

A case for simple laws

Andrew U. Frank

Abstract

I start with de Soto's thesis that the poor of the world would prefer capitalism if they could obtain it at a reasonable price. De Soto points out that poor countries lack the institutions to convert their wealth into working capital. The laws are in place in nearly all countries: there are laws defining ownership in land, land registration, and mortgages. These laws are just not used. Why?

The laws are in place but that is not enough to allow their usage; multiple cooperating participants are necessary to create capital from valuable assets. When we focus on land, we find that capitalization requires a cooperation of land registration, banking system and courts of law. For effective utilization of the opportunities afforded by the law a general understanding of legal issues is necessary; the legal system must correspond in complexity to general education and specialized legal knowledge available.

I argue that the concentration on technical issues when advising countries of the third world is misguided; the question is not whether the legal organization is in place, but whether it can be effectively used and at what cost. It seems that some of the legal institutions in the world carry a very high price tag and make them inaccessible to the poor. These institutions create inequality and limit freedom of action which is considered by Amartya Sen as the most important agent to development. The history of European saving and loan cooperatives in the late 18th and first half of the 19th century provide instructive models how to convert wealth into capital. Following these models the creation of capitalization methods should be achieved in the informal sector of the third world.

1 Introduction

The Economist in an article with the title "the economist versus the terrorist" stated about Hernandez de Soto: "... he believes that most poor people, given the chance to participate fairly in the capitalist system, would do so rather than stay outside." (The Economist, Jan 30 2003). Why laws of ownership in land, land registration, and mortgages are not used and do not have the effects they have in developed countries is the question I will try to answer in this article.

Laws are not enough to produce the desired benefits of transformation of wealth in capital. Laws are blueprints for others to use; only if they are used do they produce benefits. The conversion of wealth represented in land and improvements of the land – the buildings and other installations, the infrastructure etc. – into capital requires that several actors understand the law and use it. When we concentrate on land, we find that capitalization

requires a cooperation of land registration, banking system and courts of law. For effective utilization of the opportunities afforded by the law a general level of understanding of legal issues are necessary; the legal system must correspond in complexity to general education and legal knowledge available. Checking that the rules are in place is not sufficient, one must also investigate which other legal or social rules make it difficult to use the positive rules of the law.

I concentrate here on land and land ownership because these are the major assets of a country where much of its wealth is concentrated. Land (and the buildings on it) is a primary production factor and its capitalization in developed countries is often an order of magnitude larger than the GNP. Once this wealth is unleashed, resources for massive investment become available and development can be financed.

The paper is structured as follows. The next section details de Soto's idea of transformation of wealth into capital. It details the chain of participants necessary to effectuate this transformation and details the obstacles which are often added to the path, increasing the cost of capitalization. Section 3 describes the 'social construction of reality' of John Searle and its contribution to the formation of capital. Section 4 then describes capitalization and its practices and section 5 lists the impediments typically found. Section 6 assesses the cost of complex legal rules for the developed and the third world. The last section suggests methods to advance the process of capital formation in third world countries, reviewing the European history.

2 De Soto's concept of capitalization

De Soto has pointed out eloquently that the poor countries of the third world are very rich but lack methods to transform this wealth into capital which then can be used to fuel economic development (de Soto 2000).

2.1 Risk as an impediment to capitalization

De Soto observed two cities in Peru separated by a river: one of the two cities was prosperous, contained many multi-story buildings, where shops were installed on the ground floor. The other city was essentially a shantytown, with most commerce organized as street-vendors. The differences between the two cities were striking, but effectively the only institutional difference found was that one had a working system of land registration and the other not. In the town with the working land registration, people felt secured in their property rights in land and were able and willing to invest in improvements on the land. They built substantial buildings to house family dwellings and opened shops and made further longer-term investment in equipment etc. Such activities create employment opportunities and starts the cycle of economic prosperity in march. In the town without registration of title to land, people

felt insecure and were not willing to make long term investment in fixed assets like buildings and installations. People tried to eke out a living with short-term investment in mobile equipment which has lower economic yields and does not lead to prosperity (de Soto 1989).

2.2 An economic theory with transaction cost

The tale of the two cities demonstrates a simple aspect of economic reality: the high cost of risk which is not sufficiently considered in many social projects. Classical economic theory of free markets, going back to Adam Smith(1776), assumes three basic simplifications:

- Transaction costs are zero; the cost of buying and selling are negligible.
- All participants in the market have complete information about all other transactions; specifically they know the quantities and prices obtained by other sellers and buyers.
- No market participant has the power (or the market volume) to influence the market.

These assumptions are clearly simplifications and perhaps realized in a farmers' market; they are not encountered in important markets today. These assumptions are necessary to construct a powerful theory in which substantial laws obtain. Markets lead to prices which balance the offer and the demand, and the price of goods equals their production cost and their utility; overall, ideal markets lead to optimal common wealth – so called Pareto optimality(Samuelson 1992).

Real markets have transaction cost and Douglass North has shown that the classical theory can be extended (North 1997). In a transaction several types of risks are involved: risks with obtaining the goods in the correct quantity or quality and their usability for the intended purpose, risks in the assumption about the future and the value of the goods later, etc.. Risk is reduced by institutions. North uses the term 'institution' to describe the aggregate of legal and social rules, customs and business traditions which regulate the economy. For example, marriage or ownership of land are institutions in this sense, but also insurance, stock exchange or the law in general are institutions. Institutions consist of rules and procedures to execute and enforce them. North argues that societies develop institutions to reduce cost of transaction. This makes the economy more effective and allows development, through re-investment of the saved expenditures, and ultimately leads to a higher standard of living. North (North 1966) and Eggertsson (Eggertsson 1990) give numerous examples how the development of institutions lead to economic development; they also contrast comparable economies and argue that differences in the institutions explain the differences in their economic development. The example of the two cities by de Soto fits well in this schema of explanations: the registration of ownership of land reduces the risk involved with investing in

land and the cost of real-estate transaction, and therefore improves allocation of (land) resources.

2.3 De Soto's argument for capitalization

A standard explanation for the lack of development in third world countries is their lack of capital to pay for investments. De Soto starts with the observation that the poor countries of the world have enormous wealth accumulated in their land, buildings and infrastructure. He assesses with detailed surveys the aggregate value of land and buildings and the resulting figures are astonishingly high. The accumulation of investments of labor to improve the land and make it more productive over long periods of time have created substantial wealth which is much larger than the often discussed debts of the poor countries of the third world.

De Soto through his novel observations concludes that it is not wealth which is lacking in countries with low standards of living and low productivity. Comparing with the developed world where higher, but not substantially higher, levels of wealth can be found, he identifies the lack of capital as the major limitation. Capital is created in the developed world by bringing the existing value fixed in land and improvements on land into the capital market. The investment fixed in land and buildings can be 'liquefied' and re-converted in capital which can be invested again. This reduces the need to import capital from other countries with all the dependencies it creates.

Development can be fueled by the improved allocation of capital to productive investments. This can be compared with the historic development in Europe during the 17th, 18th and 19th century. The center shifted from England, then to the Netherlands, and finally to Germany. This shift can be explained by the improvement of the respective capital markets which started by a primitive form of capital markets in England.

One might ask where the capital comes from. My tentative answer is the need for the transfer of value earned earlier in life towards old age. In traditional societies, 'insurance' for old age is founded in social institutions, primarily in the family. Money earned earlier in life is invested in raising children who then have an obligation towards their parents when these are old. Investment can be made in improving the farm, which is then worked by a son with the obligation of support of the old generation. Both methods allow investing early life earnings to pay for old age, but include risk and are not always possible. Modern societies have created insurance, pension and retirement funds which are savings productively employed and later repaid to be consumed by retirees. Capital is put to the most effective use.

Countries in the third world lack opportunities for secure investments, other than in the family or the narrow social group of trust. Capital cannot be invested locally and must be exported to the global capital markets of the developed world; capital is not available locally, where needed. The inefficiency of the capital markets in the developing world is one of the

major impediments to development. It is often estimated that export – often clandestine and even illegal – and import of capital for third world countries are of the same order of magnitude.

One could argue here that development outside of capital markets is desirable and start a discussion of the shortcomings of the capitalist system. Amartya Sen has argued convincingly for the importance of the freedom to trade and markets as part of fundamental human freedom (Sen 2000). De Soto argues for the conversion of the wealth found in land and buildings to capital which can be used effectively for further economic development. This is a very specific, but important part of economic freedom.

3 John Searle's Social Construction of Reality: The mechanism to convert wealth in capital

The conversion of physically existing wealth to capital is through social institutions. A piece of land which can be used for agricultural production or a building which contains apartments for families to live in is valuable as a means of production and has value as such. It is useful to separate here the difference between the cost of producing something and the productive value of the same object. In perfect markets, cost and value are the same. In our imperfect world, unwise investments which have high cost and little productive value in the end, are possible and, unfortunately, frequent.

The market value of an object is – roughly speaking – its productive value minus the transaction cost. If the transaction cost is not zero, trade will only occur if the difference in the benefit from the current owner to the new owner is larger than the transaction cost. If transaction cost is high, inefficient allocations remain for long period. This can be seen in countries – like Austria – with inefficient markets for rental apartments, where large, old apartments are occupied by elderly single persons. The cost of changing to a modern, easier and smaller apartment is much higher than the improvement in the living situation is worth; often the rent for the new, smaller apartment is higher than for the old, large one!

Markets for physical objects in small quantities are simple: I give you the pound of apples and you give me the money. Risk is small: you can observe me weighing the apples, inspect the quality before the purchase and we exchange goods against money, no risk for me not to be paid. Such markets work all the world over quite effectively.

Trading in land is more difficult: how can I make sure that the purported seller is really the owner, how to ascertain the boundaries of the land, what other rights and easements may reduce the value of the land? Risk is high, resulting in high cost of transaction and imperfect markets. Land registration is the institution created to reduce this risk: in its most developed form, the buyer is guaranteed, by the registry or a separate title insurance, that the seller is the

true owner and he is guaranteed ownership through registration or title insurance; maps included in the registry guarantee the boundaries based on accurate surveying by professionals (Schoenenberger 1976). Such an arrangement reduces risk for buyer and seller, reduces transaction cost, and leads to efficient markets.

Land registration as an institution creates social reality exactly as Searle describes (Searle 1995). The brute facts of possession of land which can be plowed or where animals can graze, or possession of the family dwelling is socially reified as property right; property rights are created by actions and exist in documents. Searle uses the formula: "X counts as Y in the context Z". The document counts as the property right. Inscription as an owner on the page of parcel A in the land registry counts as ownership of the parcel A in the context of, say, Switzerland and its civil code. In this context, property – a concept of the law – includes physical possession and use of the land and the buildings on it; I obtain property to have socially sanctioned possession which I can defend against intruders and ask society to help me defend.

Land registration as an institution creates documents which count as ownership or other rights in the context of the law. These documents are valuable because they give the socially created right to a physical valuable object. Land registration connects a written document to a valuable brute fact, namely possession of land. This link consists of two steps:

- the social institution of ownership which is a sanctioned form of brute possession;
- the documents which establish my ownership.

Land registration reduces risk of possession of land and reduces cost of it: it reduces the cost of owning the land and it simplifies buying and selling land.

Legal ownership reduces my cost of defending my possession against intruders and others which intend to take it away from me by force; society will help me against adverse actions; I need not invest heavily in walls, constant surveillance and armed guards: I can rely on the courts and the police force to keep me safe from intruders.

Documented ownership of the physical land is vested in a document which makes transfer much less costly. This is better visible in a commodity exchange, for example the Chicago market in pork bellies: in lieu of exchanging actual physical pork bellies, trading is in contracts to deliver or accept a fixed amount of pork bellies of a standard quality at a fixed time. Only the paper documents, the contracts, were exchanged which reduces cost of trading enormously! Nowadays, not even documents are exchanged, but rights to buy or sell are electronically added or subtracted from accounts.

The legal system is part of the social construction of reality. The legal realm creates a parallel 'world', where the brute facts, e.g., physical possession of land etc. are transferred to

abstract concepts which are then documented. This transfer to the realm of documents and business processes organized by law is prerequisite for the conversion of brute valuable objects which have value for the physical production process, to the realm of capital.

4 Capitalization of land and its improvements

Capitalization of land is not completely achieved by registered ownership – albeit this is an important step – but in the possibility to obtain credit – i.e., new money – against the value existing in the land. If I own a valuable piece of land, I can obtain money from others because they are certain that I will pay back my debts. If I default on my obligations, the creditor will take the land from me and sell it to be paid. This institution is typically called mortgage. A debt is secured by a piece of land against the risk of me not paying back what I owe; this reduces the risk of the lender greatly, assuming that the land has a lasting value.

The legal institution of mortgage creates a link between a personal debt and a piece of land, the value of which guarantees the repayment of the debt. This link is in the realm of documents: the land must be legally owned and documented. In countries where this institution is established, mortgage credit is often obtained for a very low cost, making such credits often half the price of a business or consumer credit. Often the credit is less expensive than what is gained annually by appreciation of real estate in a developing economy and owning land bought with borrowed money is a good investment.

In countries where mortgage is a well established institution most buildings are used as collateral, i.e. guarantee, for credit; often the credit is used to improve the land or the building – for renovation of buildings, irrigation systems etc, which would be difficult to finance otherwise. The functioning capital market provides the money.

Mortgages are part of the capital market. Traditionally banks were restricted to invest savings of private people into secure loans – loans of the government or loans secured by mortgages. The legislator was of the opinion that land could not lose its value and therefore the investment would be of extremely low risk, a chain of reasoning which is usually justified.

Savings and mortgages are important for people to save money – i.e., transfer value or consumption – from one time in their life to another: we save during the productive part of our lives to finance the same standard of living when we are older and retired with no productive income. Such savings are converted by the finance markets into productive capital instead of saved under the mattress for lack of secure and productive investment.

5 Impediments to capitalization of land

There are numerous impediments to the effective use of land registration to achieve the capitalization of the wealth accumulated in land. They can be related to the law, the

organization of the registration of land and mortgages, the organization of the capital markets or the foreclosure process.

5.1 Legal institutions

The legal institution of private ownership of land can be missing; this was typically the case in socialist countries, where all land belonged to the state. The institution of lending against interest can be missing – often due to religious restrictions, e.g., Muslim countries. Whenever private ownership of land and lending against interest is legally constructed, then it seems that mortgage, i.e., a debt secured by ownership right in land is also defined.

The construction of mortgage is not sufficient; the law must also define procedures for ‘foreclosure’, the termination of the loan agreement when the debtor does not pay, and the taking of the land by the creditor. In general, the legal organization necessary for capitalization of land are available in developing countries, but they are not used.

5.2 Organization of registration

Many of the impediments restricting capitalization of the wealth in land are organizational. They are either related to the ownership of land or to the risk and cost of transaction in land.

5.2.1 Burdens on legal ownership of land

The legislator in any country I have knowledge of has succumbed to the temptation to connect obligations with the ownership of land. The extend of the rights flowing from ownership are limited, for example through planning laws. Such laws restrict the type and size of buildings one can build on the land, the uses of the land etc.. Such restrictions are often distributed over several laws which are difficult to obtain and their application is uncertain, but affect the value of the land. This increases the risk in the assessment of the value of the land for securing a debt.

The legislator also attaches multiple taxes to land. For example fees for infrastructure built by the community, but often just general purpose taxes. Taxing land is attractive to the legislator because if the owner is not paying the taxes the tax debt is converted in a lien, a debt secured by the property, similar to a mortgage. Such liens are created by law and need not be documented in a land registry. Many countries allow such liens to emerge not only for tax debts, but debts to public utilities as water, electricity or tradesmen for work contributed to improve the land etc. A buyer must research what liens exist because they reduce the value of the land; this increases the risk when assessing the value of the land.

5.2.2 Restrictions on transactions in land

The transaction, not the ownership of land, is another object which is a good candidate for taxation. It is a situation where the parties have cash in hand and the state wants its share. Taxes are often defined by law for several authorities, computed on different bases and paid to different agencies.

Notorious are rules intended to improve agrarian exploitation of the land which limit the smallest size of a parcel and restrict subdivision, give preemptive rights to next in kin or neighbors when a piece of land is sold etc. This increases the risk associated with a transaction, delays the execution until all agreements are documented and increases cost.

The simple procedure of registration of a transfer of ownership in land is burdened by such constraints to convert the simple operation of registration of a transfer of ownership or the erection of a mortgage to a costly, time consuming operation. In Ecuador during the 80s there were five taxes connected to the transfer and several agreements regarding preemptive rights of neighbors, next in kin and the agrarian reform commission to obtain before a transfer could be registered. In consequence, most transaction went unregistered, taking these parcels out of the 'legal' realm into the informal (practically, transfers were cleverly constructed as adverse possession, where the restrictions on transfer of ownership did not apply).

The situation is similarly burdened in developed countries. A real-estate transfer of ownership in Austria is now – a year after signing a contract – still not registered. Such cost can be born in a developed society with an already highly capitalized real estate market, they are prohibitive in developing countries.

5.3 Organization of capital markets

Land registries convert brute possession of land in a documented ownership in the legal realm. To convert documented ownership into capital depends on the capital markets, the banks and their organization. Banks collect money from people who have money which they do not use for consumption now but intend to save it for later; banks loan the savings to these who need money to pay for present consumption. Interest is paid that compensates for the delayed consumption and the inflation occurring. Mortgages secured by land seem a save investment, as land should participate in the inflationary rise of prices.

Banking systems in any country are a prime target for operations serving political and personal interests and are therefore heavily regulated. Often the banking system is nationalized or partially nationalized. Trust of the population in national banks is often low. Procedures of banks, nationalized or not, are often as bureaucratic as the worst of public administration.

Banks are not everywhere prepared to give loans secured by land against low interest rates to the large number of small owners; folklore has it – internationally – that it is easier to swindle a bank out of ten million Euro than obtain a credit of 10,000 Euro, even secured by land. Large commercial credits are more prestigious internally in a bank and consumer credits pay higher fees than mortgages.

Banks are justified in arguing that mortgage credits are cumbersome and have high risk, because the numerous organizational burdens connected to legal ownership of land (see previous subsection) and that land as a security is of little commercial value when the debtor defaults (see next subsection). It is therefore not sufficient to create new banks to overcome the banking system's organizational resistance, because the newly created organization will be hurt by the same impediments; it is necessary to overcome the impediments.

5.4 Foreclosure

If the debtor does not pay back the debt when agreed, the creditor has the right to obtain the security. If a debt is secured with a mortgage on land, the creditor can demand that the land is sold and the amount owed to him is paid to him, the previous owner receives the remainder if the sale leads to higher proceeds than what is owned.

Foreclosure is a complex legal procedure, where multiple interest must be balanced: there is the interest of the current owner and his family: a family can lose its home through foreclosure and social arguments have added multiple restrictions on the process. There is also the interest of the creditor who wants the money he has paid back, as soon as possible. There are also the interests of other parties that are linked with the land – form next of kin, neighbors to agrarian reform; it should not be possible to circumvent these restrictions through the foreclosure procedure.

If the foreclosure procedure does not lead within a reasonable time to repayment of the debt to the bank, banks will not consider mortgage credit as a viable line of business. From the bank's point of view, the risks are:

- The land has no market value; this may occur in countries where markets for agriculture products are depressed or swamped by imports, therefore, there is no demand for agricultural land. For example, I have encountered this situation in the Baltic States in the mid 90s.
- There is no organized market for land and sale is difficult and takes a long time; the bank ends up owning the land as a non-sellable asset.
- Procedures in foreclosure are costly and the bank must advance the cost; the more social restraints and restrictions for public interests are built into the foreclosure process, the higher the risk for the creditor, the higher the cost and the longer the delays.
- Foreclosure is typically a procedure involving the court system which may not be capable of diligent procedures, due to complex procedural laws, overburdening and understaffing. For example, in Italy, court procedures last typically years before a decision is rendered.

The development of the court system in Europe in the late 19th and early 20th century has created a social expectation that debts are always paid without delays. Foreclosure and other enforcement procedures are rare, because they are swift and with a foreseeable outcome at a high price for the offender. Therefore, people pay whenever possible before foreclosure procedures start. This custom permits credit at a low cost to the creditor.

The expectation that debts are promptly paid is not universal. Reports from doing business in the Peoples Republic of China point out that collecting outstanding debts is a major problem for foreign firms (Blackman 2000). The same is in my experience true for most of South America. In large parts of the world, there are no effective court procedures to enforce payment of debts or other contractual agreements; this is not to say that there are no legal procedures, it is the practical observation that enforcement of payment of debts is not practically feasible for ordinary business. In contrast, mortgages are very common in Hong Kong; I deduce that the Hong Kong legal and court system is patterned after the English system, with effective, low cost and low risk property registration, well regulated banking and swift foreclosure procedures.

6 Complexity of rules

The concept of giving credit against a security and to use ownership of land and buildings as security is simple enough. De Soto describes it as the liberation of the wealth existing in land, buildings and other improvements, creating capital which can be used to finance the development process in third world countries. The principle is certainly correct; for example, I would argue that the rapid development of Spain in the last part of the 20th century was financed by individual higher revaluations of real estate which then was mortgaged to pay for renovation and other improvements.

What is limiting this process? It is the cost of converting the wealth into capital. There are not only the fees which are due for the registration, the taxes associated with the mortgage, and the fees the banks charge, but the total cost to the person initiating the process. The risk associated or perceived to be associated with a business translates to cost. The effort necessary to obtain the information about the process, the risks involved etc., is a cost. Information reduces risk, lack of information is perceived as a risk. The cost resulting from the risk make it unlikely that the process of wealth to capital transformation is initiated.

The amount of knowledge necessary to understand the construction 'mortgage' and the processes involved is substantial. There are not only the rules of civil code regarding ownership, security for debt etc. (which in the Swiss civil code are about 21 pages of readable legal text), but the procedures of foreclosure, with their limitations. The substantial set of rules of public law, agrarian reform laws, urban planning etc. must be evaluated as well. In many countries, the legislator has decided that professional advice must be obtained to

mortgage real estate property – which documents the complexity and adds to the cost; often disproportionate, because of restrictions to who can provide such advice. The legislator would have been better advised to reduce the complexity and make the procedures comprehensible to the layperson.

7 How to advance capitalization of real estate

De Soto has asked whether we suggest developing countries to follow our present day methods which are inappropriate for their situation or not. He points out that we have forgotten how we got to our current system in the course of our development. I see three concrete points:

- Rules in the 19th and early 20th century in continental Europe were simpler and could be understood by most citizens.
- Self-help groups organized to give and obtain mutual credit.
- There is a social compact on orderly administration and citizens obey the law.

It is necessary to review the history of the mortgage system in Europe to understand how it evolved.

The institution of mortgage resulted from Roman law combined with the Germanic law tradition of registration of real estate ownership. Land registration was registration of transfer or registration of contracts. It was originally described in few articles in the code Napoleon that was widely translated and formed the base for most European and South American civil laws. Foreclosure laws were originally equally simple, and were a step up from medieval customs of exposing or dunking debtors who had not paid. That is, if you do not pay then your valuables – especially your land – were seized and auctioned off with the proceeds going to the creditor. This is documented in literature of the 19th century, where mortgage and foreclosure are regular themes described in simple, lay terms (see descriptions in the novels of Goethe, Balzac, Zola, etc.). The rules were simple – credit secured by land and swift foreclosure when not paid – and generally understood.

The banking system evolved to provide mortgages to small owners – mostly in a process of self-help in rural and urban communities (Stubkjaer 2004) and later the same lines of business were also offered by the large commercial banks. Savings and Loan Associations were constructed as self-help in a social group where members were known to each other; this permitted to assess the risk involved with a loan – which remains related to the persons abilities and business conduct, even if secured by real estate – and to use the institution in a socially responsible way. When the system became commercialized and anonymous, potential for abuse emerged, as demonstrated by the bank failures of the 70s and 80s in the southern states of the USA.

European countries and the USA benefited enormously from these institutions, credit was available at reasonable terms – compared with usury loans where in many countries interest rates of 10-20 % *per month* are customary. Improvements to land for agricultural purposes, but also the construction of single family dwellings could be financed using mortgages. Over time, the institutions were refined to improve the flow of capital with a secondary market for mortgages. Foreclosure laws were improved to prevent abuse by lenders and become more social but at the same time less effective for the creditor and thus more costly for the regular debtor. A host of social restriction was attached to the land, to improve agriculture, to be fair to neighbors and to the next of kin; all these rules made it less predictable how mortgages would work and increased risk. This is most likely a good example for the ‘law of unintended consequences’: a law has usually not the effects that the lawmaker intends and sometimes exactly the contrary effects. The refinement of the laws regarding land and mortgages increased risks for all parties involved, increased the requirement for accurate information and up-to-date knowledge of the often-changing law and in consequence increased cost.

In developed countries where a firm base of understanding of the basic mechanism of mortgage together with a high level of document oriented culture is available, no detrimental effects obtained. If we export today’s elaborate law systems of developed countries to the third world – as it is often done in development projects (I admit that I was technical advisor to one!) – the effect is not the desired one, because the legal foundation is not sufficient that a working land market and mortgage system develops. The related institutions (courts, banks, etc.) cannot cope with the complexity of these developed laws and the fine distinctions made in them as the result of 100 years of experience. It is necessary to create simple laws appropriate for the situation, considering the technology used in agriculture, the traditions of inheritance and neighborhoods and restrict the complexity of the law to principles which can be communicated to the users, i.e., the citizens. Laws which are only understandable by specialists, are not promoting their use.

Third world countries seem not to lack the mortgage and foreclosure laws. What they lack is the application of these laws in a form which puts them in reach of the farmers and small entrepreneurs who need the capital for development of small enterprises. Not only the cost and the procedural difficulties but also the intellectual difficulty to understand the current highly developed systems makes them unobtainable for normal citizens. De Soto’s current position seems to favor the construction of a parallel system of simple laws, as it has evolved in the informal sector of third world countries (de Soto 1989). The revision and simplification of the current complex systems with highly technical rules of law seems not to be a viable path – too large are the vested interests of the legal profession and the administrations. This is

not a situation without precedence: the banking system developed in the 13th and 14th century as an initiative of the private sector; one could say ‘informally’. One might even advance the hypothesis that many institutions of civil law were created in self-help cooperative-like groups before the rules that these groups developed became official law.

8 Conclusion

De Soto has pointed out that exporting the legal institutions working in the developed countries to the third world is not successful. The lack of capital in third world countries is not due to a lack of wealth accumulated in land and buildings but also not for wanting legal institutions like land registration and mortgage laws, and probably also not for a lack of savings. What is missing is an effective use of these institutions. The complexity of laws is perhaps appropriate for the developed countries but a major impediment to the use of the institutions defined by citizens of countries with lower levels of formal education and less experience with today’s ‘document culture’. This culture cannot be achieved through the application of rules the persons concerned cannot understand.

We have forgotten how our legal system evolved from simple principles – the Roman law, captured in the Digestes – before it reached today’s complexity. Research to identify the ‘simple core’ of a legal system is necessary. The historical development of legal institutions from simple rules to the complex constructions we have today can inspire such research. I believe that such ‘simple laws’ could also benefit the developed countries, where complexity of law has probably passed the optimal point. The core of land ownership and mortgage credit is simple. A person possesses a plot of land with determined boundary and is its registered owner. The owner can use the land as security for a loan to guarantee his repayment of a loan: if I do not repay the loan as agreed then the creditor can use the land to get repaid.

Not only legal institutions are necessary, but a full set of customs must develop to achieve capitalization of the wealth in the land and its improvements. That is, banks must offer mortgage credit and the courts must be prepared to deal with defaulting debtors. The European and US tradition points to self-help groups which initially organized mutual credit in Savings and Loan Associations, where reliance was not exclusively on the legal rules, but on simple rules laid down by the associations and social control of the debtors; giving loans to people well known in a face-to-face community is much less risky than the anonymous, standardized commercial bank proceedings of today.

The European experience justifies de Soto’s skepticism that the established administration and the legal system are capable to provide the capitalization of the smallholders necessary for the development of a country. European history demonstrates the self-help group which uses simple rules that can be understood by the participants; in today’s

parlance one says that these first mutual credit organizations were 'informal'. Looking for solutions in the informal sector in third world countries may be the path to the future.

I conclude with an observation of an Egyptian student of mine, confirming my position from a different perspective. He said that effective and functioning courts are necessary today for the middle class. The upper social strata know how to use them for their advantage and the poor cannot use them because the cost is too high. In reverse: without effective court systems, the development of the poor to become middle class is not possible.

References

- Blackman, C. (2000). China Business - The rules of the game. Crows Nest NSW Australia, Allen & Unwin.
- de Soto, H. (1989). The Other Path. New York, Harpercollins.
- de Soto, H. (2000). The Mystery of Capital. New York, Basic Books.
- Eggertsson, T. (1990). Economic behavior and institutions. Cambridge, Cambridge University Press.
- North, D. C. (1966). The Economic Growth of the United States 1790 - 1860. New York, W.W. Norton & Company.
- North, D. C. (1997). Institutions, Institutional Change and Economic Performance. Cambridge, Cambridge University Press.
- Samuelson, P. (1992). "Updating the Copyright Look and Feel Lawsuits." Communication of the ACM **35**(9): 25 - 31.
- Schoenenberger, W. (1976). Schweizerisches Zivilgesetzbuch. Zurich, Schulthess Polygraphischer Verlag AG.
- Searle, J. R., Ed. (1995). The Construction of Social Reality. New York, The Free Press.
- Sen, A. (2000). Development as Freedom. New York, Anchor Books.
- Smith, A. (1776). An Inquiry into the Nature and Causes of the Wealth of Nations (german translation published 1978). München, Deutscher Taschenbuch Verlag Klassik.
- Stubkjaer, E. (2004). "Contribution to the de Soto/Searle workshop 2003."