Yet Another Path: Another Path: Expanding De Soto’s Framework Using Ostrom’s Insights

Adrian Perez \(^1\)

1. Introduction

The answer to the question of why some economies prosper and grow while others persist in poverty is perhaps the holy grail of the economic sciences. Many answers have been offered up and many paths have been explored by economists and policy-makers alike without reaching a consensus on what is the key that opens the gates of development. Among the brave souls who have dedicated their lives to exploring this seemingly unsolvable puzzle, Peruvian economist Hernando De Soto certainly occupies a place of prominence in the contemporary field of development economics.\(^1\) After the disillusionment with the heavily interventionist policies advocated during the past decades, De Soto’s arguments favoring clear and defensible property rights and the rule of law have influenced the economic policy discourse in developing countries, especially in Latin America.

Contrary to previous “cures” of underdevelopment that focused on jump-starting aggressive capital accumulation through industrial policies such as import-substitution and strategic subsidies, De Soto’s approach seeks to harness the productive forces not of large branches if industry but rather of small entrepreneurs. According to De Soto, most of the productive assets in underdeveloped

\(^1\) Adrian Perez is a double major in the Departments of Economics and Philosophy at Beloit College.

\(^1\) For a discussion of Hernando de Soto’s work, see Volume II of *The Annual Proceedings of the Wealth and Well-Being of Nations.*
countries find themselves heavily underutilized or “frozen” as he describes them in his works. The reasons behind this inefficient state of affairs, according to De Soto, is not a failure in the “economic” system per se, e.g., lack of capital, low aggregate demand, low saving rates, and so on, but rather a failure of the legal system. Because the legal systems of most underdeveloped countries fail to successfully recognize and protect the property rights of most of the urban and rural poor, it follows that the capital and the entrepreneurial skills of most of the world’s underprivileged are wasted. The answer to the question of sustainable and equitable economic development therefore lies, according to De Soto, not in centrally planned interventions but rather in the creation of inclusive legal systems that will harness the productive potential of the common people. Following this simple yet compelling reasoning, many policy-makers throughout underdeveloped countries have devoted considerable time and energy toward formalizing property rights among marginalized groups.

Yet despite the undeniable importance of private property rights to questions of economic development, several shortcomings and omissions within De Soto’s vision of a fully formal regime of private property become apparent in the effort to implement property titling programs. Throughout his work, De Soto consistently insists that efficient institutional arrangements are already in place throughout the informal sector meaning that, at least in principle, the role of government lies in simply recognizing something that already exists. And yet, both De Soto and his followers have often endorsed top-down assignment of individual property rights in places where no such system existed before. While this in itself might not seem to present a problem, we must remember that new institutional rules are never introduced into a vacuum. In other words, the introduction of a new property rights system often necessarily results in the displacement of an already existing (although unrecognized) institutional system. This turn of events, however, is highly ironic given De Soto’s already mentioned insistence on the need of recognizing ongoing institutional arrangements. Indeed, this contradiction is a grave one since it would mean that one of the great champions for the recognition of spontaneous institutional systems might, paradoxically, be also one of its destroyers.

The root of the problem lies, I will argue, primarily in De Soto’s overly simplistic definition of property and his limited vision of what constitutes a working institutional system. Indeed, throughout his works De Soto’s advocacy for property recognition limits itself to the formalization of individual ownership of resources. This means that when confronted with different systems of appro-
privation, distribution, and allocation of resources, the response of policy-makers has been dismissive and sometimes destructive. We can thus appreciate that the simplicity of De Soto’s theory, while being one of its strengths, is also one of its greatest weaknesses.

This paper will employ the insights of the Nobel Laureate Elinor Ostrom to formulate a constructive critique of De Soto’s framework. To do so, I will first focus on the ways Ostrom’s treatment of the subject of property systems serves as a much more robust and encompassing base than the one employed by De Soto and his followers. This is so because Ostrom’s analysis of resource management is flexible enough to incorporate successful institutional arrangements other than the narrowly defined property rights systems that orthodox economics commonly depicts. Then, I will argue that in many instances recognizing and preserving successful alternative institutional arrangements (excluded from De Soto’s framework) provides an alternative that ought to be taken seriously by De Soto and like-minded thinkers given their own philosophical premises.

De Soto is not alone when pointing to property rights as a major component (if not the major component) in the recipe for economic prosperity. Clearly defined and recognized property rights have been credited with significantly reducing externalities (Coase 1960, Demsetz 1967), preventing over-exploitation of resources (Alchian and Demsetz 1973), and creating the necessary incentives for economic activity (North 1981). Furthermore, the existence of private property rights enables the functioning of markets, which in turn are credited with the efficient management of scarce resources (Mises 1949, Arrow and Debreu 1954) and of solving complex problems of social coordination in the absence of complete information (Hayek 1948, 1988). Given all these benefits, it is no surprise that more and more development economists and policy-makers find themselves in agreement on the absolute necessity of property rights for developing countries (De Soto 1989, 2000, 2002; Easterly 2001, 2006; Sachs 1994; Boycko, Shleifer and Vishny 1997).

However, although the virtues of property rights are hard (if not impossible) to contest, it does not follow that only property rights work when solving the complex problems of economic coordination. Indeed, the works of Elinor Ostrom seem to indicate otherwise. Ostrom’s genius lies in that she realized that economists had unfortunately blinded themselves into dividing all possible institutional arrangements into only two categories: the market or the state (i.e. private property or government management). In contrast, Ostrom shows that
markets and governments are but two possible institutional arrangements along a spectrum of alternatives. Indeed, throughout history and across the globe human communities have created and worked within countless systems of appropriation, allocation, and distribution of scarce resources that fall neither in a pure private property rights regime nor pure centralized control. In addition, these alternative institutional arrangements often have proved themselves to be as efficient (if not more) at achieving all the benefits economists thought to be reserved only to pure regimes of private property, such as externality control and prevention of over-exploitation of resources (Ostrom 1990, 2005).

2. Why Property Matters

Before constructing a critique to the orthodox property rights paradigm espoused by De Soto, we need to understand why such a paradigm matters, how it works and why so many economists embrace it. To do so we need to show the genealogy and shed light on the historical circumstances behind the birth of these ideas. What I hope to accomplish by doing this is to show that my position (and Ostrom’s) far from being antagonistic to the overall spirit of the property rights paradigm is, quite the contrary, an extension of the paradigm itself.

To understand the intellectual roots of the orthodox property rights paradigm, we need to think back to the cataclysmic failures of central planning of the late twentieth century. Although discredited in contemporary discourse (except in the minds of a handful of radical intellectuals) the prominent intellectual paradigm for the most part of the last century was that rational planning of the economy was not only going to be more humane, and more efficient but was also a historical inevitability only fettered by the interests of the capitalist class. In that spirit many policy regimes across the globe were pursued in order to fulfill the dream of a fully rationalized society such as the Raj System in India, or more infamously, the aggressive collectivization programs in both the Soviet Union and Maoist China. Yet by the end of the twentieth century, reality hardly matched the expectations. Central planning not only proved itself to be far less dynamic, efficient and prosperous than market-based economies, but was also strongly correlated with corruption, political repression, and dictatorship.

As a result of these failures, economists began to reconsider their previous position. Instead of seeing the economy as a set of mechanistic relationships of variables that could be predictably manipulated, economists began to see economic systems as complex networks in which the optimal outcome cannot be reached
Yet while economists made great strides in rethinking the importance of local micro-structures underlying economic and social welfare, most of them are still bounded by the very same formalistic-mathematic approach that gave birth to the chimera of optimal social engineering, or “scientism” in the words of F.A. Hayek (1952). Even though economists recognize more and more the importance of paying attention to the delicate nuances underpinning economic relationships, their advice is still often guided by rules of thumb derived from formal “universalistic” mathematical models. This way of thinking is ultimately what lies behind “shock therapy” approaches to liberalization in which market institutions are aggressively imposed regardless of the previous institutional arrangements. Although this aggressive top-down introduction to capitalism has, arguably, been shown to work in some occasions (Sachs 1994; Boycko, Shleifer and Vishny 1997), its failures in many post-Communists countries and other regions of the globe are also undeniable. It is on this page of history that both De Soto and Elinor Ostrom appear.

The title of Hernando De Soto’s book *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* presents the central question well. According to De Soto, top-down approaches to capitalism are unlikely to yield positive results because they are unable to fully tap into already existing economic potential. Simply liberalizing key industries, opening barriers to international trade, and cutting government expenditures are not sufficient to make an economy “capitalistic.” Rather, the essential feature of a capitalistic economy, according to De Soto, is that it provides a strong, clear, and stable system of property rights, which is in turn the source of entrepreneurial activity and therefore the true motor propelling economic progress (De Soto 2000). To support his point, De Soto offers an extensive historical overview on how and why the current institutional systems *evolved* in the West and how these institutions played the key role in making the West the economic behemoth that it is today.

Yet what separates De Soto from other advocates of economic liberalism is that his position is far from advocating simply to “import” pre-made institutions into a foreign context. Indeed, De Soto’s historical perspective on the emergence and evolution of property rights systems led him to conclude that successful institutional arrangements evolved by taking into account the delicate balance underlying the needs, actions and historical realities of the participants composing the
economic system. In other words, De Soto’s approach to liberalization follows the same spirit that made economists shift away from advocating central planning in favor of markets; that De Soto takes micro-structures seriously.

Indeed, far from advocating a complete overhaul of the current system, De Soto’s proposal is to skillfully work within it. The goal is thus not so much to assign property rights as much as it is to recognize property rights. De Soto is emphatic throughout its work that complex and functional systems of property rights are already in place throughout the informal economy (De Soto 2000, chapter XI). The step towards a functional set of “capitalist” institutions therefore lies in bringing legal recognition to these systems and thereby multiplying their efficiency. Legal recognition of ongoing property rights, according to De Soto, bring about these and other benefits (De Soto 2000: 69-86):

- Greater independence for individuals from local community arrangements to protect their assets;
- Clear, defensible ownership;
- Standardization and integration of property rules and property information in the country as a whole;
- Increased trust arising from a greater certainty of punishment for cheating in economic transactions;
- More formal and complex written statements of ownership that permit at low cost the assumption of shared risk and ownership in companies and insurance against risk;
- Greater availability of loans for new projects, since more assets could be used as collateral for the loans;
- Easier access to and more reliable information regarding such things as credit history and the worth of assets;
- Increased fungibility, standardization and transferability of statements documenting the ownership of property, which paves the way for national and international markets in which individuals and corporate enterprises can easily transport and exchange property.

Furthermore, because De Soto’s vision is based on already established social relationships, it also draws from the power of social capital as defined by thinkers such as Alejandro Portes (1998) and James Coleman (1988) that emphasizes the role of stable and trustful social networks as key to unleashing the collective potential of the social network itself. Also, such a bottom-up approach is less likely to suffer from the drawbacks of “institutional stickiness” as defined by thinkers
such as Peter Boettke, Christopher Coyne and Peter Leeson (2010) referring to the difficulty of breaking away from already established institutional patterns.

3. Yet Another Path

Yet while De Soto’s vision of market reform constitutes an advance above and beyond the simplistic “textbook” approach to economic liberalism, De Soto is awfully silent in his works about the possibility of there being alternative institutional arrangements besides individual private property. This is not surprising given that such omission is pervasive throughout most of the economic literature, which tacitly assumes that all management of resources are either directed by market forces or government mandates. Yet with the steady rise of New Institutional Economics this omission is been remedied little by little as scholars shed light upon the diversity of human institutional arrangements. Among the works within this branch of economics, the works of Elinor Ostrom shine as the brightest examples. Against all dogma, Ostrom’s works pierce through the tacitly imposed limits of the economics profession into areas previously reserved to sociology and anthropology.

What Ostrom brought us back from her journey beyond the limits of orthodox economic analysis is a fresh perspective that invites us to reconsider some of the most ingrained dogmas in economic theory. Contrary to what orthodox economics would predict, Ostrom’s field work shows us that common pool resources have been successfully managed throughout history and across the globe in the absence of both pure private property and government regulation. Indeed, communities across the globe have recognized the need for social cooperation in the face of scarce resources and have consequently created ingenious systems to harvest, allocate, and consume these resources in ways that will ensure sustainability for future generations.

The key to understanding such disparity between theory and reality is that economists limit their analysis to only a small subset of social arrangements. At the core of most, if not all economic models lies the presupposition that human actors are “trapped” in a set of institutions. Individuals, it is assumed, can maximize within the constraints of the given set of institutions, but they cannot change the institutions themselves. The reason why economists have been blind to such a possibility is that they have, for the most part, neglected the possibility of meaningful trust relationships among economic actors that would allow them to change the rules of the game from the bottom up. Indeed, by simplifying human
beings to the *homo economicus*, economists created relatively simple and usefully predictive models, but they also limited themselves to a narrow understanding of the human condition. In contrast, Ostrom’s emphasis on the communicative and social aspects of the human behavior opens our eyes to the possibility of efficient institutional arrangements other than private property or government regulation to emerge.

Indeed, through examples ranging from small, traditional fishermen communities in Turkey to large and modern water basins along the Californian coast, Ostrom shows us how economic actors have been capable of crafting efficient institutional arrangements with little to no outside interference. The key to a successful and stable common pool resource management system lies, according to Ostrom, in what she calls eight “design principles” (Ostrom 1990: 90):

1. Clearly defined boundaries (effective exclusion of external un-entitled parties);
2. Rules regarding the appropriation and provision of common resources that are adapted to local conditions;
3. Collective-choice arrangements that allow most resource appropriators to participate in the decision-making process;
4. Effective monitoring by monitors who are part of or accountable to the appropriators;
5. A scale of graduated sanctions for resource appropriators who violate community rules;
6. Mechanisms of conflict resolution that are cheap and easy to access;
7. Self-determination of the community recognized by higher-level authorities;
8. In the case of larger common-pool resources, organization in the form of multiple layers of nested enterprises, with small local common pool resources at the base level.

Furthermore, once we put emphasis on the communicative and intrinsically social aspects of human interaction we should be led to conclude that there are no clear cut systematic limits that separate a set of institutions or “rights” from one another. Indeed, a “right” arises from a social agreement, which in turn, is underpinned by the particular communal interpretation on the proper relationship between actors and between actors and objects. As such, we should not identify the presence or absence of private property as an “on-or-off” switch as many economists and political philosophers do, but as an end of a graduated spectrum of pos-
sible institutional frameworks. In accordance with this vision, Ostrom identifies property, as a **cumulative bundle** of “use” rights that are not presupposed by each other, meaning that they are not “all-or-nothing” kinds of rights, as is often tacitly assumed by proponents of market institutions (Ostrom 1990). This vision offers many degrees of freedom regarding possible efficient institutional arrangements that can encompass both orthodox as well as alternative institutional frameworks when dealing with economic problems.

We must, however, be careful not to romanticize Ostrom’s views on alternative institutional arrangements. In the same way that markets and governments can bring sub-optimal results under certain circumstances, alternative institutional arrangements can also fail to provide efficient outcomes. Indeed, throughout her works Ostrom never shies away from the possibility that indigenous institutional systems might fail to uphold the eight design principles and consequently fail at bringing sustainable and efficient resource management (Ostrom 2005). Furthermore, local and indigenous systems, even when they are effective at managing common pool resources in an economic sense, might fail at providing fair and just treatment to its participants if they rely on hierarchical, discriminatory or unequal results that could be seen as objectionable from a philosophical point of view through a universalistic theory of justice (e.g.: Rawls 1971, Nozick 1974).

Ostrom’s point, however, is not that all alternative institutional systems work but rather that they can work under the proper circumstances. What we are left with is therefore not a simple rule of thumb but with the contrary: an imperative to examine, weigh, and judge every case with care and with awareness of particular circumstances. We now can see how Ostrom’s vision fits within the general spirit of the other thinkers discussed here, in that their conclusions converge toward **taking micro-structures seriously.**

### 4. At A Crossroad

As I argue above, De Soto’s vision of a formal regime of property rights is robust because it draws upon the power of **already existing** institutional arrangements at the microeconomic level. By simply formalizing something that is already established De Soto’s theory exploits the social capital and local knowledge already present in pre-existing institutional arrangements. Furthermore, recognizing ongoing institutional arrangements avoids the costs associated with changing from one set of institutions to another. At its core, we can see how De Soto’s theory is in alignment with the insights offered by Ostrom and her work on common pool resource management.
Yet while the core premises of De Soto’s theory are sound, their applications have been less so. The reason De Soto’s theory works is not because it brings about a superior set of institutions, but rather because it recognizes the ones that are already in place. In practice, however, this key insight has often been substituted by the simplistic rule of thumb “assign individual property rights.” This rule of thumb by itself presents no problem when the preexisting institutional arrangements were indeed based on individual private property. But private ownership of land and resources does not hold everywhere. Indeed, alongside private property arrangements there is a myriad of alternative institutional arrangements that have emerged in order to regulate the appropriation, distribution, and consumption of resources and many of these are still practiced today. While the central idea behind De Soto’s theory, i.e., “recognize what already exists,” suggests the need to recognize these alternative institutional arrangements, the crude rule of thumb “assign individual property rights” points us in the wrong direction. Herein lies the contradiction in De Soto’s system.

What must be done is clear. If the theory espoused by De Soto is to be free from internal inconsistencies it must explicitly recognize the possibility of legally recognizing alternative institutional arrangements other than narrowly defined individual private property. By employing Ostrom’s insights on the nature of successful alternative institutional arrangements, we can expand the limits of De Soto’s vision of a bottom-up approach to formalization to include institutional arrangements other than narrowly understood private property or government management. As such, De Soto and his followers should therefore skillfully use Ostrom’s work to recognize and protect not only informal private property arrangements, but potentially any institutional arrangement that proves itself to bring efficient and sustainable outcomes.

Although the idea of legally recognizing a wide diversity of institutional arrangements might seem at first revolutionary or even utopic, we must realize that similar legal provisions are already in place in many regions of the world. Latin American governments, for instance, have a long history of giving indigenous communities relative autonomy in matters such as water supply management, land management and provisions of community justice. The irony lies, however, in that movements promoting such communal autonomy have often been politically associated with “the Left,” while movements advocating property rights have been associated with “the Right.” Thus the two approaches have been seen as
incompatible paradigms, even though the analysis presented here show that they can be reconciled in both practical and philosophical terms.

Expanding De Soto's boundaries also implies a change in the way we need to think about institutional arrangements. Instead of rushing into giving simple “universal” answers to economic problems, economists should be more careful in taking into account the unique features and problems every particular micro-economic system presents.

References


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