Understanding the Shadow Economies of the Developing and Developed Worlds

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During my time here at Beloit College, I have mainly talked about the “two-thirds world”: the developing world, including countries like Peru where I come from, and the former Soviet Union. The two-thirds world constitutes five to six billion people; it is a world that, for the most part, lacks well-functioning markets and the rule of law. Initially, the Institute for Liberty and Democracy (ILD) was primarily a research organization. However, soon after our initial research was released, we started getting calls from heads of state around the world. We began to focus on developing solutions, on the basis of our research, to the problems associated with the lack of rules, or the lack of law, within the informal economy. We have become a consultancy for leaders looking for practical solutions to overcoming the problems associated with large “extralegal,” “informal,” or “shadow” economies.

In such economies, there may be order of a sort, but without the rule of law, the order is fragmented. Rule of law means standard law. Countries like mine and others within the developing world, and countries like the Ukraine and others within the former Soviet Union—countries that are trying to make the transition toward market economies—have many different legal systems, some of them formal some of them informal, operating side by side. For markets to function, it is essential to have signals that make it possible for people to read reality and to coordinate their actions with millions, or hundreds of millions, of other people. But the signals that emanate from these differing legal systems also differ, making communication across millions or hundreds of millions of people extremely difficult. Because it is impossible to know and communicate directly with every one of these millions of people personally, a successful transition to a market economy is all about getting the signals right.

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1 I have been grateful for the opportunity to serve as the Upton Scholar and for my time here at Beloit College. I don’t teach. I don’t work in a university, and I rarely participate in events such as this wonderful forum. I would like to thank President Scott Bierman and Emily Chamlee-Wright for their kind welcome and introductory remarks.
So that is the nature of our work in the two-thirds world. Some of our critics charge that our focus is one-dimensional—that all we know about is the extralegal economy. However, this work is actually far more varied than one might think. When we begin working with a country, the head of state does not come to us asking, “Tell me what to do about my extralegal economy.” Instead, it is, “I’m fighting terrorism, and these guys are hidden in the shadow economy. How do I get the essential facts that I need to develop solutions to the problems facing my constituents? How do I get into the shadows?” Other people point to the poverty within the extralegal economy and ask, “How do we create wealth within this sector? How do we retain what has already been created in the extralegal sector, but with proper documentation so they can connect to the broader market?” Other people say, “I want to provide basic services; I want to provide clean water and build a sewage system. I want to provide electricity to my people. But in order to provide these services, I need a way to collect taxes. But how can I collect if I don’t know where they are? I may know where houses are. But who owns the houses? Who’s accountable? Who’s responsible?” Another person may say, “What we want to do is get credit to people within the extralegal economy, but credit is all about credibility. Who are the people who will guarantee repayment? Again, who’s going to be accountable?” When we talk about finding solutions to the problems associated with the shadow economy, the analysis is necessarily multidimensional, requiring expertise on a great diversity of issues.

While most of my work focuses on the two-thirds world and the lessons we can impart to reformers in these contexts, recently I have also been considering how these lessons might apply to the developed world, to countries like the United States. In the course of my travels in this country, I often ask, “What concerns Americans?” When I asked this question during my time here, the replies were, “We’re concerned about the economy, what’s happening to the economy, and what’s happening to capitalism in our own country.” Second, “We’re concerned about the fact that at this moment we are disoriented. No one knows which signals to trust anymore. What information can you trust?” I said, “Mm-hmm, that’s interesting.”

So, I would like to address my remarks to these questions. And before you say, “What an irresponsible fellow! I mean, what does he know? He’s a third worlder, and he’s coming to talk about the empire itself?” let me tell you why I’m addressing these questions.

When it comes to these issues, the fact that I am an outsider is an advantage. Einstein said that when it comes to actually doing a diagnosis of the problem, it is good to have an outsider come in. As Einstein asked, “What does the fish know about the water in which it swims?” The fish, of course, thinks that it is very agile; however, the fish only knows life in the water. As an outsider, I know water, and I know air. I can understand better than the fish that his agility has a lot to do with the water in which he swims. When I set out to diagnose the problems of the developing world, the history of the United States informs what I see. The United States found a way to overcome the problems that developing countries now face. Similarly, as an outsider to the United States, I may be in a better position to diagnose what is going on here because of my experience in diagnosing problems in developing countries.
The economic success of the United States comes from the fact that your system is based on the rule of law. This means that the United States has devised manners and customs by which information travels, and it is packaged in such a way that you are able to transmit and receive shortcut definitions about otherwise complicated concerns. These packages of information allow you to make immediate and informed decisions. Like the fish that may not be aware of the water in which it swims, you may not realize how much complex information is packaged in the signals that you read and respond to every day.

I began thinking about the lessons our work at the ILD might have for the United States in the fall of 2008. Like everyone else, I was concerned about the recession that is, in Milton Friedman’s words, a “credit crunch.” But coming from a developing country, I can offer you a new perspective on a credit crunch, because developing countries live in a permanent credit crunch.

Why? Because most people in the two-thirds world live in the anarchy of the shadow economy with their assets and contracts covered by paper that is endemically “toxic.” That is to say, it is not recorded, not standardized, difficult to identify, and hard to locate. Its real value is so opaque that ordinary people cannot build trust in each other or be trusted in a global market; they thus operate in a constant credit crunch and are stuck in poverty. In short, for shadow economies outside the United States and Europe, recession and poor credit is a chronic condition.

So, when your Treasury Secretary, Henry Paulson, went to congress to appropriate the funds necessary to buy up the huge amounts of “toxic” or “troubled” assets that banks were holding in the United States, I said to myself, “Hey, I know something about this.” The assets were troubled or toxic because the subprime lending market had collapsed, and some of that financial paper was not performing. It was critical, Paulson argued, for congress to provide the money necessary to buy up and rid the system of these troubled assets. This was debated back and forth, but congress eventually agreed to direct $780 billion toward buying up those troubled assets.

At this point, like any other observer, I wondered what Secretary Paulson would do with the $780 billion. About three weeks later, Secretary Paulson held a short press conference at the Treasury Department and said, “By the way, we’re not going to use those $780 billion to buy the toxic assets.” Instead, the money would be used for a stimulus bailout program. Astonished, I wondered how it was that Secretary Paulson could secure $780 billion in a democracy to buy troubled assets, under a program called the Troubled Asset Relief Program (TARP), but was now not going to buy them. I had to find out more.

I began by talking to my journalist friends. Secretary Paulson’s turnabout was considered a cute subject. It was not on the first page of The New York Times, not the second page, but usually on the third or fourth page among the features. I kept searching for an answer, but nobody had one. So I said, “This deserves ringing doorbells in Washington.” Over the years I have met many of your leaders. They think I am cute. I tell them about how the informal economy works. They think it is interesting—you know, chewing gum for the mind. “Good to see you, de Soto!” they say. I began asking the people I know for an answer. It is an advantage to be Peruvian.
I am not inside the system, so people tend to tell me the truth because they believe that it doesn’t really matter.

What I found out completely changed my program of study over the last year. I found out that the reason Secretary Paulson decided to not go out and buy the troubled assets was because he couldn’t find them or price them. He couldn’t find the approximately one trillion dollars’ worth of nonperforming assets in the U.S. subprime market. And I said to myself, “That is a pretty good indication that you had created a shadow economy.” When you have a system in which you can’t find the basic facts about assets and can’t put a price to them, you have what amounts to a shadow economy.

My admiration for the United States comes from the fact that you have a super legal system, a legal system that provides the facts in different forms. I have been studying facts and the forms in which they are bundled for some time. How do you bring facts together? When asked to define what the world was made up of, Bertrand Russell, the great British philosopher of the twentieth century, explained that it is essentially made up of micro facts that add up to the facts that we know. Alone, a piece of oxygen or a bit of hydrogen doesn’t mean much. But if you bring them together, you get water. So, the whole issue is how micro facts come together in meaningful packages, or signals, that quickly and informatively guide human decisions. With these signals that bundle complex information in a form that is easily accessible, we are freed from having to understand everything of importance in minute detail.

Most of the facts that we care about in an economic setting are man-made. They are the result of human intelligence putting together various pieces of information in such a way that one can quickly identify the relevant meaning of the facts. Instead of using Adam Smith’s metaphor of the invisible hand, I prefer to talk about your “unconscious hand.” Knowingly or unknowingly, the market economy in the United States operates like an unconscious hand. Through the legal and property documentation systems that you have created over time, you can quickly identify facts about the assets you hold, where and how many there are, and whether the credit you give and the investments you make are solidly backed by these assets. Property rules and documentation allow you to follow what’s going on in your so-called real economy without having to travel and meet everyone involved in the things that you buy, you finance, and you invest in.

Legal systems play a crucial role in packaging together meaningful knowledge that generates robust signals. That is why I want to help bring in the rule of law to the economies of developing and former Soviet countries. Rule of law means standard symbols, standard rules, and signs; having these established enables hundreds of millions of people unknown to one another to communicate with each other. It is this system of communication that allows us to create the extended market economy in which we can divide labor among millions, or billions, of people and create wealth.

During one of my classroom visits, I recalled Leonard Reed’s well-known essay “I Pencil,” in which he describes the complex system of cooperation that is required just to make a single pencil. How many countries are involved in the creation of a simple pencil? The answer is seventeen countries. The graphite comes from Sri Lanka. The
wood comes from Oregon. The lead doesn’t break because it is softened by candela wax from Mexico. The eraser comes from oil, which comes from Saudi Arabia. The filament of metal that wraps the eraser comes from zinc from Peru, copper from Chile, and black nickel from Nigeria. Consider any product around you. There isn’t one thing in the world that is made by one person. Each item is made by millions of people, and for millions of people to bring things together—to make the 5,000 parts of a locomotive, to make the 1,000 parts of a watch—you need coordination. You need facts; you need to identify the owner of each item and contract.

In my recent experience entering the United States through the immigration inspection center at the Miami International Airport, I saw a version of this system at work. I stood behind the yellow line, waiting for my turn. The man at the counter said, “Can you identify yourself?” I said, “I’m glad you asked that question. I am Hernando de Soto Polar de la Jara Ugarteche Landázuri Vargas y Jiménez y Angulo. I come from Peru. Interestingly enough, although all of my names may sound Spanish to you, they originally came from Italy, from Genoa. They were Alciatos, but you see, the Alciato family actually married into the de Soto family, which had more money, and that’s why the children took the de Soto name.” The man behind the counter raised his hand and said, “Stop. Just show me your passport.”

So I showed him a legal document invented by the West called the passport, which assembles in a meaningful manner various micro facts into one big fact, which proves to the reader that I am really me. A legal passport creates an identity that can be tested for truth. My passport had a photograph, so he looked at it and compared it to my face. They had fingerprints, so I put all four fingers inside the scanner, and he was able to check my fingerprints against those in the passport. The inspection agent asked, “What brings you to the United States?” I said, “I have come for a conference.” “Mm hmm,” he said. Had I said, “I am selling shoes,” he would have questioned me with greater scrutiny because the micro facts contained in his database pointed elsewhere.

A passport is full of facts that are brought together in such a way that a person without a university education can quickly identify me. My identity is made up of not just one fact, but hundreds or thousands of micro facts that are brought together, as Husserl would say, “in a moment of unity,” and they create the identity of Hernando. We are all a little bit like a passport; we are all composed of a series of micro things called atoms. The atoms come together as cells. The cells come together as organs. The organs come together as you, and you are composed of roughly thirty-two million cells. Now, it can’t be that those cells alone are you, because all of your cells die about every six or seven years. So if the cells alone were you, you would have died five, six, or even ten times already. That isn’t all that you are made of. What makes you who you are is the way those cells are combined and related to each other. So, your cells can continually die, but it’s the relationship of one cell to another that makes you who you are. That relationship of cells to each other is contained in a protocol called DNA, a nucleic acid that provides information as to how you are biologically pieced together. A passport provides information as to how you are socially pieced together. Property and business documents provide information as to
how assets are continually combined to make other assets, who they belong to, and what other interests relate to them at any given time and place. Facts don’t grow on trees. They are man-made.

The stunning accomplishment of the United States since the Industrial Revolution is not the development of gadgets. Your most stunning accomplishment is how you bundle your information together—not so much the data itself, but how you package and structure the data. We may all be fascinated by a river, but the river exists because there are banks, and the banks are what give structure to the water that flows. More important than the data that flows in this age of information technology are the structures that package that information into meaningful bundles of facts that guide you and allow you to make swift and informed decisions.

To make this point, I brought with me an apple. Because they saw me pick it up, many people know that this is my apple. But is it mine or isn’t it? How can you be sure? A stolen apple looks exactly the same as my own apple. How do you know that it’s Hernando’s apple? You can peel it, you can cut it into three or four pieces, but there is nothing that tells you that it is Hernando’s apple. You cannot tell if the apple is borrowed. You cannot tell if it has been leased. There is no way to tell if it has been used as collateral. You cannot determine if there is a secondary interest in it. You cannot know if there is a mortgage on it. You cannot tell if there is an encumbrance upon it. There is no way to distinguish a stolen apple from this one by just looking at it.

To get the economic facts on the apple, you would have to have documentation. Just as the passport conveys a meaningful bundle of information about me, a legal title conveys a meaningful bundle of information about assets in the world. The apple comes from the world of Mother Nature, but U.S. law has created bundles of meaningful information about the economic aspects of assets through the rule of law. Documentation turns the objects found within Mother Nature and the objects created by human beings into assets about which we can know innumerable facts. With appropriate documentation we can size up an investment anywhere without having to travel the whole world.

With the rule of law, you have managed to document identity and assets in a way that can be continually updated. All your airplanes, all your homes, all your buildings, all your land, all your identity cards, all your credit systems, all your capital, all of your movie scripts, all of your authors—everything is recorded. Not only are all these facts recorded, they are all publically accessible, allowing for widespread coordination within the economic system.

Consider coordination within the credit market. Credit is always given against some kind of guarantee. Publicly accessible records are essential for credit markets to function well. When the world is documented, people have the information they need to place a value on an asset, and they can infer how much credit can be extended.

Now comes the moment of drama. For more than ten years, U.S. markets have been creating paper, property rights over assets, called derivatives. Derivatives are financial paper that basically represent a property relationship to underlying assets such as houses, commercial property, or combinations of such assets.
When it became clear that derivatives were at the center of the financial crisis, and shortly after Secretary Paulson made his announcement, Christopher Cox, the chairman of your Securities and Exchange Commission (SEC) set out to tally up the troubled assets. Chairman Cox announced that it was not only the one trillion dollars’ worth of nonperforming paper in the subprime mortgage market, but roughly $600 trillion in financial assets that were created but not publicly recorded. Since the Industrial Revolution, this is first time the West has created paper that represents value, but that is not recorded. Keep in mind that the GDP of the United States is approximately $15 trillion. Shortly after Mr. Cox’s announcement, the Bank for International Settlements estimated that the right figure was one quadrillion, two hundred trillion dollars—that is, over a quadrillion dollars’ worth of financial paper that is not publicly recorded.

So, my friends, the point is this. Your bankers and your authorities have created the world’s biggest shadow economy. The shadow economies of the developing world are peanuts compared to your shadow economy. No longer do you know where most of your assets are located. This is essentially where your financial crisis comes from. When you no longer have a way of knowing the basic facts about the assets within your economy, the signals that people depend on to make swift and informed decisions no longer work.

Without clear signals, there is no way for the TARP program to work as it should—there is no way to know who has the paper that represents assets. There is no way to know who is really broke and who is not.

In your country, every stock, every $170 trillion of it, every automobile, every dollar’s worth of debt is recorded. But in the case of derivatives, this is not so. This is one source of the uncertainty that fueled the financial crisis. Further, I suspect that the amount of paper that exists in Western markets greatly exceeds the quantity of real assets that they represent. This is another source of the uncertainty. Finally, some of the derivatives, the so-called synthetic derivatives, aren’t even related to assets. Now we Latin Americans know something about that. These forms of uncertainty are pervasive. It is this uncertainty that creates the shadow economy and leads to permanent recession.

As the financial crisis unfolded, a critical problem was how to price the toxic assets that were left on the balance sheets of financial institutions. If we believe in a free market, we know what needs to happen. If I wanted to sell my apple, I could offer it for sale and see what price it would fetch—ten cents, thirteen cents, two cents—the market will tell us the right price. In Peru, we produce coffee and copper. What is the right price for these commodities? The market tells us. “But wait a second,” said the owners of the toxic assets. “That’s too simplistic. It’s unfair! We need to price these things fairly.” These are odd responses coming from a capitalist economy. What does it mean to price these assets fairly? Fair is whatever price they can fetch in the marketplace. In bad times, they are worth less. In good times, they are worth more.

Without facts, there’s a widespread fear that potential borrowers will be unable to repay their loans. When there are no clear signals, credit is paralyzed, the volume of transactions shrinks, employment declines, and property values fall. This is what
we are facing at this moment. We have managed to overcome the last hump because the government has bolstered confidence in the market. But sooner or later, the people trading in the market will understand that this is not enough. This collapse of confidence happens to us in Latin America all the time. When we flood the market with money, the first two years are great. “My God,” people say. “We’re growing at 10 percent, 11 percent! The stock market is going through the ceiling!” Then all of a sudden it comes crashing down again because there’s nothing to sustain it. You can’t get something for nothing.

Now, what can you do about this situation? First, get the facts. The United States is the king of facts. By this I do not mean rely on the expertise of financial economists. Financial economists will say that what is going on in the U.S. market is too complicated for most of us to understand. To this, I say, “Baloney!” It is much simpler than you might think. Second, it is essential to let the signals do their job in cleaning up the toxic assets—to clean up the financial paper that no longer represents value. Once this happens, once you allow the signals to work, once you know where the assets are and what they are worth, confidence will return.

I investigate shadow economies around the world, and I know that a shadow economy is the result of the lack of facts. Again, it is not that there isn’t enough information; the problem is that the information is not packaged and organized into documented facts that can be tested for truth. Having information organized according to legal structures that are standardized and easily recognized as facts is what creates trust.

When trust in the market breaks down, nobody knows where to put their money—in gold, in stocks, or in real estate. Nobody has confidence regarding where their investments will be safe.

Value and wealth creation, contrary to what Karl Marx and even Adam Smith believed, does not only come from labor. Wealth also comes from law—from the precision of an instrument that gets facts and knowledge to you in such a way that you can test them for truth and validity. My Peruvian passport conveys meaningful signals because it adheres to standards that bundle relevant information in a way that others can easily read. That is exactly what your derivative paper doesn’t have. You can’t test it for truth and validity.

The economy is not just the goods that are traded; it is also the institutions that facilitate their trade. For property rights to work, relevant information about assets needs to be clear and accessible. The essential factor in overcoming the problems you face is to allow the signals to work. It is important that we be able to accept the bad news that many of the assets that we believed had value no longer do. Just as we say when we advise developing countries, it is essential to learn the facts of the shadow economy that exists in the form of financial paper.

American society is strong, in part, because you are not afraid to talk about your failures. In this country, even before this recession, there was an average of 1.6 million bankruptcies per year. That gives you 1.6 million examples of ways in which the economy is not working, and knowing this is the first step to correcting it. The strength of capitalism is the knowledge of failures, not the knowledge of successes.
The intellectual community can play an important role in reminding us what it was that created success in the first place. What really makes the United States great, whether you know it or not, is that you have the best legal, institutional, and political system in the world; it is important to remember why it works and how you built it, because that is what’s going to get it out of this recession. The solutions are based on property rights, on institutions, and on all the things that students study at Beloit College. The United States is a great nation, but it is imperative to remember that it’s your legal system and the property rights that convey the relevant facts about the assets owned and exchanged within the market that are the source of your success.
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