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Property Rights and Credit as Keys to Growth

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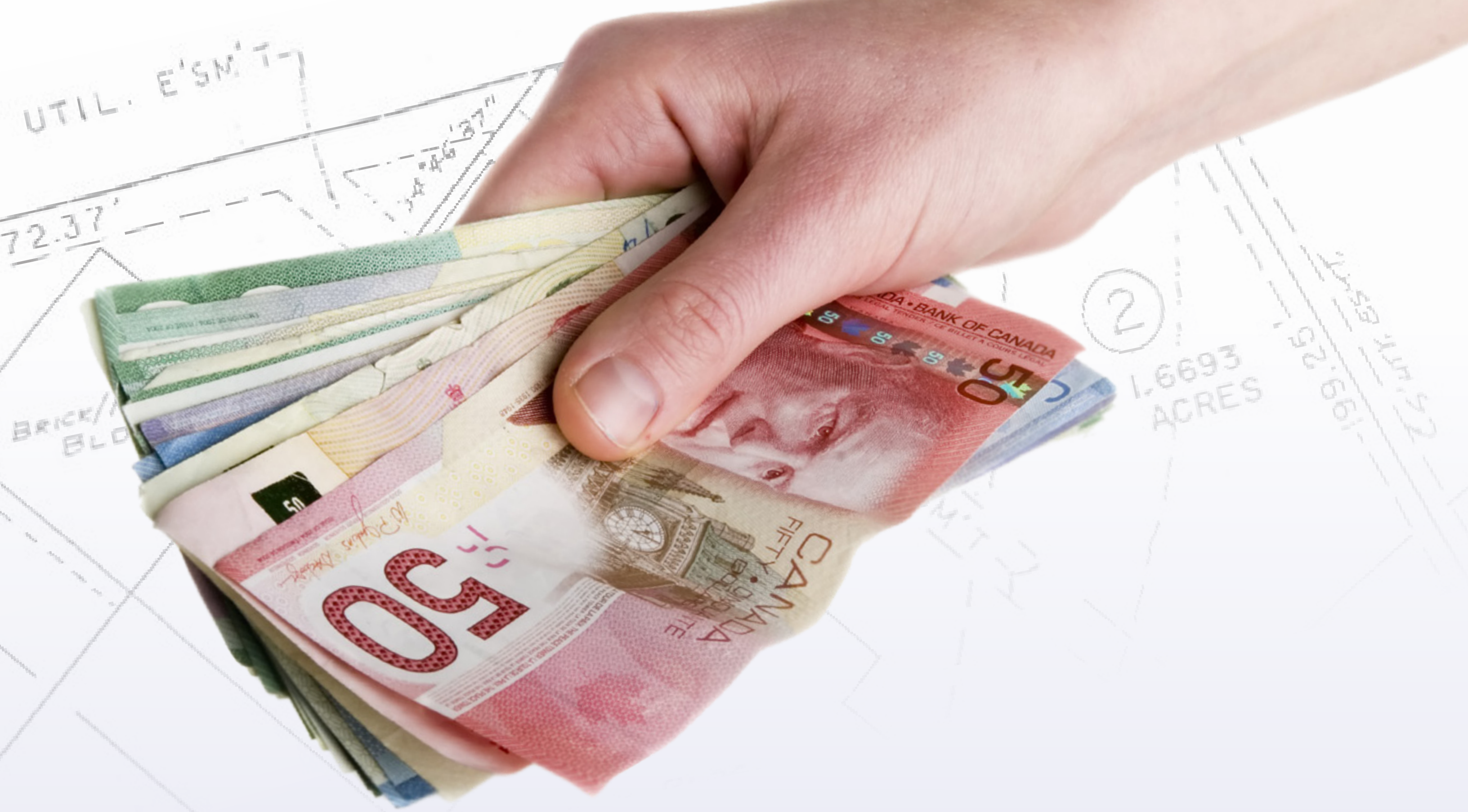
The storm clouds of recession hanging over the economies of the developed world have done much to divert attention from the plight of the nations that are still struggling to find ways to escape deep-rooted poverty. Notwithstanding the recent surge in government intervention, in the last two decades there has been a noticeable current against the ideology of planned economies, as shown by the gradually increasing world average of the Fraser Institute's Index of Economic Freedom (Gwartney et al., 2008). However, significant controversy exists over which of the elements of economic freedom are most influential in pulling a nation out of poverty, with recent studies suggesting that policies such as increased exposure to international trade and diminished government spending can actually retard development (Carlsson and Lundstrom, 2002). The case must, therefore, be made that secure property rights and unfettered access to credit are the keys to consistent economic growth.

Property is rarely effectively protected by the weak institutions in developing countries, which discourage investment among owners who are troubled by the prospect of the arbitrary appropriation of their land by the government or extralegal parties. Credit, on the other hand, is all too often unavailable to those who need it the most, due to the inefficiency of state lending schemes and the underdevelopment of formal credit markets. Land titling programs and the optimization of credit markets are also strongly dependent on one another, as the two have a symbiotic relationship in providing capital to entrepreneurs using their assets as collateral. The first step to achieving reliable economic growth in developing countries is to simultaneously secure citizens' access to property rights and reliable sources of financing.

A country cannot rise out of poverty if its legal institutions are unable to protect the property of its citizens. In theory and in practice, property rights encourage economic activity as they assure owners that they will be able to reap future rewards from their present efforts to improve the revenue-generating capabilities of their own assets. Recent evidence shows that nations with governments that focus on strengthening the rule of law see considerably higher economic growth than those that concentrate on other areas of reform policy (Bjørnskov, 2005).

A key element of any well-developed legal system is the ability to protect property owners from those who would seek to unfairly appropriate their possessions. This motivates owners to be less reluctant to invest in



the short term to make their property more capable of providing consistent profits in the long term. Surveys from two separate agricultural regions of Ghana demonstrate that with the introduction of land titling, efforts to improve farm land grew in frequency as farmers grew confident that their newfound rights would enable them to profit from their investment in the future (Besley, 1995). Increased investment in turn stimulates national economic growth, as improvements on land increase output while enhancing the ability of proprietors to spend more on goods and services provided, at least in part, by their countrymen.

Furthermore, a study by Knack and Keefer (1995) found that "the security of property rights affects not just the magnitude of investment, but also the efficiency with which inputs are allocated." This can be attributed to the fact that land titles allow for simpler delineation of an owner's rightful property, making it much less costly and time-consuming to transfer land to those wishing to acquire it. By securing the link between increased investment and future gains, and simplifying the process of buying and selling assets, property rights facilitate economic growth through the enhanced freedom given to owners to realize the full potential of their property.

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In addition to secure property rights, there is another component that is critical to pulling a nation out of extreme poverty: unencumbered access to credit. In countries where the ability of budding entrepreneurs to borrow funds is either restrained by small informal markets or wasted through inefficient legislation, the economy is doomed to stagnate as large portions of society find themselves unable to pursue viable business opportunities. In developing nations, credit is often only available to a small minority of borrowers in the middle and upper classes who already have privileged access to the banking sector through their existing wealth. The rest—especially those in rural areas—are left out of the formal economic system as their isolation from financial institutions blocks any chance they might have to pull themselves out of poverty. This leads to credit being allocated chiefly through circumstance and not merit, which is inefficient and stifles growth in the poorest regions of the world (Ali, 2007). As such, it is no wonder

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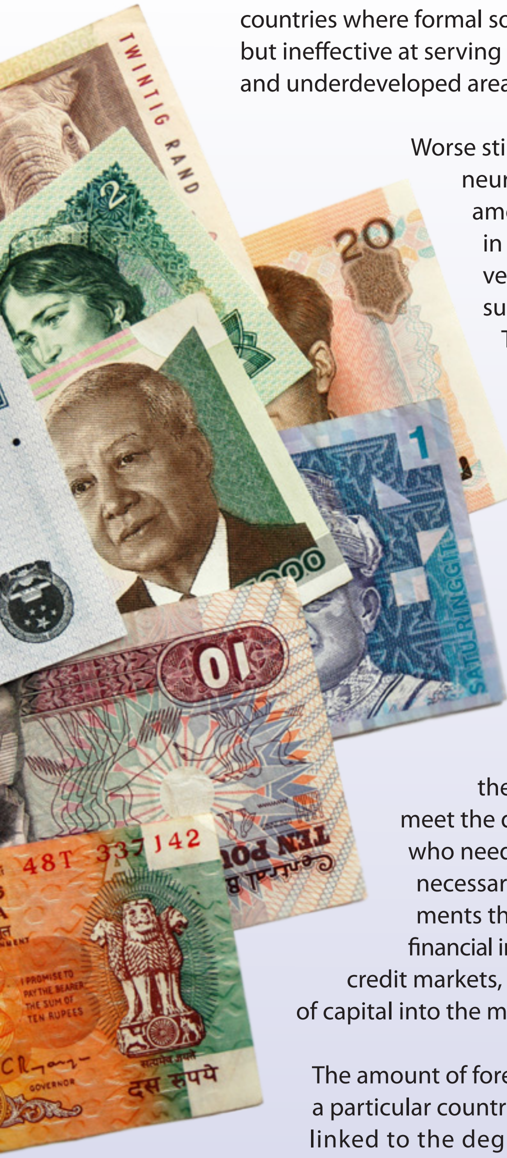

that informal credit markets are so prevalent in developing countries where formal sources of credit are established but ineffective at serving potential customers in rural and underdeveloped areas (Nisbet, 1969).

Worse still for disadvantaged entrepreneurs are governments that seek to ameliorate perceived deficiencies in credit markets through intervention, which typically includes subsidized lending programs. The experience of Cameroon’s Green Belt Operation in the 1970s suggests that borrowers question the validity of such programs because they are accurately perceived to be losing money on artificially low interest rates (Kamajou and Baker, 1980). This induces high default rates, pushing lending operations deeper and deeper into red ink until they do not have the funds to meet the demand for credit from those who need it most. What is urgently necessary, therefore, are either governments that are not afraid to strengthen financial institutions without interfering in credit markets, or the entry of outside sources of capital into the markets of developing nations.

The amount of foreign capital invested in a particular country has been shown to be closely linked to the degree with which its legal institutions are able to defend property rights (Co et al., 2004). This brings to light the vital relationship between how policies instituting availability of credit and the protection of property rights work together to secure economic growth in developing countries. Land titling programs and increased efforts to provide sustainable financing have been shown to work much more effectively when used in combination with one another; credit markets and property rights often fail to achieve the desired result of helping the poorest of the poor when used in separation.

A key reason why property rights are so effective at sparking investment and development is that they allow owners to use their assets as collateral when seeking a loan, allowing for a greater amount of money to be borrowed at a smaller risk to the lender (de Soto, 2001). If the institutions that are providing credit are either too incompetent or too tightly regulated to effectively supply the demand for capital, then the property that was unable to generate additional capital as collateral before the arrival of land titling will remain in its inert state. Research conducted in rural Paraguay by Carter and Olinto (2003) demonstrates that without a well-developed credit market already in place, property rights reforms tend to aid only wealthy farmers who are first in line to receive capital from financial institutions that are too weak to broaden the outreach of their lending.

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This result is equally strong in the opposite direction. Without an effective system of property rights, credit markets in the developing world have a habit of encouraging undesirable outcomes such as excessive default rates, which occur as a result of the high cost of enforcing repayment when lenders have limited access to the potential collateral of borrowers because of scantily codified land titles (Besley, 1994).

When banks are losing money on frequent credit delinquencies, especially in rural markets, another adverse outcome takes place: governments intervene to correct

the perceived imperfection of the market, often leading to arbitrary and politicized decisions about who can receive subsidized financing (Besley, 1994). Since the political clout of poorer farmers usually pales in comparison to the lobbying power of more prosperous farmers, lending programs created to give more opportunities for self-improvement to struggling land-owners often end up reinforcing the status quo of economic stagnation. Clearly, introducing secure property rights and access to financing separately leaves the majority of those with assets without the means to use them as an avenue towards greater investment. If legal and financial institutions are to be reformed so as to increase the overall economic freedom of citizens of developing nations, then they must be reformed in unison.

Considered independently, consolidated property rights and pervasive, minimally regulated credit markets are both closely linked to economic growth. Both work to advance the cause of economic freedom: the former makes earned assets impervious to arbitrary appropriation, while the latter allows for greater liberty to invest in profitable ventures. Most important, however, is the way strong legal institutions and well-developed financial institutions work together to achieve sustainable economic development. The most effective way to pull a nation out of poverty is to ensure that its citizens have both secure property rights and unfettered access to credit.

Michal Grzadkowski is the 2nd Prize winner in the 2009 Fraser Institute Student Essay Contest. He is currently completing an Honours Bachelor of Mathematics at the University of Waterloo in Ontario.

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