Securing Core Principles for Protected Transactions in IDA Countries: Theoretical Foundation

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Securing Core Principles for Protected Tansactions in IDA Countries: Theoretical Foundation[*]

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What are the core economic principles to be implemented for protected transactions in developing and transitional countries to trigger economic development? In recent decades two approaches have been developed which claim to answer this question: (i) *the theory of property rights* or *new institutional economics* and (ii) *the property theory of economics*. The analysis of the institution of property forms the core of both schools. They maintain that property is the most important source of economic activity.

Although economic development is only one of the topics of their theoretical framework, both schools claim to answer Richard Easterlin's seminal question "Why Isn't the Whole World Developed?" (Easterlin 1981, 1). While new institutional economics focuses on the traditional dichotomy of economics between private or individual and common or state property, *both* defined as the right to the physically *use* of *resources* and their alienation, *i.e.* their selling, inheritance, gift giving or any other way of letting, the property theory of economics differentiates between property, defined as the right of *encumbrance*, *i.e.* of pledging as security, and alienation, rights that do not change resources, and *possession* defined as the *only* right to physically use resources. The term possession is not known to economic scholars of past and present, and encumbrance has never been analyzed in the context of an economic theory of property – not even in the theory of property rights.

Therefore, in our presentation of both schools, the property rights theory will be analyzed from the viewpoint of the dichotomy between property and possession (section I) before the property theory of economics, to which this dichotomy is fundamental, will be presented in detail (section II). On the basis of both approaches it will be discussed whether their insights are suitable as recommendations for reform programs of multilateral

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development institutions, especially the the International Labour Office (ILO) and the "Instituto Libertad y Democracia (ILD), Lima (section III).

I. The theory of property rights or new institutional economics[1]

The theory of property rights or new institutional economics was founded by Armen Alchian (1965) and Harold Demsetz (1967), based on Ronald Coase (1937 and 1960) and with antecedents in Carl Menger (1871, 1892 and 1909). Their findings have resulted in a huge, impressive bulk of literature surveyed, together with an assessment of their common framework and its genesis, and sometimes even its limitations and prospects, by Furubotn and Richter (1991 and 1997), Hodgson (1998 and 2003), Williamson (2000), Voigt (2002), and Greif (2003). The state of the art of the theory of property rights as part of new institutional economics is summarized in Ryan (1987), Alchian (1992) and Demsetz (1998). The members of the new institutional school are organized in the *International Society of New Institutional Economics*. Two of them have been awarded the Nobel Prize in Economics: Coase in 1991 and Douglass North in 1993.

In the development of new institutional economics three stages can be distinguished[2]: (i) the "naïve" theory of property rights of Alchian and Demsetz, (ii) the political theory of property rights originating from North and Thomas (1973) and formulated by North (1981 and 1990), as well as (iii) the transaction cost approach to property rights or the new theory of industrial organization as developed by Oliver Williamson (1975 and 1985)[3]. As Williamson's theory does not share in all respect the fundamental characteristics of the two approaches to the theory of property rights, the transaction costs approach will be discussed

[1] The term new institutional economics is due to Williamson (1975, 1) and includes the theory of property rights *per se* as well as the so-called *transaction costs economics* developed by Williamson. In their comprehensive textbook of the school, Furubotn and Richter use both terms more or less synonymously, however, sometimes distinguishing between the "absolute" or "legal property rights" of the theory of property rights and the "relative" or "extra-legal property rights" of transaction costs economics (1997, 67-120 and 121-177 respectively. The distinction between the "property-rights approach" and "transaction cost economics" is also made by Richter (1993, 317 f. and 343); see further footnote 7 below.

[2] The three stages are due to our study of the literature, especially Eggertson 1990, Richter 1993, Richter and Furubotn 1997, and Voigt 2002.

[3] See also the development of Williamson's approach by Grossman and Hart 1986 as well as by Moore and Hart 1990.

only in so far as it is incorporated in the political theory of North[4]. Before we present the approaches of Alchian and Demsetz (I. 2) as well as that of North (section I. 3), the fundamental characteristics of the new institutional economics will be presented (section I. 1). In this discussion, the topics of Williamson's transaction cost theory will be taken into consideration.

1. The fundamentals of new institutional economics[5]

The emphasis of the property rights theory on institutional arrangements for the economic process is not new. The decisive role of institutions formed already the core of the old institutional school, the German Historical School, especially Gustav Schmoller and Werner Sombart, and the American institutional economics of Thorstein Veblen, Wesley Mitchell and John Commons. However, while the old school rejected the fundamental idea of neoclassical economics to take individuals and their preference functions as given, the new school does not challenge these assumption. It does not adhere to the idea of the old school that individuals interact to form political, legal, monetary or other institutions, with their preferences molded by socio-economic conditions. Instead new institutional economics criticizes neoclassical economics for regarding institutions as *neutral* in their effects on economic outcomes and which, therefore, largely ignores institutions. What the theory of property rights attempts is nothing else but to *extend* the neoclassical model of optimizing individuals by explicitly considering institutions, especially the institution of property rights. New institutional economics claims that only an appropriate analysis of these rights will allow to transform neoclassical economics into a mature theory of the market economy.

Not unlike neoclassical theory, new institutional economics regards property rights as an eternal and universal instrument of society to help its members to deal with each other in

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[4] This view is, of course, not shared by all members or the new institutional school. For a clear denial of Williamson's approach as being institutionalist see especially Dugger (1990). In his political theory of property rights, North does not fundamentally reject Williamson's transaction cost theory but criticizes it for methodological reasons: especially (i) Williamson's (and Coase's) inability to define precisely what it is that makes transactions so costly (North 1990, 28), and (ii) Williamson's assumption of enforcement (partners to a contract must be able to enforce compliance at a transaction cost such that the exchange is worthwhile to them) as being imperfect. The assumption does not make enforcement an explicit variable in his analysis and, therefore, gives no hint how to deal with the problems of the *evolution* of property rights, "where the key problems of institutional change, of contracting, and of performance turn on to the degree to which contracts can be enforced between parties at low cost" (North 1990, 54 f.).

[5] The section owes much to Furubotn and Richter (1997), although we do not share in all respect the authors' enthusiasm for new institutional economics.

economic exchanges. These rights exist as soon as two individuals meet for exchange of resources, *i.e.* in all types of society apart from the world of Robinson Crusoe: "This implies that it is *impossible not* to have a property rights system" (Demsetz 1998, 145; our italics). Property rights are defined as an exclusive, transferable and legal right to the *physical use of scarce resources*: "A property right to a good is a right to select among its, and only its, feasible physical uses or conditions". If this "right has the consequent income and wealth designed to a specified person, who can alienate the right to others in exchange for at least similar rights to other goods" (Alchian 1992, 223), it is termed a *private* or individual[6] property right, and a *common*[7] or state property right if it is assigned to all members of society. The latter right is defined as "a bundle of rights that does not include exclusivity of use" (Demsetz 1998, 153). A resource or good to which a private property right applies is referred to as *private property* and, correspondingly, the application of common property right turns the good into *common property*.

Unlike the neoclassical model, new institutional economics does not regard the way by which property rights are allocated and enforced as a costless process but as determined by *transaction costs.* There are inherent difficulties, *frictions* in economic exchanges and, therefore, substantial costs in any attempt to allocate property rights. In the absence of appropriate rights specification, external effects result which have to be internalized by *incentives*. To economize these transaction costs wealth maximizing individuals, therefore, substitute common property rights for private property rights as soon as they recognize that the private rights leave room for unexploited gains of exchanges or *benefits*, *i.e.* that the rights are not used *efficiently*. The question whether this change in property arrangements is triggered by self interest in the form of spontaneous order or imposed on society by civil authority, the State, in the interest of individuals, is the same as whether to prefer the "naïve" theory or the political theory of property rights. Both approaches claim the superiority of private over common property rights.

New institutional economics distinguishes between two forms of property rights: *absolute* and *relative* property rights[8]. While the former refer to the rights of the physical use

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[6] New institutional economics does not distinguish between private and individual rights. However, as has been demonstrated by Heinsohn and Steiger (1996) only in property-based societies individual rights are always private rights. The latter rights do not exist in possession-based societies which only know of individual rights. On the distinction between individual and private rights in different societies see section II. 1 below.

[7] Alchian and Demsetz use the term "communal" property rights which refers to rights in a local community or a tribe. Later authors prefer the more comprehensive term "common" property rights.

[8] To the best of our knowledge the distinction was first introduced by Richter (1993, 317 f. and 343): "There exist two types of property rights: absolute property rights, e.g., over material objects, and relative

of a good, of income from it, of its management and alienation, the latter mean *contractual obligations* that are legally binding.

Two principles of these obligations form the core of the constituency of a market economy (Richter and Furubotn 1997, 123): (i) freedom of contract and (ii) liability from contract. The most important types of contract are the contracts of sales, lease, employment and loan. Their analysis has triggered three types of *economic contract theory*, most of which has been developed by Williamson (1975 and especially1985, 15-84): (i) agency theory, (ii) self-enforcing agreements or implicit theory, and (iii) relational or incomplete theory[9].

The three types of contract theory have in common that they offer an alternative to the neoclassical model of explaining differences between ideal and actual outcomes in a market economy, *e.g.* between marginal costs and prices. While neoclassical microeconomics attributes such an inefficient outcome to monopolistic and/or monopsonistic market behavior which has to be overcome by promoting "more *competition*", contract theory stresses the need for "more *hierarchy*". In a world of frictions, transaction costs and incomplete information rule, "what may be essential to greater efficiency" in markets "are organizational improvement, measures that decrease transaction cost and/or improve incentives, arrangement that reduce risk and promote confidence, and so on" (Furubotn and Richter 1997, 147; our italics). Contract theory claims that a better understanding of this "organizational task" will not only provide insights into what is fundamental for a market economy but also allow to assess the enormous problems former socialist societies as well as the underdeveloped world have to face in their attempts to transform their economies into a free market system.

In contrast to absolute property rights, relative property rights can only be taken away by the obligor in a contract, not just by anybody. Contract theory speaks in this context of *ex post opportunistic behavior* which has to be guarded against by *ex ante measures* implying a special form of transaction costs.

Agency contract theory addresses this problem in the analysis of the so-called *principal-agent* relationship, a contract where the former engages the latter to perform some service on his behalf and delegates some decision-making authority to him, *e.g.* in the relation between stockholders and their management. After the contract has been concluded, *i.e. ex post*, *asymmetric information* arises between principal and agent because the former cannot monitor the latter's actions directly. This relation may trigger the behavior of *moral hazard* by

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property rights, e.g., contractual rights. The 'property-rights approach' deals with the first type, 'transaction cost economics' with the second"; and see Furubotn and Richter 1997, 67-120 on absolute rights (also called "legal property rights"), and 121-177 on relative rights (also called "extra-legal property rights").

[9] The following paragraphs draw on Richter and Furubotn 1997, 121-176.

the agent, *i.e.* that he or she will not act in the best interest of the principal. To guard against the information problem, the principal has to implement some form of *ex ante* monitoring or to rely on a third party, *e.g.* courts of law. Both measure cause so-called *agency costs.*

Implicit contract theory starts from the assumption that, unlike agency theory, not all agency relationships are legally enforceable agreements. In such a case, a relationship between different agents is established by *self-enforcing agreements* or an implicit contract of mutual trust and mutual sanctions. In this type of contract no third party intervenes. The agreements are based on the assumption that agents as individual utility maximizers pay tribute to the slogan "honesty pays more than dishonesty". In case of dishonesty, the honest agent has to bear the risk of the dishonest behavior by his implicit contract partner, the so-called *dishonesty costs*.

Relational contract theory assumes that transactions in a market economy are normally part of ongoing and long-term relationships between agents. These relations are to a certain degree *non-contractual*, *i.e.* implicit, informal and nonbinding. Therefore, self-enforcement agreements play an important part here. Relational contracts allow for (i) *gaps in agreements* between agents which cannot be closed by contract law, especially *bounded rationality*, *i.e.* the limits on individuals' capacity to handle information without error, and (ii) high transaction costs due to the fact that it is impossible to agree *ex ante* on all future outcomes or to verify all of the relevant information to courts of law. To protect against opportunistic behavior relational contracts are established in the form of so-called *private ordering*. Five types are distinguished: (i) self-enforcing agreements with brand-name capital, so-called "hostages", analyzed in *commitment* and *self-interest models*, (ii) the so-called *tit-for-tat strategy* representing a form of retaliatory behavior, (iii) *private third-party-enforced contracts*, (iv) private or public *regulation*, and (v) the so-called *unified governance* as exists in vertical integration of firms. The latter form of private ordering is regarded as the strongest method of protection against opportunistic behavior.

Unified governance is also regarded as one of four types of the organization and *governance structure* of a market economy, the other three being: (i) *market governance*, the main governance arrangement for nonspecific transactions of both occasional and recurrent contracting, (ii) *bilateral* and (iii) *trilateral governance* for occasional contracting, without and with third-party assistance respectively.

All in all, it goes without saying that the transaction costs approach to property rights consist not so much of a new look at the institutions of a market economy but first of all of the system's *organization by hierarchal control*, in which property rights are regarded as a simple function of transaction costs and benefits. What the new institutional model for the market reveals is, indeed, nothing else but the neoclassical model plus what its proponents have termed “organization culture”, the ways and methods of how to establish workable hierarchies.[10] The findings of the model have been applied to establish new theories for the existence of the firm, the market and the State, all of them presented in Furubotn and Richter (1997, 265-434), as well as for the existence of money and monetary institutions by Richter (1989). These attempts for a new explanation of the market economy are, however, only elaborations of Coase’s seminal insights: (i) that transaction costs are the basis for the existence of the firm (1937) and (ii) that the existence and change of institutions are due to the reduction of these costs (1960). Such criticism apart, however, we have to ask: does the extended neoclassical theory of new institutional economics open the eyes for a better understanding of how to transform economies in former socialist societies and the Third world into market systems? Before we can answer this question we have to look more detailed at the new school’s two explanations of the *emergence* of private property rights, that of the “naïve” theory and that of the political theory.

2. The “naïve” theory of the emergence of private property rights: Armen A. Alchian and Harold Demsetz

The theory of property rights as originally formulated by Alchian (1965) and Demsetz (1967) and melt together in Alchian and Demsetz (1973) has been criticized for being “naive” because it does not take care of the political and legal structure without which there will be no evolution of property rights (Eggertson 1990, 249). The founders have never bothered about this criticism, not even in their later writings (Alchian 1992 and Demsetz 1998).

Alchian and Demsetz’ theory is a theory of *private* property rights analyzed as the evolution of private out of common property rights. The latter are assumed as eternal rights existing at all times “in *every* society” (Alchian 1965, 5) apart “from the world of Robinson Crusoe” (Demsetz 1967, 347) which, a trivial insight, is no society. However, as will be demonstrated in II. 1 below, his assumption cannot be verified. What existed – and still exists -- in all types of society, and by the way even in the world of Robinson Crusoe, is *possession*

[10] A theory of organizations formed by entrepreneurs as *agents* who lobby for institutional change has been developed by North (1990) and will be discussed below in the discussion of his political theory of property rights.

but *not* property. The latter institution was created (and abolished[11]) by men at different times in history, mostly but not necessarily in the form of private property.

The "naïve" theorists of property rights, who are not aware of the distinction between property and possession and who never have bothered about the results of historical studies of antiquity and modern times on the rise and fall of property systems, formulate instead the following *"property paradigm"*: it is not necessary to develop a theory of the emergence of property rights *per se* because, as already quoted above, "it is impossible not to have a property rights system" (Demsetz). After all, Alchian and Demsetz are convinced that history of mankind started with common property rights and that, therefore, one has to explain the emergence of private property rights only. Some common rights still exist, and new ones have been established in to-days system of private property, but they should be analyzed from the viewpoint of private property rights arrangements.

Property rights are defined by the Alchian and Demsetz as the physical *use* of scarce resources: "What is owned are *rights* to *use* resources" (1973, 17; our italics). However, this right is not a property right but a right of *possession*. According to the authors, property rights can be assigned to all members of society as common rights or as rights to particular persons as private rights. The latter alternative is regarded as "the most important ownership distinction between state (public) ownership and private ownership"[12] (1973, 18), a distinction we call the dichotomy of new institutional economics for the analysis of economic systems, however a dichotomy that is ill-founded. A well-founded dichotomy is rather the distinction between the existence of property and the non-existence of property, with the prevalence of possession only in a property system (see section II. 1 below).

What is Alchian and Demsetz' fundamental distinction between private and common property systems? In both systems each person is assumed to have the "private" right to the use of a resource, but only in a private property system the person is entitled to also *exclude* others from this use. In a common property system the co-existence of private and common rights, *i.e.* non-existence of the right of exclusion, triggers instability between its members that at the best can be guarded against by *negotiations* which, however, imply high *transaction costs*. Therefore, common rights are *inefficient* and hinder "all private owners",

[11] This insight, however, is not common knowledge, rather the opposite is maintained: "Property never has been abolished and never will be abolished. It is simply a question of who has it" (Pipes 1999, xi quoting a famous historical study of 1988).

[12] New institutional economics uses the term *ownership* as synonym to property. In their property theory of economics, Heinsohn and Steiger speak only of property, not of ownership, because the latter term is ambiguous and means *both* property and possession. Their terminology will be followed in this study.

who are assumed "to have strong incentives to use their property rights in the most valuable way" (our italics), to reap the *benefits* of their rights. Sooner or later, people in a common property system want private property rights to be enforced: "Under a communal right system each person has the *private* right to the use of a resource once it is captured or taken, but only a communal right to the same resource before it is taken. This *incongruity* between ownership opportunities prompts men to convert their rights into the most valuable form; they will convert the resources owned under communal arrangements into resources owned privately" (Alchian and Demsetz 1973, 22; our italics). The alternative to overcome the incongruity between the two rights by eliminating the private rights will not be practicable, because it creates the problem of providing incentives to work as in socialist societies.

Alchian and Demsetz are right in claiming that in a common system both private and common rights exist. Starting from Coase (1937 and 1960, especially 1-5), whose negotiation-transaction costs reducing approach[13] they embrace but which never hints at a clear distinction between property and possession, Alchian and Demsetz do not understand that this system does not refer to rights of common property but of common possession, like in tribal societies or in the command system of state socialism. In these types of society common and private possession exists but never any form of property (see below section II. 1).

How do the authors verify their explanation to advance at a more rigorous formulation of the emergence of private property? As they do not find historical studies that sufficiently support their thesis, they "suspect our main alternative is to initiate studies of our own" (Alchian 1965, 134). To the best of our knowledge, the only study of new institutional economics which could have verified Alchian and Demsetz' explanation is that of North and Thomas published in the same year they formulated their *property paradigm* (1972). It will be discussed in section I. 3 below. Alchian and Demsetz themselves have not presented such historical work. However, Demsetz (1967, 351-352) has tried to find evidence in support of their explanation from anthropological studies published around the dawn of World War I on the development of private property among the Montagne Indians in Quebec.

To verify their theory, Demsetz tells the following story: Private property was highly unusual among the Montagne. The tribe's economic activities consisted mainly of the hunt for food, and for the few furs needed by its own families. With the arrival of European settlers in the 18th century, evidence of territorial hunting arrangements by individual families began to

[13] Hodgson (2003, x and xviii f.) has pointed out that Coase's explanation of institutions out of the reduction of transaction costs by spontaneous actions of rational individuals, an explanation which, other than Coase, also considers the role of the State, has been anticipated by Carl Menger (1871, 1892 and 1909) in his discussion of the evolution of the institution of money, with money as "the most tradable commodity".

be seen. Separate areas were appropriated for families to hunt exclusively, and private property of beaver houses was established by blazoning them with individual marks. Why did this happen? Due to the arrival of the Europeans "the value of furs for the Indians increased considerably" (1967, 352) because they now could be traded for novel goods from the settlers. Therefore, beaver hunting rose sharply which, however, brought the problem of common property to the open: because individuals could not exclude others from hunting, it was in no one's interest to preserve the stock of beavers. Due to the privatization of the benefits from the furs, individuals had an incentive to capture as many beavers as possible leaving to the entire tribe to bear the cost of the dwindling number of the animals. Eventually, the beavers were exterminated, and private rights to hunt them lost ground. In the end, the benefits of private rights to hunt no longer exceeded the costs of the Montagne's common rights. The instability this created for the tribe could have been resolved only by fully developed private rights, *i.e.* the right of exclusion. However, its establishment could not have been achieved either without considerable costs of monitoring and negotiation: transaction costs.

Again, it has to be emphasized that Demsetz' story about the Montagne Indians has nothing to tell us about the emergence of private out of common property rights. The tribal society he is describing, is one of possession, not of property, even not after the arrival of European settlers. Although Demsetz makes a point by demonstrating that, unlike the neoclassical model of competitive equilibrium devoid of institutions, the institution of "property", if not well-specified and, thereby, not triggering appropriate incentives, can endanger the *sustainability* of resources, the hunting grounds of the Montagnes, his arguments would have been more convincing if he had understood that his story is not one of the contradiction between common and private property but between common and individual possession. Demsetz is also right to claim that the settlers' offer of novel goods encouraged the Indians to take up their individual (not private) [14] right to hunt in a greater scale but, again, he does not understand that this right of use is a right of possession, not of property. It would have been interesting to know whether the Indians took their beaver houses or hunting grounds as collateral for loans from a bank in the settlers' society, which in any case must have been a property system, to get money for investing in better methods of hunting. To redeem secured debts would have hindered them from endangering the stock of beavers. But such issues are beyond the horizon of this founding father of new institutional economics.

However, already in 1968 a soon very influential article appeared, "The Tragedy of the Commons" by Garret Hardin. It seemed to confirm Alchian and Demsetz' theory of property

[14] On the distinction between private and individual rights see footnote 6 above.

rights (see its approval by Alchian 1992, 223) by looking at their problem of the incongruity of common and private property rights from a different angle: the stimulus to population by common property and its adverse effects on the environment. Hardin assumes a society of herdsmen, with the right to each of them to put cattle out to graze on a pasture open to all, the so-called *commons*. “It is expected that each tribesman keeps as many cattle as possible on the commons. Such an arrangement may work reasonable” as long as “the numbers of both man and beast” are kept “well below the carrying capacity of land”. Sooner or later, however, population will increase; because herdsmen gain the full benefit of adding one additional animal while the cost of its crazing is imposed on all other herdsmen. Therefore, “each and every herdsman” will be able to support a larger family. As the process continues to keep more and more cattle on the commons, the pasture will be overgrazed. “At this point, the inherent logic of the commons remorselessly generates tragedy” (Hardin 1968, 20). The very actions of rational herdsmen to maximize their gain that the common property system rewards will eventually destroy the resources upon which all depend.

Notwithstanding the indisputable facts on which Hardin’s narrative is based, the destruction of commons in medieval feudal Europe by overgrazing, *i.e.* destroying instead of sustaining resources, it reveals the same fundamental flaw as the anthropological story told by Demsetz. It does not refer to a common property system but to a command society where property did not exist[15]. The system consisted rather of feudal lords and their serfs where the former as *privileged* common possessors of land entitled the latter, against compulsory contributions, to both its individual and common use. In this relationship the serfs turned into individual and common possessors of land, however, *obedient* possessors. Therefore, the unquestionable fact that they did not care equally for their individual and common possessions tells us nothing about the supposed incongruity between private and common property.

It will be interesting to see, whether at least the famous economic-historical study by North and Thomas (1973), the forerunner of North’s political theory of property rights, will confirm Alchian and Demsetz’ approach.

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[15] This typical confusion of property and possession is already at the heart of Karl Marx’ famous story about the enclosure movement in England between the 14th and 16th centuries, which he wrongly analyses as the “expropriation” of “free peasant *proprietors*” who also “enjoyed the *usufruct of the common land*, which gave pasture to their cattle”: “*Communal property* […] was an old Teutonic institution which lived on under cover of feudalism” (Marx 1867, 740 and 747; our italics).

3. The political theory of the emergence of private property rights: Douglass C. North

As mentioned above, North' political theory of the emergence of private property rights attempts to overcome the weakness of the approach of Alchian and Demsetz of not modeling the political and legal institutions necessary for the emergence of private property rights. The political theory originated from North and Thomas (1973) and was developed by North (1981 and 1990). North' work with Thomas deserves attention because it is , together with North' study (1974) of American economic development which, however, adds nothing new to the role of property rights as developed in the book of 1973, the only economic-historical study of new institutional economics that takes up the task of supporting the fundamental assumptions of the theory of property rights.

North and Thomas (1973, 159) refer to Demsetz (1967) as the intellectual origin of the theory of property rights that underlies their economic-historical study[16]. The authors attempt to identify the causes of growth and stagnation of nations from the 18th century to our times. Their investigation results in the thesis that (i) only those countries were successful who, like the Netherlands and England, had "developed a structure of property rights" that "provided the incentives necessary for sustained economic growth", while (ii) those territories failed and remained in a state of "inefficient economic organization" which, like "the Iberian Peninsula in the history of the Western World, and much of Latin America, Asia and Africa of our times", did not master "the reorganization of property rights" (North and Thomas 1973, 159).

Reorganization of property rights means the transformation of common into private property rights. North and Thomas assume that the former rights existed – and still exist -- in all types of society. It is not only in this view that their theory of property rights is identical with that of Alchian and Demsetz. Also their definition of a property right as the right to the *use* of a *resource* is the same. And like Alchain and Demsetz, North and Thomas distinguish the effects of this use in so far only as the rights can be practiced in systems of common or private property, not in systems of possession or property. The authors blame a "common-property resource" for stagnation as well as decline because "each user has an incentive to exploit the *resource* without regard to other users, which results in continual deterioration of the resource. [...] Since *no one owns* the resource there is no incentive to conserve the resource or to improve efficiency in its use" (North and Thomas 1973, 19; our italics). This,

[16] It is interesting to note that, unlike in his second edition (North 1974, especially 18-20), North in the first edition of his historical study of American economic development (North 1966) does not mention property rights at all.

they assume, can only be achieved by changing property rights from common use to "private" (individuals!) use. Such a transformation can, however, neither occur spontaneously, as Alchian and Demsetz assume, nor at will by the ruling class. North and Thomas present instead an essentially "*efficiency* explanation" of the emergence of property rights based on changes in *relative prices*: these changes create *incentives* to construct the more efficient institution of private property. They verify the thesis with the enclosure movement in feudal England in the 13th century. The best land had all been taken up and labor grown relatively abundant, triggering a relative rise of agricultural products and a relative fall of the price of labor-intensive goods: "Since land had become much more valuable, both lord and peasant had reason to seek more *exclusive* use of land and to place more restrictions on its use by others" (1973, 12; our italics).

Notwithstanding these incentives for the emergence of private property, North and Thomas are aware that the construction of this institution not only reduces *transaction costs* of common property but also leads to *new* such costs. They claim that the costs are lowest if the reorganization of property rights is undertaken by the Government, thereby making the need for political and legal structure in the introduction of private property rights a question of how to best reduce transaction costs: "Economic growth will occur if property rights make it worthwhile to undertake socially productive activity. The creating, specifying and enacting of such property rights are costly […]. As the potential grows for private gains to exceed transaction costs, efforts will be made to establish such property rights. *Governments* take over the protection and enforcement of property rights because they can do so *at a lower cost* than private volunteer groups" (1973, 8; our italics).

The study of North and Thomas indeed supports the theory of Alchian and Demsetz by providing the political and legal structure necessary for the emergence of private property rights, although the work's explanation for the intervention of Government, the lower transaction costs, is far from convincing. Although they make a point by stressing that the allocation of resources are more efficient in a society with the regulation of the rights of their use through Government implemented rules, they do not understand that the introduction of private property demands the implantation of laws which go beyond efficient organization. Furthermore, the analysis of North and Thomas does injustice to both possession-based societies and property-based societies. The connection between a lack of efficiency and "no one owns" is without foundation because there is always a possessor – as individual or collective -- in possession-based societies. Efficiency, therefore, cannot be due to a superiority of *private* over *common* economic activity.

In his economic-historical study of 1981, an analysis of economic structure and change from Paleolithic man to the dawn of the first World War, North abandoned the efficiency view of institutions. The persistence of inefficient institutions, illustrated in North and Thomas (1973. 120-132) by the cases of Spain and France where fiscal needs of rulers suppressed private incentives, does not fit in his theoretical framework. Therefore, the author develops a neoclassical theory of the State, with the State as "a wealth- or utility-maximizing ruler" (North 1981, 23), *i.e.* that the ruler always looks at property rights as a right in *his own interest*. This approach takes into account not only that Governments support the emergence of private property rights as soon as they recognize that these rights create benefits to them, but also that inefficient common property rights prevail when Governments devise these rights in their own interest. With this analysis North hopes to explain the widespread existence of common property rights throughout history and in the present that, instead of producing growth, lead to economic stagnation. Again, he does not bother about the question whether those Governments devised of property rights at all, and not of rights of possession.

In his theoretical study of 1990, North tries to resolve a problem discussed in his explanation of inefficient institutions but not given a plausible answer in the work of 1981: why would not competitive pressure by entrepreneurs lead to the elimination of these institutions and emulate the policies of more successful ones? North answers this questions by a theory of institutions, consisting of a combination of a theory of human behavior with a transaction cost theory of exchange that both differ from the accepted ones in the property rights literature. His theory of human behavior abandons the concept of rational man by taking into account that agents frequently must act on *incomplete information* and, therefore, process the information they receive in a way which can lead to the persistence of inefficient property rights: favoring redistributive rather than productive activity, creating monopolies rather than competitive conditions, and restricting opportunities rather than expanding them, like especially in Third World countries and socialist societies[17]. The author's theory of costs of transacting does not simply state that exchanges are costly but asks why. He specifies them as (i) the costs of measuring the valuable attributes of what is being exchanged and (ii) the costs of protecting and policing rights, as well as of enforcing contracts. These *measurement and enforcement* costs are, together with the behavior of agents under incomplete information, "the sources of social, political and economic institutions" (1990, 27).

[17] "Third World countries are poor because the institutional constraints define a set of payoffs to political/economic activity that do not encourage productive activity. Socialist economies are just beginning to appreciate that the underlying institutional framework is the source of their current poor performance" (North 1990, 110).

With his combined theories in mind, North formulates the following thesis: "Property rights are the rights individuals appropriate over their own labor and the goods and services they possess [sic!]. Appropriation is a function of legal rules, organizational forms, enforcement, and norms of behavior – that is, the institutional framework. Because of any property rights structure transaction costs are positive, rights are never perfectly specified and enforced; some valued attributes are in the public domain and it pays individuals to devote resources to their capture" (1990, 33). In his discussion of the institutional framework, North emphasizes the role of *constraints*[18] and distinguishes between *informal* and *formal* constraints.

It is assumed that constraints exist in all types of societies, "from the most primitive to the most advanced": In each and every society "people impose constraints upon themselves to give a structure to their relations with others" that "under conditions of limited information reduce the costs of human interaction compared to a world of no institutions" (North1990, 36). The difference between the two types of constraints is not one of kind but one of degree. Informal constraints consist of unwritten traditions and customs which North calls *culture*. They determine human interaction in tribal societies but co-exist with formal constraints, the written laws, also in the "complex" market societies of the modern Western world. Formal constraints include political-judicial rules, economic rules, and contracts. Political rules define the basic decision structure of the polity, the State, while economic rules define property rights, the right to the use of a resource, the income to be derived from it, and its alienation; contracts contain specific provisions to a particular agreement in exchange to be enforced by a third party, the polity. Political rules "lead to economic rules, though the causality runs both ways. That is, property rights and hence individual contracts are specified and enforced by political decision-making, but the structure of economic interests will also influence the political structure" (North1990, 48). This interaction triggers bargains between the polity and economic interest groups to strengthen the existing structure of rules but equally well to alter "the more basic structure of the polity to reassign rights" (1990, 47), *i.e.* to reorganize property rights.

Reassignment of property rights as the transformation of common into private rights means institutional *change*. According to North, such a change is induced by *organizations* formed by wealth-maximizing *entrepreneurs* who "engage in purposive activity and in that

[18] The notion of constraints does not belong to the fundamentals of the traditional property rights literature as presented *e.g.* by Furubotn and Richter (1997) where it is not mentioned at all. Therefore, constraints have not been discussed in section I. 1.

role are the agents of , and shape the direction of, institutional change”. In the course of furthering their objectives the entrepreneurs “*incrementally* alter the institutionally structure” (1990, 73; our italics), a change which creates new incentives for wealth maximizing opportunities. However, institutional change cannot be achieved without a change in *relative prices*, the explanation developed in the 1973 study with Thomas: “Fundamental changes in relative prices are the most important sources of that change” (North 1990, 84). Some of these changes will be exogenous , such as those in land/labor ratios discussed with Thomas, “but most will be endogenous, reflecting the ongoing maximizing efforts of entrepreneurs (political, economic and military [sic!])” (North 1990, 84).

In North’ theoretical framework institutional change is always incremental. Although he concedes that a change in the property rights structure might also occur as “*discontinuous* change […], a radical change in the formal rules, usually as a result of […] wars, revolutions, conquest, and natural disasters”, the author simply rules out its possibility, *i.e.* without verifying his view by historical studies.[19] Instead he simply denies that discontinuous institutional change ever has existed in history: “Perhaps its most streaking feature is that it is seldom as discontinuous as it appears on the surface” (1990, 90). Therefore, he makes a declaration that, if it is right, would mean that the efforts of reformers in the Third world and transitional countries to implement appropriate property rights could only occur within a period of time too long for their life: “The single most important point about institutional change, which must be grasped if we are to begin to handle the subject, is that *institutional change is overwhelmingly incremental*. Thus, when we consider the demise of feudalism and manorialism, we observe that it consisted of a gradual restructuring of a framework in which the interconnections between formal and informal constraints and enforcement characteristics evolved over centuries” (1990, 89; our italics).

North’ political theory property rights is no theory of any significance for development and transformation policies. In his Nobel Prize lecture of 1993 he may have sensed this himself by warning to be too confident to believe that “an essential part of development policy is the creation of policies that will create and enforce efficient property rights”. The

[19] At this stage one may wonder why North does not mention the possibility of Governments for “a radical change in the formal rules” *at their own will*. After all, as will be pointed out below, such changes occurred in history. Furthermore, in his analysis of enforcement, North emphasizes “the development of the state as a coercive force able to monitor property rights and enforce contracts effectively”. Could the State then not be conceived of as also having coercive force to *implement* private property rights, too? North never raises this question, but is hampered by the findings in his study of 1981, that Governments *per se* only act to further their interests at the expense of their subjects: “No one at this stage in our knowledge knows how to create such an entity. Indeed, with a strictly wealth-maximizing behavioral assumption it is hard even to create such a model abstractly. Put simply, if the state has coercive force, then those who run the state will use that force *in their own interest at the expense at the rest of society*” (North 1990, 59; our italics).

power of polities to "define and enforce the economic rules" does not mean that they also "significantly shape economic performance". The problem is that "we know very little about how to create such polities" (North 1994, 366).

In this lecture, however, he does not question either the underlying behavioral assumption of wealth-maximizing Governments of his political theory. The approach allows for incremental institutional change to private property only that cannot be induced by the polity. And discontinuous change by the State in this direction is ruled out because this would endanger the interest of wealth-maximizing Governments to preserve common property rights.[20] But what about the Napoleonic laws that introduced private property in most of Western Europe in the early 19th century, or the reforms of Stein and Hardenberg which induced the same change in Prussia in this period, or the similar reforms by Tsar Alexander II in Russia and the Tenno Meiji in Japan in the late 19th century, or the land reforms by Syngman Ree 1949 in South-Korea and Chiang Kai-shek 1953 in Taiwan -- not to speak about the introduction of property reforms by the former *nomenklatura*, especially in China in the early nineties after the fall of state socialism? And if a ruling class only purposes its own interest, one has to ask whether it was not overturned by rebellions or wars, like the English feudal lords by the uprising of the Lollards under Wat Tyler in 1371, the starting point for the re-introduction of property in the form of private property in modern times?[21] By the way, much the same rebellions and wars resulted, for the first time in history and intensively discussed by Heinsohn (1984), in the introduction of private property in antiquity.[22]

North' political theory is not a theory of the emergence of private property rights either. To explain the institution of private property, he should have been able to distinguish between property and possession, the fundamental flaw in new institutional economics. What this means for the evaluation of its theory of property rights will be discussed in the following section.

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[20] Therefore, the State will also tend to devise inefficient property rights leading to *"unproductive activity"*: "Because polities make and enforce economic rules, it is not surprising that property rights are seldom efficient" (North 1990, 110).

[21] Of course, the Lollards had no idea of introducing private property. What they looked for was feudal land. It took over two centuries of civil wars between lords and serfs until the English system of private property in land was established, with the first Poor Laws of 1601 as the most obvious sign that a new society had been created. The system consisted of former feudal lords as proprietors of the land, and former serfs as its tenants as well as free wage-laborers engaged by the tenants. The tenants became the first capitalists; see Heinsohn and Steiger 1983.

[22] For a detailed discussion of all these events see section III. 2 below.

4. The fundamental flaw in new institutional economics: The missing distinction between property and possession[23]

The inability of new institutional economics of not distinguishing between property and possession is revealed most clearly in Demsetz' article of 1998 on the state of the art of the theory of property rights. Focusing on the rights to "uses of resources", he openly admits the difficulty to identify the very core of property rights: "They designate the owner as that person or group, as compared to others, that exercises the *most important subset* of exclusive, alienable, and presumptive rights. There is no easy way to generalize 'important subset'" (1998, 144 and 146; our italics). However, confusion of discussion can be avoided, Demsetz hopes, "if there is some understanding of 'ownership'", *e.g.* by looking at the asset *land*: "To have property rights in the land is not necessarily the equivalent of having the land. This is because many rights are normally associated with any given asset, and *subsets* of these rights can be possessed by different persons. When control of rights is separated in this fashion, it is not clear who, if anyone, controls the asset itself. To have the right to till a parcel of land is not equivalent to having all rights in the land" (1998, 145; our italics).

Demsetz never tells who the "different persons" are and what distinguishes their rights to the land. Therefore, instead of enhancing clarity of discussion, he enhances confusion of the subject by desperately looking for "*subsets* of these rights". There exists, however, *no common set of property rights* to the land *that can be divided into subsets*, *only* a common set of *possessional* rights. Each and every asset has the common characteristic only of being "owned" by a proprietor *and* a possessor. And it is *their rights* that are different, *not* necessarily *the persons* to who the rights are assigned. In the case of land the right of property, the right to its encumbrance and alienation, and the right of possession, the right to till, *i.e.* to use the land, can be assigned to one and the same person. But both rights can also be assigned to different persons, *e.g.* when the proprietor of the land rents it to a *tenant*. Then, the latter is the possessor of the land while the former remains its proprietor.

What Demsetz should have looked for is the fundamental quality of property to constitute the right of the proprietor to encumber it for obtaining a money loan. To the best of our knowledge, neither this founding father of new institutional economics nor any other member of the school ever comes close to encumbrance as the all important facet of property that makes the difference, as will be demonstrated in section II. 1 below, between a mere system of production and a genuine economy. Property rights theorists remain stuck in the

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[23] This section draws on Heinsohn and Steiger (2000, 74 f. and 2002, 29-31).

track of possession, in spite of calling it property. However, they have not so far correctly baptized their approach as the *possessional rights school.*

One would expect that, by explicitly looking at the topic possession, a scholar would finally understand its difference from property, and would no longer lump possessional rights under the term property. *The New Palgrave Dictionary of Economics and the Law* of 1998 -- to our knowledge for the first time in an economic text -- excels in devoting an entire entry to possession by a member of the new institutional school, Richard Epstein. Where does it get us? Is it understood that a mere possessional right excludes encumbrance? This possibility is not even mentioned. On the contrary, possession is defined "as the source of all property rights" (Epstein 1998, 62). This statement confirms our view that the theory of property rights merely deals with the aspects of possession when it uses the term property, with the result of a rather vague and confusing thesis: "People own property so that they may possess it, just as they possess it, so that they may use it" (Epstein 1998, 68a). The possibility of a separation between property and possession is seen only when the protection of possession is analyzed in the transfer of possession from one "owner" to another. However, the fundamental economic difference between a title to property that can be encumbered and a possessional right to physical use never comes to mind.

Consequently, new institutional economics never makes the distinction between societies which only have *individual* and common possession and societies that have private and common property titles *in addition* to *private* and common possession.[24] Property, therefore, is also seen at work in tribal and feudal -- especially socialist -- societies where, however, only the relations between individual and common rights to use resources, *i.e.* possessional rights are really analyzed though constantly called property rights (Demsetz 1998, 145; Bailey 1998; Libecap 1998; Pistor 1998; see also Alchian and Demsetz 1973, 23, and North 1990, 36 and 110).[25]

[24] As emhasized in footnote 6 above, institutional economics misses also the distinction between individual and private rights; see more detailed section II. 1 below.

[25] Who could the property right theorists have turned to for advice to learn about a proper distinction between a property-based and a possession-based society? To those people who had transformed former "capitalist" societies into socialist ones. A telling example is provided by the authorities who, in 1945, had to replace capitalism by socialism in the Soviet occupied zone of Germany after World War II. As a general rule the expropriated assets were transferred to a "sacrosanct" so-called *Volkseigentumsfonds* ("People's Property Fund"). A part of it was allocated to a so-called *Bodenreformfonds* ("Agrarian Reform Fund"). Agricultural plots given to former land proletarians were explicitly designed as something distinct from agricultural plots in the preceding capitalist society of East-Germany. Any property operation was forbidden, only possessional rights for the physical use of the land were permitted: "The economic [sic!] units created by this order must neither partly nor entirely be partitioned, sold, leased or *collateralized*", as stated by the Soviet occupied State of Saxonia-Anhalt in article VI of its *Bodenrechtsverordnung* ("Land Law Enforcement Order") of 3 September 1945 (Grün 1998, 541; our italics).

Needless to say that the different approaches of new institutional economics give no hint to the core economic principles to be obeyed for protecting transactions in underdeveloped and transitional countries. Its new look at the market as a system which can be organized most efficiently by a structure of hierarchical interwoven contracts, in which interventions by the State always will result in inefficient outcomes and where “we know very little about to create […] polities ”that “significantly shape economic performance” (North), leaves no room for turning the insights of this approach to property into recommendations for development and transformation policies. In spite of its valuable insights in the necessity to expand the neoclassical model of competitive equilibrium by institutions that demonstrate how the allocation of resources are influenced by externalities, incentives etc. influencing their scarcity and, thereby, relative prices, new institutional economics cannot be taken seriously as long as it does not know that, unlike possession, property is not an eternal, universal institution, but one which has to be introduced *before* the question of common *versus* private property rights can be discussed in a meaningful way. It remains a mystery, why this school never recognized the huge problem of informal, individual possessions of the poor in the Third world and former socialist societies, a problem that Hernando de Soto had identified already in 1986 (see section II. 4 below).

Therefore, we have to analyze how the alternative theoretical framework, the property theory of economics to which de Soto has made outstanding contributions, discusses the question of possession *versus* property.

The so-called economic units did not only entitle but also oblige their possessors to make use of them. This new duty, of course, recreated the typical relation between a feudal lord and his serf. Possessors disobeying the duty were stripped off their individual possessional right to use the land. It fell back to the “Agrarian Reform Fund“ which then transferred it to a *kolchos* type of producer with, tiny individual rights to small plots of land apart, common possession rights only. Thus, an individual *possession* was transformed into collective *possession*, and *not* some *private property* into state property.

Only recently, the “Bundesgerichtshof” (BGH), Germany’s supreme court, has exhibited the expertise missing in the advice of the economic transformation consultants. In its so-called *Bodenreformurteil* (“Agrarian Reform Decision“) the BGH states unequivocally: “By the prohibitions of *collateralization*, partition, sale and lease as well as by the *duty to work the land*, the *property* of the agrarian plots according to the [1945 socialist] agrarian reform was stripped off all the characteristics of property as lined out in civil law“ (BGH 1998, § II.1.c, 8; our italics). All the BGH’s judges miss is the insight that there is no concept of genuine property beyond civil law; see also Grün (1998).

II. The property theory of economics

The property theory of economics was founded by Gunnar Heinsohn and Otto Steiger (1996), with antecedents in Heinsohn (1984), several articles by Heinsohn and Steiger between 1978 and 1995 documented in Heinsohn and Steiger (1999b), as well as in Hans-Joachim Stadermann (1994). The theory was further developed in Heinsohn and Steiger (2000, 2002 and 2004) as well as by Stadermann and Steiger (2001). Similar approaches were formulated independently from these authors by Hernando de Soto (1986, 1997 and 2000), Tom Bethell (1998) and Richard Pipes (1999). All six authors will join to discuss their common theoretical framework at an International Symposium at the University of Bremen in November 2003 (Steiger 2003a), the results of which will be published in a volume to be edited by Steiger (2004).

The presentation of the property theory of economics starts with Heinsohn and Steiger's fundamental distinction between possession and property (section II. 1), followed by a short history of the rise and fall of the concept of collateral in economic theory (section II. 2). The core of Heinsohn and Steiger's framework, the property theory of interest and money, will be outlined in section II. 3, and the approaches to property by de Soto, Bethell and Pipes discussed in section II. 4.

1. Possession and property: Physical use of resources in mere production systems *versus* business operations of an economy[26]

The property theory of economics intends to answer what its founders regard as economic theory's core question and, therefore, as fundamental in explaining economic activity: *What is the loss which has to be compensated by interest?* Gunnar Heinsohn and Otto Steiger completely differ from the answers given so far. Thus, they do neither accept a temporary loss of goods nor a temporary loss of money as the cause of interest. When money — as an anonymized, notified title to property — is created in a *credit* contract, the interest causing loss is the loss of an immaterial yield which they have called "*property premium*" (Heinsohn and Steiger 1996, 15). In the money-creating and the money-forwarding credit contract property has to be encumbered. By encumbrance the freedom of property is temporarily blocked, *i.e.* the property premium is given up.

[26] This section draws on Heinsohn and Steiger (2000, 67-71 and 2002, 9-20).

A property premium arises automatically whenever property titles are added to possessional titles to resources and goods. This is usually done by *discontinuous* change, *i.e.* the change does *not* occur *incrementally* as new institutional economics, especially Douglass North, claims: after revolutions against feudal types of society or by simply applying the laws of property on newly-won or conquered territories which up to then had known, as tribal or feudal societies, only possessional rights. It is a legal act, not previous savings or accumulation of goods, which allows a high level of *per capita* consumption which makes the difference between mere possessional systems of production and a genuine economy which is always property driven or directed by an economic activity the authors call "business operations". Correspondingly, the economy, not production as such, disappears when property is abolished. It goes without saying that their theoretical analysis is of utmost importance for the appropriate establishment of property reform programs in the Third world and transitional countries.

An economic theory deserving this name is wanting to this very day, Heinsohn and Steiger claim, because economists have never caught up with scholars of law who, since the times of Ancient Rome, made great efforts to differentiate between possession and property. Economists did not bother about this distinction because they focus on an eternal *homo oeconomicus* and, therefore, assume that economic activity is inherent in all types of human society.

Mankind, however according to Heinsohn and Steiger, knows three distinctive systems of material reproduction of which only one is occupied with business operations.[27] Reproduction means the production, distribution, consumption and occasionally the accumulation of goods necessary for survival. These three types are:

(i) The *customary* or *tribal* society. It regulates production, distribution and consumption for its *unfree* members collectively by *reciprocity*, *i.e.* by mutual supportive provision of goods that are putatively altruistic. In case of need by one member, each and every of the others has to help him with their goods, without a guarantee that they will get the "loaned" goods. Though belonging to an intertemporal set of activity, such a loan is no credit in kind. It does not generate interest, money, or collateral. There are *no independent* institutions of *law* where the community's members can file a suit to enforce the rules of

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[27] Of course, Heinsohn and Steiger know that their three types of material reproduction are *ideal* systems of society which as such existed in few periods of history only, *e.g.* the command-based society of feudalism before the rise of the first property-based society in antiquity and the reprocity-based tribal society before the arrival of European colonialists. Even the property-based societies of the West reveal some characteristics of possessional-based societies, however, and unlike today's transitional and Third world societies, not as determining factors of their economy.

reciprocity. Only *possession* is known, not property with its capacity to be burdened and encumbered. Possession exists in the form of common and *individual* rights to the *use* of *goods* and *resources* including their returns and *alienation*. They are regulated by custom. No private rights exist. Alienation exists in the form of gifts, assignments and inheritance. Salability, of course, is unknown, because it means the alienation of property rights.

(ii) The *command* or *feudal* society. It is regulated by *coercive redistribution*. Production, distribution, consumption and, occasionally, accumulation are organized by ruling castes or aristocracies. They extract planned levies from a class of unfree serfs. In case of need, these classes are entitled to rations, portions from central storages which they have to fill in advance. The rations, though belonging to an intertemporal set of activity, again must not be confused with credit in kind. They do not generate interest, money, or collateral. In state socialism, the nobility is replaced by a proletarian *avant-garde* which maintains the loyalty of *unfree* "peasants and workers" by guaranteeing them a permanent share of the planned production. It goes without saying that there are *no independent* institutions of *law* where members of a command society can file a suit to execute their shares. Again, only possession is known, not property and its capacity of burdening and encumbrance. Possession exists in the form of common and *individual* rights to the *use* of *goods* and *resources* including their returns and *alienation*. The rights are regulated by ruling castes. No private rights exist. Alienation exists in the form of gifts, assignments and inheritance. Salability, again, is unknown.

(iii) The *property*-based society as a system of *free* individuals abolishes most of the traditional rules of reciprocity and command. It directs production, distribution, consumption and accumulation by *interest* and *money* and *contracts*, with *credit* contracts as the most important. The contracts are always *monetary* contracts charging interest and based on *collateral*. *Independent* courts of *law enforce* the fulfillment of these contracts, *i.e* they execute against the property of debtors not meeting their *liabilities*. In addition to property, *possession* continues to exist. Property and possession exist in the form of common and *private* rights, both regulated by law. Property rights are the rights to *burden* and to *encumber assets*, *i.e.* to pledge them as security, to alienate *commodities* and assets not only as gifts or inheritance but, foremost, through *sale*. Possessional rights are the rights to the *use* of commodities and assets, including their returns.

The difference between customary and command societies on the one hand, and the property-based society on the other, is a principal and not a gradual one. Tribal or aboriginal, feudal as well as socialist societies may run undisturbed for very long periods of time. In any event, they do not entail property but only *possession*. *Possessional rights are restricted to the physical use of resources*. The possession-based societies, therefore, are condemned to a mere *control of resources*. This control is executed through orders that cover the transformation of resources into consumption goods -- including their storage – and their distribution. Occasionally, resources can be transformed into investment goods, *i.e.* means of production. Therefore, *accumulation requires previous savings*, *i.e.* a lower level of consumption goods.

In the property-based society possessional rights exist *in addition to* property rights. Although they are, in no other way than in possession-based societies, restricted to the physical use of resources, they are no longer regulated by custom or ruling castes but by law. The law is valid for each and every member of the property-based society and enforced by independent courts. Therefore, individual rights of possession turn into *private* rights in the sense of *privatus* in Latin, meaning that the rights are not subject to some power relation but to neutral law ruling out such relations. Furthermore, property rights transform mere goods and resources in "moneyed" and, thereby, saleable *commodities* and *assets*. Because of the capacity of assets to be encumbered, *accumulation* can start *without previous savings*.

In the possession-based societies the phenomena of money, collateral and interest are notoriously absent. Centuries of research on tribal societies are summarized: "There is no regular market, hence no prices, hence no mechanism of exchange, hence no room for currency -- still less for money" (Malinowski 1935, 45). The reflux of loaned goods is neither guaranteed nor secured by collateral. Nothing akin to interest is offered to generate the type of reciprocal assistance common within tribes. Therefore, even cattle herding nomads do not focus on the offspring of the animals lent to fellow tribesmen "but were concerned with the loaned [cattle-] capital" (Laum 1965, 60) only. Barter exchange as the commonly assumed precondition of money could never be verified: "Barter, in the strict sense of moneyless exchange, has never been a quantitatively important or dominant model of transaction in any past or present economic system about which we had hard information. / Moneyless market exchange was not an evolutionary stage [...] preceding the arrival of monetary means of market exchange" (Dalton 1982, 185 / 188).Therefore, Heinsohn (1984, 120 f.) proposed to replace the barter paradigm of money by a private property paradigm of money.

Feudal societies were no less intensively explored for money, interest and credit arrangements than tribal ones, but with the same disappointing results. Mycenaean feudalism, which was famous for its frequent use of precious metals, had no idea of the monetary operations which became so "mighty a machine" (Starr 1977, 183) in the succeeding property-based Greek city states: "What we see of the economic system is the activity of the

OVERVIEW ***OF THE DISTINCTION BETWEEN PROPERTY-BASED AND POSSESSION-BASED SOCIETIES***

Possession-Based Societies	**Property-Based Societies**
Possession is the basis of material reproduction in animal, tribal and command societies in which property is missing. *Only* possession does exist, the right who, in what manner, at what time and place, to what extent and by exclusion of whom, may use a good or resource.	**Property** is the basis of material reproduction in the property society ("capitalism", "market economy", "monetary economy") where it transforms possession. Property exists *in addition* to possession.
Possessional rights refer to the momentary *de facto* – not *de jure* – *use* or control of *goods* and *resources* including their returns and alienation. Alienation here does not mean salability but only gifts, assignments and inheritance. *Per se* these rights are not capable of generating a genuine economy, with interest and money as its most obvious characteristics. Ironically, mainstream economics applies the term "property rights" to possessional rights. These rights consist in the form of common and *individual, i.e.* exclusive, rights regulated by *custom* or *ruling castes*.	**Property rights** are *de jure* claims which entitle their holders to the intangible (non-physical) capacities (i) to burden in issuing money against interest; (ii) to encumber as collateral for obtaining money; (iii) to alienate including selling, and (iv) to enforce. Property rights exist as common and *private* rights regulated by *law*. Their holders take possessional rights *de facto* into their service, thereby making them *de jure* too. Therefore, individual rights to possession are always private rights. Property rights transform goods and resources into saleable *commodities* and *assets*.
Means of Regulating Material Reproduction (production, distribution, consumption, and occasional accumulation)	*Means of Regulating Material Reproduction* (production, distribution, consumption, and accumulation)
"Inborn instincts" (animals), customs or *reciprocity*, *i.e.* mutual supportive duties (tribe) and *commands* or plans (feudalism/socialism) as *power* relations of *unfree* persons. (Independent courts of law are absent).	Credit and sales *contracts* as a *legally* formalized network between *free* individuals on *markets*. (Independent courts of law overrule power relations.)
Backing by and encumbrance of titles, interest and money, credit and banks, prices and markets as well as assets and liabilities are absent. Goods produced in blood relations or under orders of ruling castes (nobility, "proletariat's avant-garde" etc.) are distributed for individual consumption, for common storage, and – occasionally – for common investment in means of production. Therefore, storage and *accumulation requires previous savings* or a lower level of individual consumption. Exchange of goods is not a primary task. It takes the form of *gifts* or, as in feudalism, of trade out of stored up items to overcome shortages. An *interest-free* intertemporal lending of *goods* is restricted to periods of need in which blood relatives are obliged to mutual assistance, or ruling castes hand out rations later to be replenished by their subjects.	Property accrues an immaterial yield, the *property premium*. By burdening property for issuing *money-notes* – notified titles to property – in a credit contract, both creditor and debtor have to give up property premium, *i.e.* temporarily lose the freedom to burden or sell it. The encumbrance of the debtor's property enables the creditor *to secure the* money- notes and, thereby, their *circulation*, the burdening of his own property to *back* the notes and to guarantee their circulation in case of deficiency of the debtor. The creditor is compensated for his burdening with *interest*, the debtor for his encumbrance with money's *liquidity premium*, its capacity to finally settle debt and sales contracts. During the period of the loan, creditor and debtor continue with the physical use of the possessional side of their burdened assets. Since money is derived from property (legal titles), and not from possession (goods), *accumulation* can start *without previous savings.*

palace, which exacts produce and no doubt much else from the king's subjects, and doles out rations and materials when something has to be done, with exact notes of what has been received or issued and what should have been. […] *There is no suggestion of money or of any other standard by which values might be compared, items just being counted, weighed, or measured as they stand"* (Andrewes 1967, 29; our italics).

Although after the fall of the property-based economy of antiquity money and markets did not disappear in European feudalism of the Middle Ages, they did not become a dominant model of transaction: "We know that markets existed where the rustics certainly sold some of the produce of their fields or their farm yards to the town-folks, to the clergy, to men-at-arms. It was thus that they procured the *denarii* to pay their dues, and poor indeed was the man who never bought a few ounces of salt or a bit of iron. […] *Trade*, therefore, was not non-existent, but it *was irregular in the extreme*. The society of this age was certainly not unacquainted with either buying or selling. But it did not live, like our own, by buying and selling. Moreover, commerce, even in the form of barter, was not the only or perhaps even the most important channel by which at that time goods circulated through the various classes of society. A great number of products passed from hand to hand as dues paid to a chief in return for his protection or simply in recognition of his power. […] In short, exchange, in the strict sense, certainly played a smaller part in economic life than payment in kind; and because *exchange was thus a rare thing*, while at the same time only the poorest would resign themselves to living wholly on their own produce, wealth and well-being seemed inseparable from authority." (Bloch 1939, 67; our italics).

In the most developed command society -- that of late state socialism -- economic researchers nursed some hope because terms like money and interest, credit and debt were used. However, these notions merely applied to instruments of the commanding authority. They had nothing to do with corresponding notions in a property-based economy. At the best, they were poorly understood imitations -- typically for mere possession-based societies after the elimination of property and also for the more or less possession-based societies of the Third world and transitional countries with their poorly developed property rights. What was called the "state bank" and "commercial banks" formed a mono-"bank" system where the latter were branches of the former. The state "bank" did not hold assets by which it could regulate or even manage the issuing of its "banknotes". Its "assets" were non-tradable liabilities of public households, of administrative and production units. These "titles" did not represent claims to anything. The state bank's "credit" only gave access to those real goods whose production was intended in the plan of the central authority. Parallel to the production of goods, state means of payment were printed and distributed according to the plan in the form of notes of the state bank as well as demand deposits at its branches. These notes and deposits were called "money", but they simply were anonymized ration-cards and interest and collateral played no essential role in their credit assignment. These cards did not give an absolute command over resources but functioned as an entitlement to obtain the centrally-planned and produced goods. Thus, the cards had nothing to do whatsoever with anonymized titles to property that are the money of property-based societies.

Collateral was an alien concept. All forms of property, but not individual or collective possessions, were prohibited. The socialist "firm", therefore, could neither be bought nor sold, nor could it obtain credit by pledging its possessions. Inter-enterprise credit was prohibited, and neither a money nor a capital market could emerge. The credit system was used by the central authority for the redistribution of "cash" surpluses showing up at the producers. The role of what was called "interest" was an instrument of control or incentive to amortize credit and, therefore, negligible. Naturally, in such a system the "debtor" did not face the danger of bankruptcy if he was unable to meet dues. At the worst, a "penal interest" had to be paid, thereby reducing the amount reserved as extra "pay" to directors and workers.

It has to be emphasized, again, that possession does not disappear in the property-based society. Property titles are only added to possessional rights. Every property title has a possessional side, but not every possessional title has a property side. The possessional right determines who may *physically* use which resource or good in what manner, at what time and place, to what extent and by exclusion of whom. The property title has nothing to do with these rights of physical use. Its right is the right to *burden* with a legal claim and to alienate. The legal claim encompasses the *non-physical* uses of encumbering the property for backing money and collateralizing credit, enforcing creditors'claims and selling.

Like Demsetz (1998), Heinsohn and Steiger take *land* as a good example to illustrate the different rights to it, but unlike the former, they focus on the difference between the *use* of a possession title and the *activation* of a property title. In all three societal types — customary, command and property-based — fields are possessionally tilled to yield a physical return. Unlike Demsetz, however, the authors claim that only in the property-based society economic activity occurs. Business operations are not performed with the soil but the fence around the field. The fence, of course, does not stand for posts and wiring of the enclosure, which may be utilized in all three types of society to demarcate the rights to possessional uses. In Heinsohn and Steiger's picture the fence stands for the property title to the field. Thus, a field can be possessionally or physically harvested and non-physically encumbered at the same time. Only the latter operation belongs to a truly economically realm of business.

Within a property-based society the employment of possessional rights differs decisively from merely possession-based societies. Not only do possessional rights no longer refer to goods and resources but to commodities and assets. What is most important is that the use of assets, which is always a possessional right, is interwoven with the right to pledge assets as security, their encumbrance or fundamental property right. In a property-based society an asset as a title to property always has a possessional side. Other than in mere possession-based societies, the possessional right now is a legally enforceable title too. Once an asset has a property side its – possessional -- uses are pressed into the service of defending that side. Whereas in mere possession-based societies possessed resources are only controlled, in property-based societies they are put to an *economic* use. “Economic” means more than efficiency or optimality. In each societal structure human beings -- and by the way even animal species -- may try to handle resources with as little waste as possible or, to use mainstream’s definition of economics, to create an optimal relation between ends and scarce means of alternative uses according to individual preferences. To translate such universal propensities of living creatures into axioms of an eternal *homo oeconomicus* is the unsolvable task of economic theory. A genuine economy does not show the advantage-oriented behavior of an unfettered *homo oeconomicus*, but is the offspring of the institution of property which forces every human being -- altruistic or selfish -- to obey its laws.

2. The rise and fall of collateral as a subject of economic theory[28]

There is no economic theory deserving that name, Heinsohn and Steiger claim, because economists have never come to terms with property. This judgment may sound high nosed but has recently been supported by Demsetz: “Although our theoretical ideas about capitalism have improved as mainstream economics developed, they have never matured into a theory of capitalism”(1998, 144). While Demsetz complains that property rights have received too little attention from the three major schools of economic thought, classical economics, neoclassic economics and Keynesianism, Heinsohn and Steiger blame the schools for the very same reason they criticize the neoclassical theory of property rights founded by Demsetz.

[28] This section draws on Heinsohn and Steiger 2003a.

All schools incessantly employ the term property but fail to really comprehend its formative role. This is due to their assumption, not unlike that of the new institutional school, of eternal and universal property rights [29]. It results in the wrong dichotomy of common and private property, thereby missing the distinction between the eternal and universal institution of possession and the men-made institution of property. Therefore, all economists of past and present resemble a fish which does not know of water before it is pulled out of it. None of the schools can grasp property's unique capacity to be *encumbered* and to serve as *collateral*, yet it is this very capacity that alone creates *interest* and *money*. And with these fundamental characteristics of a genuine economy, economic activity and development, with markets, accumulation and technical progress (but also with crisis), can start as demonstrated by Heinsohn and Steiger (1996, 309-440; and see 2000, 510-513, as well as 2002, 95-111)[30].

Collateral as a subject of economic theory has resurfaced only recently without, however, it being understood as the fundamental premise for economic contracts. This is partly due to the great economic schools' neglect of an eminent mercantilist author, James Steuart, and his seminal contribution to the nexus between good securities and the creation of banknotes. Nearly a quarter of a millennium ago and for the first time in the history of economic thought, Steuart (1767) gave a clear picture of how to solve the entanglement between property, banks and their notes as ready money[31]:

"A number of men of *property* join together in a contract of banking [...]. For this purpose, they form a stock which may consist indifferently of any species of property. / When a *proprietor* of lands gives his bond to a bank, it should be understood, that as long as he regularly pays the interest of the money borrowed, the bank is not to demand the capital. For this bond they give notes, which are considered as ready money, and therefore carry no interest. So the profit of the bank is to receive interest for what they lend, and to pay none for what they owe. What they owe is the *paper* they *issue*. They owe this to the public; and the security which the public has, is the security which the bank received from the person who

[29] Classical economists, *e.g.* Adam Smith (1776, 48 f. and 365-367) and Karl Marx (1867, 747 and 789), speak of common and private property but analyze it as the common and private possessional right of use. Likewise neoclassical economists of past and present, *e.g.* Irving Fisher (1906, 18) and Gerard Debreu (1959, 78) define a property right as a right of an agent to the use of resources. Keynesians economics is "devoid of all political institutions or postulates of property" (Bethell 1998, 30). However, at least John Hicks (1980-1981, 153) pays attention to a fundamental property title, the security offered in a loan contract; see more detailed below.

[30] See more detailed the second part of section II. 4 below. For a more explicit analysis of economic and social development in the Third world based on the property theory of economics, especially the approaches of Heinsohn and Steiger as well as of de Soto, see Ulf Heinsohn 2001, 308-322.

[31] More detailed on Steuart see Stadermann and Steiger 2001, pp. 45-86, and 2004.

borrowed from them. Hence the solidity of banks upon mortgage. Their notes become money, and the whole *property* engaged to them" (Steuart 1767, II, 150 / 603, our italics).

Steuart's new insight does not lie in connecting money to good securities. That was already seen in the preceding mercantilistic "pawn and pledge theory of money". Steuart added the liberation of these securities from their bullion shackles, thereby overcoming commodity money in the form of precious metal coins. Though he does not clearly see that land property against which money is issued constitutes a mere legal title and not a physical piece of soil, his metaphor of converting land into paper money points into this very direction. This becomes clearer in his -- albeit vague -- perception that in a money issuing contract creditor and debtor alike continue with reaping the fruits of their possessions, *i.e.* the physical use of their land. However, Steuart does not go so far as to recognize this use as the capacity of the possessional side of wealth whose property side is employed for issuing money and securing credit.

Why is it of utmost importance that a bank of issue gives "credit upon nothing but the best security" (Steuart 1767, II, 603)? If a debtor defaults, the notes he has received from the bank must be withdrawn from circulation by using up the bank's own capital and, thereby, risking the bank's own default: "When paper is issued for no value received the security of such paper stands alone upon the original capital of the bank, whereas when it is issued for value received that value is a security on which it immediately stands, and the bank stock is, properly speaking, only subsidiary" (Steuart 1767, II, 151).

"Only subsidiary" must not be misread as unimportant. If the securities received for the bank's notes are not of best quality the acceptance of the notes, *i.e.* their *circulation* is endangered. Steuart had observed that in a financial crisis people become reluctant to accept the notes of "banks of subaltern nature" (1767, II, 202) because they are not so well endowed with capital. In such an emergency the redeemability of the notes in the issuing bank's own capital becomes decisive to keep them in circulation. Thus, beyond the quality of the debtors' securities, every note issued by the bank cannot help but encumber its equity. Since Steuart does not occupy himself with the loss for which interest is demanded he misses this burden of any bank of issue. Therefore, a theory of interest deserving that name is not part of his oeuvre.

However, Steuart asks why people are ready *to pay interest*. Why does one proprietor become a creditor who issues money to gain interest while another proprietor encumbers property and pays interest? Would it not be smarter for the latter to issue money against his securities himself, thereby, avoiding the payment of interest? "And for what does he [the debtor] pay that interest? Not that he has gratuitously received any value from the bank;

because in his obligation he has given a full equivalent for the notes, but the obligation carries interest and the notes carry none. Why? Because the one circulates like money the other does not. For *this advantage*, therefore, *of circulation*, not for any additional value, does the landed man pay interest" (Steuart 1767, II, 131 f.; our italics).

As long as a debtor obtains money through a loan from someone else, he is free from the obligation to redeem the notes with his property, whereby he would also forgo his possession. A debtor pays interest because only a bank of issue guaranteeing the circulation of its notes is able (i) to let the debtor keep the possessional side of his collateral and, simultaneously, (ii) does not take away its property side but only enforces its temporary encumbrance.

Looking back on his most popular achievement, the presentation of John Maynard Keynes' *General Theory* by the *IS-LM* analysis in 1937, Nobel Prize winner John Hicks felt a troubling and alarming sense that something very essential in monetary theory always had evaded both Keynes' and his own focus: "We now know that it is not enough to think of the rate of interest as a single link between the financial and industrial sectors of the economy; for that really implies that a borrower can borrow as much as he likes at the rate of interest charged, *no attention being paid to the security offered*" (1980-81, 153; our italics).

However, Hicks does not tell the reader that hardly anybody ever bothered to devote his attention to collateral. The exceptions -- apart from Steuart (unknown to Hicks) -- , to the best of our knowledge, are very few: first of all, the founders of the theory of the lender of last resort-theory of the central bank, Henry Thornton (1802), Walter Bagehot (1873) and Ralph Hawtrey (1932) emphasized, time and again, the necessity for the bank of issue to secure its credit contracts by collateral. Also Jean-Baptiste Say (1803) and David Ricardo (1817) in classical, and Knut Wicksell (1906), Joseph Schumpeter (1911) and Alfred Marshall (1923) in neoclassical economics at least discussed good securities in their theories of money[32]. None of these eight authors, however, came close to Steuart's seminal insights nor did they ever ponder the connection between the employment of collateral and the loss to be covered by interest.

The classical economists, Thornton and Ricardo, had still been aware of Steuart's treatise. Like the latter, Thornton (1802, 244) accepts the necessity of good security for the issuing of banknotes: On the other side, he opposes Steuart's supposed view of good securities as a proper limitation of banknotes. A closer look at Thornton reveals, however. that

[32] See Heinsohn and Steiger (1996 and 2000) on Bagehot and Schumpeter; and see Stadermann and Steiger (2001) on Thornton, Say, Ricardo, Wicksell, Schumpeter and Marshall; and see Steiger (2002) on Thornton, Bagehot and Hawtrey.

he is well aware of the problem of a lack of supply of such property titles in liquidity crises and, therefore, demands from the Bank of England to intervene as lender of last resort to hinder the crisis to turn into bank panic.

In his discussion of such crises, also Bagehot (1873, 187 f.) demands from the Bank of England not to shy away from providing liquidity by every possible means consistent with its safety. Therefore, in its role as lender of last resort the Bank has to obey two rules: to loan (i) against the high market rate of interest in a liquidity crisis, and (ii) only against good banking securities. If the Bank would not follow the second rule by accepting bad securities, it would endanger its reserves and, furthermore, good securities would be withhold, thereby contributing to the lack of their supply discussed by Thornton.

Without explicitly stressing the importance of good security, Hawtrey (1932, 126) emphasizes that a central bank is no less a commercial enterprise than any other bank. Therefore, acting as a lender of last resort cannot mean that it should lend to any bank that needs cash, regardless of the borrowing bank's circumstances because this would imply "risks to its *own capital*" (Hawtrey 1932, 126; our italics).

In their treatise on the role of securities in the history of economic thought, Stadermann and Steiger (2001) have found that, after Steuart, collateral disappeared from classical theory, with – besides Henry Thornton -- Jean-Baptiste Say and David Ricardo as the only exceptions to that rule.

Although assuming, like Adam Smith, that money always has to be a commodity, Say (1803, II, 31) understands, as opposed to Smith, that banknotes, other than mere "paper money" issued by the State, are not created out of nothing:. A sufficient endowment with own capital in highly liquid form as the anchor for keeping a bank's notes in circulation is also well seen by Say (1841, 306). Since, however, this eminent French economist, like all classical authors, does not recognize the economy as a monetary endeavor but conceptualizes it as a web of producers and consumers of goods, he is in no position to carry his insights on money any further. In the end, banknotes are merely seen as a representative of bullion in the form of coins, which to him remains the money proper.

Ricardo (1817, 365), too, knows very well that in the business of banking interest and good securities must be offered to obtain notes in a loan from a bank of issue. This insight is not supposed to mean, however, that "a well regulated paper money" should be created against good securities and interest. On the contrary, paper money issued should be regulated according to the value of the metal which is declared to be the standard. Therefore, he (1817, 59) rejects Steuart's idea of a money without any relation to a standard commodity. Because of his standard good view of money Ricardo (1817, 365) is forced to declare it as *neutral*, *i.e.* not related to real economic forces.

In neoclassical economics, as demonstrated by Stadermann and Steiger (2001), it was only Knut Wicksell (1906), Joseph Schumpeter (1911) and Alfred Marshall (1923) who discussed collateral in their theories of money. The exception of John Hicks apart, Keynesianism always was devoid of such considerations.

Wicksell relegates collateral merely to "the questions of banking technique" which do not deserve a deeper analysis, because the main role of good securities as a "guarantee" of banknotes or "restrictions" imposed on their issue is to document the loans by which the notes are advanced. His analysis is hampered by the fact that he regards only bullion coins as money and banknotes as "in essence the same" as cheques, "since in both cases the bank is responsible for payment or redemption of the note" (Wicksell 1906, 88-90).

As distinct from Wicksell, Marshall (1923, 301) clearly recognizes that banknotes are money, and not a substitute for the payment by money through, *e.g.* real bills. However, his bank of issue is not Steuart's credit bank but the bank of deposit. By depositing bullion coins at the bank, the public lends it "the power to issue notes" (Marshall 1923, 72). In his analysis of the notes issuing credit contract, Marshall emphasizes the necessity of pledging collateral, however, he overlooks the necessity of collateral to keep the banknotes in circulation as had been demonstrated by Steuart. According to Marshall, collateral is only a means to reduce the credit risk of the bank of issue by which it, as a mere financial mediator between its depositors and the debtors who have loaned its notes, simultaneously safeguards the deposits.

In this "stunning" theory of money and interest, Schumpeter first of all wants to disconnect money from goods by emphasizing that the former always precedes the latter (1911, 102 and 112). Therefore, he postulates that money means "the creation of new purchasing power created *out of nothing*" (73; our italics). By applying the neoclassical time preference theory of the rate of interest, with interest as the price for foregoing higher valued present consumption of goods in favor of lower valued future consumption, on this money, Schumpeter (1911,190) then arrives at his own idea of interest: The possession of a sum of money is a means of obtaining a bigger sum by creating new products for the market. Therefore, present sums of money as potentially bigger sum will have a value premium, which also leads to a price premium, the rate of interest.

How does Schumpeter manage to circumvent the importance of collateral in his theory of money and interest? After all, he does not deny its existence: "Some kind of security [...]

makes it much easier for him [the entrepreneur] in practice to obtain credit. But it does not belong to the nature of the thing in its purest form" (1911, 100 f.).

Schumpeter's liberation of fresh money from pre-existing goods presents a seminal insight. His ensuing step from -- indeed irrelevant -- goods to "nothing", however, leads onto a wrong track because economic reality, as will be shown below in section II. 3, is not bipartite -- (i) goods and (ii) nothing -- but a triad of (i) possession, (ii) property, and (iii) nothing. Therefore, Schumpeter does not comprehend what it is that is offered when collateral is pledged. His dictum of new purchasing power created "out of nothing", thus, is not so much a witty point but a clever evasion of answering the question where money comes from. Moreover, he cannot point to a loss for which a creditor has to demand interest. Not unlike the classical theory of interest, Schumpeter focuses on a possible gain of an indebted producer who by making a profit will become able to pay interest. However, a demand for interest is independent from the future profit and has to be paid under any circumstances.

It goes without saying, that the theory of property rights never discusses encumbrance and collateral. The terms are not even mentioned in their elaborated theories of economic contract. By imprisoning possession in the term property and leaving property entirely unattended, new institutional economics therefore had to give way to the school of *credit rationing* for collateral to make a comeback. Whereas the most comprehensive compendium of the economics discipline, *The New Palgrave Dictionary of Economics* of 1987, does not yet carry an entry on "collateral", *The New Palgrave Dictionary on Money and Finance* of 1992 eventually tries to fill this void (Kanatas 1992, 381-383). The growing insight in the 1980s that neoclassical assumptions about market exchange of goods are in obvious contradiction to phenomena in the credit market leads to the reappearance of collateral in economics. For nearly two centuries the credit market had been analyzed like any market for goods, *i.e.* that the price on the credit market, the rate of interest, is determined solely by demand and supply of credit. In the famous 1937 debate on "Alternative Theories of the Rate of Interest" with Keynes, it was Bertil Ohlin (1937, 424 and 427) who most vigorously takes this position.

Nearly three decades later, John Hicks observes that "there will be cases in which a firm is willing to borrow, at the usual rate of bank interest, but in which the bank will be unwilling to lend, because it is too uncertain of the firm's capacity to repay. Thus the banks' *loans* will be *restricted*, at any given rate of bank interest, by the bank's concern for the solvency of its debtors" (1965, 285; our italics). Because such restrictions cannot rule out the occurrence of bad debts, Hicks looks for a measure to protect the bank's assets. Since collateral is not on his plate he postulates that "there must be a difference to cover bad debts [...], a rate of interest which is in excess of what it [the bank] pays" (1965, 285 f.). Thus comes to the world an explanation why banks earn money by charging a higher rate than the rate at which they borrow. As mentioned above, Hicks later is awestruck by the "security offered" (1980-81, 153) by debtors.

What Hicks could not solve was taken up again as a subject, for the first time after Steuart, by the school of credit rationing leading to the 1992 "collateral" article by George Kanatas. The Nobel Prize winner of this group, Joseph Stiglitz, outlines this approach as follows: In the market for goods, an excess demand is, indeed, met in the short run by an increase of prices, and in the long run by a rise of supply, induced by the short run rise in prices, leading to a reduction of prices. In the credit market, however, an increase of demand met by a rise in its price, the rate of interest, would lead to the problem that interest is only a *promised* price. Other than the supplier of goods, the creditor has to take into account that the ability of the debtor is directly correlated to the level of the rate of interest promised. In the worst case the level of interest settled upon may push the debtor to bankruptcy and pull the creditor with him. Supposedly this risk is circumvented by "credit rationing" (Jaffee and Stiglitz 1990, 854) which requires a ranking of debtors according to their creditworthiness. The criterion for this worthiness is provided by information on the assets potential debtors can pledge as collateral.

However, such a procedure of rationing leaves credit rationing theorists uneasy. After all, as stressed by Kanatas, there is no systematic place for it in a theory of free market exchange. Collateral, to begin with, is not exchanged. It can only be exchanged when the debtor does not fulfill his obligations. Because of this embarrassing fact, the credit rationing school is forced to concede that there is "little definitive evidence on the relative economic importance of the [...] explanations regarding collateral" (Kanatas 1992, 382b).

3. The property theory of interest and money: Gunnar Heinsohn and Otto Steiger[33]

Economists' bewildering failure to distinguish possession and property and the neglect of collateral are due, according to Heinsohn and Steiger and outlined already in section II. 1 above, to their more common failure to distinguish between the character of goods and

[33] This section draws on Heinsohn and Steiger 2003a as well as 2000, 93-97 and 2002, 95-111.

resources in different societal structures: the three distinctive systems of material reproduction of (i) *custom* or *reciprocity* societies (tribes), (ii) *command* or *feudal* societies (including state socialism) and (iii) *property*-based societies. Only in the latter there exist two types of return: (i) the return of the physical use of the possessed goods and resources, *i.e.* a material yield, and (ii) the return of the title to the property of the goods and resources as assets which is an immaterial yield. The starting point for their understanding of an *economic system* is the latter return which they label *property premium*.

The concept of property premium leads to a theory in which interest and money are interrelated by simultaneously being explained out of property. Like in Keynes' monetary theory of the rate of interest, interest is tied to money, thereby overcoming the flaw of the neoclassical theory of interest to separate it from money. Unlike Keynes' theory, however, the property theory does not presuppose the existence of money. Keynes' failure to leave money itself unexplained leads to the fatal flaw of explaining interest out of money which, however, has already been created against interest. Thereby, also interest is left unexplained. Interest, Heinsohn and Steiger claim, can only be explained out of property.

Money's explanation out of property, the authors state, overcomes the flaw of neoclassical monetary economics to look at money as merely an instrument to facilitate exchanges, thereby supposing its neutralility *vis-à-vis* the economic process. On the contrary, by emphasizing that money is a means to fulfill contracts, into which agents enter with varying willingness, they show its non-neutrality. Furthermore and unlike both neoclassical and Keynesian economics, Heinsohn and Steiger look not simply at money as something whose volume has to be controlled and kept scarce by the refinancing rate of interest determined exogenously by the central bank.. By emphasizing, in addition, the property foundation of central bank money, they address the question of its quality, thereby overcoming the failure to assign the characteristics of genuine money to everything that is called money in underdeveloped and transitional countries. In these societies, the question of how to create a genuine money is tied to the question of whether the institution of property has been developed appropriately, *i.e.* the overcoming of the merely vague possenional rights by which the institutions of these countries are characterized.. It is the conviction of the authors that property reform programs of multilateral institutions, which are not based on a monetary system taking care of the question of how to create genuine money, are doomed to fail.

A title to property, *i.e.* an asset, Heinsohn and Steiger state, never comes naturally. It can only be brought about by a *legal act* – implemented from above by the State or from below by revolutionary movements -- , an act which by definition is intangible and initially does not alter the possessional state of resources. As soon as property is created by a powerful -- indeed *ex nihilo* -- , it carries the unearned property premium. This premium -- it has to be stressed time and again -- does not derive from the physical use of resources. Nor does it accrue from some pre-existing money.

What is the meaning of property premium? It is a non-physical yield of security inherent to assets. It allows proprietors to enter credit contracts and is a measure of the potential of individuals to become a creditor or debtor. In these contracts property has to be *burdened* by the creditor and burdened in the form of *encumbrance* by the debtor. Burdening does not only entail encumbrance as a claim on a parcel of real property which is usually on record. Every agent of economic activity also bears a charge over his unencumbered assets because this "own capital", the surplus of his assets over his debts, has to compensate the deficiencies of his debtors. Only the pure *rentier*, that means an agent who stays outside any economic activity, has his assets not only unencumbered but altogether unburdened.

Already with burdening and not only with encumbrance, which other than burdening entails specified and recorded exposure to enforcement, the freedom of property is blocked, *i.e.* the property premium is temporarily given up. In this period property is no longer a free title. Thus, its further burdening is limited. And an encumbered property title cannot be charged a second time.

An unburdened asset entails the capacity of a *creditor* to issue anonymized, *notified* titles to his property, *i.e.* to act like a *credit bank of issue* creating *money-notes* by *backing* them with its *own capital.*

By creating money the creditor burdens his assets (property), *i.e.* blocks his freedom over these titles for the time of the loan contract. Property premium also entails the capacity of a *debtor* to borrow the money-notes by pledging titles to his property as security, thereby encumbering it. In both cases goods and resources are neither transferred nor touched. Creditors and debtors continue to acquire the returns of the material yield due to the possessional rights to their resources. Credit operations, thus, never interfere with the physical use of resources. They only deal with titles to property.

In principal, every proprietor can as a creditor issue anonymized claims against his property. All these types of money-notes take the form of transferable documents which have to be *redeemable* in the issuer's property because otherwise they would not *circulate.* However, in the evolution of money, both in antiquity and early modern times, only those creditors survived as issuers of money-notes who as solvent proprietors, *i.e.* people with a high ratio of own capital or equity, established strong *credit banks*.

By burdening and, therefore, blocking property in the money issuing contract, the credit bank gives up immaterial property premium in exchange for a specified amount of money-notes promised by its debtor: *the rate of interest*. The debtor, in addition to this promise, has to *secure* the refunding of the loan and, thereby *the circulation of the notes*, through giving up property premium by encumbering his property: the pledging of *collateral*. Thereby, the property premium of the creditor materializes into interest, and the collateralized property premium of the debtor is turned into *liquidity premium* attached to the money-notes he receives. The collateralized property of the debtor must be at least equal in value to the notes loaned to him.

The credit bank cannot help but to establish its own *standard* in the very moment it issues notes or *money proper.* Therefore, Keynes (1930a, 3) was right in his insistence that money proper can only exist in relation to a standard of measurement, his *money of account.* This standard must reckon the issued notes in terms of an abstract unit necessary for denominating their amount in the debt contract in which they are created. It must not be confused with a standard of measurement which is derived from a standard physical good as *unit of account* or *numéraire* as in neoclassical theory.

In the neoclassical model of a barter economy the commodity chosen as unit of account is assigned the price *1 (one)* and serves, thereby, as the *nominal* anchor for the prices of all other goods. However, this anchor can only help to express their exchange ratios or *relative* prices. In the truly monetary economy based on property, the credit bank does not need a commodity selected as a nominal anchor. Instead it issues -- denominated in its money of account -- money-notes as anonomyzed claims to its property, but never to its possessional goods. *Uno actu* with the credit bank's setting a money of account by granting a loan, all property titles and contracts, contracts of credit, sales, lease and employment, receive prices in this standard and are, thereby, nominal or *money* prices.

There is no issuing of money-notes, Keynes' *money proper*, which are not simultaneously backed by encumbered debtor-property. This means that the creation of money cannot be separated from the process of loaning it to a proprietor-debtor. Thus, both the issuing of money-notes and the establishment of a loan contract occur *uno actu. Money is created in a credit contract but is not itself a credit*. Interest settled in this contract goes to the credit bank who by issuing notes redeemable in its property, *i.e.* its own capital, has lost property premium which must be compensated. The notes go to the debtor who also has lost property premium but who at the same time not only has gained the loaned money's liquidity premium but, in addition, preserved his right to use the possessional side of the collateral pledged to the credit bank. As long as the debtor fulfills his obligations, the bank is not allowed to touch the collateral, *e.g.* by using it for redemption of its notes. This has to be done by the bank's own capital. Therefore, interest is not only a compensation for the credit bank's loss of property premium but stands simultaneously for the fact that the latter does not gain the debtor's property premium.

This is why interest is demanded by the credit bank and why it is paid by its debtor. In other words: why only the *loan* of money-notes or liabilities of a debtor carry interest and money notes *per se* or liabilities of a creditor none. James Steuart (see section II. 2 above) has called the difference between both types of liabilities the *"advantage of circulation"*. Stadermann and Steiger (2001, 69) have brought out this advantage as follows: *"Debtors pay interest because only the bank [of issue] is able to let the debtor keep the possessional side of his collateral and[at the same time] guarantees its property side."*

Heinsohn and Steiger's thesis, that property has to be blocked temporarily for the issue of money, also pertains to the case of "non-redeemable money" in the modern two-stage banking system where the credit bank of issue is the central bank, with the monopoly to issue notes, and the debtor its counterparty commercial bank. Both parties have to hold unburdened property or assets: (i) the commercial bank in the form of good securities to be pledged as collateral so as to enable the central bank to secure its loan and, thereby, the circulation of the notes issued in this contract, and (ii) the central bank in the form of own capital or equity to guarantee their circulation in the case it has to withdraw them when the commercial bank fails to pay back the notes it owes the central bank. The central bank's own capital also guarantees redemption of the money-notes, although in the two-stage banking system, as distinct from a one-stage system with private credit banks as issuers of money, any holder of the central bank's notes is no longer allowed to redeem them today. This right is restricted to the counterparties of the central bank, the commercial banks, who redeem the money loaned when they refund their credit. In this case, the central bank has to return to them their good securities. If their loans have turned into bad loans, the central bank has to employ its own capital to withdraw the notes issued to the bad bank *from circulation* and, thereby, to *guarantee the circulation* of the notes issued to the solvent banks.

In the two-stage banking system, too, both parties in the money-creating contract temporarily lose their property premia: the central bank loses its property premium without gaining the commercial bank's and, therefore, *demands interest*, while the latter's loss of property premium is *compensated* by the liquidity premium of the money lent from the former. This enables the commercial bank to give up its money, *i.e.* lose its liquidity premium, by loaning it at *another*, higher rate of interest than that paid to the central bank. It goes without saying that Keynes' liquidity premium or *monetary* theory of the rate of interest, as developed in the *General Theory,* overlooks the rate of interest *charged by the central bank* as the creator of money. The latter rate exists *before* liquidity premium can be transformed into interest *charged by the commercial bank* who, like any other agent in the monetary economy, cannot create money but has to lend it against interest before it can loan this money anew against interest. Therefore, Heinsohn and Steiger claim, "Keynes' explanation of the rate of interest is like a pig with a fiddle" (2003, 19).

It has to be emphasized, time and again, that it is only the immaterial property premium which gives rise to the material yield of interest *on* money loaned as well as the immaterial yield of liquidity premium *of* money hold, *in addition* to the material yield of the physical use of possession. In the money-creating contract, creditor and debtor retain their material possessions, whose immaterial property titles are pledged to secure the credit and, thereby, the circulation of the money-notes and to guarantee their circulation in case of the debtor's default. Both continue with their possessions' capacity to earn a material yield which exists beyond their property side, *i.e.* the immaterial yield of property premium. Therefore, due to the use of collateral, goods are never transferred in a loan contract as the neoclassical theory of the rate of interest suggests.

Backing by own capital and securization by collateral, property titles, are the basis of the only system of material reproduction which with due right can be termed an economy – the property-based system. These titles are not only the *fundamental requisite* for the establishment of a genuine monetary system but also *for any economic activity that triggers development*: business operations, markets and competition, credit and interest, prices and profits, capital, free wage-labor and entrepreneurial production, as well as accumulation and technical progress – a development which, however, also implies the other side of the medal: market failure, bankruptcy, crisis, unemployment and missing social security as likewise unavoidable outcomes of the property-based system. Therefore, Heinsohn and Steiger develop their property theory of interest and money into a coherent property theory of economics which, however, does not neglect the State as a necessary institution both for the establishment and survival of a property-based economy.

To start with, the authors emphasize that every agent in the property-based economy needs a genuine money for his business operations. Therefore, what ultimately constitutes economic activity is the credit contract by which money-notes are created by a bank of issue and forwarded to a commercial bank that cannot create money. The money created is a genuine money only if (i) the contract does not charge alone interest and repayment but also demands the loan's securization by collateral of the commercial bank to , and if (ii), in addition, the contract is backed by the property titles of the bank of issue, its own capital.

The credit contract between the bank of issue and a commercial bank is followed by the loan contract between the commercial bank and a non-bank, most prominently a *producer* or entrepreneur, in which the former forwards the money loaned from the bank of issue as *capital*, again against interest and collateral by the producer and secured by the bank's own capital. Capital are not the "capital goods" or "real capital", assigned to the means of production by neoclassical economics, but only the money advanced: "Therefore it is not necessary for anyone to abstain from consuming pre-existing goods or to save them in order that real capital can emerge. The advanced money proper never represents existing goods possessed by someone, it represents immaterial property titles. *They are encumbered but never transferred*" (Heinsohn and Steiger 2000. 93).

The producer has, in a first step, to organize an always *monetary production* of goods, *i.e*. money-priced quantities, by buying likewise moneyed quantities of means of production as well as by engaging *free* wage laborers in *employment contracts* in which *money wages* have to be paid. In a second step, the indebted producer has also to sell the monetary goods as *commodities* in *sales contracts* on the market to raise at least the money to fulfill his obligations to discharge the loan and to pay interest. The market, therefore, is not an institution where the rights of the use to goods are exchanged to the mutual benefits of their possessors, as the property rights theory assumes, but an institution to gain sales contracts for money. In these contracts rights of persons are transferred in their role of both proprietor and possessor.[34]

To pay interest the producer must be able to generate a value surplus in the monetary production, the rate of *profit*. Therefore, interest-generated profit brings about the *accumulation* so characteristic of a property-based economy.[35] Thus, unlike in mere possession-based societies, this mechanism does not depend on a previous accumulation of saved goods: "The dynamics so typical for property-based societies are disconnected from an endowment of resources. They wholly depend on immaterial titles to property created *ex*

[34] In the sales contract the buyer becomes the proprietor of the commodity only after fulfilling the obligation to pay the demanded price. Before the fulfilment of this obligation, he is only a possessor of the commodity, and as such must pay interest like a debtor in a loan contract. If the buyer does not pay the commodity at all and uses it up, destroys it or transfers it to another person, the seller can enforce a title into his property.

[35] This statement must not be confused with the popular thesis that investments in real capital and, therefore, accumulation are due to already existing profits, *i.e. financed* by profits. This can occur, of course, but typically investments are financed by a money loan. Only if the producer is able to pay the interest on the loan, his investments will turn into accumulation.

nihilo" but burdenable for the credit issue of money proper and encumbrable for its loan as capital (Heinsohn and Steiger 2000, 94). The possibility for profits, and thereby accumulation, can be enhanced by *competition*. For Heinsohn and Steiger competition means, besides the introduction of innovative products, first of all a producer's look for and application of *technical progress* in the form of labor-saving techniques of production. Why labor-saving methods and not methods that save money for capital goods? Money paid as wages in an employment contract that, like the credit contract, always must be fulfilled without any guarantee of entering a sales contract, is irredeemable lost, while money paid for capital goods can to some extent be redeemed because, unlike the laborers, they are the producer's property. Furthermore, capital goods c an be acquired on credit, thereby, other than labor, not requiring the full cash outlay.

Accumulation is not a one-way street. It can be intensified or brought to a standstill or turned into *stagnation* by and in the wake of *business cycles.* To explain the latter, the authors focus on collateral as a measure of an indebted producer's *creditworthiness* as well as the *willingness* of the producer to run into debt and, thereby, risking his collateral, *i.e.* its property premium. The good securities debtors have to pledge to get access to credit have no material or eternal value but are, as assets, always subject to *market valuation*, which is determined by the expected rate of profit and the market rate of interest. The value of assets increases (decreases) when the rate of profit rises (falls) and the rate of interest falls (rises). A *boom* , therefore, starts as soon as the value of assets that can be pledged as collateral rises because it increases both the creditworthiness of debtors and their willingness to become indebted. Correspondingly a *recession* may occur, and eventually lead to a *crisis*, by a devaluation of property titles pledged as collateral, with the risk of turning debts into bad loans. Good securities, then, are more scarce than ever.

In such a case interventions to turn the tide are mostly helpless because there is no institution in the property-based economy which can supply good securities. The only resort would be the State by risking the taxpayers' money, however, without a guarantee that they can be redeemed (Steiger 2002). The State is not only the necessary institution to create and implement property laws and enforce property rights by public-created but independent courts of law. It is also the only institution that can safeguard the always crisis-ridden economy. This also holds true for the State as the only institution in the property-based society which can safeguard a system of social security that the mechanisms of the economy itself never can guarantee sufficiently.

4. The approaches to property by Hernando de Soto, Tom Bethell and Richard Pipes[36]

The approaches to property by Hernando de Soto, Tom Bethell and Richard Pipes are strikingly similar Heinsohn and Steiger's property theory of economics[37]. In addition, all these authors demonstrate that the institution of property is not only the condition *sine qua non* for a genuine economy but also for the institution of *liberty.* It is only with respect to their emphasis on the economic and liberty aspects of property that Pipes, *e.g.* differs from Heinsohn and Steiger. As the title of his book of 1999 shows, *Property and Freedom*, Pipes is explicitly concerned with property as a pre-condition for liberty; however this relation is not neglected in Heinsohn and Steiger's discussion of the property-based economy either (see section II. 1 above). And Pipes does not neglect to look at property as a pre-condition for economic activity. Also Bethell and de Soto discuss both aspects. In the multilateral institution for property reform programs, the Lima-based "Instituto Libertad y Democracia" (ILD) founded and led by de Soto, liberty is part of the name. Bethell and Pipes are concerned with the theory and history of property *per se*, while Heinsohn and Steiger in their historical and theoretical discussion of property emphasize the connection between property, interest and money. De Soto is most concerned with property reform programs in the Third World and in transitional countries but his programs are discussed in a historical-theoretical context.

The differences in emphasis may be due to the fact that, unlike Heinsohn and Steiger, neither Bethell nor Pipes and de Soto are academic economists. Both de Soto and Bethell studied economics, but the former worked most of his life as a manager of international companies and institutions while the latter served as a journalist at a well known American newspaper. Only Pipes is an academic, however not an economist but a historian. While the approaches of Bethell, Pipes and de Soto are influenced by each other[38], they were developed as independently from Heinsohn and Steiger as their theory from those of Bethell, Pipes and de Soto. However, in his most recent work de Soto (2000, 56 and 218; and see 2003,) has recognized the striking similarity between his approach and that of Heinsohn and Steiger and accepted their property theory of interest and money.

In terms of terminology Pipes is closest to Heinsohn and Steiger by clearly distinguishing possession from property: "*Possession* refers to the physical control of assets,

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[36] This section draws on Steiger (2004a, 2004b, 2004c, and 2004d); see also Betz (2003).

[37] This has been recognized by Heinsohn and Steiger 1999a, 52, 2001, 205 f., and 2002, 20.

[38] See Bethell 1998 (8, 16 f. and 137 on Pipes, and 12, 27, 186, 195-200, 202 f., 337 and 340 on de Soto), Pipes 1999 (281, 286 and 288 on Bethell, and 236 on de Soto), and de Soto 2000 (56 on Bethell, and 177 f. on Pipes).

material or incorporeal, without formal title to them: it is ownership *de facto* not *de jure*. It is customarily justified by prolonged use and/or inheritance from ones progenitors what in English law is called 'prescription', and asserted by physical force and tacit community support. […] Through most of history and in many parts of the world today, assets are held in this form. *Property* refers to the right of the owner or owners, formally acknowledged by public authority, both to exploit assets to the exclusion of everyone else and to dispose of them or *otherwise*" (1999, xv; last italics ours). From the viewpoint of Heinsohn and Steiger both definitions could have been more detailed. The definition of possession only holds for possession-based societies. In a property-based society possession is not only possession *de facto* but also *de jure*, *i.e.* no longer an individual right only but a *private* right. And the definition of property could have been enhanced by telling what the disposal of assets by "otherwise" means. The important property right of encumbrance is not discussed.

Unlike Pipes, Bethell (1998, 25) does not distinguish between possession and property but between "three configurations of property rights: private, communal and state. Private property decentralizes ownership, conferring upon an individual or individuals the rights to use some good and to exclude others from doing so. […] They can sell their property rights to others and retain the proceeds. With communal property, the rights to some good are shared in an undefined fashion, by a definite or an indefinite number of people. […] With […] state property, the managers who control access to it are employed and salaried by the state and legally cannot profit from the disposal.". This sounds much like the definition of property rights by new institutional economics, a school which Bethell praises with due right because it had discovered that property rights are the foundation of economic activity.[39]

However, Bethell's approach is very different to the property rights theory, especially the political theory of North. While North looks at common property as an eternal, universal institution out of which private property emerges by incremental changes due to an interaction between an always existing economy and a governmental-legal structure, with the former shaping the latter, Bethell, like Pipes, does not take property for granted. He does not deny "that the influence flows in both directions, but the former – *the influence of law* over economy – *is by far the most important*" (1998, 26; our italics). Quoting de Soto's

[39] "It's remarkable that as recently as 1981 'property rights' was thought of as a new 'field' in economics. In fact, property is not so much a field as it is a foundation for all fields of economics" (Bethell 1998, 310). In the mid-1970s dominant neoclassical theory still had avoided to specify the institutional rules that encourage economic activity: "One winner of the Nobel Prize in economics said in the 1960s that the structure of property rights has no effect on people's behavior" (Bethell 1998, 28). Another one, Paul Samuelson, "skirted questions of ownership to a paragraph under the rubric of 'capitalist ideology' ", and still another one, Robert Solow, "referred to Proudhon's 'insight' that 'property is theft' " (Bethell 1998, 8).

explanation of economic backwardness in the Third world (de Soto 1993), Bethell emphasizes that "the law has long been *'the missing ingredient'* in the economic discourse" (1998, 27; our italics).

De Soto's explanation of the causes of underdevelopment in the Third World and former socialist societies is strikingly similar to the approach of Heinsohn and Steiger, however, with a different emphasis. While the latter focus on property, with its right of encumbrance as the basis for economic activity and then discuss its absence in developing and transitional countries, de Soto starts with the absence of property in these societies and then arrives at a theory of what triggers economic activity. Instead of using the terminology of possession and property, he speaks of "informal" and "formal" property but his distinction is the same as in the theory of Heinsohn and Steiger.

Notwithstanding our objections against the approaches to property by Pipes, Bethell and de Soto, they all make most important contributions of our understanding of this institution as the fundamental requisite for economic development and property reform programs.

The value of Pipes' contribution lies in his economic-historical foundation of the decisive characteristics of what makes a society look like in which the institution of property, both common and private property, is not known. He emphasizes that property is not an eternal, universal institution but created and abolished by men at different times in history, like the establishment of private property in Russia in the wake of the Emancipation Edict of Tsar Alexander II in 1861 and its elimination in the wake of the Bolshevik Revolution of 1917. Russian history is the main focus of Pipes' study of the institution of property. Already in the seventies he arrived at the seminal insight, thereby contradicting the view of new institutional economics that, unlike in the Western world, even in today's Russia "it is not the presence but the absence of property that is taken for granted" (Pipes 1999, xi): "Social organization, as exemplified by the *rural commune* and the *artél'* [co-operative association] was, in the Slavophiles' opinion, the *natural* form in which Russians' social instincts expressed themselves. *Legality* and *private property* were *alien* to the Russian spirit" (Pipes 1974, 267; our italics).

Therefore, Pipes is able to present the obstacles to property reform programs in the Third world and transitional countries. People to which private property, legality and freedom rights is alien will be hostile to the implantation of a property rights system. Instead of creating a large class of independent producers, people who have "a hard time making ends meet" at the best will take the "title only to sell" it because they see private producers "as thieves of common property" (Pipes 1999, 207): "Russia's experience indicates that freedom cannot be legislated: it has to *grow gradually*, in close association of property and law. For while acquisitiveness is natural, respect for the property – and the liberty – is not. It has to b e inculcated until it sinks such deep roots in the people's consciousness that it is able to withstand all efforts to crush it" (1999, 208; our italics).

This sounds much like North's political theory of the emergence of property rights. However, in his case studies of England in the 17th and of Russia in the 19th and 20th centuries, Pipes (1999, 121-158 and 159-208) demonstrates that it was the *discontinuous* governmental-legal introduction of property rights, especially to land that triggered economic activities in these countries in the form of "a moneyed economy" (1999, 205), thereby contradicting North's view of *incremental* change. Like in "patrimonial", stagnant Russia before 1861 in which the institution of private property was unknown, its expropriation in 1917 did not lead to a system with only another, not to speak of superior, economic activity. With due right, Pipes does not call the Communist system a common property economy but a system which as "economy failed dismally" (1999, 212) and where all the characteristics of a monetary economy disappeared. It was a command society, with "the concentration of all economic resources in the hands of the state" and only 1.5 percent of agricultural land left for individual use (1999, 214 f.). The system could have been characterized more clearly as a state possession-based command society, with tiny individual possessions and without any form of property. In spite of his most promising distinction between possession and property, Pipes (1999, 97 f.) relies too much on North' political theory of property rights.

Although Bethell praises North, he accuses economists and economic historians for circular reasoning in explaining economic development who, ironically like North[40], *e.g.* "attempted to use economic data to explain England's economic development. *Effects* – wages, prices, coal production, savings, capital – *were tried out as causes*. But nothing definitive emerged from these manipulations. One set of numbers could not very satisfactorily account for another. Mathematics could not be substituted for the neglected effect of law" (1998, 90 f.; our italics). B ethell refers to Max Hartwell as the only authority who remarkably has pointed out the missing comprehensive study of the relationship between law and the economy: "No historian has detailed the steps by which, for example, the marked economy

[40] In spite of their emphasis on property rights, North and Thomas (1973) and North (1974) are good examples for such circularity of arguments, because for them it is changes in relative prices that are decisive for economic and institutional development, and not the other way round; see above section I. 3. The circularity also holds true for David Landes' famous studies on the superiority of the West in economic history (Landes 1969 and 1998). His neglect, more or less, of the history of property rights " 'ends up telling the story of *how* the West got rich, rather than *why*' " (Bethell 1998, 76 and 348).

was achieved in terms of government action or changing law; no historian has [… traced] the chronology both of legal and economic change. It is my thesis that perhaps the most distinctive and unique national characteristic that distinguished England from Continental countries in the eighteenth century, in the century also of England's lead in industrialization, was English law" (Hartwell, 1971, 247 and 250).

Stating that property cannot be taken for granted means that it is created by men, *i.e.* by *discontinuously* changing the political and legal structure of society. It means also that the institution of property can be abolished by men by the same change. Bethell verifies his approach by economic-historical case studies that contradict the explanation of incremental change by economic historians like North[41]: the rise and fall of property in the ancient societies of Greece and Rome (1999, 61-74), its new beginnings in modern times in England (1998, 75-91), its elimination in Russia after 1917 (1998, 137-152), and the recent introduction of property rules in mainland China (1998, 327-341). By focusing on changes in law and government that lead to a relation between individuals and the ruling class in which the former cannot hold property securely, Bethell also succeeds in resolving historical puzzles, like the stagnation of the Arabic economies from the late 17th century to our times (1998, 225-242) and the starvation crisis in Ireland in the mid-19th century (1998, 243-256). Bethell's analyses would have been even more convincing if he had shown that in both cases private property was turned into individual possession instead of speaking of legal changes by the rulers that turned private into "nominal proprietors".

The approach to property of de Soto is a challenge to the traditional explanation of underdevelopment. Therefore he starts his analysis by questioning four widespread assumptions of development schools: (i) illegal economic activities in backward countries represent "only poverty and marginalization", (ii) the activities are "incompatible with the entrepreneurial spirit" of advanced economies, (iii) "mechanisms and institutions" promoting development "are unable to function" in the Third world, and (iv) underdevelopment is the result of "foreign exploitation" (de Soto 1989, xxiii). According to the author these assumptions are not based on serious research. They represent prejudices and reflect the inability to understand the "true potentialities" of a Third world country like Peru which is the focus of his study of 1989.

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[41] However, North most recently has approved Bethell's thesis of the superiority of law. In an article together with Stephen Haber and Barry Weingast, entitled "If Economists Are so Smart, Why Is Africa so Poor?", he claims that "most African nations today are poorer than they were in 1980, sometimes by very wide margins. […]. More shocking, two thirds of African countries have either stagnated or shrunk in real per capita terms since the onset of independence in 1960." The authors analyze the problem as simply as Bethell. Reformers have made the basic mistake of assuming "that economic reforms can create efficient markets without simultaneous reform of the political institutions" (Haber, North and Weingast 2003); see also Bethell 2003, 2.

De Soto demonstrates that most of the economic activities in Peru are performed in what he calls an “informal economy”, especially in the sectors of housing, trade and transport. “Informal” means that the overwhelming majority of the people has no “formal” rights to its resources. Why? Property laws exist, but the *access* to formal property rights is *costly*[42] for all but a tiny minority, the ruling class. Therefore, in spite of its huge potentialities the informal economy remains in a state of inefficiency: loans, especially, cannot be secured by collateral because informal debtors lack formal property. This causes sky-high rates of interest, with the result of low levels of investment in production and no long-term investment. *Poor countries are not poor because they lack resources* and entrepreneurial spirit or the law of property *but because their resources are* “*dead capital*” (de Soto 1997, I, 2).

How can “dead capital” be transformed into *“live capital”*? Because the majority of informal resources “lack *value as collateral for securing the interests of creditors*, […] these assets must first be formalized so that ownership can be traced and validated, and exchanges can be governed by a legally recognizable set of rules” (1997, I, 6; our italics). Thus, the property right of encumbrance, the pledging of assets as good securities, that forms the core of Heinsohn and Steiger’s theory, is also at the heart of de Soto’s approach. In addition, and in accordance with these authors, he observes carefully that “property exists in a social and not a physical space”, like the possession of a mere good: What most economists and policy makers do not understand is “that property is a concept rather than a thing in itself” (de Soto 1997, I, 24).

In his most recent study of 2000, de Soto enhances his approach by not only emphasizing that it is “property documentation” that first turns a mere good into an asset allowing for its collateralization to secure economic transactions. With reference to Heinsohn and Steigers property theory of interest and money, he also holds that the recorded property title “ultimately provides the justification against which central banks issue money. To create credit and generate investment, what people *encumber* are not physical assets themselves, but

[42] In a later study on Egypt, de Soto found that to formally acquire a parcel on state-owned desert land to build a dwelling and then register the property, “it requires the individual to carry out *77 bureaucratic procedures* in some *31 different public and private offices*, all of which could take some *6 to 4 years of red tape*” (de Soto 1997, I, 13).

Most recently, in a discussion of the Asian crisis of 1997, Camille Cornand has shown that even supposedly developed emergent economies suffer from the problem “of red tape” in property rights procedures: “In a large number of countries, national bankruptcy laws do not exist, or they function incorrectly. In Indonesia, on the eve of the 1997 crisis, there existed hardly any legal framework. Thailand’s courts became famous for requiring *ten years* to handle a case, and in South Korea the awkward manner of application of the domestic bankruptcy laws to medium size *chaebols* contributed considerably to the withdrawal of capital” (Cornand 2003, 6; first italics ours).

their property representations […]: *money presupposes property*" (2000, I. 55 f.; our italics)[43]. It could be added, not only money but everything in the monetary economy and all forms of economic activity presupposes property.

Therefore, to transform underdeveloped and transitional systems into well functioning economies, de Soto concludes, it is not enough to implement *macroeconomic* stabilization and adjustment programs as multilateral institutions like the International Monetary Fund or the World Bank propose. The *"crucial missing ingredient"* of these programs is the *microeconomic*, legalized *"access to formal property"*, the establishment of property rights to the resources most of the people in these societies already hold. First with formalized titles "people feel that their property is under their own legal control", they are ready to enter credit contracts and have "the incentive to invest their intelligence and work in improving" their resources, *i.e.* to engage in genuine economic activity (1997, I, 4 and 6 f.).

Although they never have formulated this proposal as explicitly as de Soto, Bethell and Pipes as well as Heinsohn and Steiger[44] have approved of de Soto's basic message: *for creating economic activity property laws have to be introduced as the rights of each and every member of the society, especially the poor*. In section III below de Soto's proposal will be discussed more detailed in the presentation of the reform programs of the multilateral institution he has founded, the ILD. Its programs will be compared with reform programs of an established organization, those of the ILO.[45]

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[43] Strange as it sounds, none of the major Western consultants trying to help transformation has understood the essential connection between creating property titles -- as the collateral basis -- and the issuing of genuine money. Though they vaguely sense the importance of property, they mostly see it as a means to unleash greed and competition suppressed by the former communist authorities. Harvard University's master adviser, Jeffrey Sachs, provides a typical example for this view. He explicitly demands to put the cart before the horse. Instead of initiating the entire transformation process by enabling agents to obtain credit through entitling them with collaterizable property, his vision is to make this move only as "the *final* step" (Sachs 1993, 80; our italics); see also Heinsohn and Steiger 2001, 206 f.

On the other side, Ronald Coase at least admits in his Nobel Price lecture of 1991 that even new institutional economics lacks the knowledge of how to transform former socialist societies: "The ex-communist countries are advised to move to a market economy, and their leaders wish to do so, but without the appropriate institutions no market economy of any significance is possible. *If we knew more about our own economy*, *we would* be in a *better* position to *advise them*" (Coase 1992, 714; our italics).

[44] See Bethell (1998, 202), Pipes (1999, 236), Heinsohn and Steiger (1999a, 52 and 2001, 205), and Stadermann and Steiger (2001, 12 f.). Furthermore, Heinsohn and Steiger (2001, 213-219) have outlined a program of how to transform the remains of the command system of former socialist Slovakia into a property-based economy which is very similar to de Soto's ideas.

[45] Because we had no access to development programs of the World Bank's International Development Agency (IDA), the European Bank for Reconstruction and Development (ERBD) and the Center of Economic Analysis of Law (CEAL), only those of the ILO, its social finance programs, will be analyzed. We acknowledge the ILO for providing us with three of its reports. The programs of the IDA are discussed in the empirical part of our study; see Raja and Schaefer 2003.

III. Analysis of reform programs of multilateral institutions

The central question of reform programs is the same as the question of how to apply the two different approaches to the institution of property, new institutional economics and the property theory of economics, as conceptual and operational criteria for strengthening legal security in developing and transitional countries.

It goes without saying from our discussion of the former school in section I above, especially section I. 4, that the theory of property rights is not able to deliver such criteria, neither in its "naïve" version by Alchian and Demsetz nor in its political formulation by North. Notwithstanding its achievements in convincingly demonstrating that the neoclassical model of competitive equilibrium has to be expanded by the institution of property because the latter decisively influences the allocation of resources, the basic assumption of property rights as eternal, universal rights leads new institutional economics to underestimate the difficulties to introduce these rights in countries where they never have existed, like in the Third World, or in former socialist societies where they had been abolished for several generations. The implementation of a property system is not a question of hierarchical organization of the different contracts in these nations' markets . The missing distinction between possession and property hinders new institutional economics to understand what it is at stake: it is not the problem of how to transform common into private possession, which the school misses by labeling it as a question of common *versus* private property, but the introduction of the institution of property *per se*. And the fundamental characteristic of this institution, the capability and right of property to be encumbered, of pledging assets as good security, the theory of property rights has bothered about as little as it paid attention to the informal rights of the poor in the underdeveloped parts of the world.

Therefore, we are left to analyze the property reform programs of the property theory of economics, those of the ILD (section III. 1). They will be compared with the social finance programs of the ILO (section III. 2). Conclusions from the analysis of the programs will be presented in section III. 3.

1. Property reform programs of the "Instituto Libertad y Democracia" (ILD)

What are the guidelines for property reform programs developed by the ILD? Most recently the ILD has made the following programmatic statement: "The Institute for Liberty and Democracy (ILD) is committed to the poor, *not* to property. If we advocate *the right of the poor to property*, it is because we have hard evidence that one of the most important causes of poverty in Third world and former Soviet nations is the exclusion of the poor from a good property system" (ILD 2003, 1; our italics).

According to the ILD, a good property system is defined as a system that triggers economic activity by property law, a law that provides and enforces rules and contracts: rules that organize the market as well as the titles and records to identify agents, and contracts that allow people to exchange goods and services as well as to apply for and *guarantee credit*. Furthermore, a good property system allows people to represent their resources in *standardized* and universally *accepted* form and to store and transfer their value into *capital* assets: by "using shares, corporate stocks, patent rights, promissory notes, bills of exchange, or bonds" (ILD 2003, 1). It is not enough to introduce property law but it has to be implemented as a law for each and every member of society. In most developing and transitional countries the law exists but the majority of the people are excluded from it. They have no legal property rights to their resources and, therefore, remain poor.

The main challenge for property reform programs, according to the ILD, is the task of how to transform the extralegal, informal rights of the poor to their resources into legal, formal rights. Property reform programs of established multilateral institutions fail because they document only the already existing formal property, most of which belongs to the ruling class: the surveying, mapping and modernization of property registries carried out by consultants and service companies financed by these programs. The programs fail, because "they contribute very little to *the fundamental challenge of converting informal into formal property* in the first place. In effect, before the property of the extralegal poor can be documented by traditional mapping and registration approaches it must be put into a form that standardized legal and recording systems can recognize and classify. […] This means that a developing nation's recording system has to be geared to *recognize and accept informal proofs of ownership* before state of the art" documentation "can take place" (ILD 2003, 2; our italics).

According to the ILD, property reform programs require therefore that Governments in developing and transitional nations obey the following seven rules: (i) feasibility of the institutional change, (ii) technical ability to identify, locate and classify rights over extralegal assets, (iii) reform of the legal system so as to make these assets legally acceptable, (iv) field operations of engaging the poor and bringing them voluntarily into the rule of law, (v) a mopping up obstacles that hinder the legalization of the poor, (vi) specification of property documents in legal forms that make them usable to generate new wealth by transforming "dead" resources into "live" capital assets, and last but not least (vii) recognition of property documentation and records of the poor so that they can *collateralize* their assets and enter *credit contracts*.

The ILD is convinced that only through such property documentation, the resources of the poor can be turned "from quickly outdated snapshots into 'living' cadastres", because (i) it provides the poor with "the incentive to keep registering their subsequent transactions" and (ii) it encourages them to be interested to maintain (ii) "current official records of property rights and boundaries instead of slipping back into the informal sector" (ILD 2003, 2).

The ILD property programs are, as their seven rules demonstrate, first of all *legal reform programs*. They are based on the insight, emphasized by Bethell, that law most importantly influences the economy, and not the economy the law as the new institutional school assumes. An appropriate implementation of property law, *i.e.* an institutional change that results in a changed microeconomic behavior of the poor by legalizing their informal, individual possessions into formal, private property is enough to trigger the economic activity lacking in developing and transitional countries. The activity cannot be induced by macroeconomic stabilization programs which leave the property structure untouched. Furthermore, property law can only be installed by governmental-legal, *i.e.* discontinuous changes. However, the changes demand *democratic* rule and *freedom* rights allowing for surveillance of the rulers by the poor, and also for their right to enter contracts without interference by the rulers. This claim is implicit in the ILD programs but could have been stated more explicitly. More serious is that the ILD does not discuss the necessity of independent courts of law for ensuring that legal rules are followed and contracts can be enforced.

In the late nineties, the ILD developed a property reform program for Egypt on behalf of the Cairo-based Egyptian Center of Economic Studies (ECES) (de Soto 1997)[46]. In its careful study of the Egyptian economy, the ILD presented surprisingly large numbers for the informal sector: 92 percent of real estate and land in the urban sector, and 87 percent in the

[46] Similar ILD programs for Haiti, Peru and the Philippines are discussed in various passages in de Soto 2000 (see index, 239 and 241).

rural sector are not legal property but extralegal, informal possessions. Over 70 percent of the informal, individual resources belong to the poor and are, according to the ILD, equivalent to some US $ 240 billion. The study reveals that there is no lack of property law in Egypt but the procedures to formally acquire property are very *costly* (de Soto 1997, I, 13; see footnote 27 above). The difficult task of how to remove this obstacle was discussed in a joint session by de Soto and several Egyptian economists documented in the study (de Soto, I, 37-49). The economists supported the ideas behind the ILD program but doubted whether it was applicable to Egypt and whether the poor would actually benefit. All participants, even de Soto, could not present a quick and easy solution of how making property rights a right for each and every member of Egyptian society[47]. Why?

As explained by Ahmed Ghoneim, professor of economics at Cairo University and civil servant at the Egyptian Ministry of Industry, de Soto, although his diagnosis is right, gravely underestimates the transaction costs for the poor if property rights would be implemented (Steiger 2003b). People in Egypt are accustomed to a system where most transactions are informal and tolerated by the State. And these transactions are *not costly*. To formalize them would not immediately create the benefits de Soto eagerly is looking after, only huge transaction costs as demonstrated by North (see section I. 3). After all, the transaction cost approach of new institutional economics makes a point. One cannot implement an institution which by the majority of a society is feared as endangering their material reproduction and which would deprive them from the basic security guaranteed by the State. In Egypt “the bureaucracy had always given security to both sides, the rulers and their subjects” (Hermann 2003, 13). The benefits of formalization may be experienced after a certain period but this does not solve the problem of insecurity associated with its introduction. Ghoneim’s analysis confirms Pipes’ insights that property cannot be legislated but has to grow gradually. However, such incremental change never has happened in history.[48]

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[47] Maybe a renewed discussion of the ILD program in Egypt would benefit from Bethell’s above mentioned explanation for even today’s poor economic performance in the Arabic world, the insecurity of property rights: “When wealthy Arabs bought property in the West after the oil boom, it came with secure titles attached. By contrast, property is held insecurely all over the Arab world. […] The problem is that there is *no security against the depredations of the state* itself“ (Bethell 1999, 225; our italics).

[48] It has to be mentioned that the ILD under the direction of Enrique Díaz Ortega and in co-operation with the ECES has developed a “Business Formalization Project for Egypt”, the results of which will be presented on a Conference at the ECES, Cairo, December 2003. At the same direction aims a “Business Agenda for Egypt” to be formulated until the end of 2004 by the “Sectretariate for Entrepreneurs” of the ruling National Democratic Party. Most of the Egyptian entrepreneurs have been graduated from the German School of Cairo which they regard as the best form of development aid that Germany delivered to Egypt; see Hermann 2003, 13.

2. The social finance programs of the International Labour Office (ILO)

The social finance programs of the ILO are *not property reform* programs. They aim not to overcome what the programs of the ILD want to remove: the extra-legal informality of the possession of resources by turning them into property titles, so that they become assets, with the *quality* of collateral. On the contrary, ILO programs aim only at removing what they have identified as the key problem of the small and medium enterprise (SME) sector in development countries[49], the *lack* of collateral acceptable to banks. The lack of collateral is regarded as a *major constraint* for many SMEs which has to be *substituted* by other, *social* forms of finance. The ILO is not hostile to the demand for collateral *per se* but criticizes it as a "requirement imposed by regulatory authorities as well as a principle of sound banking practice", which may be meaningful in highly developed economies but definitely not in the different social structures Third world societies (ILO 2001a, 3; see also ILO 2001b). Why?

The ILO gives two answers which are surmounted by the stunning insight that what is lacking in developing countries should not be required because collateral is not only a constraint with unfavorable outcome for the SMEs but also for the banks: (i) "The lack of acceptable collateral reduces the volume of small-scale finance and investments, thus leaving output and employment at a sub-optimal level" for the economy as a whole. (ii) Collateralization implies costly transactions which, "like other transaction costs, drive a wedge between borrowers and lenders, thereby increasing costs to the borrower and reducing return to the lender" (ILO 2001, 3). Needless to add that these costs will also reduce output and employment in the underdeveloped economy.

Therefore, the demand for collateral in loan contracts between SMEs and banks in the Third World is regarded as being counterproductive. But what is the alternative to collateral? The ILO recommends so-called *collateral substitutes*, *e.g.* "peer pressure (group-based forms of collateral like joint liability), probation of credit-scoring (i.e. the threat of loss of acess to future loans), interlinked contracts, co-maker arrangement without intended enforcement" (ILO 2001b, 21 f.). These substitutes do not mean a threat by the crediting bank to execute into its debtor's property, "the sanction is rather the prospect of no longer having access to credit" (ILO 2001b, 23 f.). The substitutes are praised for not only enhancing investments by SMEs but also for reducing bank transaction costs related to collateral. Why? Because they can be used to circumvent the costs property titles imply by their very nature of being legal

[49] The ILO discusses the relation between the SME sector and banks on basis of findings in the following countries: Bolivia, India and Tanzania (ILO 2001a), Bolivia, Dominican Republic, India, Indonesia, Malaysia, Mexico, Nepal, Niger, and the Philippines (ILO 2001 b), and India (2002).

titles: “Collateral substitution is a technique which replaces conventional assets, which have a market value and can be possessed through legal and juridical process, by ‘assets’ without market value and *to which claims cannot be* or are generally not *enforced through courts*” (ILO 2001, 3; our italics). This is indeed a most innovative interpretation of the transaction cost theory of new institutional economics. But while this school tries at least to explain private property out of the reduction of the high transaction costs of common property, the ILO aims to reduce the unquestionable transaction costs even private property arrangements imply. What the ILO proposes amounts to is nothing else but the abandonment of the fundamental characteristic of property, its capability and right to be encumbered without which there will be no economic activity of any significance. The idea that there would be even more economic activity in developing countries by substituting collateral is as naïve as the popular view of creating more wealth by abolishing “unproductive” interest payments on loans.

Surprisingly, the ILO identifies another key problem that SMEs face in the Third World: “Many land and other *property owners cannot borrow against* these *assets* because these are *not properly documented*. Many others *possess property* – even for a long time – *but do not own it*” (2002, 3; our italics). This is indeed the very problem that the ILD programs want to overcome by legalizing such informal rights and, thereby, turning possession into property. The ILO, however, is not interested in solving the problem of informal assets. Its social finance programs are no property reform programs. They do not challenge existing property rights as the rights of the ruling class only. Instead its programs only want to implement substitutes for property titles as collateral if they are lacking. What the ILO does not know, however, is that its collateral substitutes at the best could be turned into customary rights, like possession in tribal systems which, as has been demonstrated above (section II. 1), are doomed to stay at a level of material reproduction that today would be called underdevelopment.

However, there exists an alternative to collateral substitutes which the ILO, unfortunately, does not discuss. Also in highly developed economies SMEs, especially start-ups of young entrepreneurs, often face the problem that they lack collateral. How is the problem overcome? The State steps in as a substitute and guarantees the bank loan in a form of “venture capital”. This means, of course, risking taxpayers’ money. But this method is as social as collateral substitutes and, in addition, has the advantage of not violating the rule of the property-based economy that credit contracts have to be collateralized.

3. The limitations of analyzing reform programs

Our analysis of reform programs is preliminary insofar as we had no access to programs of the other established multilateral institutions, the World Bank (IDA), EBRD and CEAL. But we wonder whether their programs would overcome the limitations of those of ILD and ILO to clearly demonstrate how the core economic principles have to be *implemented* to further economic development. In any case, if such programs would have triggered a property-based economy anywhere in the world we, and not only we of course, would have heard of them.

What are the limitations of the programs of ILD and ILO? While the property programs of the ILD are on the right track in grasping the core economic principles without which there will be no economic development, it has so far not succeeded in showing *how* to successfully implement these principles, only that this is not an easy task. Needless to emphasize once again, that the social finance programs of the ILO have not hinted at the core principles at all. In the first hand its programs are *social*, *not* financial programs. And as such they are not suitable to solve the problems of underdevelopment and transition. Finance programs have to be based on the laws of the property-based economy. There is no rhyme or reason in social minded finance programs. On the contrary, they confirm the critique of the ILD against the reform programs of established multilateral institutions because they avoid the difficult task of turning extra-legal possession into legal property. We fear that the programs of the other development institutions are in no way better than those of the ILO.

Therefore, we propose to support our theoretical findings not only through the analysis of reform programs but also by economic-historical case studies on the rise and fall of property in different parts of the world at different periods in history. This should be studies which focus on *discontinuous* change of institutions, *not* on incremental change like that by North and Thomas (1973): *e.g.* works like the studies by Heinsohn (1984) on antiquity, by Bethell (1998) on ancient Greece and Rome, England, the Soviet union and China, as well as by Pipes (1999) on England and Russia.

The most interesting historical events for an economist are indeed those which until now are, the named authors apart, not discussed in mainstream economic history, though they are the ones that bring about property titles. Such events are revolutionary turning points after which the titles immediately trigger an economic activity ruled by interest and money. Even the few scholars who strongly sense that intimate and powerful connection still regard it as an enigma: “The manner in which loans became so mighty a machine is mysterious” (Starr 1977, 183)[50].

Already for the first property-based society within the Graeco-Roman world the quick emergence of “sale, loan and credit” in “a class of equals” is not seen as an incremental “product of Indo-European tribal organisation, but as a social system growing out of the ruins of an ‘Oriental despotism’” (Humphreys 1978, 68 f. and 73). The ruins have to be taken quite literally because archaeologists have revealed naturals cataclysms as causes of institutional changes like the abolishment of feudalism and the rise of private property in the Greek city states.

The bond between property and this mighty machine is especially well researched for the rise of England’s private property system as the outcome of the Lollard upheaval of the late 14th century, and the ensuing two centuries of civil strife between former lords and serfs for its uncontested implementation. This revolution does not only recreate property of land as it was already known in antiquity but, for the first time in history, also brings about personal freedom not tied to land: the free wage laborer (Heinsohn and Steiger 1983).

The tie between property and a loan driven economy is also well demonstrated for the England-induced governmental property reforms in the early 19th century by the Napoleonic laws for most of Western Europe as well as by the Stein-Hardenberg reforms in Prussia. In the late 19th century Russia’s Tsar Alexander II and Japan’s Tenno Meiji follow suit.[51] In the 20th century, South Korea’s top down implantation of the land reform act of 1949 under Syngman Ree increased the percentage of creditworthy landed proprietors from 14 to 93 percent between 1953 and 1959 (Lankov 2003) being instrumental to an astonishing economic take off. Indeed, South Korea has been the most amazing developmental story of the post-war era turning the freshly propertied nation into a world competitor within a single generation. At that time, only Taiwan, with her authoritarian Chiang Kai-shek property program “Land to the Tillers” of 1953 proved to be a comparable credit-driven economic development.

Starting in the 1990s, mainland China is repeating South Korea and Taiwan’s property revolution from above (Mc Gregor 2002a. 6). The secret behind the admired boom of Shanghai as the nation’s powerhouse lies in an increase in the share of property in the city’s real estate from zero to 90 percent between 1990 and 2000: “Just 10 years into its experimental housing reform program, Shanghai has gone from having next to no private

[50] This and the following paragraphs draw on Heinsohn and Steiger 2004, prelude.

[51] Unfortunately, economic-historical studies on the events in Western Europe, Prussia and Japan, which could further enhance our insights about the appropriate way of how to implement property, are not known to us.

home ownership – all but outlawed after the communist revolution – to a market where more than 90 percent of homes are privately owned" (McGregor 2002b, 13). On January 5, 2003, China's workers are liberated from all quasi-feudal restrictions and, thereby, turned into free proprietors of themselves (Hutzler and Lawrence 2003, 2). Four centuries after England's final implementation of property and the abolition of serfdom, the world's most populous nation eventually has followed a model that turned Britain into the dominating empire of modern times.

Most recently, in 2003, the High Representative for Bosnia and Herzegovina, Paddy Ashdown, well aware of clear cut property titles as the precondition for a credit-based economic development, did not count on any evolutionary solution but imposed a land registration law whose offices are controlled by a government-independent judiciary system and, therefore, meeting the collateral requirements of banks (Pergande 2003, 12).

On the basis of these historical events, our discussion of property rights can only emphasize once more the findings of the property theory of economics for property reform programs in the Third world and transitional countries: *the core principles triggering economic activity are embodied in the institution of property that, both as common and private property, is created by men. At no time in history and nowhere in the world, property has existed as common property that by incremental changes has or can be transformed into private property; what has existed at all times and everywhere is possession, both in its forms of common and individual possession. The introduction of the institution of property into the merely possession-based societies of underdeveloped and transitional countries can only occur through discontinuous change of their governmental and legal structure which, however, is not a task which can be achieved by mere legislation or by property reform programs of multilateral institutions. To overcome the hostility against private property in these parts of the world is a Herculean task which these institutions are the least appropriate to shoulder. Therefore, property reform programs at the best can support and strengthen governmental and legal structures in the developing and transitional countries favorable to property rights . And it is these structures which have to be scrutinized before property reform programs can be discussed in a meaningful way.*

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