "The Problem of Economic Development in Russian Intellectual History" in *Continuity and Change in Russian and Soviet Thought*, ed. E. J. Simmons (Cambridge, Mass., Harvard Univ. Press, 1955), p. 13. For a more detailed statement of his point of view, see in particular his article "Economic Backwardness in Historical Perspective" in *The Progress of Underdeveloped Areas*, ed. B. F. Hoselitz, Chicago, 1952.

latecomers is not generally held back by objective scarcities or by the absence of specific "prerequisites," [15] a view which we have ourselves expressed in the preceding pages.

We find it more difficult to follow Gerschenkron in his explanation of the launching of the development effort. According to his analysis, the economic operators do not at first deem the putative rewards worth the tedious effort of overcoming the backwardness of their society, of introducing all kinds of reforms and institutional changes, of reconstructing their own value systems, etc. But, as relative backwardness increases owing to further advances of the industrial leaders, the advantages to be reaped from economic progress loom larger and larger until finally the effort is undertaken. In a way, the underdeveloped country is thus pictured in the role of an Oblomov who can bring himself to leave his beloved bed and room only if the outside weather is irresistibly splendid.

The implication here is that the operators really know all the time what needs to be done to shed backwardness and to achieve development and are therefore able to weigh the costs against the expected benefits of development. But this point must be questioned. Just as there is no given set of "prerequisites" for economic development, so it is impossible to define a fixed number of backwardness features. What is a hindrance to progress in one setting and at one stage may be helpful under different circumstances. To give just one example, the institution of the extended family has often been considered as an obstacle to development because it dilutes individual incentives; [16] but it can also play a constructive role as it permits a primitive society to adapt itself to new technical activities: maximum use can be made of available spare time and new tasks can be undertaken without prior mastery of such complications as hiring labor and keeping accounts.[17]

In any event, the underdeveloped countries see only the fruits of economic progress and have little advance knowledge of the road they

15. Gerschenkron, "Reflections on the Concept of Prerequisites of Modern Industrialization," *L'Industria* (April–June 1957), pp. 357–72.

16. See, e.g., B. Higgins, "The Dualistic Theory of Underdeveloped Areas," *Economic Development and Cultural Change*, 4 (Jan. 1956), 111; a good general treatment is in Bauer and Yamey, pp. 64–7.

17. C. S. Belshaw, *In Search of Wealth. A Study of the Emergence of Commercial Operations in the Melanesian Society of South-Eastern Papua* (Vancouver, 1955), chs. 5 and 7.

need to travel to obtain them. If they desire these fruits, they will somehow set out after them. Thus they will find out about the changes required in their own society in the course of the development process as they make false starts and as they meet with, and overcome, successive obstacles. It is in this fashion rather than a priori that they will determine which of their institutions and character traits are backward and must be reformed or given up. The tension of development is therefore not so much between known benefits and costs as between the goal and the ignorance and misconceptions about the road to that goal.

Thus determination is not enough after all. It needs to be combined with a perception of what needs to be done, and this perception is acquired only gradually, in the course of the development process. For one thing, few areas of human affairs exhibit such a lack of correspondence between ends and means: to achieve higher per capita incomes, current consumption must be reduced; to make available more leisure time, work must be more rigorously scheduled; to obtain a more equitable distribution of income, new inequalities may first have to be created, etc., etc. No wonder, then, that economic development has so often been a by-product of the quest for political and military power. The choices and decisions that need to be made to achieve development are far more germane to the pursuit of power and prestige than to that of increased welfare.[18]

The nature of the "binding agent" which somewhat mysteriously is supposed to organize and achieve cooperation among the many factors, resources, and abilities needed for successful development is now becoming clearer. It seems to consist in a "growth perspective" which comprises not only the desire for economic growth but also the perception of the essential nature of the road leading toward it.

The question is once again whether we are much advanced by looking at matters in this way. If a "growth perspective" is needed for

18. For this reason, it is interesting to note that a country's standing in the international community is increasingly affected by the extent to which it is achieving economic development. This new international competition is already becoming a force hastening economic advance in many countries. It is facilitated by the increase in the speed and volume of communications and has become formally possible as a result of the invention of a—still very imperfect—scoring method, namely the compilation of national income and income per capita estimates.

growth, we have also just pointed out that this perspective can only gradually be acquired in the course of growth. So it would seem that all we have achieved is to saddle ourselves with yet another vicious circle. But, to paraphrase Orwell, while all development circles are vicious, some are more vicious than others. All circles result from the two-way dependence between development and some other factor, be it capital or entrepreneurship, education, public administration, etc. But the circle to which our analysis has led us may perhaps lay claim to a privileged place in the hierarchy of these circles inasmuch as it alone places the difficulties of development back where all difficulties of human action begin and belong: in the mind. An aspect of this difficulty which seems to us of particular interest will now be explored in greater detail.

The Idea of Change as an Obstacle to Change

It has become fashionable to declare that the desire and drive for economic development has caught the imagination of people everywhere. Admittedly there are still many millions who have failed to let themselves be caught. Nevertheless, the awareness that economic progress does not need to remain the monopoly of a few nations has been widening rapidly and certainly has penetrated some social groups in practically all countries.

The feeling that change and progress is possible and desirable is bound to represent a highly dynamic force in a hitherto stationary society. But if this feeling is due primarily to outside demonstration rather than to one's own experience, it may lead to a variety of misconceptions about the process of change that inhibit the achievement of the new goal until a modicum of learning has been achieved.

The group-focused image of change. To understand why this may be so, we shall first look at the well-known—and frequently romanticized—communal, cooperative, cohesive type of society. The individual members of such a society usually have a definite place and role assigned to them, and the possibility of change and improvement in their economic fortunes hardly enters their horizon. The total product having long been stationary, individual improvement could only take place at the expense of other members and of the cohesiveness

5

Some Caution about Property Rights as a Recipe For Economic Development

David Kennedy

In recent years, enhancing the security and clarity or formality of property rights has become something of an *idée fixe* among global development policy experts. The legal orthodoxy which has accompanied neoliberal economic prescriptions routinely affirms that "clear and strong" property rights are a prerequisite to a functioning market economy and that stronger and more formal property rights will promote efficiency and growth. It is not surprising that strengthening property rights has become a standard part of the recipe offered by outside experts for China, often on the basis of an assertion that a strong private property tradition has historically been responsible for robust growth and development in today's most developed industrial societies.

This is more ideological assertion than careful history, however. Western economies have experienced periods of aggressive industrialization and economic growth with a wide range of different property regimes in place. Throughout the West, property rights have always been embedded in a complex legal fabric which modifies their meaning and qualifies their enforcement. As one sorts through the technical details of any Western legal regime, moreover, it is notoriously difficult to say just which entitlements are "clear" or "strong." No property law regime is composed solely of "rights"—there are always also lots of reciprocal obligations, duties, and legal privileges to injure. Since all entitlements involve at least two economic actors—the one with a right, the other under a duty—what is strong and clear to one may well seem weak and vague to another.

Nor is there a compelling analytic supporting the suggestion that "clear and strong" property rights lead inexorably to market efficiency or economic growth. The ideas about property law which undergird assertions that strong and clear rights will lead to economic efficiency and growth become incoherent when we begin to translate them into technical legal regimes. In fact, most proposals for strong and clear property rights rest, at least in part, on lay conceptions about the legal order which are simply not warranted. These include ideas like the following:

- that "property rights" have an ideal form which can be disentangled from the warp and woof of social and economic struggle in a society;

- that "private order," including property rights, and "public regulation" can and ought to be cleanly separated, the one supporting the market, the other potentially distorting it;
- that "strengthening" property rights has no distributive implications, if only because property law concerns the "rights" of individuals over things rather than complex relations of reciprocal rights and duties among people with respect to things;
- that concerns about social uses and obligations are only properly pursued outside the property regime, through social regulation of one or another sort;
- that in a well-functioning market economy, all "private" rights can and will be freely rearranged by market forces, rendering decisions about their initial allocation unimportant;
- that the *formalization* of property rights leads cleanly to both efficiency and growth, eliminating the need for policy judgment about the desirability of alternative uses and distributional arrangements.

Each of these six ideas supports the notion that the development of a proper law of property can be accomplished without facing complex questions of social, political, and economic strategy. But each is incorrect. Property law is a critical domain for engaging, debating, and institutionalizing development policy, but it is not a substitute for strategic analysis and political choice. Property law is everywhere a *mix* of formal rules and quite discretionary standards, of strong entitlements to act and obligations restricting one's ability to act, just as property law is everywhere embedded in a complex combination of public and private legal regimes. The result is a dense fabric of rules and procedures for *adjusting* competing claims on and uses for a society's productive resources.

In short, choices about the meaning and allocation of property rights pose the sorts of policy questions familiar to economists thinking about development policy. If we are seeking economic growth of this or that sort, who should have access to what resources and on what conditions? "Clear and strong property rights" are neither an escape from these questions nor a ready-made answer. Property law is simple one place in which struggles over these questions have been carried out. In this short essay, I review these common, if mistaken, ideas about property rights in the West in light of the Western experience. My objective is to place the strategic choices embedded in any property regime in the foreground and to counsel hesitation before accepting conventional neoliberal wisdom about the importance of "clear" or "strong property rights" for economic development.

~~preoccupied with rebuilding a theoretical appreciation for the connections between public and private authority and rebutting the idea that public and private could, in fact, be analytically distinguished. Repeatedly, economic, social, and other policy considerations we might associate with public regulation and administrative action have become routine components of private law doctrines.~~

Moreover, over the last century, legal professionals in the United States have become ever more adept at multiplying the number of possible combinations of public and private authority. Indeed, creative lawyering is often about expanding the toolkit of possible institutional arrangements which combine public and private authorities in novel ways. This proliferation of mixed arrangements was made more possible as jurists lost confidence in the plausibility of a sharp analytic distinction between private arrangements—like property law—which reflected the free "consent" of private individuals and public law which entailed coercion through the plenary power of the state.

It is always difficult to date the emergence of such a general understanding, but two jurists writing in the early twentieth century have often been credited. In the United States, Robert Hale stressed the role of state coercion in private law arrangements by focusing on the ways in which those without property could be forced to refrain from using resources owned by others.[2] Hale emphasized that the property rights of owners placed others under a legal duty to make due without access to assets, an obligation which would be enforced by the state should they trespass or seek to convert another's property for their use. There was, he argued, an unavoidable element of coercion and public power in the routine operation of the private legal order.

At about the same time, Morris Cohen argued that because property is a state-sanctioned right to exclude, it is also the power to compel service for use or the payment of rent. He wrote: "We must not overlook the actual fact that dominion over things is also imperium over our fellow human beings."[3] For Cohen, property is more than the legal protection of possession. It also determines the "future distribution of the goods that will come into being,"[4] which we might well have considered exclusively the province of public law and sovereignty.

> The owners of all revenue-producing property are in fact granted by the law certain powers to tax the future social product. When to this power of taxation there is added the power to command the services of large numbers who are not economically independent, we have the essence of what historically has constituted political sovereignty.[5]

This insight made it easy to see the parallel between the sorts of policy questions faced in making "sovereign" regulatory decisions and those faced in the allocation and definition of "private" property rights. For Cohen, economic policy ought to drive decisions about the allocation and meaning of property: "the essential truth is that labor has to be encouraged and that property must be distributed in such a way as to encourage ever greater efforts at productivity."[6]

Here begins a century-long relationship between legal and economic analysis. For lawyers, the discovery of this relationship brought liberation from a professional experience of necessity—the experience that private rights *had* to be arranged this way rather than that, because of the "nature" of property. There were many ways in which they might be arranged, all had economic effects, and each would harness

public authority and private power. Cohen was particularly concerned to disentangle the argument for a strong property system from any preconception about who ought in such a system to have which specific rights.

> It may well be argued . . . that just as restraining traffic rules in the end gives us greater freedom of motion, so, by giving control over things to individual property owners, greater economic freedom is in the end assured to all. This is a strong argument . . . It is, however, an argument for legal order rather than for any particular form of government or private property. It argues for a regime where everyone has a definite sphere of rights and duties, but it does not tell us where these lines should be drawn.[7]

Cohen was attentive to a number of specific issues: how firmly to set intellectual property rights to stimulate innovation without preventing the productive use of the knowledge ("patents for processes which would cheapen the product are often bought up by manufacturers and never used") and how to combine property rights with antimonopoly power to prevent "abuse of a dominant position" through compulsory licensing or in other ways. The details of his particular policy preoccupations are less important, however, than the broad terrain opened up for legal analysis by the general acceptance within the profession of the background idea that property and sovereignty perform parallel functions and ought to be thought available for rearrangement in numerous ways depending upon one's policy preferences.

Nevertheless, it is still common to imagine that property rights in some sense come *before* or lie *beneath* whatever public regulation has been added on top. Of course in a sense this is certainly true—property rights are everywhere restrained and modified by a regulatory framework. The law relating to property in every society rests within a broader legal context which affects the meanings property entitlements will have. Numerous adjacent legal regimes affect the meaning of property rights in every system—laws about taxation, bankruptcy, consumer protection, zoning, family law, corporate governance, environmental regulation, and many more. In this sense, the use of economic resources is nowhere the exclusive concern of "property law."

Even if we could imagine the absence of explicit regulation modifying rights, however, the idea that property rights exist before or outside public policy would still not be sound. Hale and his contemporaries were correct that property rights are, in the end, only as strong as one's ability to bring the state into play as their enforcer. The enforcement and definition of property rights depends upon the larger regime of private law and procedure which may be organized to strengthen or weaken various interests in society. Procedural and institutional arrangements make it easy for some and difficult for others to mobilize the state to protect their interests. Moreover, property rights also vary when combined with different "private law" regimes of contract and tort or obligation. A strong tort regime of duties to avoid negligent injury to others may limit one's legal privilege to use one's property to another's detriment. In the end, we must recognize that the private legal order is shot through with public policy commitments, relies upon the state for interpretation and enforcement, and never controls access to resources in the absence of public law restrictions or permissions.

The neo-liberal legal orthodoxy recognizes this—that is why they place property rights front and center. But, as we have seen, calling for "strong and clear property rights" tells us almost nothing about how to allocate initial private law entitlements so as to promote development. Should resources be concentrated or dispersed, should their use be exclusive or shared, ought those with neighboring plots be able to undermine one another's profitability through competition, or ought ownership to imply exclusive access to particular markets, and so on. Do we want to encourage the emergence of large national firms or many small holdings?

In my experience, the idea that "strong" rights might substitute for answering such question even when making initial allocative decisions is strengthened by two related but mistaken ideas. The first idea is that one ought to focus first on achieving efficiency—in the sense that, given factor endowments, resources within an economy are moving steadily towards their most productive use—and leave questions of distribution until later. This separation of efficiency and distribution is familiar, if contested, in economics. It makes little sense once we try to translate it into legal terms. There is simply no way to "get efficiency right" without relying on some initial definition and allocation of entitlements. These may be exogenous to the economic model, but they cannot be exogenous to the design of a legal and economic order. Put another way, there would be no price system absent the legal capacity to own, bargain, and contract. Setting up such a scheme *distributes* access to resources and establishes the capacity and respective powers of economic actors. How one does it influences what happens next. Entrenching some powers and players at the expense of others will influence the direction of an economy's development as well as the outcome of future social and political struggle over policy. Factor endowments are routinely treated as exogenous because there simply is no economic analytic for establishing an "efficient" initial allocation. In the real world, however, it must be done, and doing so requires policy, social and economic strategy.

Moreover, it is important to recognize that most economic analysis of legal rules focuses on efficiency rather than growth. This may sound like deferring distributive concerns—"growing the pie before cutting it"—but it is quite different. Indeed, there is no reason to think that the move to an efficient allocation of resources will lead to more than a one-time increase in income. It is easy to imagine a society moving from an inefficient to an efficient allocation of limited resources and ending up in another stable, but still rather low-level, equilibrium. Indeed, it may well be that growth requires the introduction of inefficiencies. Whether efficiency leads to growth will often depend on who reaps the efficiency gain and what they are permitted to do with it—questions whose answers will often be rooted, in turn, in the allocative structure of private law entitlements.

The second and related idea lending support to the "strong and clear property rights" recipe is the notion that in the general run of things, no matter how entitlements are initially allocated, we can count on market actors to rearrange them so as to maximize the productive use of a society's physical assets. As a result, the initial allocation of rights is relatively unimportant, just as the details of a private law regime are less important than the fact that whatever rights are

established be "clear" so that the transaction costs of their rearrangement will be as low as possible.

It would be excellent if this turned out to be true—we could avoid any number of social and political struggles about just how to set up the legal regime. Unfortunately, this idea is also mistaken. It is certainly true that when markets work well, actors do respond to price signals and rearrange entitlements to shift resources to more productive uses. When we analyze the impact of entitlement allocations we must always think in socio-legal terms, aware of the ways in which economic actors will respond to our definition of rights and duties—will they rearrange them, ignore them, respect them, and so forth. Of course, not all entitlements are for sale or subject to private rearrangement. You may not sell your bodily organs, empty the coffers of a trust without regard to the named beneficiaries, or, in some cases, sell what are seen to be family assets in divorce even if they are held in your name. More importantly, markets for entitlements routinely fail and transaction costs are ubiquitous. Consequently, in normal situations, we ought not to expect entitlements to flow seamlessly to their most productive use.[9]

The best we are usually able to do is to allocate entitlements so as to mimic as closely as possible the allocations which we can predict might result from bargaining in the absence of transaction costs and market failures. This is itself not at all easy to do, as a generation of law and economics scholarship in the United States has made abundantly clear. Moreover, an initial allocation of entitlements may establish a pattern of relative wealth and poverty which renders the price system an unreliable mechanism for allocating resources to their socially most productive use. Where differences in initial income are extreme, wealth effects may mean that a market price sends completely different signals to the current owner and the potential purchaser. A variety of other cognitive biases may similarly impede transactions in entitlements.

The idea that we need not worry too much about initial allocations is often expressed in a more cautious version, which begins to slide from analytic to practical rule of thumb. One often hears it said that in the great run of cases one can probably count on market forces to reallocate for efficiency more confidently than one can count on government policy to do so. Of course it is true that governments can be terribly inept. We might expect comparative empirical analysis of government and market failure to be helpful here. Unfortunately, the complexity of such an analysis in the real world is so great that it is far more common for the analytic to give way at this point to the more general hunch that private parties are more likely to be get things right by the light of the price system than are bureaucrats navigating by ideology.

In any event, we will have to rely on government for enforcement of the initial allocation enacted by the private law regime—and it will matter how they do it. There is simply no escaping the problem that we have no analytic for assessing the efficiency of the *initial* allocation. In a sense, entitlements can only ever be *rearranged* by markets through buying and selling. Doing so presupposes a regime of property and contract which defines what it means to own, to buy, and to sell. Before we bargain over the price of a particular entitlement, we need to know whether this or that person has the capacity to own or to sell it. We will only be able to bargain once we know just what the state will routinely enforce—whether, for example, ownership entails the privilege to use one's property so as to

There is a long tradition of associating legal formality with industrial capitalism and economic growth. The precise economic justifications for legal formality nevertheless remain vague. Seen as a general quality of the legal order, formality has been thought to improve the rationality and effectiveness of bureaucratic instrumentalism, ensure reliability and predictability among private actors, promote openness and transparency for both public agents (through bureaucratic regularity) and private actors (through price signaling and the reduction of transaction costs). Indeed, formality has often been treated as a kind of cure-all elixir, capable at once of restraining bureaucratic discretion and creating markets. Moreover, formalization carries some of the moral fervor of individualism, responsibility, and democracy. Formality will make the exercise of state power open and predictable, the rights and commitments of all citizens easy to understand, interpret, and enforce without the need for further policy judgments or the expertise of professionals.

This can all sound sensible—until you try to define a technical regime to implement it. In fact, developed societies differ a great deal in the relative formality of their legal arrangements and every developed legal regime is a complex mix of formality and informality. Sometimes excessive formalism ("red tape") can seem an obstacle to economic performance. Indeed, the urge to "formalize" law downplays the role of standards and discretion in the legal orders of developed economies and the importance of the informal sector in economic life. Max Weber long ago pointed out the puzzle that industrial development seemed to have come first to the nation—England—with the most confusing and least formal system of property law and judicial procedure. Polyani famously observed that rapid industrialization may have been rendered sustainable—politically, socially, and ultimately economically—in England precisely because law slowed the process down.

The informal sector—a sector governed by norms *other* than those enforced by the state or which emerge in the gaps among official institutions—is often a vibrant source of entrepreneurial energy. This was certainly the case in the post-transition economies of East and Central Europe. In many developed and developing economies, the dynamic economic life of diasporic and ethnic communities often relies on a certain distance from formal state power. Even the commanding heights of the developed economies are often self-consciously antiformal—from the "old boy's network" to free-trade zones. Businessmen in developed economies routinely disregard or sidestep the requirements of form or the enforceability of contracts. Indeed, the American "Uniform Commercial Code" explicitly sought to reflect the needs of businessmen precisely by reference to the "reasonableness" of contractual arrangements as that broad term is understood in the business community.

Moreover, the association of development with formalization downplays the range of possible legal formalizations, each with its own winners and losers. Formalization allocates understanding and shifts access to resources compared to the situation prior to formalization. A clear title may make it easier for me to sell my land. The impact on the price of land is less clear. Formalization of my title might make my land cheaper or more expensive for my neighbor to buy depending upon the value we each place on clarity and the range of other modes of property available. The reliable enforcement of

contracts might make me more likely to trust someone enough to enter into a contract. This also may increase—or decrease—the price they can demand for their promise. In the absence of formalization, perhaps I would need to pay a premium to ensure he performed—or perhaps his promise would be worth less if I needed to procure the public good of clarity and enforcement on the private market.

Formalization may reduce or eliminate the chance for productive economic activity for some economic actors. Although clear title may help me to sell or defend my claims to land, it may impede the productive opportunities for squatters now living there or neighbors whose uses would interfere with my quiet enjoyment—or the access members of my family have traditionally had to the same parcel. Clear rules about investment may make it easy for foreign investors—but by reducing the wealth now in the hands of those with local knowledge about how credit is allocated or how the government will behave. An enforceable contract will be great for the person who wants the promise enforced, but not so for the person who has to pay up. As every first-year contracts student learns, it is one thing to say stable expectations need to be respected, and quite another to say whose expectations need to be respected and what those expectations should legitimately or reasonably be. To say anything about the relationship between legal formalization and *development* we would need a theory about how assets in the hands of the title holder *rather than* the squatter, the foreign *rather than* the local investor will lead to growth, and then to the sort of growth we associate with "development."

Moreover, the relative "clarity" of property rights will often be in the eye of the beholder. For local entrepreneurs, informal and technically imprecise arrangements may be far more comprehensible and predictable than any formalization, while a clear set of nondiscretionary rules about property, credit, or contract might make a foreign legal culture more transparent to me as a potential foreign investor. Formalization was often the substantive development program urged upon nations by foreign direct investors. At the same time, formalization of titles—like the adoption of international standards and accounting procedures—may render an economic sector altogether incomprehensible for many economic actors who had previously been active in it. Conventional forms of credit may simply dry up—and there is no guarantee formalization will give rise to a dense enough market to generate new forms of credit responsive to new forms. Although formalization might encourage foreign and discourage local participation in an economic sector—like real estate—it might also discourage foreign investors who might otherwise jump the knowledge barrier to participate in the local market.

In short, the economic consequences of formalization will depend upon a very localized assessment of who benefits and what they do with their new knowledge about and access to resources. In land reform, ought title to be given to the "head of household," to "the family," to the "matriarch," or to the community in common? Before formalization, each may have had some call on the resources of the land. Formalization may place all the eggs in one basket. Whether farm production or urban sprawl—and ultimately GDP—will rise or fall may depend upon just which basket that is.

Moreover, it will not always be the case that increased formality strengthens an owner's title. Indeed, although they are often conflated in discussion, the case for formalization is distinct from that for "strong" property rights. Sometimes an owner's entitlements will be strengthened by the use of a standard rather than a rule—the right to use my property in any "reasonable" way may well be "stronger" than more precise enumeration of prohibited and permitted uses, depending upon the surrounding cultural meanings of "reasonable." When a tangle of precise local rules can only be manipulated by insiders—foreign investors may prefer to rely on vague standards which are given meaning in routine business practice where they come from. Similarly, non-owners may well prefer the ability to make "fair use" of copyrighted material to an enumeration of permitted excerpting practices.

For development policy, it is not enough to defend "formalization" as a technical matter of "good law." The form of property protection everywhere raises allocative and distributional questions requiring political or economic analysis to resolve. All too often, formalization offers itself as a substitute for all the traditional questions about who will do what with the returns they receive from work or investment, how gains might best be captured and reinvested or capital flight eliminated, how one might best take spillover effects into account and exploit forward or backward linkages. Or questions about the politics of tolerable growth and social change, about the social face of development itself, about the relative fate of men and women, rural and urban, along different policy paths.

Over the last years, enthusiasm for formality in legal arrangements has supported various reforms associated with the opening of local economies to global economic forces. In international discussions of economic policy, formalism has meant strict construction of free-trade commitments, the harmonization of private law so as to eliminate "social" exceptions susceptible to differential judicial application, the insulation of the international private law regime from national judiciaries, the simplification and harmonization of national regulations, the substitution of privately adopted rules for public law standards, the development of a reliable system of bills of lading and insurance to permit contracts "for the delivery of documents" rather than goods—eliminating rejection for nonconformity, and the formalization and standardization of international payments systems and banking regulations. At the national level, formalization has meant the regularization—and reduction—of local administrative discretion, the simplification of procedures for access to credit or administrative permission to engage in economic activity, the adoption of internationally recognized accounting, safety and other regulatory standards, as well as of private and commercial law regimes familiar to foreign investors, and the extension of formal land tenure regimes to markets and assets traditionally managed informally.

Although each of these reforms could be seen, at least in some cases, to involve a relative increase in the formality of entitlements, it is difficult not to conclude that they hang together more comfortably as elements of a general project to disestablish the development state and open markets to private investors. In that project, sometimes it will be useful to render some entitlements more formal—while others will need to be relaxed or simply left alone. Conspicuously absent is a

nuanced analytic capable of distinguishing entitlements due for formalization from those better left as is. Rather, there is something mesmerizing about the idea that a formalization of entitlements *in general* could somehow substitute for struggle over these issues and choices. This may be why one rarely hears carefully calibrated demands for clarity here, but not there, of these entitlements, but not those. It is in this sense that what may have begun as an analytic devolves into program or slogan.

CONCLUSION: ANALYTICS AND IDEOLOGY IN THE CASE FOR ENTITLEMENT REFORM

We probably ought not to be surprised that policymakers repeatedly fall back on general ideas about "strong" and "formal" entitlements when making development policy. It is extremely difficult to link a rigorous economic analytic to the detailed choices involved in constructing a legal regime. Moreover, it is not as if lawyers themselves know how to make the necessary allocative decisions. In constructing a legal regime, it will often be necessary to choose between two entitlements and, ultimately, two different social actors. For more than a century, in such situations, legal analysts have turned to other fields for insight about what to do. It would be a relief if one could decide simply by preferring strong to weak rights, formal to informal legal arrangements—and end up with economic efficiency, growth, and development!

Lawyers long ago realized that they cannot figure out how to make technical decisions about the structure of private entitlements without assistance from the best political and economic ideas. As a result, lawyers have internalized a whole series of debates which are familiar to economists, sociologists, psychologists, moral philosophers, and other social scientists. The "economic analysis of law" represents one such strand—lawyers borrowing bits of analysis from economics to help resolve technical choices within the legal field. Lawyers do not always do this well, of course. It would be more accurate to say that a variety of slogans and lay versions of economic or social theories have become part of the standard analytic repertoire of the legal profession. But the practice of referring to economic analysis makes it all the more puzzling when economists return the favor by proposing that difficult questions of economic policy be solved by implementation of "good law," "strong rights," or "clear entitlements."

It turns out that for both disciplines, the pretense that legal regimes are designed by the light of careful analytics is exaggerated. In both fields, we often find ideology posing as analysis instead. Land reform offers a good example. The economic and political significance of law is easy to see in land reform programs, precisely because land reform is law reform—a change in the allocation of entitlements among people with respect to land. As a technical matter, "land reform" presents numerous choices. It may involve public or private land, acquired through purchase or expropriation or some combination, with more or less compensation to past owners. The compensation may be current or deferred, linked to alternative productive investment or open-ended. Land reform may be

apply to large or small or all parcels, to parcels used in some ways and not others. The new owners may be selected in different ways, and may have a variety of different entitlements—to use, sell, occupy, till, or rent the land, under conditions or unconditionally, individually or collectively. The land may become public or communal property, may be more consolidated or more dispersed after the reform, and so forth. Land reform may disrupt or solidify existing power dynamics within families, may track or disrupt traditional or customary patterns of land ownership and usage. As a practical matter, land reform may involve more or less land, may involve relocation or not, may be more or less effectively implemented, and may be extended beyond its formal terms by popular support, or resisted tooth and nail on the ground. In the postwar period, land reforms differed quite dramatically in all these ways.

None of these choices can be resolved by reflection on the "nature" of property, or the desirability of "strong" and "clear" property rights. It may be that careful economic analysis could clarify which approach to each issue is most likely to generate development in specific situations. To the extent that this is true we might expect land reform programs to reflect careful fine-tuning in light of development objectives rooted in this kind of analysis. In fact, however, postwar land reform in developing countries reflected far more the pull and push of political and ideological struggle. As a general matter, land reform was routinely associated with import substitution industrialization, more a matter of loose ideological fit than careful economic analysis. For contemporaneous economic theories of industrialization and growth the agricultural sector was not in focus. But the expropriation of rural landowners seemed analogous in a general way to the nationalization of industries or natural resources, which were themselves seen as a way to achieve the objective of mobilizing the nation's resources for a big push to industrialization.

Although policymakers argued for "land reform" as a tool for economic development, the specific choices necessary to design a land reform program came to have connotations associated with ideological and political positions. It was then common for technical choices which seemed ideologically analogous (more or less state, more or less collective management) to be linked together—and decoupled from careful assessment of their many possible economic consequences in particular settings. In literature about the details of land reform—paying compensation, allocating land to individuals, families, or communities, and so forth—discussion then focused on the significance of these details for the ideological meaning of the reforms—public or private ownership, expropriation with or without compensation—or their likely impact on rural poverty, itself not a priority for the economic development theories of the day.

In the implementation, political opportunity counted for a great deal. Far-reaching land reform regimes were implemented in postwar Japan and in regions where the collapse of Japanese colonial rule or occupation allowed land reformers to ignore the interests of the landed, who were no longer politically entrenched. Where relatively strong or authoritarian national regimes were independent of landed interests, as in postwar Taiwan, more far-reaching programs were possible. As the great ideological division of the world emerged in the postwar years, land reform was often a marker for a regime's political identity. In Mexico, it was remembered and continued as part of a nationalist and socialist tradition linked to

Law, Drugs, and Development:

The regulation of the marijuana market in Mexico

Alvaro Santos, Georgetown Law

You are an analyst working at *Prosperity Now*, a consulting group that gives policy advice to governments on drafting laws and regulations on a variety of matters. The government of Mexico has approached your firm requesting advice on the potential effects of changing the current prohibition regime concerning marijuana. There has been a heated debate in the country concerning possible reforms and all political parties, including the ruling party, have introduced bills in Congress.

The legal framework

The Mexican government outlaws marijuana possession, consumption, cultivation, and distribution under the General Health Law (LGS) and the Criminal Code. Mexico is also bound by international law to *criminalize* marijuana possession. Under the United Nations Single Convention on Narcotic Drugs of 1961, marijuana is a Schedule I narcotic that signatories, including Mexico, agree to proscribe. Likewise, under the U.N. Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances of 1988, individual member states further agree to actively criminalize possession of the drugs prohibited by the Single Convention and follow-on treaties, including marijuana. The treaties also created the United Nations Office on Drugs and Crime (UNODC), which monitors compliance with the treaties and seeks to coordinate member state efforts to combat drug trafficking.

The Mexican Supreme Court recently decided a case concerning marijuana. In November 2015, the Court decided in favor of the individual members of a non-profit called SMART (Sociedad Mexicana de Autoconsumo Responsable y Tolerante, A.C) who had requested a license to carry out acts related to personal, recreational consumption of marijuana (such as cultivation, production and transportation). The request, which explicitly excluded any commercial act, was denied by Federal Commission for the Protection against Health Risks (COFEPRIS), based on the prohibition established by the Federal Health Law. The court declared that the federal law violated the constitutional right to free development of personality, established on Article 1 of the Mexican Constitution.[1] It is important to note that although this decision may influence other cases it does not yet have binding force as precedent.

Previously, in August 2015, another marijuana-related case was decided when a federal court issued a permanent injunction against the decision of the Council of General Health (CSG) not to allow the importation of cannabidiol (CBD), a marijuana derivative, for the epilepsy treatment of a girl called Graciela Elizalde Benavides

[1] For a synthesis of the case and related documents *see* http://www.smartclub.mx/el-caso.html
[2] For the in-depth story of the case *see* http://www.porgrace.org.mx/la-historia.html

(Grace). As a result, the parents of Grace, who suffers from the Lennox-Gastaut syndrome, are now able to import the medicine and the girl's health condition has reportedly improved.[2]

On April 19, 2016, at the meeting of the Special Session of the United Nations General Assembly (UNGASS) on the World Drug Problem, Mexican president Enrique Peña Nieto gave a speech where he recognized that prohibition was failing and needed to be revised and that drug policies needed to be based on human rights and public health.[3] After the speech the President's political party, the PRI, introduced a bill in Congress that called for decriminalization of consumption, up to 28g, and for the legalization of marijuana for medical purposes (produced abroad). Legislative groups from the center-right (PAN) and center-left (PRD) parties have both proposed bills that call for the whole legalization of marijuana, but the bills don't count with the full support of their respective parties. The PRI has the most seats of any political party in both houses of Congress but in neither does it reach a simple majority.

Violence

Violence in Mexico continues to rage. Since 2007, when then President Felipe Calderón (PAN) declared the war on drugs up to 2014, more than 164,000 people had been killed[4] and 30,000 have disappeared. Thousands of people have been displaced from their communities. Incarceration rates have spiked for drug-related crimes, many of them of a non-violent kind, including possession and consumption of marijuana. Although the Peña Nieto administration has de-emphasized the war on drugs, the policy remains largely unchanged. Violence levels have varied but the average levels of violence are as high as during the Calderón administration.

Domestic and international human rights organizations have sharply criticized the Peña Nieto administration for systematic violations by the army and the police in the conduct of the war on drugs. One of the most well known episodes concerned the massacre of 43 students in Ayotzinapa, Guerrero, where police forces, in conjunction with a drug-related criminal organization are believed to have kidnapped, killed, and disappeared the students. The government investigation has been largely discredited in a report by an independent group of experts working under the auspices of the Inter-American Human Rights Commission. While the government originally welcomed the work of the expert group, it changed its position after the report was published severely criticizing the group and stopping its collaboration.

---

[2] For the in-depth story of the case *see* http://www.porgrace.org.mx/la-historia.html

[3] http://www.cinu.mx/comunicados/2016/04/el-problema-mundial-de-las-dro/

[4] "La violencia en México provoca más muertos que las guerras de Afganistán e Irak" http://www.abc.es/internacional/20150811/abci-guerra-narco-muertos-irak-201508101829.html

Changes in U.S. regulation

In the recent U.S. November elections four states legalized marijuana for recreational use and four for medical use. This brings the number to eight states that now allow marijuana for recreational use, and twenty-eight that allow it for medical use. California, which just legalized it, shares a border with Mexico. The federal government has maintained the prohibition on marijuana. However, in 2013, the Attorney General issued a memorandum guiding federal enforcement of marijuana specifying that it would not enforce the federal prohibition on states that legalized marijuana and complied with certain conditions. These conditions included, inter alia, not selling to minors, not crossing state borders, and not involving criminal organizations. The impact of these changes in the transnational market is yet unclear but some analysts have reported a decrease in the importation of Mexican marijuana into the U.S.

The debate

Advocates of legalization argue that criminalization is responsible for the high rents that drug cartels can command, which creates incentives for violence, bribery and corruption. Illegality, they argue, induces market actors to fight each other using violent force to enforce their deals, rather than resorting to courts and formal dispute resolution mechanisms. Illegality also induces drug cartels to expand their businesses into other criminal enterprises such as extortion, kidnapping, and human trafficking. Drug cartels are also prone to bribe State officials or use violence if needed, the better to protect their market and ensure their profits.

Legalization proponents also argue that the potential health harm of marijuana is lower than that of other substances, such as alcohol and tobacco, which are currently legal and regulated. They claim that the effects of prohibition in terms of health, human lives, security, and corrosion of the State considerably outweigh the negative health effects of marijuana consumption, which was why prohibition was introduced to begin with.

Proponents of maintaining prohibition argue that legalization will make the drug cheaper and more accessible, producing a substantial increase in consumption and its concomitant negative health effects. They also argue that the health effects of marijuana are particularly damaging to adolescents, who will be able to easily obtain it once it becomes legal. On security and violence, prohibition proponents argue that the State should not compromise or negotiate with criminal organizations like the drug cartels. Instead, the State should enforce the law and fight the drug cartels by strengthening the military, the police, the courts, and ensuring that the State exercises control over the territory. The state should invest resources in improving enforcement and making sure that the rule of law prevails.

Policy options

Your client has asked you to consider the possible economic and developmental effects of reform and of the status quo. There are currently at least four policy options, arising from the bills in Congress:

1) Maintain prohibition
2) Decriminalize consumption by raising the allowed threshold of possession to 28g (currently 5g). Make consumption in public spaces an administrative violation. Maintain prohibition otherwise.
3) Decriminalize consumption (28g) and allow marijuana for medical uses. Require medical prescription for marijuana use. Allow marijuana products approved by the Mexican, FDA-like agency called Federal Commission for the Protection against Health Risks (COFEPRIS), made by pharmaceutical companies. Keep prohibition of cultivation and production of marijuana.
4) Legalize all market activities related to marijuana, including cultivation, production, distribution and sale.

You are asked to give an opinion based on what you think would be most desirable from a development perspective. You need not consider the feasibility that your policy proposal would have political support given the current political configuration in Mexico. This is something that your client will have full occasion to consider.