

**The Mystery of Capital and Economic Calculation:
How de Soto's Insights Illuminate the Austrian
Case for Private Property**

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In the Socialist Calculation Debate, Mises and Hayek argue that in the absence of private ownership of the means of production, economic calculation is impossible.¹ In its simple form, the Mises-Hayek contention is an either-or proposition: either we have private ownership of the means of production and hence the economic calculation it makes possible or we have common ownership of the means of production and, in inevitable consequence, are groping in the dark of the abolition of rational economy (Mises, 1920, p. 110).

But is economic calculation simply an either-or matter? Hernando de Soto's *The Mystery of Capital* centers on the vast differences between formal and informal property systems. In the West, ownership means formal, legal title; in most of the Third World, it means informal, untitled possession. In the West, property systems are integrated, and records are centrally maintained and standardized; in the Third World most property is held informally,

¹Mises's argument may be outlined as follows:

- \$ Economic efficiency requires that producers be able to calculate the costs of methods of production, so as to choose the least-cost method.
- \$ Economic calculation depends on scarcity-indicating prices (the term is Don Lavoie's; see Lavoie 1985) of production goods.
- \$ Scarcity-indicating prices of production goods can be generated only in actual markets for those goods.
- \$ Markets for production goods are possible only if those goods are privately-owned.

and records are non-integrated, ad-hoc, and non-standard, if, indeed, they exist at all. De Soto shows that these differences in private ownership matter, in particular to people's ability to produce capital (p. 5). But if economic calculation depends on private ownership of the means of production, and if the institutional details of private ownership vary from place to place, shouldn't the nature and quality of economic calculation vary with those institutional details?

We contend that it does. Surely Mises and Hayek are correct that economic calculation depends on private ownership of the means of production. By putting some institutional flesh on the abstract bones of private ownership, however, de Soto points us toward a deeper understanding of what Mises and Hayek taught us about economic calculation. De Soto's work invites an examination of how the institutional details of private ownership might determine the extent and quality of economic calculation and thereby the efficiency of markets in different regions. De Soto helps us see that in the absence of formal, legal title to productive assets economic calculation is possible—indeed, it goes on continually in the Third World—but crippled. The institution of formal, legal title, by contrast, means better economic calculation. Our purpose here is to explain why.

We identify two ways in which the institution of formal, legal title improves economic calculation: by extending and integrating markets for physical assets, and by fostering the development of new productive uses of these assets. In both ways, it improves the meaningfulness of asset prices; more meaningful asset prices mean better-informed economic calculation that will lead to more efficient production processes.

Extending the market

De Soto points out that formal, legal property systems extend and integrate the markets for assets by reducing the risks and transaction costs of buying assets. The link to economic calculation is direct: More extensive markets for assets mean that asset prices reflect more knowledge of the particular circumstances of time and place (Hayek, p. 80).

Formalization and integration of property records

De Soto observes that as a result of formal, legal property systems, meaningful, accurate information about assets is readily available:

As a result of integration, citizens in advanced nations can obtain descriptions of the economic and social qualities of any available asset without having to see the asset itself. The formal legal property system lets them know what assets are available and what opportunities exist to create surplus value. Consequently, an asset's potential has become easier to evaluate and exchange, enhancing the production of capital. (p. 54)

With the integration of asset records into formal systems of legal title, individuals within the bell jar of Western economies are able to obtain information about any asset without incurring the high transaction costs of inspecting that item personally. One aspect of integration is centralization. Essential data on every piece of real property and most businesses are centrally recorded. Inside the bell jar everyone can look up records on all property.

Another aspect of integration is standardization. Inside the bell jar, property titles record current and past owners in a consistent fashion, and define property boundaries with reference to standardized maps in standardized measurements. Standardized, reliable, understandable description of productive assets. E.g., land titles, leases, mortgages, small business registrations, and articles of incorporation. Allow people to compare economically relevant aspects of different assets in standard categories. Standardization of

property records thus makes meaningful comparisons of different assets straightforward, even though particular assets within a category might differ dramatically in size, location, profitability etc. Accordingly, this standardization in property representation allows markets in different regions, or for related assets, to overlap.

While formalization and integration of property records inside the bell jar makes it easy for people to get essential information on assets, outside the bell jar, by contrast, people do not know where to find out, or even if they can find out, what they want to know about an asset. Can informally held lot, for example. There may be no written records pertaining to the asset. Even if written records do exist, some are likely to conflict with others. In either case, definitive, generally accredited records seldom exist. Information about assets is available only locally. Within the communities where assets are located. And informally. In non-standard, ad-hoc fashion. Outside the bell jar, information about assets is dis-integrated.

....lead to more extensive markets....

The centralization and standardization of property records inside the bell jar have an important consequence for economic calculation. That is, as de Soto makes clear, they lead to more extensive, unified markets for assets. They do so primarily by reducing risk and its associated transaction costs.

Under a formal legal property system, potential buyers have a system in place to protect their rights to what they buy. Accordingly, making a purchase is far less risky within the bell jar than outside it. If, for example, we buy a piece of land somewhere in the West, we typically go to a bank to apply for a loan (in the form of a mortgage) to finance our purchase. The bank, in turn, to protect the security of its loan, will require title insurance. This we can easily obtain, for a small fee, from a title insurance company that efficiently conducts a title search through the standardized, centralized records. At closing, the bank grants the mortgage, we sign the final documents, and the (insured) title of the house. Legal ownership of the house. Is officially transferred to us. Because the transactions occur within an integrated, formal property system, these procedures are

straightforward, comprehensive, and inexpensive, and our costs of securing our title are minimal.

Suppose, on the other hand, we wish to buy a home in the informal sector of Lima, Peru, where integrated, centralized, standardized property records do not exist. There, for any house we wish to consider, we must circulate through its community, find those who know the local rules, and do our best to find out what would be involved there in securing our title. The need to physically go from community to community results from the absence of a centralized, integrated, system of property information. As de Soto remarks:

How can the huge amounts of assets changing hands in a modern market economy be controlled, if not through a formal property process? Without such a system, any trade of an asset, say a piece of real estate, requires an enormous effort just to determine the basics of the transaction: Does the seller own the real estate and have the right to transfer it? Can he pledge it? Will the new owner be accepted as such by those who enforce property rights? What are the effective means to exclude other claimants? In developing and former communist nations, such questions are difficult to answer. For most goods, there is no place where the answers are reliably fixed. That is why the sale or lease of a house may involve lengthy and cumbersome procedures of approval involving all the neighbors. This is often the only way to verify that the owner actually owns the house and there are no other claims on it. It is also why the exchange of most assets outside the West is restricted to local circles of trading partners. (p. 47)

When we buy a piece of land in Lima, we can't be sure we own it at all. There may be more than one claimant to this land. We may find difficulty in simply developing a list of all of the parties we need to ask about this property in order to secure our rights to it. Even then, we would have no formal, legal guarantee against other claimants.

Of course, the risks associated with buying an asset can be reduced in the world beyond the bell jar. But risk reduction always comes at the price of higher transaction costs. Once these costs become too great—when they no longer offset the risks of buying the asset—the incentive to bid on the asset in the first place disappears altogether, and the number of market participants decreases.

In sum, formal, legal property systems reduce the risks involved in buying an asset; reduced risk lowers transaction costs; lower risk and transaction costs give more people an incentive to buy and sell assets. In this way, formal, legal property extends and unifies asset markets.

Yand more extensive markets mean that prices reflect more local knowledge.

The final step in this first line of reasoning that formal, legal title leads to improved economic calculation is that in more extensive, integrated markets, market prices convey more knowledge of the particular circumstances of time and place (Hayek, 1945, p. 84).

Implicit in Mises' and explicit in Hayek's work in the Socialist Calculation Debate is that sound economic calculation resulting in productive efficiency depends on the ability of prices to reflect scarcity—systemic scarcity—accurately. This ability depends on prices reflecting the local knowledge of (almost) everyone in the system that might use or supply a resource. As Hayek explains, the price of

each kind of scarce resource [is] a numerical index which cannot be derived from any property possessed by that particular thing, but which reflects, or in which is condensed, its significance in view of *the whole means-end structure*. Y[In] these quantitative indices (or Avalues@) Y *all the relevant information* is concentrated (Hayek 1945, p. 85).

Here, Hayek is evidently talking about an extended, unified market, in which (nearly) all the demanders of Aeach kind of scarce resource@ have access to (nearly) all the supply. Only in such a

unified market will Aall the relevant information [be] concentrated@ in the going prices.

Such a unified market can exist, according to de Soto, only where the institutions of formal, legal property exist first. As the proportion of actual to potential market participants increases, the aggregate level of knowledge in the market rises. As greater numbers of people bid on the assets they deem desirable, the prices of these assets reflect more local knowledge and thus more accurately reflect their potential value in that technical context. Because formal, legal title extends the market for productive assets beyond the local, informal regimes that characterize the informal sector, it allows Athe use of [more] knowledge in [that] society,@ in Hayek=s terms. As markets expand, the market values of assets increasingly reflect their actual economic potential. Each additional market participant adds his or her own creativity and vision to the reservoir of potential uses of these assets, bidding their prices up or down accordingly.

An example

To illustrate the point, let us consider the meaningfulness of the price of an informally held corner lot in Lima, whose occupant (we won=t say owner) wants to sell it.

AThe exchange of most assets Y is restricted to local circles of trading partners@ in such an institutional setting (de Soto, p. 47). That implies a much narrower market for our corner lot than would exist for the same lot inside the bell jar. The demand side comprises only the few people within the Alocal circle of trading partners@ who might be interested in buying a corner lot of that description. The supply side is thin also, because corner lots in other parts of Lima (and elsewhere in Peru and South America) are governed informally by different rules about which each Alocal circle of trading partners@ is ignorant and about which it would be very costly for them to learn. Physically similar corner lots located in separate communities, then, are not *institutionally* similar enough to be Ain the same market.@ Each is on a different supply curve.

Under these circumstances, the going price of that corner lot will reflect the lot=s Asignificance in view [*not*] of the *whole* means-end structure,@ but only of *part* of it. *Less than* Aall the relevant

information [will be] concentrated in the lot's price because only a few demanders bid for it, and only a few other lots are supplied along with it. The price, of that lot, then, reflects the local knowledge of only a small proportion of the buyers and sellers to whom it might be economically relevant.

In short, the price is unable to accurately communicate the relative scarcity of such assets in the region as a whole. The law of one price does not hold. The price of similar corner lots in different cities (and different parts of Lima) will probably reflect the value of each lot in its narrow local circle, but it will not reflect the lot's values in the larger region that *could* be unified and made one market by extending a comprehensive system of legal titling.

If, on the other hand, a comprehensive system of legal titling incorporated all of the lots in the region, the price system in that institutional context *could* do the job Hayek credits it with of accurately communicating the relative scarcity, and hence the *potential* value, of such assets in the whole region. The law of one price would hold. The price of similar corner lots in different parts of Lima would be closely related and would reflect their highest potential value.

Fostering discovery of new and additional productive uses of assets

A second way in which formal, legal title improves economic calculation is that it brings more kinds of capital items into the market. Hence, it improves economic calculation by expanding the range of capital combinations from which entrepreneurs can choose.

Formal, legal title to a physical asset documents that asset's owner. Accordingly, it establishes that owner as the one who may lawfully divide up and assign to others particular uses of the physical asset. In terms of the common metaphor of ownership as a bundle of rights, formal, legal title establishes in law who is in charge of the bundle.

Consider, for example, the owner of a corner lot somewhere inside the bell jar. To improve the lot, she might get a mortgage on the land, use the funds to construct a building, and then lease the

building to a tenant, perhaps a fast-food franchise. In doing so she has defined three sticks in the bundle of rights to her land. One, created through the mortgage contract, is a contingent ownership right—the right of the mortgage lender to the land if she defaults on her mortgage payments. A second stick in the bundle, which she creates through the lease contract, is the right of the tenant—the fast-food franchise—to occupy and use the land and building, for a specified time. The third stick in the bundle, also created through the lease contract, is her own right to rental payments from her tenant.

Outside the bell jar things are entirely different. Absent formal, legal title—that is to say, absent a clear and generally acknowledged owner—there is no one in charge of the (potential) bundle of rights to an asset. No one may lawfully define the sticks in the bundle; no one may assign those sticks to others by contract. Accordingly, outside the bell jar there are not many sticks in the bundles of rights to assets. De Soto emphasizes that through much of the third world and former soviet nations, owners' rights are limited to little more than occupancy and physical use.

To pick up the last section's example of the corner lot in Lima, the current occupant cannot get a mortgage. He dare not lease it to anyone outside his local circle of trust, if he dares lease it at all. Of course a fast-food franchise, which might bring significant capital and know-how to the property, is not likely to lease land from someone with no enforceable right to lease it.

The importance of formal, legal title to the development of capital, then, can hardly be overemphasized. De Soto is correct that it is the all-important prerequisite to transforming physical things into capital, from which surplus value may be abundantly created. Why? Because if, and only if, it is clear who is in charge of the bundles of rights associated with physical assets can there occur the marvelous defining, *unbundling*, and assigning of various subsidiary rights by contract. These subsidiary rights are the surplus value, the parallel life as capital outside the physical world, that de Soto emphasizes. Formal, legal title to physical assets is the foundation on which is built the complex web of contractual relationships that define the non-physical capital uses of those physical goods.

Consider how remarkably complex this web actually is, with reference only to real estate. Based on real property ownership are mortgages and second mortgages. In the last few decades, financiers inside the bell jar have also developed mortgage-backed securities. Through these, thousands of investors confidently purchase the right to tiny pieces of mortgage payments on thousands of properties they know nothing about. They trust the titling process and the contracts. Another kind of real estate-based capital asset is real estate investment trusts (REITs). Through REITS, thousands of REIT stockholders own their shares of hundreds of properties in far-flung areas, as a way to invest in a diversified batch of properties.

The significance of all this to economic calculation is that in supporting the entrepreneurial development of new capital instruments in giving physical assets a parallel life as capital outside the physical world, formal, legal title gives entrepreneurs more production methods to choose among. In a well-integrated economy, the price of each of these capital assets will reflect the greater array of productive possibilities. The calculations entrepreneurs make based on these prices will lead them to choose production methods that are truly economical.

Absent formal, legal title, there are lower-cost options *potentially* available which are not *actually* available, because business people invent those options only in a robust property system. The paucity of options outside the bell jar means less ability for the price system there to establish the *real* cost of production, given the society's technical capabilities.

Conclusion

Reading de Soto points to a richer understanding of Mises' claim that private ownership leads to rational economics. Economic calculation is not simply an either-or matter, its possibility determined by the presence or absence of private ownership. De Soto's book illuminates the implications for economic calculation of the range of institutions private ownership can mean. At one end of the spectrum, private ownership can mean what it does outside the bell jar—mere possession. In that (crippled) institutional setting, Mises' claims about the importance of private property to economic

calculation and rational economics are entirely valid: As long as informal owners can buy and sell possession rights, even if only within a small circle, (limited) markets for assets emerge, prices are generated, and those prices reflect the assets' economic potential in that uncertain and limited context. The economy will be rational, but far short of its potential.

At the other end of the spectrum, private ownership means what it does inside the bell jar—formal, legal title. De Soto helps us see how this kind of private ownership dramatically enhances the meaningfulness of economic calculation, and thereby economic rationality. Robust, legal, formal private ownership of the means of production extends the markets for physical assets and leads to the proliferation of new capital assets based on physical assets—more sticks in the bundles of rights—giving entrepreneurs more options. The resulting production decisions are more rational in that more human imagination is incorporated; more of the options that people are able to conceive can actually be used. There's more local knowledge, more know-how in the system. Hence, the overall pattern of production is more rational and wealth-producing.

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