

## Chapter 4 Security and stability

4.1 The outbreak of war or other widespread violence spells the end of almost all productive investment. Peace is surely a prerequisite to unleashing entrepreneurial activity, but firms require more than peace to commit energy and resources to investing productively. They require an environment where personnel and property are reasonably safe from criminal acts, where rights are secure, and where government policy exhibits at least some predictability. An insecure or unstable environment has its most tangible effect on property rights, and hence this chapter concentrates on the impact of insecure rights on the investment climate and what governments can do to make them more secure.

4.2 Secure property rights link effort with reward, assuring all firms—large and small, informal and formal, rural and urban—that they will be able to reap the fruits of their investments. The better protected these rights, the stronger the link between effort and reward and hence the greater the incentives to open new businesses, to invest more in existing ones, and simply to work harder (box 4.1).

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### **Box 4.1 Property rights reform in China: Even modest progress can ignite a strong response**

After China's Maoist revolution, households were allocated farmland that they could not sell, rent, or otherwise transfer. All production belonged to the government, and periodically the authorities would reassign land in response to their assessment of "need." Whether a household worked the land hard, or hardly at all, did not affect its well-being. All households received an equal share of the community's total production. Effort was divorced from reward, resulting in the stagnation of agricultural production in the 1970s.

Since 1982 China has been granting farmers greater rights to land. Initially, they were permitted to sell anything they produced in excess of a fixed amount due the government each year. This was followed by a gradual lengthening in the time they were allowed to farm the land. At first land could be taken away every three years, but that period has been progressively lengthened. In some parts of China it now runs as long as 30 years.

Improvements in agricultural productivity depend in part on investments that take time to pay off: increases in the amount of fertilizer applied, the number of wells drilled, and so forth. As the length of farmers' land tenure increased, so too have investments to make that land more productive. Besides altering rights to land to better link effort with reward, Chinese policymakers liberalized prices and took other steps to boost production. The combined effect of these reforms was to boost agricultural output by 42 percent over 1978-84. Almost half this increase has been attributed to changes in land rights.

*Sources:* McMillan (2002), Lin (1992), World Bank (2003d).

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4.3 New evidence confirms how important secure property rights can be. Recent surveys from Poland, Romania, Russia, Slovakia, and Ukraine show that entrepreneurs who believe their property rights are secure reinvest between 14 and 40 percent more of their profits in their businesses than those who don't.<sup>1</sup> Farmers in Ghana and Nicaragua invest up to 8 percent more in their land when their rights to it are secure.<sup>2</sup> By contrast, to compensate for the greater insecurity of property rights, equity investors in African firms require returns as much as 50 percent greater than those in firms in industrial countries.<sup>3</sup>

4.4 Studies across a broad range of countries find that the more secure the rights, the higher the level of growth. They also show that even modest improvements in security can increase annual economic growth rates by as much as one percentage point.<sup>4</sup> No matter what factors are included in the analyses and what measures of property rights' security are used, all report a close connection between growth and property rights security. Indeed, the large number of studies all reaching the same conclusion led one commentator to observe that the link between secure property rights and growth has “withstood an unusually large amount of scrutiny.”<sup>5</sup>

4.5 Drawing on experience in developed and developing countries, this chapter focuses on five measures governments can take to improve the investment climates of their societies by enhancing the security of property rights.

- Verifying rights to land and other property.
- Facilitating property exchanges and contract enforcement .
- Reducing crime.
- Ending the uncompensated expropriation of property.
- Reducing policy instability and uncertainty.

#### **Verifying rights to land and other property**

4.6 Providing secure title reduces the risks of fraud and mistake in property transactions, thus allowing buyers, renters, lenders, and others wanting to acquire an interest in property to do so with confidence they will get what they bargained for. The reduced risks show up in the difference in price between titled and untitled land. The value of rural land in Brazil, Indonesia, the Philippines, and Thailand increases by anywhere from 43 percent to 81 percent after being titled.<sup>6</sup> For urban land, titling increases the value by 14 percent in Manila<sup>7</sup>, by almost 25 percent in both Guayaquil, Ecuador,<sup>8</sup> and Lima, Peru, and by 58 percent in Davao, Philippines.<sup>9</sup>

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#### **Box 4.2 Secure property rights and environmental stewardship**

When rights to natural resources are uncertain, those in immediate control often feel they should “use or it lose it.” After all, if they are not sure the resource will be theirs tomorrow, why not take as much as possible today?

Fisheries are often depleted because of this use-it-or-lose-it syndrome. Each fisherman catches as much as he can as fast as he can, knowing that others are doing the same. The result is that the stock of fish is soon exhausted. But Iceland devised a way to use property rights to overcome this problem. Each fisherman was awarded a quota of fish based on how much he had historically caught. The fisherman was free to catch up to that number of fish each period or to trade some or all of the quota to others. The quota prevented overfishing while giving each holder an interest in ensuring the future health of the fishery. Since the adoption of a quota for herring, stocks have increased as has the catch. Quota schemes have produced similar results in New Zealand and Nova Scotia and Peru is now experimenting with a quota system as well.

Another example of the relationship between secure rights and environmental stewardship involves land. Ethiopian farmers are less likely to plant trees and build terraces to protect against erosion—and more

likely to increase the use of fertilizer and herbicides—when their rights to land are insecure. And when the rights to gather firewood, graze animals, and otherwise use the resources of neighboring forests are recognized, Kenyan communities keep careful watch to ensure that they are not overused.

Cross-national studies confirm the close link between secure rights and environmental stewardship. One recent analysis of 53 low and middle income countries concluded that a modest improvement in the protection of property rights could reduce the rate of deforestation in these nations by as much as one-third.

*Sources:* Deininger and others (2003), Samuel and Pender (2002), Pender and others (2001), Mwangi, Ongugo, and Njuguna (2000), Norton (2002); Gissurason (2000); Newell, Sanchirico, and Kerr (2002).

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### *Title to land*

4.7 Secure title to land also encourages investment. Farmers in Thailand with title invested so much more in their land that their output was 14–25 percent higher than those working untitled land of the same quality.<sup>10</sup> In Vietnam rural households with a document assigning clear rights of control and disposition commit 7.5 percent more land to crops requiring a greater initial outlay and yielding returns after several years than households without documentation.<sup>11</sup> In Peru almost half those with title to their property in Lima’s squatter settlements have invested in improvements, compared with 13 percent of those without title.<sup>12</sup>

4.8 Titling can improve access to credit when product markets, lending institutions, and the other elements of a financial infrastructure are present. Land ownership is an important indicator of creditworthiness, and a registered title allows lenders to easily verify ownership. Titled land is also accepted more readily as collateral. Lenders can determine whether others have an interest in the property and thus assess the likelihood of seizing the land if the borrower refuses to repay the debt.

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#### **Box 4.3 The distribution of property rights**

As economic activity intensifies, the returns from establishing rights over a resource increase accordingly. The paradigmatic case involves rights to the lands of the Labrador Peninsula, now part of Canada. These lands were home to otters, raccoons, and other fur-bearing animals, and as demand for pelts grew in 18<sup>th</sup> century Europe, the risk of overhunting increased appreciably. But because the land was held collectively, individuals had no incentive to curtail hunting. Parceling the land out to extended families solved the problem, giving each an incentive to restrict the taking of animals living on their land to sustainable levels. Allocating rights to natural resources to groups, families, or individuals continues to protect against deforestation, overfishing, and other practices that permanently damage the environment (see box 4.2).

Changes in property rights regimes can create strains within a community. Although the transition to a system of better defined rights increases the wealth of the community, some members will gain more than others, and some may even be worse off. Less skilled hunters realized more from curbs on hunting in Labrador than the more skilled. The problem is political: finding acceptable mechanisms to allocate the gains and losses while maintaining the advantages from more clearly specified rights. The bargaining to reach a solution can be difficult, and an impasse is always possible.

Why do some groups reach agreement and others not? One explanation is social capital—the trust, norms, and networks that facilitate coordinated action. Social capital tends to be higher when the community is smaller and more homogeneous and when information about the effect of different solutions circulates freely. As a number of studies confirm, these factors have been critical to community-wide agreements on the use of resources. And as *World Development Report 2002* explained, the larger the community, the

more ethnically and culturally diverse, the more open to trade, and the greater the spread in levels of income and wealth, the less likely an accord will emerge.

In an ideal world, government would act as an impartial arbiter among competing interests, nudging them in the direction of a mutually advantageous agreement while curbing opportunistic behavior and ensuring that norms of justice are observed. Governments rarely achieve this ideal, however. Instead, as an analysis of the creation of rights to farmland in 23 countries over three millennia shows, those in control of the governmental machinery often use their power to favor certain interests—aristocrats, colonists, and others with political influence—at the expense of the small peasant farmer.

A more recent example is the privatization of state property. As with land rights, the sale of state-owned property in an ideal world would produce a solution advantageous to all, transferring factories and other productive assets to those who can most efficiently exploit them at prices that reflected their value in a market economy. But some privatizations have favored a select few, as have several recent mass privatizations in Eastern Europe and the former Soviet Union. Indeed, one poll shows that 80 percent of the Russian public believes that the mass privatizations of Russian enterprises in the 1990s were unfair.

As Hobbes recognized, and several modern authors have recently tried to model, there is a dynamic at work in enforcing property rights. If enough citizens accept (or at least acquiesce to) the current regime, the government's enforcement resources can be devoted to bringing those who refuse to accept existing arrangements into compliance. Greater compliance produces a virtuous circle. As more people believe others will respect the current regime, their incentives to respect it increase too. And those who would undermine secure property rights face ever higher levels of deterrence as government brings more resources to bear on fewer individuals.

Similarly, when large numbers of citizens believe the existing distribution of rights is unfair, the resulting tensions undermine secure rights and produce a downward spiral of noncompliance. Government is not helpless in the face of widespread discontent with the distribution of rights, however (see box 4.9).

*Sources:* Demsetz (1967); Libecap (1989); Putnam, Leonardi, and Nanetti (1993); Ostrom (2000); Binswanger, Deininger, and Feder (1995); Transition (2003); Hoff (forthcoming).

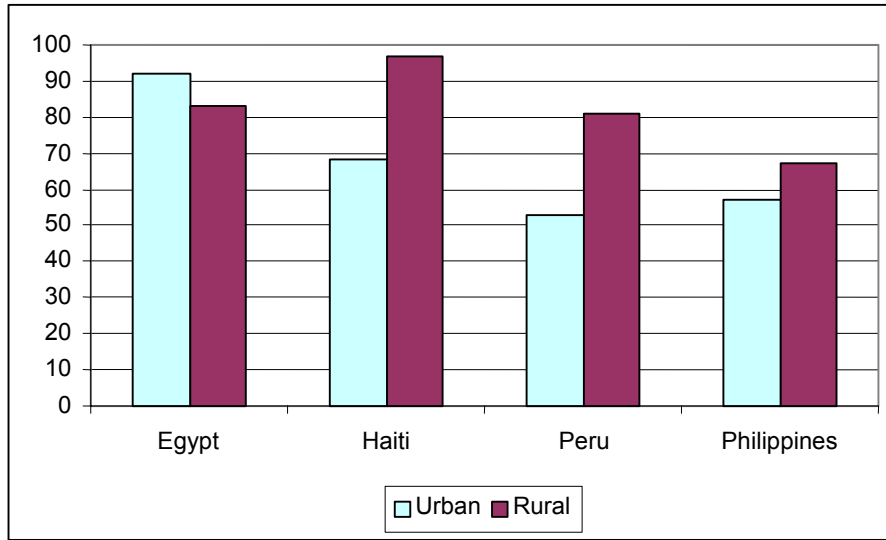
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4.9 Farmers with secure title in Costa Rica, Ecuador, Honduras, Jamaica, Paraguay, and Thailand obtain larger loans on better terms than those without. In Thailand farmers with title borrowed anywhere from 50 percent to five times more from banks and other institutional lenders than farmers with land identical in quality but without title.<sup>13</sup> The benefits extend beyond farmers. In Peru residents of urban areas in Lima that received title to their land have used the titled land as collateral to buy microbuses, build small factories, and start other types of small businesses. Lack of secure title—common in many countries (figure 4.1)—is thus one more obstacle smaller entrepreneurs face when trying to find financing for their operations.

4.10 Securing rights contributes to a better investment climate in ways besides boosting investment and enhancing credit access. Titled owners do not have to waste time at home guarding their property. In Peru those with title to their land worked outside the home an average of 20 hours more than those in the same neighborhood whose land is not titled.<sup>14</sup> In Vietnam, the productivity increases associated with more secure rights allow farm households with secure rights to spend an average of nine weeks more time working off the farm than those without secure rights.

**Figure 4.1 Not entitled?**

Estimated proportion of citizens living in untitled houses (%)



Source: De Soto (2000).

4.11 Even the landless poor can benefit when rights are secure. Owners with insecure rights are frequently reluctant to rent their land, fearing that a tenant may try to assert a claim to the property. Many will thus let their land lay fallow rather than risk leasing it to a household wanting to work it. Alternatively, they will rent it only to those they know well. In either case, productivity suffers because the rural poor—less likely to be a part of the owner’s social circle—are denied access to land.<sup>15</sup> In the Dominican Republic the effect of securing owners’ rights increased the number of plots leased out by 21 percent, with 17 percent more households obtaining access to land. Poor households realized the largest share of benefits. The percentage of poor tenants increased by 40 percent and the actual area rented to them grew by 67 percent.<sup>16</sup>

4.12 Titling benefits both individual landholders, through investment incentives and credit access, and the community at large, through its impact on growth and poverty reduction. While the price governments charge for titling services should reflect this mix of public and private benefits, that price should not be inflated because of red tape or demands for "unofficial" payments by registry staff. Maintaining monopolies over surveyors, notaries, and other professionals that prepare the necessary documentation can also boost costs and so deter registration. In Russia surveyor fees equal to two years of the minimum wage keep many from registering their property.<sup>17</sup> In Peru the key to titling urban land belonging to the poor and near-poor was breaking the notaries’ monopoly over drafting deeds.

4.13 *Maintain an effective titling program.* Governments can improve the security of land title by maintaining an efficient land registry, something becoming easier with advances in computer technology. But even this straightforward measure can face challenges.

4.14 First, the cost of issuing initial titles can be significant, particularly when a large percentage of land is untitled, as is the case in many developing and transition economies. Conflicting claims may need to be resolved, boundaries determined, and accurate maps drawn. In recent World Bank-supported projects the unit cost of a title or first registration ranged from \$9.90 in Moldova to \$24.40 in Indonesia to \$1,354 in Latvia.<sup>18</sup>

4.15 Second, it is typically much easier to provide title to land where de facto ownership rights are recognized in the community than where titling may encroach on the claims of others. The programs in Thailand and Peru began by issuing titles to residents whose rights were essentially uncontested, either by other individuals or by the government. As support for the projects grew, and experience in administering them increased, the titling effort was extended to areas where the issues were more complex (box 4.4).

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#### **Box 4.4 Thailand's 20-year program to title rural land**

In 1982 the Thai government began a 20-year project to title and register farmland throughout the kingdom. The aim? Enhancing farmers' access to institutional credit and increasing their productivity by giving them an incentive to make long-term investments. Just over 8.5 million titles were issued during the life of the project. And along with those issued outside it, the number of registered titles increased from 4.5 million in 1984 to just over 18 million by September 2001. Studies conducted during the project show that it met both its objectives: titled farmers secured larger loans on better terms than untitled farmers, and productivity on titled parcels rose appreciably. The success in Thailand is attributed to several factors.

- There was a clear vision for the project, a long-term plan to achieve it, and a commitment by the government and key stakeholders to project implementation.
- A strong policy, legal, and institutional framework was in place for land administration.
- The project built on earlier efforts to issue documents recognizing holders' rights to their land.
- Registration procedures developed by Department of Lands were efficient and responsive to public demand.
- The public had confidence in the land administration system and actively participated in the reform process.
- The interests that complicate projects in other countries—public notaries, private lawyers, and private surveyors—were not present.

*Source:* Burns, Background paper for the World Development Report 2005.

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4.16 Even when there are no rival claimants, titling reforms can run into resistance. Land registry personnel often oppose modernization, either from inertia or the loss of opportunities to collect side-payments from registrants. In Russia, Ukraine, and other former socialist countries opposition to rural land titling has come from the managers of collective farms. Titling requires breaking these farms up into individual parcels, threatening managers' jobs and income and weakening their power over the farmers.<sup>19</sup>

4.17 *Consider alternatives to full-blown titling.* A large titling program is costly and requires many trained professionals. Before initiating a program, governments should consider whether its policy objectives can be realized through measures short of providing a full legal title. In Niger, where security of rights was the goal, a simple community-based registration scheme sufficed.<sup>20</sup> In Honduras simple title documents that lenders can hold while the loan is outstanding have been enough to improve the flow of formal credit to small farmers.<sup>21</sup> In urban areas, too, interim measures short of full

titling can begin to meet residents' needs for greater security.<sup>22</sup> Botswana has issued urban dwellers use certificates. These have protected holders from eviction while the government considered options to address urban landlessness.<sup>23</sup>

4.18 *Ensure competition among service providers.* Whatever the means chosen to enhance the security of property rights, governments need to be sure that consumers are not overcharged for the required services. Experience in the United Kingdom, Australia, and the Netherlands shows that transaction costs can be reduced, without sacrificing the quality of service, by introducing competition into the provision of services associated with land transactions (box 4.5).

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**Box 4.5 De-monopolizing property transaction professionals**

In early 1984 the British government announced it was considering ending the legal profession's 180-year monopoly on providing the services required to buy or sell real estate. Within months, reports began circulating that prices for conveyancing services were falling. Spurred by favorable responses from consumer organizations, and over the vigorous objections of the organized bar, the government went through with its proposal to open the market to non-lawyers. Starting in October 1987 anyone passing a rigorous licensing examination was permitted to offer conveyancing services. And in accord with an earlier reform, both legal professionals and licensed conveyancers were allowed to advertise rates and services.

Competition brought prices down without sacrificing quality. The mean price charged for conveyancing services fell almost 10 percent between 1983 and 1986, a period when housing prices, and thus the fees under the old schedule, rose significantly. Consumers asking for an estimate of the cost of the services realized significant savings because providers cut their initial quotes for fear of losing the business. Despite the price reductions, consumers buying or selling real estate after de-monopolization reported the same satisfaction with the services, if not more.

Similar deregulation initiatives have brought the costs of land transactions down in the Australian state of New South Wales and in the Netherlands. Conveyancing fees in New South Wales fell an average of 18 percent in the mid-1990s after the market was opened to non-lawyers, saving the community close to \$A100 million in fees. In the Netherlands abolishing the professional monopoly held by real estate agents lowered costs and provided consumers with a greater selection of services. These results are consistent with a broader study of professional regulation conducted by the European Commission. It finds that less regulation of lawyers, notaries, and other legal professionals enhances consumer welfare without compromising other values.

*Sources:* Domberger and Sherr (1989), Baker (1996), Philipsen (2003), European Commission (2004).

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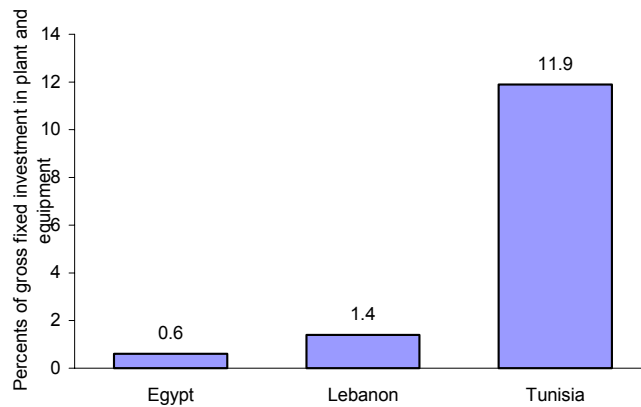
### *Title to other property*

4.19 Titling automobiles, equipment, machinery, and other valuable forms of "movable" property can provide benefits similar to titling land. As with land the registration can facilitate access to credit. Lenders can verify ownership and determine whether others have already either lent against the property or may have some other interest that would make it difficult to foreclose on the property in the event of default. Experiences in Romania and Indonesia demonstrate the value of movable property registries. Both countries created one in 2000. By the end of 2003 Romania had recorded 200,000 entries while in Jakarta alone in 2003 creditors sought to register 12,000 interests in vehicles, machinery, and other items covered by the new law.<sup>24</sup>

4.20 The easier it is for banks and other financial institutions to recover the property in the event of nonpayment, the more willing they are to lend. A common method for lowering the costs of foreclosure is for the lender to retain title to the property. The lender simply leases it to the borrower for a fixed period of time at an agreed upon price, often payable monthly. Not only can such leasing agreements simplify foreclosure proceedings, but as chapter 6 explains, they are also an important means for broadening access to finance. Small and medium firms do not need to accumulate the funds required to buy machinery or other assets outright but can obtain the equipment by paying a bank, or a firm that specializes in leasing, a monthly rental fee.

4.21 The extent to which firms can take advantage of leasing depends largely on how secure the lessor's rights in the property are. If, in the event of nonpayment, the lessor must go to great lengths and expense to reclaim the property, it will require that firms leasing the equipment provide large cash advances or other forms of guarantees.<sup>25</sup> In Egypt it can take years to repossess leased property, in Lebanon anywhere from nine months to 2 1/2 years. In Tunisia, by contrast it takes three months at most to obtain a court decree order permitting repossession.<sup>26</sup> Partly as a result of lessors' ability to obtain these orders quickly, estimates from 2000 show leasing to be far more prevalent in Tunisia than either Lebanon or Egypt (figure 4.2).

**Figure 4.2 Leasing activity is much greater in Tunisia than Egypt or Lebanon, thanks to laws speeding repossession**



Source: World Bank (2002).

4.22 One type of property of growing importance is intellectual—the patents, copyrights, trademarks, and other legally created rights to enjoy the fruits of one's intellectual efforts. Because intellectual property is intangible, and can be transported easily across national boundaries, international agreement on the enforcement of these rights is critical to its protection (box 4.6).

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**Box 4.6 Intellectual property rights: the ongoing debate**

Inventors and authors often require an incentive to develop innovative products—that has been recognized since at least the 4<sup>th</sup> century BCE. Today, the incentive is provided by granting creators of new inventions, software programs, or other products a patent, copyright, or other similar right to their creation. An idea of



how powerful this stimulus can be comes from a recent analysis of spending on research and development by American firms. A modest increase in the value managers expect to realize from patenting new products was found to boost R&D by anywhere from 11 percent in the biotech industry to 8 percent in the pharmaceutical industry to 7 percent in the chemical industry.

But this stimulant comes at a price. Intellectual property rights give their holders the exclusive right to sell the product embodying their creation. While the time period is limited, during it holders are free to charge whatever price they wish irrespective of production costs. Intellectual property rights thus need to strike a balance between society's interests in fostering innovation and in keeping prices to consumer low.

Finding the right balance is a challenge. Early in the 19<sup>th</sup> century, when the United States had few authors but many readers, English writers complained that the American government did not enforce their copyrights. But as the United States produced more authors, government policy toward copyright changed until the U.S. became a leader in persuading other nations to honor copyrighted works. For the past two decades countries where the majority of innovative products are produced have urged countries that mainly purchase these products to strengthen their enforcement of intellectual property rights to prevent the dilution of incentives to innovate. While the debate continues, four recent developments are helping to change its terms.

First, more firms in more developing countries are now producing innovative products and thus have a direct stake in the protection of intellectual property rights. In Brazil and the Philippines short duration patents have helped domestic firms adapt foreign technology to local conditions while in Kuwait, Morocco, and Ghana local software firms are expanding into the international market. India's vibrant music and film industry is in part the result of effective copyright protection while in Sri Lanka laws protecting designs from pirates have allowed manufacturers of quality ceramics to increase exports. Software and recording industry firms in Indonesia report that they would expand production if their copyrights were better protected.

Second, a growing number of developing countries are seeking to attract foreign direct investment, including in industries where proprietary technologies are important. However, foreign firms are reluctant to transfer their most advanced technology, or to invest in production facilities, until they are confident their rights will be protected. Innovators in many knowledge-intensive industries simply will not invest where the protection of their intellectual property is uncertain.

Third, there is growing recognition that consumers in even the poorest countries can suffer from the sale of counterfeit goods, as examples ranging from falsely branded pesticides in Kenya to the sale of poisoned meat in China attest. Consumers usually suffer the most when laws protecting trademarks and brand names are not vigorously enforced.

Fourth, there is a trend towards addressing intellectual property issues one-by-one, helping to identify areas of agreement and find common ground on points of difference. An agreement at the WTO ministerial meeting in November 2001 reflects developing countries' need for access to medicine. Discussion is under way too on policies that would give manufacturers of patented goods greater flexibility to sell at lower prices in poor countries than in wealthier ones.

How nations recognize intellectual property rights can be as important as the decision to protect them. When the United States established a patent regime in the early 19<sup>th</sup> century, it modeled its laws after those of the United Kingdom. But unlike the U.K., the fees for registering a patent were very low, innovators were free to license their patents to others, and administrative procedures ensured even-handed application of the law to all. Broadening access to intellectual property rights spurred an enormous increase in innovative activity, and shortly after a mid-century exhibition in London, where British officials were shocked by America's technological achievement, they paid the American government a high compliment: they followed its example and opened up their patent regime.

*Sources:* Primo Braga, Fink, and Sepulveda (2000), Maskus (2002), Arora, Ceccagnoli, and Cohen (2003), Nathan Associates Inc. (2003); Hoff and Stiglitz (forthcoming); Luthria and Maskus (2004).

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### **Facilitating property exchanges and contract enforcement**

4.23 Property rights are more secure, and more valuable, when the costs and risks of exchanging them are low. Delays or uncertainties in the enforcement of exchange erode their value and diminish the opportunities and incentives to invest. In an ideal world, all contractual exchanges would occur without a hitch. Neither party would ever fail to deliver the promised good or service or be short on the quality or quantity promised. It is easy to see why such a world would have an extraordinarily favorable investment climate. Firms could commit to long-term, complex commercial relationships with perfect strangers, confident that the other side would faithfully uphold its end of the bargain over as many years as the contract lasts.

4.24 It is also easy to see why such a world doesn't exist. Anytime the parties do not pay with one hand and take with the other, there is a risk that the party who performs later will breach the agreement. Governments can help firms cope with these risks by fostering the dissemination of accurate reputation information and supporting effective dispute resolution and enforcement mechanisms.

#### *Facilitate the flow of information about reputation*

4.25 Reputation is central to assuring contract performance in all societies.<sup>27</sup> In deciding whether to contract with a new partner, firms are guided by what they know about the potential partner's history of complying with contractual obligations. A firm is more likely to contract with those who have a good reputation. Various entities have emerged to meet the demand for such information. They collect information on the creditworthiness and reliability of individuals and firms and provide it to financial institutions, industrial companies, and others in the business community. Those who contemplate breaching their obligations know that if they do, all will soon know.

4.26 But government policy sometimes hinders the creation of firms that market reputation information by restricting the flow of commercial or financial data. Free-rider problems, highly concentrated financial systems, and other market failures can also retard the emergence of private organizations that gather and disseminate reputation information.<sup>28</sup> Governments should first remove the impediments to circulating accurate data on creditworthiness.<sup>29</sup> If private firms still do not enter the market, government can. In Bangladesh, Bolivia, Bulgaria, Nigeria, Romania, and Vietnam government-owned reporting agencies have been established, building on data collected by the central bank.<sup>30</sup>

#### *Reform courts and other dispute resolution mechanisms*

4.27 There are limits to the reach of reputation-based mechanisms. Firms without a history of creditworthiness will have difficulty gaining a foothold in the market. Reputation mechanisms also depend on participants being willing to collectively boycott anyone with a bad reputation. As economies expand, however, the difficulties of enforcing a group boycott increases. More information on more individuals and firms must be collected and disseminated, and the temptation to cheat, or free-ride, on the agreement grows. Eventually, a centralized contract-enforcement mechanism operated

by the state becomes a less costly alternative.<sup>31</sup> Rather than incurring substantial costs before entering into a transaction, firms find it less expensive to turn to a court after the fact to resolve differences over performance. The importance of courts grows as the number of large and complex long-term transactions increases.

4.28 The impact of a well-functioning court system extends far beyond the number of cases it resolves. The more timely and predictable a court's decisions, the better able firms are to predict the outcome of any dispute. As predictability and timeliness improve, the number of disputes filed may decline, because a credible threat of pursuing a remedy in court provides incentives for the parties to honor their obligations. Bargaining takes place in the shadow cast by the courts and the laws they enforce. The stronger the shadow they cast, the lower the risk of transacting, the larger the number of transactions, and the lower their cost.<sup>32</sup>

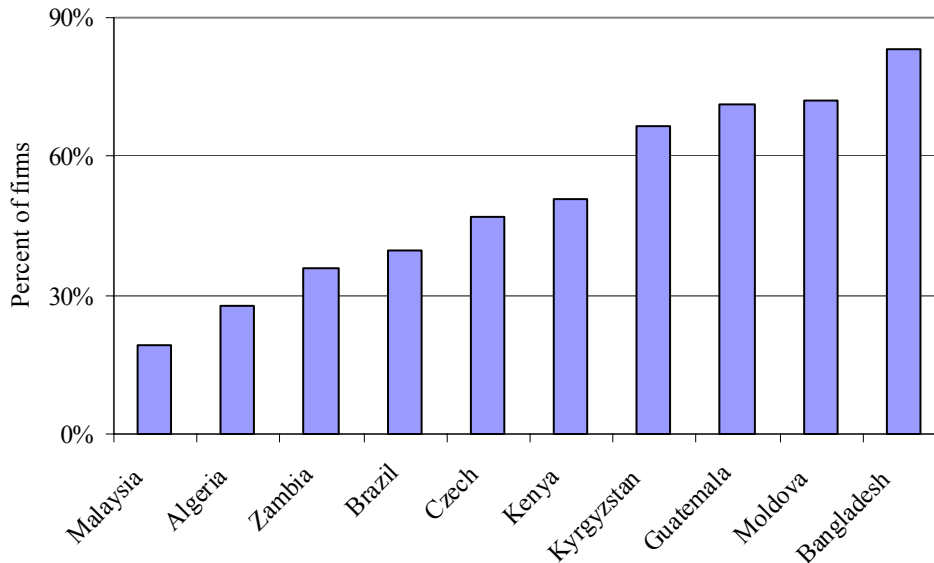
4.29 Where the shadow is weak, a firm's costs and risks increase. In India those whose contracts have been breached or who have suffered other injury must either accept a sharply discounted settlement or wait years, if not decades, to have their case resolved in court.<sup>33</sup> A weak shadow can also make some transactions so risky that they never occur, for if there is no way to assure performance, the risk of going forward may simply be too great. Or firms may circumvent the judicial system altogether, taking the costly but less risky route of purchasing their suppliers or customers and so turning arms-length transaction into transactions within firms.<sup>34</sup>

4.30 New research underlines the importance of well-performing courts for a better investment climate. Studies from Argentina and Brazil show that firms doing business in provinces with better performing courts enjoy greater access to credit.<sup>35</sup> New work in Mexico demonstrates that larger, more efficient firms are found in states with better court systems. Better courts reduce the risks firms face, and so increase the firms' willingness to invest more.<sup>36</sup>

- Firms in Brazil, Peru, and the Philippines report that they would be willing to increase investment if they had more confidence in their nation's courts.<sup>37</sup>
- Those in Albania, Bulgaria, Croatia, Ecuador, Moldova, Peru, Poland, Romania, Russia, Slovakia, Ukraine, and Vietnam say they would be reluctant to switch suppliers, even if offered a lower price, for fear they could not turn to the courts to enforce the agreement.<sup>38</sup>
- Firms with confidence in the courts in Poland, Romania, Russia, Slovakia, and Ukraine are more likely to extend trade credit and to enter new relations with local firms.
- In Bangladesh and Pakistan the World Bank's Investment Climate Surveys show that while firms with confidence in the courts make half their sales on credit, those with little confidence extend credit on only one-fourth of their sales.
- In Burundi, Cameroon, Côte d'Ivoire, Kenya, Madagascar, Zambia, and Zimbabwe, where firms have little confidence in the courts, they are unwilling to expand trade by doing business with any one other than those they know well.<sup>39</sup>

4.31 The investment climate surveys show that in many countries firms have little confidence in courts (figure 4.3). One reason may be the length of time and the cost required in many countries to resolve even simple cases. The World Bank's Doing Business Project shows that for 2003 the time required to collect an overdue payment ranges from 50 days in Singapore to 1,000 in Poland, with costs ranging as high as five times the income per capita in Malawi. Nor does the evidence show that slower, more costly courts deliver better results than less expensive, more expeditious ones.<sup>40</sup>

**Figure 4.3 Share of firms that do not believe the courts will uphold their property rights**



Source: World Bank Investment Climate Surveys.

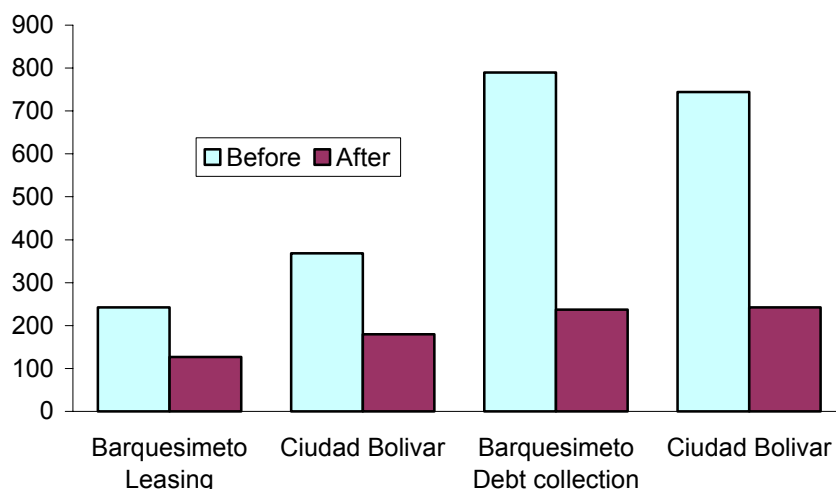
4.32 *Strengthen court systems.* As *World Development Report 2004* showed, agencies that provide a public service perform better when they are accountable to users, when users have a say in the policies governing the delivery of the service, and when those providing the service have a strong incentive to deliver quality services. These same principles apply to courts.

4.33 A common result of giving users more voice in the operation of the courts is procedural simplification. Court procedures in many developing and transition countries are more complex and costlier than those in industrial nations. Not only does the evidence show these lengthier and more expensive procedures provide no offsetting benefits, but they often are simply a further drag on entrepreneurial activity.<sup>41</sup> In Brazil, complex court procedures retard credit markets and increase the cost of credit transactions.<sup>42</sup>

4.34 Procedural reform can be coupled with computerization and other information technology. Such reforms help courts become more efficient by automating tasks previously done manually (figure 4.4). They make courts more transparent as well, enhancing accountability. In the Venezuelan cities of Barquesimeto and Ciudad Bolivar, the median time to resolve leasing and debt collection cases fell sharply, from 790 days

for debt collection cases in Barquesimeto to 237 days, after automation and related reforms were introduced. In Quito, Ecuador, procedural changes making proceedings more compact and immediate reduced the median time required to resolve cases by 85 percent.

**Figure 4.4 Reforms speed up business in Venezuelan courts**  
(days from initiation to termination)



*Source:* Supreme Court of Venezuela.

4.35 One frequently considered option for speeding up commercial cases is the creation of either a separate court or the separate division or chamber within an existing court to handle business disputes. Tanzania’s recently created commercial court draws praise from lawyers who appear before it, and although its filing fees are higher than the ordinary courts, to which litigants can also turn, its case load continues to grow.

4.36 But efforts to create specialized commercial courts in Bangladesh, Indonesia, Cape Verde, Côte d’Ivoire, Pakistan, and Rwanda have so far been less successful. The difference often lies in the political support courts enjoy. In Tanzania the court handles cases filed by banks and other financial institutions and they constitute a powerful lobby in support of the court. But in Bangladesh, Indonesia, and Pakistan the reverse is true. In these countries, it is the targets of court action who hold the power. In Bangladesh and Pakistan the defendants are influential citizens being asked to repay millions of dollars in loans from state-run banks. In Indonesia the defendants are being asked to accept significant losses in court-ordered reorganization and liquidation proceedings. In all three countries, the courts have not enjoyed the political backing required to overcome this opposition.

4.37 Court performance depends on judges, lawyers, clerks, and other participants working to ensure the timely and accurate resolution of disputes. Differences in court performance are largely a function of different incentives.<sup>44</sup> When participants have strong incentives to see that cases are decided expeditiously, accurately, and at a reasonable cost, court performance improves dramatically

4.38 Legal professionals who work in and around courts often fear that changing incentives will affect their incomes. In Tanzania reformers overcame the lawyers' opposition by persuading key members of the profession that they would benefit from reform. As confidence in the courts increased, reformers argued, more cases would be filed, so the demand for legal services would increase. In several countries, working groups of senior judges, respected members of the bar, and civil society have come together to develop a consensus on the benefits of reform.

4.39 A special challenge in court reform is that the judiciary is usually a separate and independent branch of government. Officials in the executive can urge judges to reform, and the legislature can pass laws to streamline procedures, but implementation depends on the courts. One step the executive can take on its own is to review its use of the courts. Governments are often the largest single user of the courts, and as a study in the Indian state of Andhra Pradesh shows, government often contributes to delays by pursuing matters it has no chance of winning and lodging appeals it is sure to lose.<sup>45</sup> Curbing such behavior can reduce the demands on the courts and allow them to concentrate on genuine disputes.

4.40 *Remove impediments to private dispute settlement.* Fostering private resolution through arbitration, mediation, or conciliation will also improve the contracting environment. Not only are these methods often less expensive than a lawsuit, they can produce more accurate decisions as well. Where the dispute involves technical issues, the parties can select an engineer or other expert versed in the relevant issues to decide the matter.

4.41 Some governments discourage private dispute resolution mechanisms through regulations dictating the procedures that must be followed and limiting who can serve as an arbitrator or mediator. In Bolivia and Tanzania various restrictions on alternative dispute resolution mechanisms prevent firms from taking full advantage of them.<sup>46</sup> By contrast, in Colombia and Peru—where government has enacted legislation enabling the use of alternatives, the results have been promising. A commercial arbitration chamber run by the Bogotá Chamber of Commerce handled 371 cases in 2001 involving claims of Col\$3.2 billion. The Lima Chamber of Commerce resolved 182 commercial disputes in 2000 in an average time of less than six months.<sup>47</sup>

4.42 Where the parties to an arbitration or other alternative dispute resolution mechanism contemplate continued dealings, each has an incentive to abide by the arbitrator's award. Each may also comply because of the effect on its reputation if it refuses to do so. If a party refuses to honor an arbiter's decision, it runs the risk that other firms will decline to do business with it in the future.

4.43 Where the incentives of repeat dealing or reputation are not present, the courts can backstop arbitration by permitting the prevailing party to bring an enforcement action. To be an effective backstop, the law must not give the loser in an arbitration proceeding a long period or numerous ways to challenge the award. The United Nations Commission on International Trade Law recommends that courts should be permitted to set aside awards only in limited and precisely defined situations. Otherwise, as has

happened in India, litigation over the validity of awards can spiral out of control as the losing side seeks to win in court what it lost at the arbitration table.<sup>48</sup>

4.44 Access to arbitration in a neutral country is often important to foreign investors, who may fear that the courts in the country of the investment are biased against them, or too slow, or too inexpert to hand down a timely and accurate decision. International arbitration has emerged as an important way for investors to reduce the risks of submitting disputes to local courts.<sup>49</sup> To improve the investment climate, governments should remove obstacles to international arbitration as well, by joining relevant international conventions and ensuring effective mechanisms exist to enforce the resulting awards. For example, the Russian government recently clarified that awards by international arbiters in disputes involving minority shareholders in Russian corporations are enforceable in domestic courts.

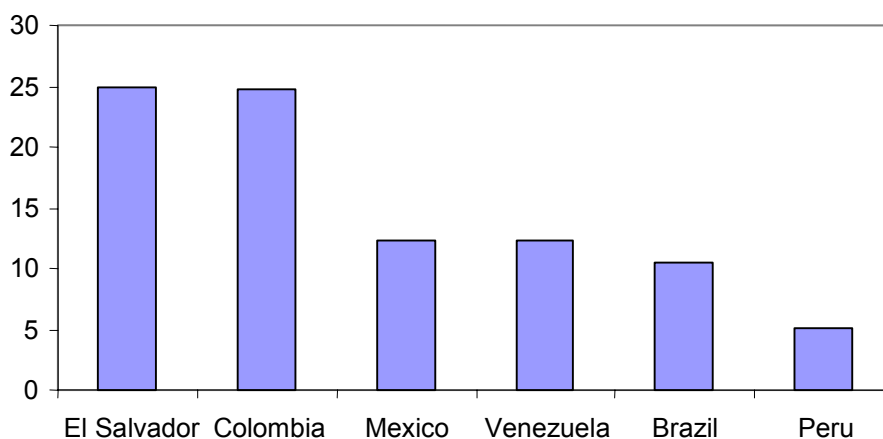
### **Reducing crime**

4.45 Robbery, fraud, and other crimes against property and against the person undermine the investment climate. Rampant crime discourages firms from investing or increases the costs of business, whether through the direct loss of goods or the costs of taking such precautions as hiring security guards, building fences, or installing alarm systems. In the extreme, foreign entrepreneurs will decline to invest, and domestic ones will flee the country for a more peaceful locale.

4.46 Estimates compiled in 2000 show the devastating impact of violent crime and property crime on the economies of six Latin American nations. In Colombia and El Salvador almost one-quarter of national GDP was lost to crime; only in Peru was the cost of crime less than 10 percent of gross domestic product (figure 4.5).

**Figure 4.5 Crime takes a heavy toll on many Latin American economies**

Cost of crime as a percent of GDP, 1999-2000

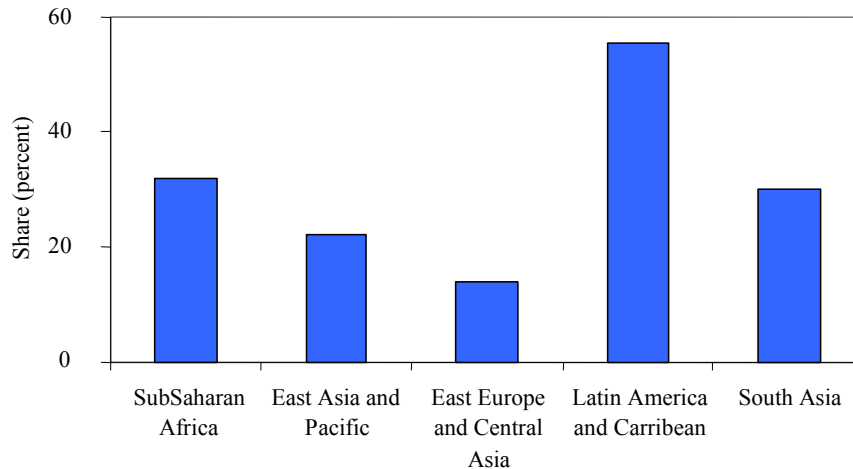


Source: Londoño, Gaviria, and Guerrero (2000) p. 27.

4.47 The World Bank’s Investment Climate Surveys show that crime retards entrepreneurial activity in every region. In Latin America almost 60 percent of firms surveyed judged crime to be a serious obstacle to conducting business. In Sub-Saharan Africa, South Asia, and East Asia over 20 percent said the same (figure 4.6).

**Figure 4.6 Crime is a significant constraint on firms in all regions**

Firms reporting crime a major or moderate constraint on doing business (%)



*Source:* World Bank Productivity and Investment Climate Surveys.

4.48 The impact of crime varies by country. In Nigeria the investment climate survey shows 37 percent of firms identify crime as a major or severe constraint on their operations, in Zambia the figure is 50 percent, and in Kenya 70 percent. In Guatemala an extraordinary 80 percent of the country’s firms say it is a major or severe constraint. Crime tends to have a similar effect on firms of all sizes. One exception is Bangladesh. Although 45 percent of medium and large firms say crime is constraint, only 20 percent of the small ones do.

4.49 A 2002 survey of 400 Jamaican firms offers further insights into the way crime can affect incentives to invest.<sup>50</sup> Just under two-thirds of firms surveyed reported being the victim of some kind of property crime during 2001, with many firms repeatedly victimized. More than one-fourth had property stolen once a quarter, with 9 percent reporting theft once a week, and 22 percent saying they were defrauded at least once a quarter. Firms of all sizes and locations were victimized. Eight of 10 farmers reported equipment or livestock stolen during 2001. Financial firms were most vulnerable to fraud. Manufacturing, distribution, and construction companies all reported significant theft and fraud. Smaller firms were more likely to be victims, and more often, than larger firms. Extortion, fraud, robbery, burglary, and arson caused 116 of the 400 firms to suffer losses amounting on average to J\$665,000. The cost of crime as a percentage of revenue was 9 percent for small-firms and firms with J\$20-50 million in annual revenues. Manufacturing firms reported that crime cost them nearly 6 percent of annual revenues.



4.50 When government is not strong enough to protect property rights, private organizations selling “protection services” fill the void. Some, such as private security services that protect shopping malls and downtown business districts, cooperate closely with the police. Others are not nearly so law abiding. “Violent entrepreneurs,” as a recent analysis of organized crime in Russia labeled them, rely on force and intimidation and often end up demanding a share of the profits of the firms they “protect.”<sup>51</sup> While respondents to the WBES survey said that organized crime has less impact on their business than street crime, the Jamaica survey suggests the data may understate its effect. Many businesses are reluctant to admit they are victims of extortion, either from shame or fear of violent reprisal.

4.51 Firms can do much to do reduce property crime—from installing burglar alarms to posting night watchmen. But there are limits to what they can achieve without government assistance. Property crime is rarely a crime of passion, suddenly triggered by overwhelming feelings of jealousy, betrayal, or rage. Instead, as analysts have recognized for more than two centuries, it is almost always motivated by a calculation, however rough, of the benefits to be gained against the consequence of apprehension and punishment (box 4.7).<sup>52</sup>

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**Box 4.7 Crime, poverty, and inequality**

Evidence from a single country over time or from many at one point in time shows that an increase in relative poverty or income equality leads to a rise in crime. One study drawing on data from developing countries finds that a relatively modest increase in inequality would produce an average increase in robberies of 30 to 45 percent. Another study suggests that a 5 percent drop in GDP would produce an immediate 50 percent jump in the robbery rate.

On one view, this relationship follows as a matter of economic logic. The decision to commit a crime depends on whether the return, discounted by the likelihood of apprehension and punishment, exceeds the gain from working. The more unequal the distribution of income and wealth in a society, the larger the potential gains from crime for those at the bottom of the scale.

Another view is that inequality is associated with discrimination and other social factors that affect character formation—and is thus the “real” cause of crime.

Study after study affirms the great power of the economic explanation. But there is always a residual, something left over after all economic factors are included, that explains part of the crime rate. This residual becomes more significant as the time frame lengthens. Long-run changes in the crime rate appear to respond to societal forces largely independent of economic ones.

Several policy implications follow from what is known. One is the importance of reducing relative poverty and inequality, not only for reasons of social justice, but for the very practical reason that it is a sure way to cut crime rates. A second is that sharp increases in relative poverty or inequality call for an immediate response. Both crime prevention and crime deterrence programs need to be expanded rapidly to dampen the inevitable rise in crime likely to follow. Third, each society needs to examine what accounts for the part of the crime rate not explained by economic factors. In other words, what shapes the character of its citizens?

*Sources:* Bourguignon (2000), Demombynes and Özler (2002), Wilson (1992).

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4.52 Combating crime is a major challenge in all societies, rich and poor. Experience suggests that governments can change the incentives for criminals through better law enforcement, stronger deterrence, and more effective crime prevention programs.

### *Better enforcement*

4.53 Apprehending and punishing criminals is a classic government function, but one often not performed with great efficiency. Reactive policing, where police simply receive reports from victims and then attempt to apprehend the responsible party, is notoriously ineffective. Modern policing is “problem-oriented.” It attempts to identify recurring crime problems and—with other government agencies and civil society—change the conditions leading to these problems. The approach emphasizes crime mapping, working with communities, and investigative techniques, rather than a generalized “get tough on crime approach.” Nor can policing be separated from human rights concerns: force may be required to capture and detain suspects, and the police need to be accountable to multiple constituencies when they use it.

### *Stronger deterrence*

4.54 Government can also improve its the deterrent effect of its criminal justice system. Are the penalties for theft, robbery, and other property crimes enough to alter a thief’s cost-benefit calculus? Are they applied consistently? How effective is the overall system at preventing and deterring crime?

4.55 No matter the penalties, criminal law is only as effective as those who enforce it. The police are the frontline enforcement agency, and any crime reduction initiative must begin with ensuring their effectiveness. But police reform is a challenge—for developed and developing countries alike. It is hard to monitor the actions of individual officers on patrol or to prescribe how they should handle the variety of often dangerous situations they confront on a daily basis. Difficult working conditions coupled with the sometimes hostile relations between police and citizens tend to isolate the police, creating a strong sense of loyalty among officers, and making external oversight and accountability difficult.

4.56 Despite these hurdles, some promising approaches emerged in the 1990s under the rubric of community policing. Although the details differ across countries, and even within countries, such policing includes one or more of the following (box 4.8):

- Assigning officers to foot patrols so that they can concentrate on those offences that are major annoyances to local residents and firms and build relationships with the community.
- Meeting regularly with individuals and firms to hear their views on police priorities.
- Analyzing trends and focusing efforts rather than responding to each individual crime as a report comes in.<sup>53</sup>

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**Box 4.8 New York City’s police reforms—*are they exportable?***

In the mid-1990s crime rates in New York City fell dramatically. Murders plunged 68 percent, burglaries 53 percent, and car thefts 61 percent. This extraordinary turnaround in crime helped support an economic renewal as employment levels, property values, and the growth rate rose sharply.

Much of the credit for this achievement is attributed to police reforms introduced by William Bratton during his tenure as head of New York City’s Police Department from 1994–96. The reforms were built around two principles: wholesale changes in management to reward those who succeeded in combating crime while penalizing those who didn’t, and a proactive crime fighting strategy.

*Incentives.* Bratton inherited a department where promotion depended not on arresting criminals but on avoiding scandals, conflicts with the community, and indeed any activity that might make waves. After long consultations with officers and other stakeholders, some 400 changes in the way the department operated were made. Recruiting standards were raised, training was improved, and disciplinary procedures were modernized. Most important, power was devolved to precinct commanders, the department’s line managers—and a new career system rewarded commanders who reduced crime rates.

*Strategy.* Department personnel developed a new computerized data management system to rapidly compile crime statistics and plot emerging trends and the locations of crime. “Compstat” turned out to be critical to the entire reform process. By providing weekly totals of crime and arrests by precinct and comparing them to historical data, supervisors could evaluate the performance of the precinct commanders, which they did at weekly strategy sessions. The system also allowed the department to adopt a new strategy. Rather than react to individual crime reports, managers could spot evolving patterns and re-deploy personnel accordingly. At the same time, the police began concentrating on the infrastructure that supports individual crimes. Instead of targeting individual car thieves, they went after those who dealt in stolen automobiles thus shrinking the thieves’ market.

*Exportable?* Several Latin American cities have begun experimenting with different aspects of the New York City reforms. Fortaleza, a tourist stop on the Brazilian coast, has created its own version of Compstat, and is striving to improve police-citizen relations. Chile adopted several New York City-style reforms, including the redeployment of police to high crime areas, more policing on foot, and better methods of collecting and analyzing crime statistics.

Bratton acknowledges that New York City’s experience must be adapted to the very different cultures and crime environments in the developing world, where the police are often not yet fully subject to civilian control and respect for citizen rights can be weak. Even so, as he and one of his key collaborators in the reform effort have argued, the underlying principles—devolving power to local commanders, holding them accountable for results, building citizen confidence in the police, and adopting proactive crime fighting strategies—are as applicable in Santiago or Fortaleza as in New York’s toughest neighborhoods.

*Sources:* Bratton and Andrews (1999), Lifsher (2001), Fundación Paz Ciudadana (2001), Fundación Paz Ciudadana (2002), Webb-Vidal (2001), Bratton and Andrews (2004).

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4.57 Putting police into the community increases their accountability and provides citizens with a greater voice in their operations. Community policing contributes to more effective policing as well. Police solve very few crimes on their own, fewer than 10 percent in a recent U.S. study. Victims and witnesses from the community have to come forward with information about the perpetrators for police to improve on this figure. As the South African police have learned, by forging stronger ties between the police and citizens community policing has furthered cooperation between the two, leading to higher arrest rates and greater respect for human rights.<sup>54</sup>

### *Strengthen prevention*

4.58 Governments need to resist the temptation to look for answers only within the confines of the criminal justice system. Several recent studies show that well-designed crime prevention programs are more cost-effective than criminal justice approaches.<sup>55</sup> A classic study in the United States found that for every dollar invested in prevention programs, six to seven dollars could be saved in criminal justice expenditures.<sup>56</sup> Effective prevention strategies include early interventions for at-risk teens, school-based initiatives to teach social competency skills and reduce violence in and around schools, and other programs to build character and foster community responsibility.<sup>57</sup> Emerging evidence from Colombia shows that handgun control and restrictions on the sale of liquor can reduce violent crime significantly.<sup>58</sup> Situational crime prevention—in which physical space is modified to make the commission of a crime more risky or less lucrative for the potential offender—is a promising prevention strategy for housing ministries or local governments.<sup>59</sup>

4.59 Government can also take some of the profit out of organized crime by reducing the regulatory burden on firms. Surveys of retail stores in three Russian cities show that protection rackets and other forms of organized crime flourish when the regulatory burden is high.<sup>60</sup> As the regulatory burden increases, store owners are less able to comply with the rules and thus more reluctant to call on state agencies to protect them from criminals or enforce their contracts. Organized criminals then step forward to meet the demand.

### **Ending uncompensated government expropriation of property**

4.60 The discussion so far has focused on how governments can help firms cope with threats to their property rights from third parties. But as chapter 2 showed, government can itself be an important source of threats to the security of property rights. A government strong enough to protect property is also strong enough to take it.<sup>61</sup>

4.61 All governments reserve the right to take property in some circumstances. To combat health emergencies, government must be able to order the destruction of livestock or poultry spreading disease. Without the power to take land, those holding parcels needed to complete an expressway can “hold up” government by demanding unreasonable prices to sell. The taking, or expropriation, of property can also be a more efficient means of obtaining it for public purposes than open market purchases. When an underground water pipe must traverse a large number of properties, the costs of reaching an agreement on price with each individual owner will be far greater than setting a price by decree.<sup>62</sup>

4.62 But governments have also seized private property where the public interest was less clear. Mass expropriations usually occur in the wake of violent upheavals, as when the post-1917 government in Russia or those in power in Eastern and Central European after World War II seized private property. Since then, expropriation has been most commonly associated with the nationalization of foreign investments, though recent experience in Zimbabwe shows that local firms are not immune (box 4.9).

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**Box 4.9 Property wrongs: is there ever a statute of limitations?**

If one buys a watch from someone who found it on the street, can the true owner later recover it? If a farmer settles on apparently unclaimed land and plants crops, can the land's real owner later evict him?

Easy cases are when the watch purchaser or farmer knew, or had reason to know, that the owner was lurking out there somewhere—the watch had the owner's name engraved on it, the land was registered or fenced. But when the watch seller genuinely appeared to own it or the land really did seem to be unclaimed, the answer requires trading off the right of ownership against the security of transactions.

Allowing the watch purchaser to defeat the owner's claim to recover it makes transactions more secure. Permitting the owner to reclaim it makes the right of ownership more secure. This tradeoff is often enshrined in a statute of limitations, a law setting a fixed period for challenging a transaction and providing that once that time has elapsed, the transaction can no longer be attacked. After that, the watch buyer and settler become the "true" owners.

Statutes of limitations embody the consensus societies have reached to resolve the ownership-transaction tradeoff between individuals. But reaching a consensus is difficult when different communities within a society are on opposite sides. In Zimbabwe many argue that land taken during the colonial wars of the 19<sup>th</sup> century should be returned to the descendants of the true owners. Current holders reply that, in most cases, they bought the land after independence, decades after the initial seizures, and preserving the security of these transactions should trump the right of ownership. Similar arguments are a feature of the political landscape in countries as different as Australia and Guatemala, and New Zealand. That the argument has in some cases gone on for decades is a sign that no easy solutions exist to claims of property wrongs, that there is no statute of limitations to invoke to extinguish claims, no matter how well grounded.

Policymakers confronting these situations face a dilemma. To allow the argument over the fairness of the current distribution of property to fester can undermine the security of property rights and, in the extreme, lead to civil war, as in Guatemala. But attempts to redistribute property can also have disastrous consequences. Since Zimbabwe began seizing white-owned land in 2000, agricultural production has dropped precipitously. Africa's fastest growing economy in 1997 became its fastest shrinking in 2003.

Between inaction and ill-conceived action, policymakers have many options for reaching a solution. One is to purchase land for redistribution, a policy Zimbabwe had pursued until 2000, albeit at a glacial pace, and one Brazil, Colombia, and South Africa are following with World Bank support. Policies to remedy the consequences of the existing distribution of property are also promising, from efforts to equalize educational opportunities to changes in tax policies. Addressing the needs of those disadvantaged by the current distribution of property by such "leveling up" measures requires significant resources and is considerably easier when the economy is growing. And it is thus that the relationship between a sound investment climate and property wrongs comes full circle.

*Source: Pound (1959).*

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4.63 Property need not be taken in its entirety, or in a single stroke, to constitute a "taking" or "expropriation." Taxes may be progressively raised to confiscatory levels or regulations made so onerous that an owner is forced to sell all or part of the property at a depressed price. While the outright expropriation of foreign investments has become less common in recent times, these forms of indirect or "creeping" expropriation have grown significantly.<sup>63</sup>

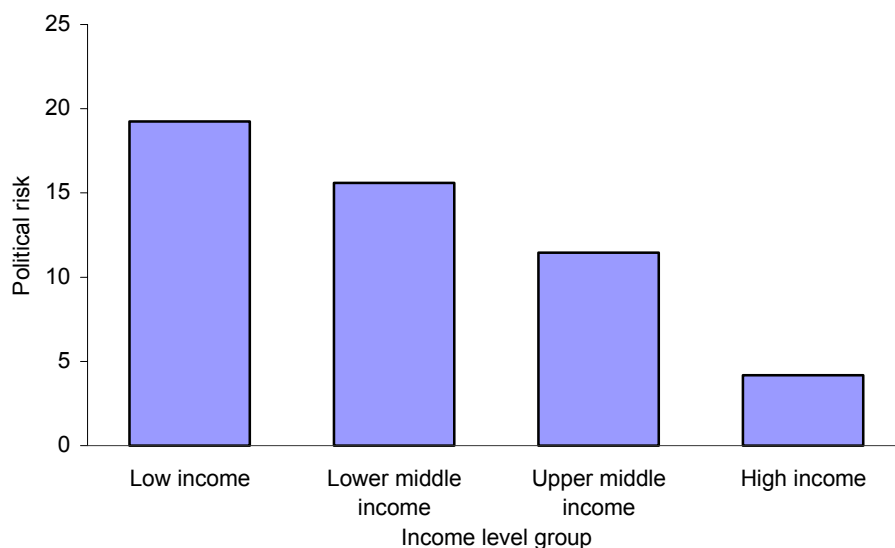
4.64 Foreign investors are often particularly vulnerable, because it may be politically attractive for politicians to target foreigners, and local courts may be reluctant to rule against the host government if a dispute arises. Large and immobile investments are especially at risk. Because they cannot be moved to another location in response to changing circumstances, they constitute what Vernon called an "obsolescing bargain,"

being exposed to host government efforts to renegotiate unilaterally the terms of the original agreement.<sup>64</sup> Foreign investments in private infrastructure projects have both these features—and are often in politically sensitive sectors with returns subject to regulation, making them even more vulnerable.<sup>65</sup>

4.65 The threat of expropriation varies from project to project, even in a single country.<sup>66</sup> While not amenable to precise measurement, the risk of expropriation is reflected in measures of "country risk" or "political risk" prepared by various rating agencies (figure 4.7). Some governments have credible mechanisms to restrain these threats and, coupled with a history of treating investors fairly, investments in these nations are perceived to involve only modest risks. Other governments have not yet established the same record—or have not been able to credibly commit to restrain such risks. When this is the case, investors will either decline to invest, avoid undertaking investments that are difficult to reverse, or require higher rates of return to compensate for the extra risks. In some high-risk countries in Africa, investors require returns on equity of 50 percent more than in a typical industrial country.<sup>67</sup>

**Figure 4.7 Risky business**

Average country rating in 2003, by income level, on political risk



*Note:* Political risk is defined as the risk of non-payment or non-servicing of payment for goods or services, loans, trade-related finance and dividends, and the non-repatriation of capital. Principal risks include war, civil disturbance, nationalization, a change in rules on capital outflow or currency convertibility and lack of foreign exchange. The vertical scale has been inverted and so higher values mean higher political risk.

*Source:* Euromoney website.

4.66 The significance of the risk of expropriation is reflected in the diversity of strategies firms pursue to address it.<sup>68</sup> Political risk insurance can be purchased, but it protects the investor only partly and can add 2 percent a year to the cost of the investment. Involving a "connected" local firm as an investment partner can be another form of "insurance," though such strategies often backfire when a "new crowd" takes power—as some Indonesian firms discovered recently. Better strategies involve efforts

to ensure the power to expropriate property is subject to credible limits. This means devising ways to limit its reach and establishing an effective mechanism to review its exercise, as well as addressing the incentives governments may face to misuse the power.

*Limiting the reach of power to expropriate*

4.67 Governments should be clear that property will be expropriated only to serve a public purpose—and that when it is expropriated there is a credible assurance of prompt, adequate, and effective compensation. The public purpose limitation reduces the ability of governments to use the power to favor private interests. Compensation provisions provide some assurance to firms that the loss will not be total if assets are expropriated. They help too to deter governments from “overtaking” by ensuring that government must pay for what it takes.

4.68 Setting the compensation price can be difficult. A requirement that governments pay “fair market value” is difficult to apply because by definition there is no willing seller. Various broad formulas have been adopted to determine compensation: “just” in the United States, “proper” in Spain, “adequate” in Malaysia and Mauritius.<sup>69</sup> In Germany, policymakers must pay what is “a fair balance between the public interest and the interests of those affected.” In South Africa the amount must reflect the use, history, market value, and previous state investment in the property as well as the purpose of the expropriation.

4.69 Although these policies could be set forth in a statute, at least the basic elements should be in the document most difficult for government to change: the nation’s constitution. This is the approach of most industrial countries and a growing number of developing countries. The same assurance is also often found in international agreements dealing with investment (chapter 9) and sometimes in specific contracts.

4.70 Defining the precise boundaries of an expropriation for which compensation is payable is a challenge. While creeping or indirect expropriation may take many forms, governments cannot be expected to compensate firms for every action that influences the value of their property in some way. Routine adjustments to tax policies and regulatory regimes may make some firms worse off but do not constitute an expropriation for which compensation should be paid. The test should center on the impact of the action on specific property rights and the comparative costs of compensating versus purchasing in the open market. These are the standards that have emerged in the laws, regulations, and court decisions of many countries. They make it clear, for example, that a change to an environmental regulation that has a diffuse effect across a large number of firms does not rise to a compensatory taking. Similar standards are emerging in the arbitration cases decided under international investment treaties (chapter 9).

4.71 In devising their policies in these areas, governments must bear in mind that they are not writing on a blank slate. Where their predecessors have recklessly expropriated property, the current government may need to overcome the effects of a reputation that it had no hand in making. Following a wave of expropriations in the 1980s under a law providing minimal compensation, Peruvian firms in the early 1990s were reluctant to

expand operations or invest in new ones. To help restore confidence, the 1993 constitution explicitly requires government to reimburse firms for the actual value of any property taken and any “possible loss” as well. Where, for example, the land on which a factory is located is taken for a highway, government must not only pay for the land but also reimburse the owner for the costs of moving the machinery and other equipment to a new location.

*Establish a mechanism to review the exercise of the expropriation power*

4.72 Limitations on the government's power to expropriate are credible only if means exist to ensure that the limits will be respected. Ordinarily, this will be a court separate from the executive. But while the courts in many developing countries are gradually breaking free of executive branch control, the history of judicial independence in industrial nations teaches that this process can take decades. It requires not only a well-trained and dedicated cadre of judges but vigorous and sustained competition among the political parties as well.<sup>70</sup>

4.73 When domestic courts are weak, or their credibility is low, government can agree to submit disputes involving expropriation to an international tribunal instead. As discussed in chapter 9, a growing number of international investment treaties provide for this option. Although the treaties deal with foreign investment, there are “halo” effects for local firms, reducing the likelihood that they would be singled out. And there is no reason why governments cannot agree to similar arrangements with local firms.

*Create incentives against the misuse of the expropriation power*

4.74 The incentives governments face to expropriate property in an arbitrary manner are ultimately influenced by the broader social and political context. As chapter 2 emphasized, taming the “grasping hand” of government can involve a broader range of strategies, including efforts to improve the accountability of governments, enhance the transparency of the government-business interface, strengthen competition, and ensure the benefits of a better investment climate are shared widely in society. Governments may also need to respond to a distinct but related phenomenon of “social expropriation” prevalent in some societies (box 4.10).

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**Box 4.10 “Social expropriation?”**

Reconciling the need to provide individuals with the incentive to work and invest with the welfare of the broader community is a challenge every society confronts. Firms in industrial countries are taxed to pay for housing, health care, and other social benefits for those unable to provide for themselves. Although any tax dulls incentives, well-designed schemes ensure the loss in output is justified by broader welfare gains.

In many African nations, where formal welfare state transfer programs are nonexistent or function poorly, community norms exist to ensure that those who prosper care for members of their extended family. Some students of African development worry that such norms, which could be termed a “culture of social expropriation,” retard incentives to invest and economic growth. The Cameroonian author Daniel Etounga-Manguelle has written that this culture threatens the personal initiative and dynamism that must be Africa’s engine of development.



History teaches that the transformation from a close knit agrarian community to a modern industrial society can strain communal bonds. This reinforces the importance of viewing investment climate improvements in a broader social context, including efforts to ensure that the benefits of improvement are shared widely in society, and taking measures to help people cope with change.

*Sources: Etounga-Manguelle (2000); Polanyi (1944).*

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### **Addressing the harmful effects of policy instability and uncertainty**

4.75 Expropriation may be the most direct government threat to secure property rights, and thus the incentives to invest productively. But it is not the only one. How governments make and implement policies can also generate uncertainty that undermines the value of property rights and chills the incentives of firms to invest.

4.76 Policy instability and uncertainty can arise from a variety of causes. At one extreme are what might be termed “macro causes.” They include interstate war and domestic conflicts, which can depress investment long after the end of the conflict.<sup>71</sup> They also include poor management of macroeconomic policy. At the other extreme are what might be termed “micro causes,” which can arise from a new law or regulation whose precise scope or interpretation is unclear or from arbitrary or unpredictable interpretations or enforcement actions by officials.

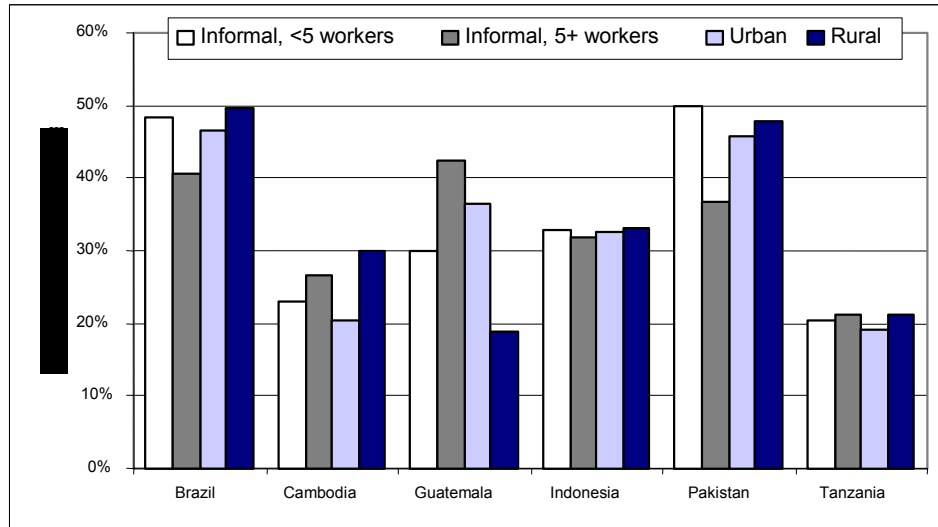
4.77 Across developing regions and irrespective of size, firms report that unpredictable or unstable policies have a major impact on their operations. Indeed, they typically rate it as their greatest concern (chapter 2). According to the WBES survey, the proportion of firms identifying policy and regulatory uncertainty as a serious constraint on their operations range from 45 percent in Africa to more than 70 percent in South Asia, Central and Eastern Europe, and the developing states of East Asia. By contrast, only a third of the firms surveyed in OECD countries considered instability a serious constraint. Across developing regions, the WBES data show that eliminating macroeconomic instability<sup>72</sup> would increase the probability of making new investments by 15 percent. Surveys undertaken for this Report show that policy uncertainty is also a significant concern to firms in the informal economy (figure 4.8).

4.78 Unstable or unpredictable policies make it harder for firms to evaluate investment opportunities, causing firms to shorten planning horizons and demand higher returns. Concerns can be particularly acute in such regulated sectors as infrastructure, where the profitability of the venture is often determined directly by government regulation. Hungary's first attempt to involve private investment in its energy sector—before defining the policy and regulatory framework—attracted few bids and the tender was aborted. Two years later, with a clearer regulatory framework in place, it attracted nearly \$2 billion in investment. Policy instability may also increase the risk of expropriation, with the consequences discussed earlier. And even narrower uncertainty—such as that over the interpretation of a particular regulation—can have a stifling effect on particular firms or activities. It may also be used as a means of extracting bribes from firms in return for favorable interpretations.

4.79 Not all policy changes undermine the investment climate. Reducing tax rates and simplifying regulations, while involving change, can improve it. Even a radically different new government can be welcome if it is committed to fostering growth, as in Central and Eastern Europe in the early 1990s.

**Figure 4.8 Uncertainty is a concern for informal firms as well**

Share of informal entrepreneurs reporting policy uncertainty as a major or severe constraint



Source: Informal firms survey undertaken for *World Development Report*.

*Addressing the "macro" causes of instability and uncertainty*

4.80 Improving macroeconomic management can help address some sources of instability and risk (box 4.11). Addressing other sources of risk—including political instability and social conflict—often demands deep institutional change. Ultimately, governments need to provide the same kind of credible commitment about future action that firms seek about expropriation. As the evidence in chapter 2 showed, levels of growth and investment are higher in nations where political leaders face more checks on their behavior, where policy markets are relatively competitive, and where information to evaluate policymakers is widely available. As with expropriation, efforts to build a social consensus are also important. When political institutions are properly structured, they add credibility because they limit arbitrary behavior by politicians and officials.<sup>72</sup>

**Box 4.11 Macroeconomic stability and the investment climate**

A sound investment climate takes as a starting proposition that there must be sufficient macroeconomic stability before microeconomic policies gain much traction. Low inflation, sustainable budget deficits, and realistic exchange rates are all key. Instability deters investors by making future rewards more uncertain. It can also undermine the value of assets.

High inflation and volatile real exchange rates are two examples. Their effects are particularly harmful on those with fixed incomes, local currency denominated assets, and few means of protecting themselves from declining purchasing power. They also weakens the position of creditors, making access to credit more difficult. Large firms are more likely to have tools at their disposal to cope with these risks, including better access to dollar accounts, financial instruments, and credit from overseas. Medium and small firms are likely to be hardest hit.

The costs of macroeconomic instability can be high. Several countries in Latin America, the region that experienced tremendous fluctuations in the 1980s, experienced absolute declines in GDP per capita, leading the 1980s to be dubbed the “lost decade” in Latin America.

Achieving stable macroeconomic policy was much of the focus of policy debates in the wake of the oil crises of the 1970s and the debt and related financial crises of the 1980s. And there has been good progress. The extremely high inflation in Latin America has been brought down. In the 1980s Bolivia and Nicaragua experienced extreme inflation over 10,000 percent a year, Brazil and Argentina over 3,000 percent a year and Mexico, Uruguay and Peru over 100 percent a year. By 2001 inflation in all countries in the region were under 15 percent with the exception of Ecuador at 38 percent. Countries have lowered budget deficits significantly; Brazil and Mexico, having run double-digit deficits, have seen periods of mild deficits and surplus. The crises in East Asia and Russia in the late 1990s, while sharp and painful, have been followed by recovery—with countries with more flexible microeconomic conditions and better investment climates recovering faster.

*Sources:* World Bank (2003e), Easterly (2001), Hnatkovsk and Loayza (2004); Desai and Mitra (2004); Caballero, Engel, and Micco (2004).

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### *Addressing the "micro" causes of policy uncertainty and unpredictability*

4.81 Government can commit to consult firms and other stakeholders about proposed policy or regulatory changes likely to affect them. That can reduce the concerns of firms and in some cases elicit useful suggestions to fine-tune policy approaches. Where the source of unpredictability or uncertainty flows from a new law, governments can reduce ambiguity in its drafting and quickly promulgate more detailed regulations providing clearer guidance to firms and to those charged with administering or enforcing it. The timely publication of regulatory and administrative decisions can also help build a body of precedents that can curb administrative discretion and foster predictability.

4.82 On complex or sensitive matters, an advisory opinion or pre-clearance process might be instituted—common for competition laws in many countries and a growing practice with complex tax issues. Governments can also promote certainty by entering into specific contractual commitments on key policy and regulatory issues (box 4.12).

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#### **Box 4.12 Contracting for certainty**

One strategy governments can adopt to promote policy certainty and stability is to enter specific contractual commitments with firms. While it is obviously not feasible to do this with every firm in the economy, these approaches can be useful to deal with risks associated with major investments.

During the first wave of foreign investment after World War II many firms entered contracts with host governments that included "stabilization clauses." Covering everything from tax rates to the duties payable on capital goods imported to develop a project, to the rules governing foreign exchange and profit repatriation, these clauses sought to freeze in place those host government policies that could affect the return on the investment. These approaches have been applied to major resource projects and extended to private infrastructure projects (where they often include specific commitments on tariff regulation) and to other major investments.

Besides such global efforts to deal with policy change, firms, both domestic and foreign, are seeking advance rulings and other forms of before-the-fact signals on how government will interpret various laws and regulations. One example: the transfer pricing agreements that developing and developed countries often sign with domestic and foreign firms.

A major factor in determining a multinational firm's income tax is whether national tax authorities in the countries it operates will agree with the prices it uses to transfer goods and services among its corporate affiliates. Because these transfer prices can be manipulated to shift tax liability from one country to another, tax agencies usually reserve the right to determine whether the prices reflect market conditions. The methods for making these determinations involve a good deal of judgment, thus introducing a great deal of uncertainty into the calculation of the taxes due.

To make their tax bills more predictable, companies have pressed governments to enter into advance agreements on the appropriate level of transfer prices. China, Colombia, and Mexico have entered into hundreds of such agreements. India and Thailand are considering similar programs.

*Source:* Waelde and Ndi (1996); Tropin (2003).

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### **Other qualifications of property rights**

4.83 The discussion highlighted some of the challenges—and the opportunities—for governments in improving the security and stability of property rights in their societies as part of efforts to create a better investment climate. But all governments deliberately qualify property rights through the ways they regulate and tax firms. Some of the special issues government must grapple with in those important areas are the subject of the next chapter.

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## Endnotes

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- <sup>1</sup> Johnson, McMillan, and Woodruff (2002b).
  - <sup>2</sup> Besley (1995), World Bank (2003c).
  - <sup>3</sup> Erb, Harvey, and Viskanta (2000).
  - <sup>4</sup> Torstensson (1994) and Knack and Keefer (1995).
  - <sup>5</sup> Keefer .
  - <sup>6</sup> World Bank (2003d) page 44.
  - <sup>7</sup> Jimenez (1984).
  - <sup>8</sup> Lanjouw and Levy (2002).
  - <sup>9</sup> Friedman, Jimenez, and Mayo (1988).
  - <sup>10</sup> Feder and others (1988) page 121.
  - <sup>11</sup> Do and Iyer (2003).
  - <sup>12</sup> Base line data from Bank project cited in Baharoglu (2002) page 19.
  - <sup>13</sup> Feder and others (1988) page 67.
  - <sup>14</sup> Field (2002).
  - <sup>15</sup> World Bank (2003f) pp. 98-117.
  - <sup>16</sup> Macours (2003) pp. 35-36.
  - <sup>17</sup> World Bank (2003d) page 97.
  - <sup>18</sup> The higher rate in Latvia is due largely to the use of sporadic processes.. Also, in Latvia's case the process involves the restitution of rights that existed prior to its incorporation into the Soviet Union. The relatively low cost of titles in the Eastern European compared to costs in the other parts of the world has been attributed to the fact that such projects generally do not involve complicated legal investigation of title, that most of the Eastern European countries already have reasonable quality geodetic networks and base mapping for the entire country, that many of them do not physically mark parcel corners or even locate the parcel in any way other than through a plan in the office, and that salary levels for professional and technical staff in these countries are generally low in comparison with countries in other regions, Adlington (2002).
  - <sup>19</sup> Deininger (2002).
  - <sup>20</sup> International Institute for Environment and Development (2001).
  - <sup>21</sup> Siamwalla (1993), Stanfield and others (1990).
  - <sup>22</sup> United Nations Human Settlements Programme (2003) page 109; Baharoglu (2002) pages 30-31.
  - <sup>23</sup> Yahya (2002); Government of Botswana (2002).
  - <sup>24</sup> Fleisig and De la Peña (2003) page 50.
  - <sup>25</sup> International Financing Corporation and Canadian International Development Agency (2001).
  - <sup>26</sup> World Bank (2002).
  - <sup>27</sup> For example, long-distance trade in North Africa and the Mediterranean was flourishing thanks to an intricate network of contracts which no government had the power to enforce. Traders relied on the long-term benefits of repeat dealings to overcome the short-term temptation to cheat on a single contract. See: Greif (1989).
  - <sup>28</sup> Klein (1992).
  - <sup>29</sup> World Bank (2003a) pages 91-106, Jappelli and Pagano (1999).
  - <sup>30</sup> Jappelli and Pagano (1999).
  - <sup>31</sup> Milgrom, North, and Weingast (1990).
  - <sup>32</sup> Mnookin and Kornhauser (1979).
  - <sup>33</sup> Galanter and Krishnan (2003).
  - <sup>34</sup> Williamson (1995).
  - <sup>35</sup> Cristini and Moya (2001) and Castelar-Pinheiro and Cabral (2001).
  - <sup>36</sup> Laevan and Woodruff (2003).
  - <sup>37</sup> Castelar-Pinheiro (1998), Sereno, de Dios, and Capuano (2001), Herrero and Henderson (2001).
  - <sup>38</sup> Johnson, McMillan, and Woodruff (2002a); Broadman and others (2004).
  - <sup>39</sup> Bigsten and others (2000); Fafchamps and Minten (2001).
  - <sup>40</sup> Djankov and others (2003).
  - <sup>41</sup> Djankov and others (2003).
  - <sup>42</sup> World Bank (2003c).

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- <sup>43</sup> Messick (1999), Burki and Perry (1998).  
<sup>44</sup> Messick (1999), Burki and Perry (1998).  
<sup>45</sup> Chengappa (1999).  
<sup>46</sup> On Tanzania, see: Kahkonen and others (2001) page 25. On Bolivia, see Fleisig and De la Peña (2003).  
<sup>47</sup> Inter-American Development Bank (2002).  
<sup>48</sup> Ahmadi (1999).  
<sup>49</sup> United Nations Conference on Trade and Development (2003) page 19 (without effective enforcement, claim is of no financial value).  
<sup>50</sup> World Bank (2003b).  
<sup>51</sup> Volkov (2002).  
<sup>52</sup> Unless otherwise noted, this section follows Polinsky and Shavell (2000).  
<sup>53</sup> Stone and Ward (2003).  
<sup>54</sup> Schärf (2002).  
<sup>55</sup> Greenwood and others (1998); Waller and Sanfacon (2000).  
<sup>56</sup> McDonald (1996).  
<sup>57</sup> Sherman and others (1998).  
<sup>58</sup> Villadeces and others (2000); Mockus (2002).  
<sup>59</sup> Buvinic and Morrison (2000).  
<sup>60</sup> Frye and Zhurabskaya (2000).  
<sup>61</sup> Rossiter (1961) page 322.  
<sup>62</sup> This section is based on July '03 note on Takings which draws principally on Mattei (2000) and Shavell (2004).  
<sup>63</sup> Chifor (2002).  
<sup>64</sup> Vernon (1971).  
<sup>65</sup> Wells and Gleason (1995).  
<sup>66</sup> West (2001).  
<sup>67</sup> Erb, Harvey, and Viskanta (2000).  
<sup>68</sup> For a review of strategies employed by investors in private infrastructure projects, see Smith (1997).  
<sup>69</sup> Van der Walt (1999).  
<sup>70</sup> Stephenson (2003).  
<sup>71</sup> Collier and Hoeffler (2002).  
<sup>72</sup> Bates and others (1998) page 11.