

# Property Rights, Legal Protection and Financial Sector Development

Banking and Finance

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## EXECUTIVE SUMMARY

One of the biggest issues discussed by economists is welfare distribution and poverty in particular. Why do so few benefit from the technical advances made in the last 200 years or so?

A prominent voice in this discussion is Hernando de Soto (2002). He argues that people at the base of the economic pyramid are lacking the legal support and protection of the state. Significant bureaucracy and regulation costs deter poor people from participating in state protected systems and frameworks. Absence from these systems however results in several competitive disadvantages.

When comparing the books of Hernando de Soto (1992, 2002) with the contributions of other authors, many analogies can be found. He follows similar ideas as prominent authors like Demsetz (1967), Libecap (1989) and North (1992) do. De Soto additionally introduces the idea of informal norms for those who do not enjoy protection by law and or other systems.

When looking at the descriptions given by de Soto (1992, 2002) we can follow that he describes two legal systems. One is the formal legal system namely legislation covering property rights and other law established via the political process. This process has similarities to that described by Libecap (1989) and North (1992). The political process is skewed in favour of the elite in society. This leads to inefficient law. The other legal system described is the informal property rights system. Poor people create social communities which help them to overcome the limitation imposed by the lack of legal protection. In these communities the norms establish more as described by Demsetz (1967). The informal norms are based on the social community, which has analogies to the concept of social capital described by Fukuyama (2001).

In the books of de Soto (1992, 2002) the two legal systems stand in conflict with each other. He argues that for developing countries to catch up the informal norms need to be included into the legal system and the high costs of bureaucracy and regulation have to be significantly reduced.

Many aspects of de Soto's argument can be found to be important for poverty alleviation. The procedures required to set up a company can be found to be relatively expensive when compared to the GNI per capita, and include many complex steps in developing countries (Motta et al., 2010). When looking at land reforms the findings become ambiguous. Some countries performed very well after having undertaken land reform. The land to the tiller reforms in

Asia, are known to have been a successful step in introducing economic growth (Bruce, 2014). Nevertheless, on a global perspective, the success of land reforms is questionable. Especially reforms in Africa and South America where results were not good (Bruce, 2014). A paper that comes close to the ideas of de Soto is that of Bellemare (2010). He distinguishes between de facto and de jure land rights and shows that in the case of Madagascar, productivity benefits were only found where the de jure granted rights were assumed to be de facto enforceable.

A large raft of literature looks at the topic of poverty using the concept of economic institution which includes property rights. For example Acemoglu et al. (2013) and Besley and Persson (2011). The arguments of de Soto are supported by those books. The importance of property rights is mentioned, but other factors which are part of economic institutions are probably also important. They find that poverty is man-made and that most of the other factors attributed to poverty are relatively unimportant for economic development.

When looking at the assumptions concerning poverty it can be found that de Soto's argument is best applicable to South America. Nevertheless, the forms of poverty seem to vary across countries, and other factors might also help to move people out of poverty, for example education, or business strategy.

Following the arguments of de Soto (2002), good property rights and legal protection should help poor people to gain access to finance and help to overcome some of the restrictions imposed upon them by poverty. The second part looks at how well this argument works, by examining how well cross-country differences in financial inclusion can be explained through the existence of property rights. This part uses data published by the World Bank and the International Property Rights Alliance.

Financial inclusion is estimated to play a key role in alleviating poor people out of poverty. While the evidence for poor people is not that clear, it is for small companies. Access to credit increases opportunities and has secondary effects on poverty through increase in market power particularly wages. (Demirguc-Kunt and Levine, 2009)

First the International Property Rights Index is compared with the percentage account ownership among the 40% poorest within a country. This regression finds a significant effect of the level of property rights establishment to financial inclusion. This is also the case if literacy is included within the model. The international property rights index has some shortcomings however. This is why a second approach, built on the arguments of the first part is established.

Three key factors are used to measure how well a property right system works: Control of corruption; the ease of business start-up; and the enforceability of legal protection. The discussion of these effects shows that they are all correlated to financial inclusion. Finally, the key factors are subsumed into two models. The first model excludes literacy because of the limited data reach. In this model we find a significant effect of property rights establishment on financial inclusion. The second model also accounts for education. Even with the enlargement of the model the positive effect is still found for both years observed.

Overall it is concluded that the effect of property rights on poverty alleviation and on financial inclusion is important. Looking at the empirical work of other authors contributing to this topic shows that the solution cannot be found by optimizing one key figure. Poverty remains a complex issue with many facets. The solutions need to be country specific. Ultimately there are two conclusions. The inclusion of informal norms, particularly the creation of de facto property rights is important for successful reforms. A significant reduction in the bureaucracy and cost of business registration could be a starting point in the process leading to prosperity.