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property Rights as a Vehicle to Foster Economic Development

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Abstract

This paper studied the benefits of secured property and contract rights to foster economic development especially for developing economies. It examined this through individuals especially the poor accumulating and protecting properties in accordance with the Laws of the State in order to access finance for wealth creation. It described the rate and extent to which property rights protected by the State is an indication of how effective or ineffective the Laws of the States are with regards to the branches of government in existence especially the judiciary which is saddled with the responsibility to enforce the Laws of a State. It also showed the harmony between property rights, access to finance and economic development in relation to a market based economy.

Key Words: Property rights, access to finance, developing economy and economy development,

1. Introduction

The general believe amongst economists and scholars worldwide is that property rights occupy a very important role in any developing economy. The belief is that strong property rights are at the heart of economic growth and development. This assertion has however generated a lot of controversies amongst different economists, policy-makers, legal luminaries, academic scholars and writers the world over.¹ The interest in this topic stemmed from trying to determine and understand the causal factors for economic growth. The need to explore and understand the reasons for the wealth creation and the different growth rates in countries.

The purpose of this paper is to analyse and understand the general concept of formal property rights from the purview of the formalisation of property rights and their place in developing economies. It does this by examining the role formal and informal property rights regimes play in accessing finance and economic development in developing economies

The paper also assesses the place of the State in the provision of a well-defined system in the form of necessary social, legal, political and economic institutions for the protection of private property rights and the assistance of these institutions in the enforcement of such rights when infringed upon.

The paper is divided into five sections. The first section introduces the paper. The next section evaluates property rights in a market based economy. Here the concept, Ingredients and benefits of formal and informal property rights regimes were discussed. It also considered how far the State should intervene in putting in structures to protect private property rights.

The third section of the Paper examined property rights in relation to economy development. It described the ways through which formal and informal property rights can affect the economic development of a State. The Paper did this by examining how property rights assisted in the alleviation of poverty within States thereby encouraging trade and market activities.

¹ John Williamson, 'What Washington Means by Policy Reform, in Latin American Adjustment: How Much has Happened?' 7, 17 (John Williamson ed., 1999)

The fourth section evaluated the link between property rights and access to finance. It analysed property rights as a bridge to the growth of market and finances which in turn gives way to economic growth and development thus helping the poor secure access to finance in order to increase personal and societal wealth. The Paper argues that the connecting nexus between poverty and prosperity is property and concluded by reiterating the place of a well-defined and secured property rights regime in economic growth and development. The last section concludes the paper.

2. Property Rights in a Market Based Economy

The essential elements of property rights are exclusivity, transferability and universality.² Harold Demsetz defined property rights as "an instrument of society and [they] derive their significance from the fact that they help a man form those expectations which he can reasonably hold in his dealings with others. These expectations find expression in the laws, customs, and mores of a society. An owner of property rights possesses the consent of fellowmen to allow him to act in particular ways. An owner expects the community to prevent others from interfering with his actions, provided that these actions are not prohibited in the specifications of his rights."³

In market based economies though the prices for goods and services are primarily determined by the market forces, government intervenes at various levels and to varied extents by providing a favourable environment. With regard to property rights, it raises the question as to what extent the government should interfere with property rights? The role of government in securing property rights is an important one although their interference should be limited. There is a need for government to interfere with property rights because they must protect the legal rights of property owners if resources are to be used efficiently.⁴ The importance of this is discussed fully below.

Although not the main focus of this paper it is beneficial to consider the weaknesses of property rights in other economies such as the socialist or communist economies as well as when property is communally owned with the aim of showing why property rights thrive best and more effectively in a market based economy. Where property is state or communally owned, it is usually not managed efficiently.⁵ Where property is state owned, the government appoints agents to manage the properties. The agents are not free to make unfettered decisions about the property and as a result cannot put the property to the most efficient use. Also persons who can put the property to the most efficient use do not have access to the property and because the agents do not benefit or lose personally if the value of the property increases or reduces they have no incentive to manage the property efficiently.⁶ Similarly, where property is communally owned no one takes responsibility for managing the property and the property will be overused.⁷

However, a strong system of private property rights in a market based economy is said to encourage efficient allocation of resources. A strong system of property rights leads to the efficient allocation of resources because owners of properties are able to employ them in ways that would produce the greatest value and it has been stated that "Economic growth occurs whenever people take resources and rearrange them in ways that are more valuable"⁸ Where there exists strong property rights in any economy the properties become easily tradable and assignable thereby leading to an exchange economy which fosters growth.

For a system of property rights to function effectively there is the need for other factors to be in place. This is where the government plays an important role by putting in place an efficient legal and social framework. There is need for a regime where legal rights such as property rights and contractual rights are well recognised and enforced.⁹ The recognition and enforcement of property rights go hand in hand and cannot be substituted for each other.¹⁰ This will consist of a system of functional regulatory

² Michael Trebilcock and Paul Erik Veel, 'Property Rights and Development: The Contingent Case for Formalisation' (2008) Vol. 30 University of Pennsylvania Journal of International Law 403

³ Harold Demsetz, 'Toward a Theory of Property Rights' (1967) Vol. 57 The American Economic Review 347

⁴ Bruce A. Reznick, 'Property Rights in a Market Economy' (1996) Economic Reform Today 29

⁵ Armen A. Alchian, 'Property Rights' The Concise Encyclopedia of Economics, <http://www.econlib.org/library/Enc/Property_Rights.html> accessed 27 July 2014

⁶ Ibid

⁷ Ibid

⁸ Paul M. Romer, 'Economic Growth' The Concise Encyclopedia of Economics <http://www.econlib.org/library/Enc/Economic_Growth.html> accessed 20 June 2014

⁹ Richard A Posner, 'Creating a Legal Framework for Economic Development' (1998) Vol. 13 The World Bank Research Observer 1

¹⁰ Chong-En Bai, Jiangyong Lu and Zhigang Tao, 'Property Rights Protection and Access to Bank Loans: Evidence from Private Enterprises in China'

agencies to enforce these rights such as the police, judiciary, and access to a registry for registration of title to property as well as securities.¹¹ The presence of these institutions allow for the clear documentation of dealings between parties and the speedy resolution of disputes. Without an efficient legal framework no one will be willing to take investment risks.¹²

Most scholars agree on the need for a functional system of property rights for economic development. However, there is a divergence of views on whether or not there is a need for a formal system of property rights or whether the informal system will function as effectively. A formal system of property rights has been stated to function more effectively on the following grounds. Firstly a formal system is more definite and secure in protection property rights than an informal system. Secondly, where the State plays a role in implementing property rights the "uncertainty is reduced or completely eliminated."¹³ Thirdly, a formal system of property rights will reduce transaction costs as third parties have access to information to a person's rights over property without having to incur so much cost. For example a search can easily be carried out in a registry for title to property.¹⁴

Proponents of informal property rights have argued that an informal system of property rights is also effective and that a formal system of property rights can be quite expensive because it needs a formal legal system to function and a poor country may not be able to afford this. However it has been asserted that "without a good legal system" a country "may never be rich enough to afford such a system."¹⁵ Also Hernando Desoto a renowned economist stated that "[t]he formal property system is a capital's hydroelectric plant."¹⁶ Posner has suggested a solution to this problem by recommending that a developing country need not invest in expensive legal reforms at the outset but begin modestly.¹⁷

Michael Trebilcock and Paul Erik Veel have explored the literature supporting the fact that an informal system of property rights will function effectively. They explore the suggested alternative means to formal property rights such as the game theory analysis and the development of informal norms. The game theory suggests that where a 'tit for tat' approach is imbibed it may lead mutual cooperation between parties and subsequently even lead to respect for land tenure.¹⁸ In addition, they also opined that where there is cooperation amongst a close knit set of people, this would lead to the development of norms with regard to security of land tenure if a welfare-maximizing rule were in place.¹⁹ However, one would immediately note that these suggested alternatives to formal property rights are limited in their applicability. This is because they would only function effectively amongst individuals who trust themselves. Although there is evidence to show that informal systems of property rights function effectively²⁰ based on the arguments for a formal property rights regime it is safe to agree with the view that a formal system would function more effectively. This is because it would be more widely recognised and where there is a need for external transactions informal property rights will not suffice because they are only recognised within small communities.

3. Property rights, Economic Development

In recent times scholars have reached a consensus that there is a strong link between the protection of property rights and economic development. The reasoning behind this link is not far-fetched and it simply flows from the fact that people who invest in property should have the freedom to use it as they see fit. Where they possess the right to use the property without interference they are more open to investing in the property which will invariably lead to economic development. On the other hand where there is a fear or possibility of their property being expropriated they will refrain from making any investments.²¹

Gerald O'Driscoll Jr. and Lee Hoskins have stated that "Prosperity and property rights are

¹¹ Ibid, Vol. 14 Economics of Transition 5
¹² Posner (n9) 2

¹³ Ibid
¹⁴ Trebilcock (n2) 410

¹⁵ Posner (n9) 3

¹⁶ Hernando De Soto, *The mystery of capital Why Capitalism Triumphs in the West and Falls Everywhere Else* (Black Swan 2001) 45

¹⁷ Posner (n9) 3

¹⁸ Trebilcock (n2)

¹⁹ Ibid

²⁰ Posner (n9) 2

²¹ Ibid

Los Angeles, 'Institutions, Property Rights, and Economic Development in Historical Perspective' 5 <http://www.gla.ac.uk/researchmedia/189284_en.pdf> accessed 20 June 2014

inextricably linked and that Nations prosper when private property rights are well defined and enforced.”²² In explaining the importance of property rights to economic development they assert that a strong property rights regime is a determinant of how effectively prices in an economy will allocate resources and that the more effectively resources are allocated, the greater the wealth creation. They stated further in support of the importance of strong property rights in economic development that property rights is the sole means by which countries can use what they own to promote economic development without external help.²³

In the International property Rights Index 2011 report the success of highly wealthy industrialized countries is linked to a system of secure property rights.²⁴ The Report states that where a strong system of property rights exists in a country it internalises costs and benefits thereby providing the proper incentives for good management of resources. Property rights are also believed to play a significant role in allocating resources to those uses which are most valued by and beneficial to the society.²⁵

Tim Besley and Maitreesh Ghatak have highlighted four main ways in which insecure property rights can affect economic activity. They stated that firstly, there is a greater risk of expropriation. Secondly, it increases the cost incurred by individuals in protecting their properties thereby reducing productivity. Thirdly, property is not easily transferable to those who will make the best use of it and thereby it fails to facilitate gains from trade. Fourthly, property cannot be used in financial market transactions for example as collateral.²⁶

De Soto asserts that lack of strong property rights affects economic growth. He based his assertions on facts and figures collected from Africa, Asia, Latin America and the Middle East. He states that the poor people in these economies already possess enough assets that amount to immense values of wealth. He however went further to state that the assets gathered by the poor could not be properly utilized because;

“they hold these resources in defective forms: houses built on land whose ownership rights are not adequately recorded...Because the rights to these possessions are not adequately documented, these assets cannot easily be turned into capital, cannot be traded outside of narrow circles where people know and trust each other, cannot be used as collateral for a loan and cannot be used as a share against an investment.”²⁷

He compared this to the situation in the West where every property is properly documented and registered.²⁸ The strong property rights regime in the West enables those in possession of property rights use the properties to generate capital which ultimately leads to economic development.

De Soto classified assets which are not documented as “dead Capital”²⁹. He further stated that the amount of dead capital in developing and former communist countries amounted to \$9.3trillion and this amount is about double the total circulating US money supply.³⁰ This amount is huge and if invested would do a lot to develop the economies where such dead capital is held. In response to De Soto’s classification of dead capital, Governments in developing countries are seeking ways to turn the dead capital in their countries to viable assets. It is recommended that one way of turning dead capital to viable assets would be to develop property rights regime in the country and ensure that minimal transaction costs are incurred.³¹

Other case studies have shown severally that there is a relationship between strong property rights and economic growth. In a paper on development in OECD countries, the authors having carried out empirical research stated that enforcing strong property rights can hasten the development of countries. However, the authors mentioned the need to put other factors in place alongside enforcing strong property rights which include an independent judiciary amongst others.³² They further stated

²² Gerald P. O’Driscoll Jr. and W. Lee Hoskins, ‘Property Rights: The Key to Economic Development’ (2003) Policy Analysis, available at < www.cato.org/pubs/pas/pa482.pdf > accessed 28 June 2014

²³ Ibid

²⁴ The International property Rights Index 2011 Report 19 < <http://www.internationalpropertyrightsindex.org/> > accessed 28 June 2014

²⁵ Ibid

²⁶ Tim Besley and Maitreesh Ghatak, ‘Reforming Property Rights (2009) < <http://www.voxeu.org/index.php?q=node/3484> > accessed 14 August 2014

²⁷ De Soto (n16) 6

²⁸ Ibid

²⁹ Ibid 28

³⁰ Ibid 32

³¹ The International property Rights Index 2011 Report (n24)

³² Mahmoud Khalil, Shereef Ellaboudy and Arthur Denzau, ‘The Institutions and Economic Development in the OECD’ (2007) Issue 12 International

that developing countries might not need external assistance if they have strong property rights.³³ Richard Roll and John Talbott's research into the determinants of wealth buttresses the fact that strong property rights play a significant role in economic development. In seeking the determinants of wealth, Roll and Talbott based their study on GNI per capita as a means of economic well being. Fourteen determinants were examined over a five year period (1995-1999) and they discovered that property rights is one of the most significant factors that affects economic growth.³⁴ To further prove that property rights among other determinants are not effects of high income but causes, they traced the course of GNI per capita before and after political liberalisations and dictatorial retrenchments and discovered that averagely political liberalisations are followed by dramatic improvements in a country's income.³⁵ They however, mentioned other factors which can aid the development of countries and these include; promoting an independent judiciary and effective regulation.³⁶ Roll and Talbot stated further that where a country has strong property rights there might even be no need for much external assistance as the country could develop from within. They asserted that a country with weak property rights also discourages foreigners from direct capital investment for fear of expropriation.³⁷

Shing-Yi Wang looked at the impact of private property rights on entrepreneurship. Wang looked at a housing reform in China which allowed state employees purchase their houses at subsidized rates. She found that the property reform increased self employment as well the ability of individuals to finance entrepreneurial ventures by allowing them capitalize the value of their properties.³⁸ This is evidence that having property rights will amount to the efficient allocation of resources such as using property as collateral. The overall implication of such activities will be economic growth.

Simon Johnson, John McMillan and Christopher Woodruff sought to answer the question: "Which is the tighter constraint on private sector investment: weak property rights or limited access to external finance?" In order to do this, they conducted a survey of new firms in post-communist countries. They found that lack of strong property rights discouraged firms from reinvesting their profits, even in situations where loans were available. They came to the conclusion that in an economy with relatively strong property rights regime firms reinvested their profits, and that on the other hand where property rights are relatively weak, firms are not encouraged to reinvest.³⁹

To further support the fact that strong property rights promotes economic development it has been reported that Wells Fargo a financial services company which operates in the suave United States financial market credits its success amongst other things to "stable and balanced legal and political environments with clear property rights and contract enforcement."⁴⁰ Stephen Knack and Philip Keefer also carried out empirical research and concluded that "institutions that protect property rights are crucial to economic growth and to investment"⁴¹ They concluded also that protection of security rights affects the magnitude of investment and goes further to affect the efficient allocation of resources. From the case studies above it is clear that property rights play a very important role in the economic development of a country.

4. Property rights and Access to Finance

In recent times, there is a consensus between scholars on the fact that property rights and access to finance are linked. De Soto's work has brought more attention to the link between property rights and access to finance and consequently property rights has become recognized as being more than "just a technical matter but rather something that is part of an infrastructure for growth and

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³³ Richard Roll and John Talbott, 'Why Many Developing Countries Just Aren't' (2001) The Anderson School of UCLA, Finance Working Paper No. 19-01
³⁴ <http://www.ssrn.com/abstract=292140> accessed 28 September 2014

³⁵ Shing-Yi Wang, 'Credit Constraints, Job Mobility and Entrepreneurship: Evidence from a Property Reform in China' (2008) 1 <http://www.chinasummerinstitute.org/wp-content/uploads/shingyi-wang-china2008.pdf> accessed 18 May 2014

³⁶ Simon Johnson, John Mcmillan and Christopher M. Woodruff, 'Property rights and Finance' (2002) NBER Working paper series

³⁷ <http://www.ssrn.com/abstract=305078> accessed 22 May 2014

³⁸ Mahini Malhotra et al, 'Expanding Access to Finance: Good Practices and Policies for Micro, Small, and Medium Enterprises' (2006) World Bank

³⁹ available at < http://info.worldbank.org/etools/docs/library/236032/SMEAccessToFinance_Final_083106.pdf accessed 28 June 2014

⁴⁰ Stephen Knack and Philip Keefer, 'Institutions and Economic Performance: Cross-Country Test using Alternative Institutional Measures', (1995) UCLA Paper No. 23118, 18 posted 10. June 2014 <<http://mpra.ub.uni-muenchen.de/23118/>> accessed 28 June 2014

sustainability.”⁴² A strong property rights regime is an important factor in securing access to finance because it enables holders of the property rights have access to credit because their property can be used as collateral for loans.⁴³

Some scholars have asserted that providers of finance are more likely to give credit where it can be secured with collateral and that the non-provision of secure and formally registered property rights as collateral can act as an impediment to accessing finance especially for the poor.⁴⁴ This is because the banks usually screen candidates who are in search of finance by assessing whether or not they can produce adequate collateral for the loan being sought. This is a measure used by the banks to reduce credit risk.⁴⁵ The need for an efficient legal system for the protection of property rights comes to play because property rights can only be effective in promoting access to finance where firstly it is secured and can be transferred to the providers of finance and secondly where the providers of finance believe that they will be able to gain access to the property used as collateral in the event of a default in the repayment of the borrowed finance.⁴⁶

Erica Field and Maximo Torero conducted a study on urban land titling in Peru. They evaluated the effect secured property title had on credit supply. In their study they compared loan approval rates when titles were requested by the banks as collateral and when titles were not requested. They found that property titles are linked with approval rates on public sector loans by as much as 12% when titles are requested. However, they found no evidence linking property title to an increase in the likelihood that private sector banks would give credit although they found that interest rates are considerably lower for applicants with titled property regardless of whether the banks asked for collateral.⁴⁷

The limitations in the provision of finance have been linked amongst other things to weak property rights and contract enforcement. It is recommended that a way for Governments to increase banks willingness to provide finance is by creating a strong property rights regime wherein both lenders and borrowers have clearly defined property rights. In addition, it is asserted that a strong property rights regime will not only improve access to finance but will go further to enable borrowers access cheaper and longer term loans thereby promoting economic development.⁴⁸ However, scholars have emphasized that having a strong system of property rights is not sufficient in ensuring access to finance, it is pertinent to have legal provisions that ensure debtors' and creditors' rights.⁴⁹ The effectiveness of the legal rights depends on strong enforcement of the law. For example the lack of an effective legal system to enforce laws in the Russian Federation has been said to impede the development of a deeper credit market.⁵⁰ In addition where a property is open to expropriation it reduces the chances of gaining access to finance from the banks. The risk of expropriation which is usually higher in countries where property rights are not secure discourages the banks from lending money.⁵¹

A strong property rights regime is often fundamental for providing access to finance for economic development. The lack of strong property rights limits the ability of property to generate finance and failure to generate finance leads to a failure in economic development. The World Bank in 2004 conducted a study of 37 countries and it was found that countries in the 25th percentile for property rights protection had loan spreads 87 basis points lower than those in the 75th percentile.⁵² Also according to De Soto, in the United States, the most significant source of funds for new businesses is a mortgage on the entrepreneurs' house.⁵³ If a strong property rights regime did not exist in the United States the entrepreneurs would not be able to mortgage their houses in order to secure finance.

It is very important to note that the poor securing access to finance which is made easier by having strong property rights in place leads to overall economic development. Thus there is a link

⁴² Bengt Kjellson and Lars Magnusson, 'Property Rights, Access to Finance and Poverty Reduction – the FIG Challenge' 2 A paper presented at the Sweden FIG Congress 2010; Facing the Challenges – Building the Capacity Sydney, Australia on 11-16 April 2010

⁴³ Trebilcock (n2) 406

⁴⁴ Erica Field and Maximo Torero, 'Do Property Title Increase Credit Access Among the Urban Poor? Evidence from a nationwide titling program'. (2006) 1 available at < http://www.economics.harvard.edu/files/faculty/18_FieldToreroocs.pdf > accessed 02 July 2014

⁴⁵ Ibid

⁴⁶ Trebilcock (n2) 406

⁴⁷ Field (n44) 1

⁴⁸ Malhotra et al (n40) 12

⁴⁹ Ibid

⁵⁰ Ibid 12

⁵¹ En bai (n10) 6

⁵² Malhotra et al (n40) 12

⁵³ De Soto (n16)

between access to finance and economic development. The important role played by access to finance in economic development was identified as far back as 1939 when Joseph Schumpeter stated that "capitalism is that form of private property economy in which innovations are carried out by means of borrowed money."⁵⁴

5. Conclusion

The importance of property rights in securing access to finance for the poor and for economic development is highly recognised by economists. Property rights play a very important role in the efficient allocation of resources within an economy. Where a strong system of property rights is not existent, people would refrain from investing for fear of expropriation. As shown by the case studies, strong property rights are a fundamental determinant of economic development. Though some scholars have argued that there are other alternative factors that can function effectively and lead to economic development, this paper has shown that they are not as effective as a strong regime of property rights. This is simply because they are limited in their applicability to small groups of people and cannot be used effectively outside of small communities to seek external assistance.

This paper has also shown that there are other requirements that need to be put in place if the benefits of a strong system of property rights are to be fully explored. These factors include the recognition and enforcement of property rights, there should be functional regulatory agencies to enforce property rights such as the police, an independent judiciary, and access to a registry for registration of title to property as well as securities. It is advisable that governments in market economies put in place effective institutional frameworks that clearly defines and supports property rights so that properties can be used exclusively, easily transferred and alienated to ensure efficient allocation of resources.

Furthermore, scholars have also agreed that there is a link between the property rights and the poor securing access to finance. This is because where there is a strong system of property rights persons are allowed to use their properties as collateral when seeking access to finance. The case studies discussed above show that putting a strong property rights regime in place will make it easier for people to secure finance as the banks will be more willing to give loans where the borrowers possess security which can be collateralised. It should also be noted that it is necessary to put in place an environment where the banks as well as the borrowers can easily enforce their rights in case of a default by either party. Where such an environment exists it will encourage the banks to give more loans thereby increasing the access to finance and overall economic development.

⁵⁴ Joseph A. Schumpeter, *Business Cycles; A Theoretical, Historical and Statistical Analysis of the Capitalist Process* (1939) (New York: McGraw-Hill) 216