

Rethinking Liberalism: An Interview with Hernando de Soto

The conventional wisdom that democracy and free market capitalism provide the best means available to achieve a high standard of living has come under attack. Many believe the current financial crisis is evidence that global capitalism has the potential to create a level of misery that is intolerable. Moreover, even before the crisis, sustained economic growth in certain countries seemed to contradict the widely held assertion that political liberalization inevitably accompanies its economic counterpart (as evidenced by the rise of China). Such challenges to the intellectual order behoove us to seek perspective on how and why these systems that underpin our economic and political interactions succeed or fail, and what their futures may be. In a recent interview with *the Journal*, Hernando de Soto helps us do exactly that.

Mr. de Soto has gained recognition for his argument that legally enshrined property rights have been essential to the development of a successful capitalist system in the West. He also argues that the institutions necessary to emulate this success are largely absent in much of the developing world. In this interview, Mr. de Soto discusses these points from a global perspective, answering questions about the specific role of certain countries, the importance and relevance of their histories to present realities, and finally, what he sees as the potential future path some of them will take. As debate continues in the public sphere regarding the future of global capitalism and democracy, we hope this interview provides you with as much insight as it did us.

The Journal: Your organization, the Institute for Liberty and Democracy, predicates itself on the ideals of free market capitalism and liberal democratic institutions. However, many critics often cite the current economic crisis and severe disparities of wealth throughout the world as evidence that institutional liberalism is an inherently flawed way to organize society. In your view, is political and economic liberalism still the most viable model?

de Soto: Well, first of all, let me tell you that my institution believes the formulas that traditionally enrich the West are behind its prosperity simply because we've seen them work on the ground. It doesn't start off from the fact that we read something and we preferred it to something else that we read. It actually started with the fact

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that when we have visited grassroots organizations in Peru and in other developing countries where we have been called to work—including small villages, squatters' organizations, street vendors' organizations, or trading organizations like those little ones that exist from Africa to Asia—what we see is that the way they are organized, as opposed to what anybody may suspect, is essentially democratic. So democracy seems to be a natural trait for people, one in which people wish to organize themselves on a consensual matter.

Additionally, if we are all for market mechanisms and especially for globalization, it's also simply because, as opposed to what many people will tell you about what they've seen in the third world, what we have actually seen—whether we've been in Tanzania, Ethiopia, or where we work in the Philippines—is that the poor are organized to try and participate in the market. Maybe it was different 60 years ago or 100 years ago and nobody recorded it, but today, that's the way it goes.

So we see this is the tendency. We have yet to find a trading or a business organization inside or outside the law in a developing country that is organized on dictatorial means, or seen somebody trying to create a closed economy within a tribal circumference anywhere in Africa. We haven't seen that.

So when we look at the two issues that you are mentioning, what we see is, of course, that in many cases it doesn't lead to all the prosperity one would want. But we think this is due not to the absence or shortcomings of a market economic system or a good democracy being in place, but that many countries are still missing some of the elements that have made these systems successful in the West. So we think the tendency is to go towards these two formulas of a market economy and political freedom, because there seems to be nothing really better on the ground. Obviously, getting there is not an easy task and the tendency is for these systems, in the beginning, to have their problems and even to fail.

We've seen this of course also in the history of Europe. It was only in the late 1940s, or you could even say the beginning of the '50s, that Germany was able to put in place a successful market economy and a successful democracy. It takes time to get there. It doesn't necessarily always work on the first try.

So if today in the global economy you see that there are many laggards, and that the differences in income are extremely high between those who have some kind of prosperity—meaning the close to 1 billion people in the West and the elites of the developing world and former Soviet nations—and the majority of the people in the developing world, we don't think it's because globalization and its institutions haven't worked for this majority. Instead, we think it is because they actually have not had access to these institutions.

So the reply to your question is that it's not that the system doesn't work for everybody. It's that the system has not yet been fully implemented.

The Journal: Is there a relationship between the continued success of the United States as the world's dominant political and economic model and the resilience of institutional liberalism?

de Soto: Probably yes. I think the United States does represent, by excellence, the most successful model, among other things, because the US is a multi-ethnic society, it works as a multi-ethnic society, and it so happens the world is multi-ethnic. So the fact that the US is successful means that the US can preach by example.

It also means that the US has the finest schools in the world, and they all follow that line, and that automatically keeps an enormous amount of elites in developing countries going to Mecca and bringing the message back. So the United States is evidently a very important factor.

Some people at the beginning weren't very optimistic. Ortega Gasset, a Spanish libertarian whose ideas were fundamental to European thinking, didn't actually believe that freedom and its economic or its political manifestations would last that long. Among other things, he said the thought behind all of these ideas is so sophisticated, so complex, and it requires such a high degree of understanding, that it's going to be difficult throughout history to find leaders that are always on top of things and understand that this is the best way to go.

But probably what he didn't figure, what he didn't count on is the fact that the United States would be continually successful, and would always be that sort of little flame that everybody could look towards where both successes and failures could be well-examined.

Friedrich von Hayek also had a similar perception. He said this is going to be a hard road and it's going to be uphill all the way, because it's really a small, little flame in the middle of a big, black sea that represents freedom. Further, maybe freedom is represented in Anglo-Saxon countries, and the majority of the world isn't quite there yet. So he also didn't necessarily think they would be successful. Well, he didn't say it in those words, but he did say that it would be a hard slog ahead and we would really have to fight for it. Both in *The Road to Serfdom* and in his later works he kept on insisting that the Second World War was a very dangerous period, because liberalism, as we know it today, was only really alive in a couple of countries, and they were both Anglo-Saxon countries. So I think the United States has had a very important role to play. By keeping the flame alive, it has been able to set an example.

There's also another aspect there that's very important. This is the capacity of the United States to demonstrate its strength and give the whole system resilience because it's a country that's very self-critical. I mean it's a country that starts off simply last year saying, "Well this last year we have had in the United States 1,600,000 bankruptcies." So the first thing one starts saying is, "Oh that looks like bad news." But what you keep on proving is that by continually being able to enunciate and describe your failures—and file for bankruptcies—you are a society that probably learns even more from its failures than from its successes. Whether some people fully or consciously realize this or not, the fact is that gives you enormous strength. So yes, I'd say that the resilience of the United States to continue down the road of liberalism has been crucial to the survival of the very idea itself worldwide.

The Journal: What role do you think the United States should play in promoting liberal ideas worldwide, such as property rights, for example?

de Soto: Well I think it has a very important role. It continually advocates the protection of property rights. It tries to make it part of any bilateral or international treaty that is signed. So it's doing that part.

The problem I think that the United States has always had in terms of predicating the value of property rights is providing the formula that initiates them in countries that don't yet have the necessary institutions legally well-entrenched. Let me explain. In other words, we know today what a good system of property rights should look like, because you see it in the United States. You can go and look at your local laws, federal laws, your Securities and Exchange Commissions, your Chicago Mercantile Exchange or the Unified Commercial Code. It's all there.

But the real problem around the world is not how do we perfect our property institutions, but how do we set them up in the first place so that they work for everybody? That was something that the United States did one to two centuries ago. You could call that the genesis. That meant how do you deal with a bunch of people who were breaking the law? I don't know; Texans were breaking the law. For all practical purposes Texas belonged to Mexico. The Gold Rush was a stampede of illegal land grabs.

These kinds of things occurred, yet the United States was able to convert what seemingly were disruptions of the British inheritance of law or the inheritance of British law, and convert it into a social contract that brought property rights to everybody. I think Americans tend to forget that first stage. The tendency is when they're abroad, every time they see a disruption of the status-quo, they try and bring back George III. They often forget that George III, the feudal system, and the status-quo had to be destroyed before you actually had some kind of a liberal system in place that benefited everybody, and therefore was stable.

So I think the United States has a lot to do, but I think it also has to remember that the people who pulled off the switch from a collectivist system, a feudal system, a patrimonial system, or a tribal system—whatever you want to call it—into a modern market economy were essentially revolutionaries. And you must be in a position that recognizes that revolutionaries are key to the matter, and you should stop automatically defending—in a knee-jerk fashion—anything that is a disruption to the status-quo abroad, because the disruption of the status-quo may actually be necessary to set up a system like yours in the rest of the world.

The Journal: In your answer you mentioned this problem of the US being able to provide a viable formula for others to follow. Because arguably, the United States was founded upon property rights, in fact you mentioned this in your book, *The Mystery of Capital*, do you believe it might be the case that there is a cultural barrier in developing countries that prevents the kind of acceptance or proper implementation of property rights in the same way that it was done here?

de Soto: No. I don't think that there is any such obstacle. I think the problem is that those who talk about 'backward peoples' developing countries have a bias in the other direction. Everywhere we go, we find a very different story.

For example, we were hired by the government of Tanzania in an exercise that involved over 900 researchers to actually go into the countryside and the cities to find out if the tribes were culturally predisposed towards a collective economy, like the ones that you have in other tribes. After going through 26 provinces with facts in hand, we found out that only 11 percent of all the territorial surface of Tanzania was controlled by pastoral tribes. So you could say that there was some kind of collectivist governance.

In fact, our study concluded that 89 percent of the land had already been privately parceled out, albeit illegally. In other words, it wasn't in the books. But tribes, on their own, were already moving towards a private economy. In fact, in 90 percent of them, the land had been privatized.

Additionally, in terms of businesses, we found out that only one percent were in tribal or state hands. Ninety-nine percent were actually in private hands, albeit illegal private hands.

So wherever we go, from Mexico, to Peru, to Tanzania, all the stories that we hear—these people are culturally different, there is a clash of civilizations—all of these notions are based on wishful thinking. In fact, the whole world is moving towards a market economy, and if it doesn't prosper, it's because a successful market economy doesn't only require holding things privately. It's also about having standard laws so that what is held privately can be defended, can be traded, and can create prosperity.

The Journal: In a speech you gave for the Inter-American Development Bank in June of 2006, you alluded to a metaphoric pendulum that swings from one side to another between pro-free market growth and populism. You had mentioned that Latin America had been swinging back and forth on this pendulum. What does this tell us about democracies in Latin America?

de Soto: Well, it tells us that every time somebody who says they're pro-free-market assumes power, they lack those lessons of your forefathers of the 18th and 19th century of making property and business in legal forms widely available.

These leaders sort of believe that if you assume power and simply photocopy or scan US laws, Swiss laws, or laws from whatever libertarian country you can think of, and then put them into place, somehow everybody will sort of fold into the system. And what we keep on seeing is that it's not enough to photocopy your laws. In fact, you have to look at every case in particular and see what the transaction costs are of entering the legal system as it is being designed, or rather as it is being copied from the West.

So you find that you have in Peru, probably on paper, laws that are much more coherent than you do in the United States. However, it still takes 289 days, working

eight hours a day, to get the authorization to start a small little enterprise with just one sewing machine. In the case of Egypt, where you had British colonization, you also had the best World Bank experts helping set up commercial law. Yet, it still takes a person working eight hours a day for 549 days to get the authorization to open a bakery.

And those are only the costs of entrance into the business. In fact, once you put your bakery into operation, the amount of time it will take you to have a contract in force in the private sector plus the amount of time it will take you to deal with red tape from the government will be substantial. Additionally, if, for instance, you want to exit the business, change venues, or change your specialization, this will also take time. Most people, in fact, do make these changes according to the history of their particular business, which again requires an enormous amount of time. In other words, the rules that make the market work aren't just simply saying, "Freedom for everybody." Freedom has got to be very carefully articulated.

Freedom is a system of rules and behaviors that are standard, are respected, are known, and have to be enforced. Freedom is man-made. It isn't something that comes from nature. So what it tells me about Latin America is that Latin American libertarians are those who feel they are libertarian or have libertarian advisors, but they haven't known how to pull it off.

These systems, though put into place, are still loaded with old mercantilist and patrimonial institutions inherited from Spain that actually privilege a few and don't open the market for everybody. So the result, of course, is, that since electorates or the people marching in the street basically have only two choices—keeping those who are in power or replacing them with whatever else is available, generally the populists—the populists keep coming back. This is in spite of the fact that they don't have the formula.

The other thing, of course, that's interesting about all this is that it is not necessarily those that have ideas of freedom in Latin America that will bring freedom into place. Many times the first steps toward a free market economy will be made by people who initially believe quite the contrary. This is easy to see, for example, in Mexico, where different presidents who have been elected on a populist agenda actually end up supporting a free market system. You can also see it in China. It's the communists that are creating one of the most powerful market economies in the world.

So the fact that the pendulum swings, to me, is less of concern as long as both sides realize that the only way the system is going to stick, once you make it work, is if it is widely available. This, in turn, requires a lot of crafting and a lot of reforms. It just doesn't happen by itself.

The Journal: You had mentioned transaction costs. The Philippines, Honduras, and Haiti, for example, are three countries that your research has focused on. These countries continue to rank relatively low in the World Bank's Ease of Doing Business Index. What does that tell us about the internal institutions in these countries? What

does it imply about why it is so difficult to start a business in these countries?

de Soto: Well first of all, none of these countries fully implemented any of our recommendations, unfortunately. Our work in each of the three specific countries you've talked about has remained at the level of inventory. In other words, there's high consciousness now, but there's a lot of work to be done to create a free market economy in these three countries. But these are three countries that have had an enormous amount of difficulty trying to implement these reforms.

In the case of Honduras and Haiti, it's because these are...let's start off with Haiti; it's a very troubled country. I mean they're the first people to admit it. It's the poorest country in Latin America. It's a country that suffered an embargo from the United States, which also tremendously impoverished it. Further, it's had a long tradition of cruel and abusive dictators.

For all practical purposes, they have been called a failed state in the sense that they actually have a government that is a working government. So you got to get that. What I mean is that whatever you do, somewhere along the line, a lot of great men—the Washingtons and Jeffersons of this world, or even a Napoleon in France, or a Charles de Gaulle, or an Adenauer and an Erhard in Germany, or a Schuman and a Monnet in France—somewhere leadership has got to exist to put into place a viable government that can then implement reforms. That hasn't happened in Haiti. This is public knowledge.

Honduras is also one of the poorest countries of Latin America. It has made, generally, a few advances, but it hasn't done everything that it could do because, among other things, a lot of reforms have not yet been publicized enough. These reforms not only have to be on the technical books, but they also have to become part of a political agenda, a motivating agenda.

In the case of the Philippines, which does much better than the two previous countries we were talking about—it's got a higher GDP per capita, etc.—it's also been a very troubled country politically. It is one in which none of the people who believe the things that you and I do have been able to actually form a consensus around these ideas. It just hasn't happened.

In other words, you could draw up the best blueprint in the world, but if there isn't—I don't know, a great leader that also is able to sell it, implement it, and create a broad consensus on these things—it won't happen. So the way we see our work is that, at least, we're putting the numbers into place. We're putting the blueprints into place. But every change will require leadership. There is no way that things just happen automatically. Behind every success story in the West there was a moment when some very enlightened men and women got into place and actually not only had a blueprint, but actually found the ways of selling it and implementing it. That hasn't happened in the three countries you've just talked about.

The Journal: In addition to enlightened, bold leadership you also mentioned institutional legal reform. What other conditions do you believe are necessary for

property rights to function effectively in the developing world?

de Soto: Well essentially I think it's the kind of thing we're doing, which is to indicate that they're already there in the first place, that it's not an American export. Everybody likes to feel that what they're doing has got local grassroots.

The most important thing I think that we have found out throughout the world is that most of these property rights actually exist in every country. We think they were pretty much put into place at least over the last 50 to 60 years. The world has changed and the feudal systems of most developing countries are broken down.

So one of the important things is to plug in the concept to local customs and practices, because if you are able to determine that most of your nation has property rights—something the Tanzanians are beginning to do very successfully, for example—and demonstrate that it is not a Western import, then that is the way Tanzanians will do business. It gives you an enormous amount of strength. So I think one of the most important things that you can do is to document this phenomenon of indigenous property rights that are already in place, but that are not legally recognized, so that as quickly as possible all the old anthropological and sociological books can be put to rest, and one can finally see the country. You've got to get that general idea. You know, we also had it in Peru that we approve of the tradition of a socialist empire. We come from the Incas. This is our way of doing things, etc. However, once you put that to rest and you're able to demonstrate with figures that the overwhelming majority isn't there, everybody gets the courage to initiate reform. So information is an important part of that whole gain.

The Journal: So it seems you're alluding to a kind of grassroots campaign where there is a process that involves rallying the people, and then plugging in the concept of property rights into their customs because they're already there. Is this a correct assessment?

de Soto: Yes. The way to do it, first of all, is this. You might not believe it, but there is no idea in most of the world of how people actually hold their assets and make their living. Honestly, there is not.

When we started working in Peru, the official figures indicated that there was over 50 percent unemployment or underemployment in the country. Now if 50 percent of your population is unemployed, after three months they're necessarily dead, because it means they're not earning sufficiently to even feed themselves. So obviously those were misguided figures.

When we went in and started to find out that people were not unemployed, that everybody actually did work, but that they worked illegally out of properties where they were using and transferring assets that were theirs and running businesses that were theirs, everybody was able to recognize that what they thought they did only on their own was actually a national trend. The moment that happens, you can then place the idea of a market economy before the people, because you can then describe

it.

Most people in the world, even in your country, are relatively simple people. So it's very hard to take Friedrich von Hayek, Joseph Schumpeter, or Milton Friedman and get everybody to read them. It's not going to happen. But what you can do is you can say, "What you're doing is exactly what's got to be done. However, with a good legal property rights system and a good legal system, you will be able to leverage your goods and put them into the market." Then people will understand, "Oh, so a market economy is what I'm doing, but with all the assistance and all the freedom that is necessary." You don't need a complicated message.

So what I'm saying is this. It is the tendency, unfortunately, among those who are libertarian in the West of not being interested in what the poor actually do and how they make a living. This has been added to a similar tendency present in developing countries themselves. So they're for the markets, but they have no idea of how to find a local constituency.

On the other hand, you've got the populists or the leftists, who do try and help poor people. That's their message. That's what they're involved in, but don't think of asking them if they support a market economy or a private sector economy. That's the dilemma.

So the first thing one has to do is actually find out what it is that most people are doing. In the case of Albania, for example, we found out easily that nobody actually knows what is going on inside 80 percent of the economy. They call it a black economy. Until you find out what's going on inside and what it is that these people are doing, you're not able to tell them who they are. Nor are politicians going to have the courage to come out and say, "Look, you're already on the right track. We've just got to get the right legislation into place."

So the first thing isn't starting a grassroots revolution. The first thing is showing that the grassroots revolution has already started and that all your neighbors are doing the same thing, and we can all talk about moving towards a market economy because it's not inimical. It's not against the local culture.

The Journal: Just a quick follow-up to that. Why haven't these groups that you mentioned, in what you call the extra-legal sector, organized to create a voice in the public choice model where they pressure the government into being recognized?

de Soto: Well yes, they do that. The thing is that it takes time. If you're going to believe Marx, he will tell you that it was already obvious that there was booming capitalism in Europe about 500 to 600 years ago. Yet it only gelled and was able to topple the system of privilege about 150 years ago. So it takes time.

If you look at Venice, which was obviously a capitalist system, it was doing much better and was a much more beautiful than any of its neighbors. Another 500 years had passed before the rest of Italy caught up. So these things take time, among other things, because the people who are doing it don't necessarily ascribe their success to the fact that they've got free market rules, but may instead decide to ascribe it to the

fact that they're a particular culture.

You've got to be familiar with that in the United States. I mean here you've got people like Huntington saying, "Well, there's something about us Protestant, Anglo-Saxons in the United States that's very special." I can understand local pride and all of that, but it does confuse and blur the message.

So you do have a lot of people in all these countries that are trying to move in that direction, but the agendas are confusing and not necessarily organized. There are thousands of these organizations. I was surprised when, in Peru, we started seeing very early on in the 80's that everybody was into a market revolution. Then we started saying, "Now we've got to find out the organization that keeps all these people together," and there was no such organization. There were just thousands of these organizations all moving in the direction.

That's why I said that leadership is so important, because leadership means when somebody turns around and says, "Wow, there's a lot of us here. We need some kind of unified control that allows us to really make a political movement or make a statement that everybody will listen to." That's why it takes so much time. That's why in my organization, whenever we're hired by governments, we keep on pushing towards getting a local inventory. What this does is it brings forth the message, "Yes you are a majority," and hopefully somebody will say, "My God, I got to pick up the reins of this revolution," or as Maltatoo used to say, "My God, the way to succeed in anything is when you see a parade coming, all you have to do is identify it, make sure you've made the right identification, and just get in front of it."

You're not going to create the movement yourself. The movement is already in place. You've just got to know where it is, where it's at, what its vocabulary is, and what the necessary message is. Then you're able to make something effective that can tumble the old order.

The Journal: With the rise of China and Russia, much attention has been redirected towards their internal institutions. Many have attributed their high economic growth rates specifically to a phenomenon known as authoritarian capitalism or crony capitalism. Do the recent successes of these authoritarian capitalist states represent another path towards sustainable economic growth and political stability?

de Soto: I don't think so, because many earlier capitalist systems were initially pretty crony capitalist. The French, for example, had a very strong crony capitalist system before the French Revolution, and it wasn't enough. That's why the French Revolution came; but there was already a large bourgeoisie class that made deals with the king.

Even in the US it was only somewhere in the middle of the 19th century that the US started setting up, in any significant manner, institutions that allowed people to record their businesses and set them up without political authorization. Before that, you actually needed an act of the US Congress or a local congress. You couldn't record your company and go into business without political authorization.

So it was all pretty much crony capitalism. To give a few examples, if you said, "I want an enterprise, the purpose of which is to discover whether America exists." Even in this case, Christopher Columbus had to go out and make a deal with the Queen of Spain. And in the case of the UK, if you wanted to set up the South Sea Company or trade with India, you had to sit down with the king, and he gave you a charter and took 30, 40 percent of all your gains.

So crony capitalism is generally the way that capitalism begins. When it begins to be successful everybody says, "Whoa, these guys who have the charter are making a lot of money. I want some, too." Then you get the forces going for a popular rising.

So the fact that China and Russia may have started with traits or symptoms of crony capitalism doesn't make me think that we've got a new phenomenon. It's just that, unfortunately, that's the way the phenomenon starts in many countries. You hope that they'll democratize pretty soon, but it's nothing new.

The Journal: What about the authoritarian aspect, the centralized control? Especially with China, where to a certain extent, the government dictates through five-year plans where the economy is going to grow, and businesses have to adapt to it. Rather than the government adapting to the free market, business has to adapt to the government. So it's a highly centralized, dictated economic policy. What are your thoughts on that in terms of the more authoritarian aspects of their capitalist model?

de Soto: Well that's the way it was in France, that's the way it was in Germany, and I repeat, that's the way things are. That's the way it always started. The United States was a rebellion against that sort of thing. But if you take the continual history, the way it started in Britain or in different places where most of you migrated from, that's the way it began.

In other words, before there was a consciousness that you had to adapt yourself to the market rather than the other way around and respect the invisible hand, Adam Smith had to write and then people had to bring his ideas into fruition. Generally speaking, before this, there was always a tendency to believe that government should be the first and only authority.

One of the interesting quotes that sort of proves that, or at least lends support to that idea, is referred to as "States in Little." This was the main argument of those people and politicians who didn't want their countries to give anybody free access to enterprise. Instead, they believed that previous political authorization needed to be given. They argued that if we allow anybody to have bylaws and create an organization that is beyond the family or bigger than the family, we will be creating "States in Little." There must only be one state.

That was the growing and predominant idea all the way till the end of the 19th century. So what I'm trying to say is that it's not that China is different. Sure it's got things that are different. Russia is different. However, the sort of a capitalism whereby it is recognized that the market itself is a democratic element, and that the government has to adapt itself to the market rather than the other way around, is

only a recent achievement of the West. Therefore I'm not at all surprised that this is the way it's being born in the East.

The Journal: Do you foresee that there is ultimately an incentive for these countries to adapt more representative democracies and liberal institutions internally?

de Soto: I think so. Nobody can really tell the future, but I would think so. You see, once a market economy starts growing and people get used to prosperity, etc., the only way you can provide the rules of the game that actually suit everybody and allow you to become more productive, and for you as a politician to remain popular, is to be able to listen to what people need and want. That means listening to prices and listening to what people need to do, and all of that takes us towards democracy in a market economy.

You see, at the beginning you can jumpstart the economy with a very tight elite being in control. But over time, it gets too complex. You will actually need much wider market institutions. You will need to listen to the market, and you will have to listen to everybody and get them to participate in decisions; otherwise, you won't be able to keep up. So I think it'll come sooner or later. Now it may come a lot later. I don't know, but I think that is the tendency.

I don't think that we're about to discover that a non-free market is going to beat a free market. A free market has enormous advantages over a non-free market in that information is available. It's all about information.