Towards a renewed development theory: Hernando de Soto and institutionalist contractualism

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1. Economic development theory in Latin America

ECONOMIC GROWTH THEORY UNDERWENT a radical change in the 1950s. After World War II, with the declaration of the end of colonialism, the FAO published the data of the first food enquiry involving seventy nations, which was begun in the 1930s by the League of Nations, following the large-scale destruction of foodstuffs in Latin America, on occasion of the 1929 crisis, in order to maintain price levels in the import markets of Europe and the USA.

A few years later, in 1951, the UNO completed statistics on the population and the per capita income in the different parts of the world, and, with the universal declaration of human rights, sanctioned that everyone had the right to a standard of living that could guarantee an adequate level of wellbeing. The results of this enquiry showed that the world was divided into two parts: one part was rich and in many areas underpopulated; the other was poor, with high rates of population increase, and therefore subjected to Malthus' tragic predictions.

The Hot Springs Conference in 1943 was the first evidence of this change of attitude: the delegates of 45 nations revealed the conditions of undernourishment of their respective populations, and agreed to wipe out the black stains of hunger on the world map of qualitative demography. With the Atlantic Pact, the great powers declared that one of their aims was to free from need "every man in every country". The Roman Catholic Church took a closer interest in the issue, too, because of the grave destruction the war had brought about. In April 1946, Pope Pius XII issued a message to the Christian world, underlining the fact that humankind was threatened by the poverty which weighed heavily over at least a quarter of the world's population.

The 'discovery' of underdevelopment – or of the Third World, as it was defined by the French demographer, A. Sauvy – posed new, different problems of interpretation regarding the theory of growth which had been formulated by the Classic English School for a society which, from the second half of the eighteenth century, was starting out on the path to industrialization, and which still competed with Holland (by then in decline) to be the world's richest country and to have the most modern economic and social institutions[1].

The production function, which identified the basic elements of growth as capital and labour in relation to their contribution to income, changed and widened in meaning to embrace development factors that were external or residual, particularly technological innovation, the formation of human capital and, later, structural and institutional changes. Thus the production function became qualitative as well as quantitative, resulting in new models of endogenous growth. One of these was proposed by R. Lucas and P. Romer who incorporated the above-mentioned qualitative factors which, insofar as they can be reproduced, generate increasing yield; another was the so-called non-Walrasian or K-balance growth models which, using the theory of economists such as R. G. Barro or I. Grossman as a basis, take capital in the

1. To contextualize economic development theories, cf. Giuseppe Di Taranto, *Sociedade e Subdesenvolvimento na Obra de Josué de Castro*, (Cejup, Belem 1993), pp. 115. For a critical view in the ambit of globalization, S. Amin, *Il capitalismo del nuovo millennio. L'economia politica dello sviluppo dal XX al XXI secolo*, (Edizioni Punto Rosso, 2001), pp. 142. Cf. also *Latin American Politics and Society*, vol. 46, n. 1, 2004 and vol. 50, n.3, 2008 (University of Miami).

broadest meaning of the term to include knowledge and any other factor that can be reproduced. Thus it is subject to increasing yields, in opposition to classical theory's claims regarding physical capital and labour.

In the Latin-American countries, in particular, the neo-liberalist view of growth was devised by the United Nations Economic Commission for Latin America, its greatest theorists being W. A. Lewis, C. Furtado and R. Prebisch[2]. On a political level, it hoped for a bourgeois democratic alliance capable of bringing about the reforms necessary to start a huge process of economic and social change, and, from the doctrinal point of view, it referred to the theories formulated in the nineteenth century by the liberal elite, and supported by a precise psychological conditioning: everything that came from Europe, and later from the United States, represented progress, and the closer the relations with the western world, the quicker would be Latin America's march towards modernity. Other economists, too, were inspired by these principles, despite their awareness of the shortcomings of neoclassical economy, and of prices as a Third World market-regulating instrument; these included A. Gerschrenkon, G. Myrdal, H. Mynt, R. Nurkse, P. N. Rosenstein-Rodan and W. W. Rostow, who summarized this approach in the expression "Do as we have done".

The investment of physical capital was deemed essential to overcome the fundamental cause of the economic gap: the different scale of development due to the time lag between the growth of the rich countries and that of the poor countries.

2. On the United Nations Economic Commission for Latin America, it is useful to remember some not recent but fundamental works: the article by Albert O. Hirschman, "Les ideologies du développement économique en Amérique Latine" in *Amérique Latine: articles et essais,* (Paris 1963), pp. 1-59, and the books by the three authors quoted: W. A. Lewis, *Teoria dello sviluppo economico,* (Milan 1972); Celso Furtado, *La formazione economica del Brasile,* (Einaudi, Turin 1970), and *Teorie dello sviluppo economico,* (Bari 1972); Raul Prebisch, *Capitalismo periferico: Crisis y trasformacion,* (Mexico City 1981).

In Latin America, agriculture was still the main source of production, and gave landowners political power, which derived from economic power. Alongside these feudal-type archaic forms, there was the commercial side of production, not in the domestic market because it did not exist, but in the global market, and this led to a second method of accumulation: the enrichment of the merchant bourgeoisie, which became the rising social class. Feudal and commercial systems together did not create a capitalist organization. And so, on a political level, the Economic Commission for Latin America, as has been noted, hoped for a bourgeois democratic alliance that was capable of carrying out the reforms necessary for more rapid economic and social modernization. These reforms included substituting imports by means of industrialization, increasing production based on technical progress, shifting part of the marginal – and marginalised – population from the primary to the secondary sector and adopting a single market for the Latin American countries with a common customs tariff for the rest of the world, a proposal that the United States agreed to for Central America but to which they objected for Latin America[3].

It is a well-known fact that this school of thought clashed with neo-Marxism, whose main exponents included P. Baran, R. M. Marini and A. G. Frank. Frank, in particular, believed that Spanish-Portuguese colonialism had already established a capitalist-type economic system in South America. Underdevelopment was the outcome of Latin America's internal integration and, at a global level, of its fundamental contradictions: expropriation-appropriation of the surplus; polarization in metropolitan centres and peripheral satellites which, being unable to benefit from the surplus produced, were destined to remain underdeveloped; integration of the peripheral centre's economy into the capitalist structure and, consequently, into its contradictions. Development and underdevelopment thus became the defining elements of a single historical

3. On the Common Market of the South, cf. Francesca Romana Lenzi, *Cile e Mercosur. Modelli di sviluppo e internazionalizzazione*, (Edizioni Nuova Cultura, Rome 2009), pp. 55-81 and 120-131.

process, since the underdevelopment of some areas of the world was useful for the growth of other areas[4].

Latin America had undergone a cyclic growth process in which specialization in single-crop cultivation – instead of diversifying production – had always been geared to the requirements of the rich countries. In many areas, for example, the successive cycles of sugar, animal husbandry, precious metals, coffee and rubber gave rise to an exploitation process, which enabled the home merchant bourgeoisie to benefit from a high accumulation rate, and the foreign merchant bourgeoisie to do so through marketing.

In actual fact, both the neo-liberalist school and the neo-Marxist school were of the same opinion regarding the analysis of the causes of underdevelopment, but they differed in the solutions to the problem they put forward. R. Prebisch, for example, like A. G. Frank, argued that the international division of labour attributed to Latin America the role of a peripheral area in the global economic system, on account of the continual deterioration of the terms of trade with the centre.

The Economic Commission for Latin America's *desarrollismo* considered development as a constituent element of the transition from archaic, feudal forms of production to capitalist commercial, and subsequently, industrial forms; whereas, starting from the hypothesis that capitalist-type structures already existed, neo-Marxism hoped that a peasants' revolution would give rise to a collectivist system, as had already happened in China and in Cuba. It was not fortuitous that C. Furtado, one of the most eminent members of the Economic Commission for Latin America, yet a scholar who was also close to the neo-Marxists' theoretical positions, wrote that liberal and socialist philosophy constitute ideological formulations deriving from the class war caused by classical capitalism. The effectiveness of liberalism depends

4. André Gunder Frank, *Capitalismo e sottosviluppo in America Latina,* (Turin 1969); *Idem, America Latina: sottosviluppo o rivoluzione,* (Turin 1971); Idem, *Lumpenborghesia: Lumpensviluppo,* (Milan 1973). Cf. also Giuseppe Di Taranto, "Para una Història Economica do Brasil", *Revista do Tecnologico,* vol. 3 no. 1, 1991, pp. 100-107.

on a social context in which technical development works to provide solutions to the conflicts caused by the expansion of productive forces; the effectiveness of socialism, as a contractual instrument for the wage-earning class and a means of improving the political institutions, depends on the existence of a dynamic situation in which conflict between the classes plays an important role. "In the underdeveloped countries, the penetration of technical progress does not facilitate the solving of considerable social conflict, and the masses that pour into the big cities have no class awareness stemming from economic rivalry with the owners of the means of production. The inadequacy of the ideological formulations we have mentioned is particularly serious, given the predominance of the political problems"[5]. This means that new paradigms were needed to wipe out underdevelopment in Third World countries, in particular through a different role for the institutions, and for politics, which is the institutions' instrument.

2. De Soto and the growth paradigm

IT IS INTERESTING TO NOTE that the different interpretations and solutions that have been described were the basis of Hernando de Soto's analysis in the 1980s. This analysis was influenced by the changes that were coming to a head, both in economic theory and in practice, for developing countries too. The structuralism paradigm, which envisaged internal intervention by individual third-world countries and international aid to overcome underdevelopment, gave way to the affirmation of the Washington Consensus and the glorification of the free market, through new operational instruments such as microbased macroeconomics[6].

De Soto's liberalism succeeded in combining the competitive free system and some of the Economic Commission for Latin America's

5. Celso Furtado, *Gli Stati Uniti e il sottosviluppo nell'America Latina*, (Milan 1971), pp. 19-20.
6. Roger E. Backhouse, *The Penguin History of Economics*, (Penguin Books Ltd., London 200), pp. 319-320.

main points. The existence of a capitalist mercantile class in Latin America, the impossibility of postponing agrarian reforms so as to restore the land's fundamental economic and social function and deliver its profits to the general public and, above all, the definition and registration of property rights using new institutions that were able to guarantee the transition from an unofficial economy to a legal economy, were the subject of de Soto's book, *El Otro Sendero*, published in 1986[7]. The book deals with the economy of Peru, but not only that. Peru is de Soto's native land, and is chosen as an example representing the Latin American situation. These subjects are analyzed in greater detail and extended to the wider condition of third-world underdevelopment, an obsolete term nowadays, but one which occurs frequently in de Soto's book *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*, published in 2000, with editions in English, Spanish, Dutch, Chinese, Portuguese and Italian[8].

In de Soto's opinion, the lack, or the scant implementation of, agrarian reforms have resulted in rapid urban migration and the creation of an unofficial economy alongside the legal one. The inheritance of colonialism and "the lack of a decentralizing feudal experience" have prolonged the mercantile system in the American subcontinent and in numerous regions that were more underdeveloped than Europe, and have prevented the transition to a market economy. Migration to the cities' outskirts has, over a period of time, given rise to extra-legal activities that, through the "putting out" system – in other words, entrusting part of or all the stages of the production process to outsourcing –, has enabled those who worked within the legal economy to reduce production costs

7. In the English translation, Hernando de Soto, *The Other Path*, (Basic Books 1989); and in the Italian translation, *Idem, Povertà e terrorismo. L'altro sentiero*, Rubbettino Editore, (Soveria Mannelli 2007).
8. Hernando de Soto, *Il mistero del capitale. Perché il capitalismo ha trionfato in Occidente e ha fallito nel resto del mondo*, (Garzanti, Cernusio 2001); for a reasoned summary of this book's contents, cf. Hernado de Soto, "Listening to the Barking Dogs", *European Journal of Anthropology*, n. 41, 2003 and J. Clift, "Hearing the Dogs Bark", *Finance and Development*, December 2003, pp. 8 *et seq.*

and their relative taxation to the point of total evasion, "causing political instability that gives rise to continual violation of the law"[9].

The main point of de Soto's analysis, in fact, is that there is a vast component of workers and activities that are informal or extra-legal (outside the law) in Latin America and in the other developing countries. Their expansion is due to the lack of written, and therefore legally valid, property rights, and excessive state interventionism, with mercantilist methods and contents, based on the redistribution of wealth among the various business groups more than on the production of wealth.

Each individual right, through a contract, contains an implicit real right. On these grounds, de Soto considers property rights as the set of personal and real rights which confer on the person who owns the property the right to dispose of it, and to benefit from it freely, to the exclusion of all others. On the contrary, in the Third World there are more beneficiaries than owners, because of the informal economy. This informal economy does not consist of masses of outcast peasants – who represent less than 5% of the population of Peru, and who, according to the neo-Marxist doctrine of Abimael Guzman, ex-leader of the Maoist revolutionary movement *Sendero luminoso*, should have been proletarian masses ready to rebel against the bourgeois oligarchies' capitalist structures – but of 80% of the population that owns assets worth more than 14 times the foreign investments in Peru.

Extending his analysis, de Soto estimates the value of the informal economy within the world's underdeveloped areas to be about 1,300 billion dollars, slightly less than 50 times the loans the World Bank granted the poor countries between 1970 and 2000. And so the real dichotomy is not the typical Marxist one between capital and labour, but between bureaucrats, politicians and entrepreneurs, who profit by and depend on governments' favouritisms, and those who operate in the legal and extra-legal economies without being able to benefit from them. According to de Soto, given that these latter categories have no

9. Hernando de Soto, *Povertà e terrorismo, op. cit.*, pp. 345 and 313.

guaranteed property rights and cannot distribute shares, they are unable to access investments, and not having patents or rights, cannot safeguard their innovations. Because they have no access to contracts and to justice, they cannot develop long-term projects or make themselves legally responsible for their assets; nor can they use their land, houses or businesses to secure credit for themselves.

In this respect, the Third World's economic system is still mercantilist, taking this term as meaning the demand and supply of monopoly rights through laws, rules, grants, taxes and licences; in other words, a set of privileges that create a wall of legal barriers, which exclude the poor. Mercantilism is, in fact, a politicized, bureaucratized sphere, controlled by redistribution associations (cartels) that have ruled Europe before and during the Industrial Revolution, until the birth of democratic capitalism. It is, therefore, necessary to reorganize the institutions and the legal system in order to guarantee entrepreneurs' instruments for everyone. And to include the excluded in an open economy, because it is not possible to transfer an asset in the international, globalized market without establishing a formal property system. If European and American entrepreneurs had not had access to limited liability systems and to insurance policies permitted by law, de Soto wonders, how many risks would they have run? How much capital would they have accumulated without valid documents? How many times would they have opted for market bankruptcies and tried to start again from scratch, if the law had not permitted them to convert debts into shares?

The most serious distortion caused by mercantilism is to have submerged the enormous human capital and the potential contribution of extra-legal workers, in that illegality has transformed a great number of people into entrepreneurs, who know how to choose the best opportunities by organizing the available resources. Wealth, in fact, is none other than the product of the combination of interchangeable resources and productive labour. The market economy is based on resourcefulness and on the talent of different individuals and their capabilities, and not on the limited contribution of an arbitrarily chosen elite. The real challenge is to achieve a legal and institutional system that reflects this new situation and that enables the economy, that has sprung up spontaneously, to function, so that it gives competitive entrepreneurs and markets maximum security instead of hindering them, transferring the responsibility that governments have monopolized until today[10].

In order to obtain these results, it is important to optimize the functioning of the legal institutions through a process of legal simplification. This should be made possible by monitoring automatically the importance of the laws passed; however, their effectiveness remains to be verified. This can be accomplished by means of provisional laws, whose effectiveness must be limited in time, if they are unable to provide guaranteed results.

Decentralization, i.e. the transfer of legislative and administrative responsibilities from the centre to regional and local authorities and to intermediate bodies so that the authorities are in closer contact with the situation and the problems to be solved, is equally important. Lastly, there is deregulation, in other words increasing the responsibilities and the opportunities of private individuals and reducing those of the state. The state should provide the legal instruments that encourage development. That means changing the institutions so that the property of every activity becomes increasingly widespread and everyone can be certain of having an undisputed claim to it and of reaping the legal benefits of labour and capital. It is not fortuitous that, unlike the nationalization processes carried out by the governments of Argentina, Ecuador or Venezuela, the economic policy of opening up to the market pursued by recent Peruvian governments is also the result of its theories and its research in the field. Today, despite marked social inequalities, Peru has the highest income amongst the Latin American countries, because of

10. Hernando de Soto, *Il mistero del capitale* in Atlante Luiss, *Cinque scenari per il futuro*, (Luiss University Press, Rome 2006), pp. 121-138; also in Giuseppe Di Taranto, (ed.), *Dai sistemi economici alla globalizzazione sistemica*, (Luiss University Press, Rome 2007), pp. 109-127.

a careful internalization of the globalization process by means of policies that facilitate foreign investment in the fundamental sectors of its production system: oil, gas and mining, in particular, gold and silver.

As well as an appropriate macroeconomic policy, microeconomic governance is a crucial factor to promote and protect property rights, facilitate access to trade and transactions between individuals, and to give them the necessary confidence to save, invest and produce. The real remedy for violence and poverty is to acknowledge the ownership and labour of those whom officialdom excludes today, so that belonging will bring identity and responsibility instead of revolution, because when people develop a sense of independence and confidence in their own means, they believe in their capability and their economic freedom.

3. The financial crisis

DE SOTO'S MOST IMPORTANT WORKS were written between the second half of the 1980s – known as the *decada perdida* for Latin America on account of the failure of the development policies[11] – and the beginning of the twenty-first century. This was a period characterized by two important revolutions of the contemporary era: one a political revolution, the fall of the Berlin Wall and of the communist bloc in Europe, and the other an economic revolution, the globalization process in the form of the recasting of economic systems – capitalism and collectivism – through the assertion of market theory and practice. This latter is strictly set within the framework of the Washington Consensus, inspired by Ronald

11. Jaime Rojas Elgueta wrote on this subject that "very few know that until the 1960s Venezuela, Argentina, Brazil and Columbia enjoyed a per capita income that was equal to, if not higher than, that of those countries that are prosperous today. It is only from the 1980s that the huge gap between Europe and Latin America was recognised, a period Latin American experts call the *decada perdita*, to underline how, over a short period of time, the opportunity of becoming countries with widespread, high-level wellbeing, of becoming developed countries, was lost." (J. R. Elgueta, *Postfazione* in *Atlante Luiss*, 2006, *op. cit.*, p. 154).

Reagan and Margaret Thatcher's neo-conservatism and the International Monetary Fund's neo-liberalism, and endorsed, as has been noted, by the new paradigms of micro-based macroeconomics, as a consequence of neo-monetarism and the neoclassical school.

De Soto is aware that the capitalist system is not perfect, but he considers it the best, if it allows everyone to start from conditions of equality, freedom and respectability. Globalization cannot be halted – writes de Soto – and therefore it must be controlled in the interests of all nations. And the recent financial crisis, which has shown the difficulty of an international governance of a market without any regulation[12], has enabled de Soto to update his theory on property rights as the basis for economic security, in connection with the issue of derivatives too. It is not fortuitous that the imperative of new regulations nowadays puts juridical practice above economic theory and calls for a new international order to overcome a recession which, in some aspects, is more insidious than that of 1929, because it is less evident and more hidden. In fact, by means of a new form of credit engineering, based on derivatives and securitization, the recession has transferred the risk factor from financial brokers to savers.

De Soto claims that it is impossible for one thousand billion subprime loans to have triggered a loss of 60,000 billion in a year. In October 2009 he wrote: "I was struck by the former US Secretary of the Treasury, Paulson, when he asked Congress for 780 billion to reform toxic assets. Then twenty days later, he revealed that that money was to boost the economy. This happened because those toxic assets were not found. They were not registered. For the first time, the American economy, based on Anglo-Saxon legal principles, had created a shadow economy where derivatives were not even traceable". The Securities and Exchange Commission calculated that this shadow economy

12. Cf. on the recent financial crisis, Paul Krugman, *The Return of Depression. Economics and the Crisis of 2008*, (W. W. Norton& Company, 2009); R. Posner, *A Failure of Capitalism. The Crisis of '08, and the Descent into Depression*, (Harvard University Press, 2009).

amounted to some 600,000 billion dollars, ten times the global GDP, while studies carried out by the Bank for International Settlements estimate that it could be even double this sum: 1,200,000 billion dollars[13]. In order to manage and study a phenomenon, it must first be quantified, but before anything else, the value of the derivatives in circulation must be known. De Soto is of the opinion that not very much is being done to this end because, as some experts claim, the banks do not want government interference in their affairs, since Wall Street has Washington in its power, and it is suspected that the bankers fear that the figures are so high that they would trigger panic among their customers. And, lastly, because it is still believed that "the market will manage to put everything back in order: all that is required is to stand aside and let capitalist vultures dispose of toxic securities, using their discreet, profitable methods". The direct consequence is that information on derivatives is not standardized, and that there are thousands of securities in circulation that have been sold, resold and scattered in bulk here and there throughout the market. In fact, "certain derivatives are structured in such a slippery and shifty manner that the banks cannot understand what is in their portfolios and the American law-courts continue to refuse many distraint requests based on stock of this kind". This gigantic shadow economy of derivative securities infects everything it touches. It is thought that a simple default of 7% on sub-prime loans – equivalent perhaps to 1,000 or 2,000 billion dollars – rapidly contaminates other securities, creating a deficiency of 50,000 billion dollars in the US economy, because of the loss in value of real-estate shares and yields. Therefore derivatives must be quantified and identified, " tracing a legal boundary around every single one of them, using the instrument of real-estate law (recognition, registration, traceability, standardized identification, the possibility of being summoned as responsible in the case of negative external effects)". And de Soto takes his cue from derivatives

13. Hernando de Soto, "Il diritto salverà l'economia" in *Il Sole 24 Ore*, n. 290, 21 October, 2009, p. 5.

to remind the reader that "in the non-western world, where it originates, this is the standard situation. With the exception of the minority represented by the westernized elite, almost everyone lives in the anarchy of the shadow economy, with their assets covered by endemically toxic securities: not registered, not standardized, difficult to identify, difficult to locate, with a real value that is so unspecified that ordinary citizens have no way of building up mutual trust or of relying on the global markets. In other words, for the shadow economies outside the United States of Europe, a credit squeeze and a slump are chronic conditions... " He concludes that "rescues, quantitative expansionist policies, injections of currency and tax reductions cannot continue, because in the long run the money will run out and credit will remain scarce. This is because the huge mass of credit available does not consist of money, but of activities that grant property rights, such as fungible real-estate stock, loans, bonds and derivatives that have some of the financial attributes of money (those that economists call money-ness). In the whole world there are only 13,000 billion dollars of cash in coins and banknotes, but hundreds of thousand billion dollars worth of money-ness securities. If we want credit to begin to flow again, confidence in securities must be restored as soon as possible. And this means calculating assets, registering them, finding them, disposing of toxic securities and preventing any future devaluation whatsoever of the securities that represent property rights, bringing them back into the sphere of contractual regimes. Many interesting proposals were put forward at the G-20 summit in London... However, at present the world of derivatives is devoid of useful facts and a structure enabling us to obtain the sense, data and confidence necessary to put an end to the credit squeeze"[14]. In de Soto's opinion, this is another reason why property rights – at present enjoyed by just under 2 billion of the global population – should be included among human rights, and this is the aim de

14. Hernando de Soto, "Le regole per scacciare gli avvoltoi tossici", *Il Sole 24 Ore*, n. 101, 12 April 2009, pp. 1 and 10.

Soto, as President of the UN Commission for the Legal Empowerment of the Poor, has set himself, together with Madeleine Albright. The excess liquidity generated by the national plans to boost the economy will be "the opportunity for change" according to the Peruvian economist.

4. De Soto and neo-institutionalism

IN THE CONTEXT OF NEO-INSTITUTIONALIST ECONOMICS, de Soto may be considered the founder of a new, innovative line of research, concentrated on property rights and applied to development theory.

According to him, the legal-institutional system is the cause of the gap that exists between the industrialized countries and the underdeveloped areas, because of an ethnocentric view of the world put forward by economic growth experts who, in their theories and models, have omitted to analyze the differences between the institutional levels each nation has reached. "And so the debate on development should be reformulated", he wrote in his first book, *El Otro Sendero*, "to take into account the importance of legal systems"[15].

As well as guaranteeing the exclusive enjoyment of an asset, property rights have a basic economic function, in that they allow their holder to create wealth by means of the capital that can be made by selling, mortgaging or merely guaranteeing the asset.

A number of economic historians, including Douglass C. North[16], the winner of the 1993 Nobel Prize for Economics, argue that the first industrial revolution in Europe was based on the various states' drawing up of contracts for property rights, as well as the important reduction in transaction costs connected with the stipulation of contracts, financial and insurance operations, brokerage intermediation, accounting and so

15. Hernando de Soto, *Povertà e terrorismo, op. cit.*, p. 281.
16. Douglass C. North, *Capire il processo di cambiamento economico*, (il Mulino, Bologna 2006), pp. 145 *et seq.*

on. Since the greater complexity of trade and of the internal and international division of labour resulted in higher transaction costs, the institutions' aim is to mitigate them to make them as competitive as possible, as is the case in the developed countries. On the contrary, in the emerging regions, the underdevelopment of the legal systems and the uncertainty stemming from the lack of specifically registered property rights result in the increase in these costs, further delaying the development process.

For de Soto, property rights and low transaction costs may be considered incentives capable of increasing the value of everyone's resources, through investment and innovation; since innovation is the higher-risk utilization of capital, institutions must guarantee the certainty of these rights, as well as appropriate, efficient contracts for their organization and transfer, because they make it possible to modernize development processes and to trigger the market economy.

This interpretation crosses the boundaries of neo-institutionalism applied to the enterprise theory and its relative transaction costs: its main exponents include R. Coase, O. Williams, A. D. Chandler, A.A. Alchian and H. Demsetz, with their book *The Property Rights Paradigm*, and, more recently, the late lamented J. K. Galbraith[17].

De Soto considers the enterprise as an organization where commitments and transactions among customers, borrowers, suppliers and investors take the form of stipulated company agreements, examined and executed by brokers, those in charge and managers. It is true that this a combination of standard contracts, but only because the institutions make them available to different people so that they can conclude their transactions efficiently. The legal-institutional system's conforming to the structure of the economy must go beyond the enterprise and

17. John Kenneth Galbraith, one of the most representative contemporary neo-institutionalists, has frequently underlined the necessity to find new paradigms for economic doctrine, because " economic theory and teaching are everywhere very far-removed from reality" (*L'economia della truffa*, (Rizzoli, Milan 2003), p. 4).

permeate the entire socio-cultural system of every country, becoming the essential pre-requisite to the start of the modernization process. It makes more sense – he wrote – to adapt the laws to the real situation rather than to try and change everyone's behaviour, because the law is the most useful instrument of change available[18].

De Soto is without doubt an innovator of neo-institutionalism of the neoclassical school. He included in the orthodox theory the role played by those institutions capable of defining and preserving title deeds and considered them as decisive or, in any case, crucial factors of market equilibrium, especially when the orthodox theory was incapable of representing and ensuring appropriate behaviour to this end on the part of economic agents. He substitutes rationality and methodological individualism with institutions capable of satisfying the needs and optimizing behaviour, which are also the outcome of the history, customs, traditions and levels of development each society has reached regarding its own path dependence.

In this respect, de Soto's analysis contains insights into the process-oriented contractualist neo-institutionalism that ascribes more importance to the instruments used – from official legal systems to property protection – than to the objective to be reached, because the former are instrumental to the latter, and are summed up in the only context possible nowadays: the market economy as a final state.

In order to understand the importance of institutionalist economics, it should be remembered that, after its birth, thanks to T. B. Veblen (1857-1929) with *The Theory of Leisure Class* and the papers by J. R. Commons (1862-1945) and W. C. Mitchell (1874-1948), and before its success in the American academies, numerous American economic experts who had rejected or refuted the results of the neoclassical theory went to German universities, where the "new historical school" opposed its methods and contents, and about one sixth of them carried out their post-graduate specialization there. The importance of the Germanic

18. Hernando de Soto, *Povertà e terrorismo, op. cit.*, p. 281.

mainstream diminished after World War II and, thanks to the almost undisputed acceptance of neoclassical microeconomics, neo-institutionalism found new impetus at the end of the 1950s and once again in the United States, where the Law and Economics School of the University of Chicago was instrumental in spreading it[19].

At present, its claim for a better resource allocation by means of the market is at the basis of modern economic growth theory, of which Hernando de Soto is deservedly one of the most representative exponents. The founder of the Lima Institute of Liberty and Democracy, which *The Economist* considers one of the most influential think tanks in the world, de Soto has been selected by *Time* as one of the five principal innovators in twentieth-century Latin America, and is included in the list of the one hundred most important leaders in the world. The former President of the United States, George Bush, declared that "de Soto's research offers a clear, promising alternative to the economy's stagnation", while his successor, Bill Clinton, defined him as "the world's greatest living economist". At present, alongside the Institute of Liberty and Democracy, his main activity is the drawing up of development programmes for the formation of capital to support the marginalised sectors of the population in Asia, Latin America, the Middle East and the countries of the former Soviet Union[20].

Despite some criticisms of De Soto's writings, because they are believed to have provided even more fuel for the Washington consensus, thereby contributing to increasing the difference between wealth and poverty in the emergent countries, and some criticisms of the work of the Institute of Liberty and Democracy, which is believed to have overestimated the wealth due to the unofficial economy[21], the Nobel

19. Giuseppe Di Taranto, "Introduzione alla storia economica", in *Storia dell'economia mondiale*, (Monduzzi, Bologna 2000), pp. 8-11.

20. Cf. Atlante Luiss 2006, *op. cit.*, p. 231.

21. G. R. Rossigni, J. J. Thomas, "The size of the informal sector in Peru: a critical comment on Hernando de Soto's *El Otro Sendero*" in *World Development*, v. 18, 1990; M. Bounding, "Fine Words, Flawed Ideas" in *The Guardian*, 11 September, 2000; C.

Prizewinner Ronald Coase has defined *The Mystery of Capital* as an "absolutely convincing" book that "will have a beneficial effect on all concepts of economic development".

Woodruff, "Review of de Soto's *The Mystery of Capital*" in *Journal of Economic Literature* vol. 39, December 2001; A. Gilbert, "On *The Mystery of Capital* and the Myths of Hernando de Soto" in *International Planning Review*, vol. 24, February 2002; M. Davis, *Planet of Slums*, (Verso Books, 2007). De Soto's reply to some of the criticisms received is contained in J. Clift, "Hearing the Dogs Bark" in *Finance and Development*, December 2003, pp. 8 *et seq*.