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PANEL 3. SOCIAL ASPECTS AND FINANCING OF INDUSTRIAL RESTRUCTURING

Topic 6. Financing the industrial restructuring

**THE IMPORTANCE OF EFFECTIVE PROPERTY RIGHT SYSTEMS FOR INDUSTRIAL
RESTRUCTURING***by Mr. **Geoffrey Hamilton**, Regional Adviser, UNECE**Introduction**

One of the massive tasks of enterprise restructuring is the need to mitigate the awful social costs involved in such restructuring. Many regions, cities and towns in the countries of central and Eastern Europe and the CIS are built around enterprises. The restructuring of the latter will in many cases not only mean the end of the company but also the demise of the region, city and town. This is bad enough. There are however many areas in the transition economies, southeast Europe, the South Caucasus etc., which are conflict-prone and where enterprise restructuring will exacerbate such tensions and increase the risk of conflict.

What is required is a model for the countries of central and Eastern Europe and the CIS of enterprise restructuring that leads to economic growth and at the same time promotes social development and alleviates poverty. There is indeed a growing interest in developing such models for enterprise restructuring which combines the goals of enterprise efficiency and competitiveness with poverty alleviation. One of the main keys to unlock the wealth in an economy, to promote social development and to alleviate poverty is an effective property rights regime.

A: What is an effective property rights regime?

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In the 1980s the UK economy was in decline. It was producing products that were being manufactured more cheaply in other countries. The economy was over dependent on steel, shipbuilding and coal mining and a massive restructuring was necessary to restore competitiveness. Property rights were an intrinsic feature of the successful restructuring that took place. Thousands of UK citizens were allowed to own their homes and to use these as collateral on new businesses. Property markets grew strongly as more people acquired mortgages, shares and owned their own homes. People who were offered to buy their state-owned housing, did so eagerly and took mortgages for the first time. There was a huge growth in financing services, i.e. mortgage banking, insurance and all sorts of property related companies. A huge number of new small businesses were created. It was thus not the poor who suffered as might have been expected. Restructuring accompanied with an effective property rights regime avoided massive social costs and created for the first time a new class of 'stakeholders' and property owners. Accordingly, in the 1990s, the United Kingdom emerged, from being one of the weaker to one of the stronger economies in Europe.

The role of the property rights regime becomes more apparent if we compare the UK property rights regime – a modern advanced industrial economy - with that of any of the developing countries. The Peruvian economist, Hernando de Soto, has argued that poor people in developing countries have already trillion of dollars in assets in their homes and businesses but they are worthless to them except to live in or use, because they cannot be collateral for loans.¹ This is because the poor are outside the legal systems in their countries: Many of them live in shacks with no addresses, no title, and no access to a court that would validate the title. They can in theory go to the courts and obtain legal title but they do not because of the length of time it would take. In Egypt, for example, it is calculated that over 500 days are needed to complete all the government paperwork to legalise a new enterprise. In the poor economies overall, the registration process - which is often further hampered by the need to provide bribes and other problems - can take from nine months to two years. In the US in many cities it takes just two hours in a morning or through the mail.

Equally important is the high costs of the law. In the developing countries the costs of law are far higher than in developed countries. Douglas North (1990) in his analysis of the role of institutions argues that the difference between the US and developing countries is in the cost of the law and the costs of various transactions. In prosperous countries, transaction costs are low relative to national income, while the opposite is true in a poor country.

In western advanced economies, property rights work. In the UK the role of the property rights system is not often mentioned in the success of restructuring. Success tends to be attributed to privatisation and liberalisation. Property rights are often taken for granted. However the UK success owes much to the effectiveness of its property rights regime. There are banks that honour title and which have experience of holding interests in land as collateral. Banks help land to be traded, which generates value. The housing market facilitates labour mobility, which in turn facilitates enterprise restructuring. In the UK and other countries too there is subsidised legal aid tailored for low-income groups. Property buying services are widely available on every street and now on the Internet. This is the inner workings of the market economy - the mystery of capitalism - why it works in the west and has more problems elsewhere.²

B. The strength of the informal economy in the transition economies

Turning to the transition economies of central and eastern Europe it can be observed that in contrast with western economies, the property rights regimes are much less effective. This is apparent in the tremendous strength of the informal economy. The informal economy is large in many transition economies. The size of the 'extra legal' economy has grown, not declined as the transition process moves forward. This is a reflection of institutional uncertainty and the difficulties of governments to implement institutional reform

¹ The Mystery of Capital, Hernando de Soto, Black Swan, London, 2001

² De Soto op. cit.

and effective protection of property rights. The informal economy is estimated to be as high as 60 per cent of GNP in Russia. It is of similar levels in the countries of Southeast Europe. Its strength is due to the preference of entrepreneurs for extra-legality rather than the unpredictability of the formal economy, that is, taxation rates that keep changing, a host of unnecessary red tape and petty and grand corruption and so on.

Some economists welcome the strength of the informal or the black economy. It is a cash economy, liquid and fast. It is argued that the informal economy is a 'chaotic' capitalism that will breed the future entrepreneurs and risk takers. However, the informal economy is at the same time a drain on the economy as a whole. Businesses are not registered; property not declared. The economy suffers from a loss in taxation revenues. The legitimate entrepreneur is penalised by paying taxes and the services of public utilities, which the entrepreneur in the informal economy avoids. The entrepreneurs in the informal economy also cut themselves off from the regular sources financing such as the domestic commercial banks. There is no doubt that there is a lot of velocity in these economies but the 'get rich quick attitude' reflected in conspicuous consumption, low savings are arguably not laying down the roots for a sustainable economic transformation. Moreover, selecting to work in the grey economy while a rational decision, is nevertheless not a cost free strategy as such enterprises are often the victims of having to pay bribes to officials to turn a blind eye to their extra-legal business operations.

The informal or black economy, of course, exists everywhere not just in central and eastern Europe and the CIS. It exists side by side the formal economy virtually everywhere. The problem in some transition economies is that the informal economy is almost the only one which appears to be working.

The strength of the informal economy is a major factor in the near total dearth of private bank finance throughout the transition economies. In south east Europe for example, private commercial banks cannot lend because there is no enforcement of mortgages; lenders cannot repossess property as a collateral if a borrower defaults on the loan.. Without private sources of capital, the reconstruction task for the region will not be successful. The informal economy means moreover that the financial services industry, i.e. mortgage banking, insurance, real estate companies, are either non-existent or only serving the wealthier strata. With land possessing little or no value there is little demand to take out an insurance policy from an insurance company. No domestic mortgage systems means that entrepreneurs cannot apply for a mortgage to finance their business: in the US, mortgages are the single most important source of income for start-up companies. The weakness in property markets is also reflected in poor governance and the huge upsurge of crime and corruption at various levels of the public administration. Thus, because of the strength of the black economy there is a tremendous amount of assets not being used for restructuring or development: untapped capital – 'dead capital'.

The 'black and informal economy' needs to be stopped because it is holding back the emergence of a 'legitimate economy' and the financing that can help enterprises and the poor alike.

C. How can we remove the bottleneck? How can the poor be integrated into the market economy through the extension of their property rights?

The poor in society choose to operate inside the informal economy. The challenge is to create the institutions, laws etc. to encourage the poor to operate in the formal economy.

Legal systems

Legal systems are weak in many transition economies. The property rights systems are not effective. It is not just the legacy of communism and its treatment of property rights. In many countries historically property rights have never been properly respected or enforced.

There is therefore a need for legal or property codes, so that people can legalise their homes and poor people can obtain credit. A property code should provide incentives for enterprises to become 'legitimate'. This task is not an easy one. First of all there is no simple model of property laws that can be transferred and adapted to local circumstances. Because procedures and laws have in the west grown over centuries – often not even being written down- the transfer of laws to transition economies has been problematic. The result has often been brilliant laws but weak enforcement. Laws are not developed to deal with the specific requirements and situations of the emerging private sectors in transition economies. There is a need to develop a more effective mix of local and best practice taking into account the local entrepreneurs in the informal sector. These laws and institutions should have 'incentives' to encourage the local businesses to formalise and become registered and legal. They need to consult and dialogue with local business and the local populations. De Soto urges legislators in drafting these codes to 'listen to the barking dogs'. Some sort of amnesty to give entrepreneurs encouragement to become part of the formal economy is needed. This form of encouragement is used in many European countries. Legal aid schemes, too, can be a useful tool to bring the law closer to the people.

Political support

High-level political support is required to make property rights and land more accessible to the poor. This is needed to create a consensus within the country over the need to spread property rights to all groups. Empowering the poor can challenge political elites and established property owners and create tension and even the risk of violence.

Administrative and bureaucratic procedures red tape

People should be able to establish and run their legal enterprises cheaply and easily. Unnecessary administrative and bureaucratic procedures and red tape should be reduced or removed.

Focus on the poor and a the development of a stakeholders economy

Investment in property ever since the transition process began has tended to be skewed to meet the demands of multinationals. Since 1990 a similar cycle of investment has taken place in each transition economy: first, investment in four or five star hotels for the influx of business people; second warehouse facilities for the distribution and export of the multinationals; third the establishment outside the city centres of huge hypermarkets and mega malls owned by western retailers; and fourthly the development of top class leisure and other centres of recreation for wealthier citizens. The EBRD might also encourage investment in residential property rather than exclusively commercial property. The poor must be both the catalyst and beneficiaries of property rights reform.

Conclusion: The Role of the UNECE Land for Development Programme

In 2001, the UNECE Real Estate Advisory Group (REAG) declared a 'land for development programmes' to raise awareness of the importance of property rights for development, to improve legal codes, to streamline administrative barriers to registration and to focus on the poor and to develop their stake in property markets.

Some priorities for action can be mentioned:

- **A workable mortgage system targeted at the poor** needs to be created as priority project involving local authorities, banks and the governments. In the Philippines massive schemes for providing mortgages to the poor are being implemented. It would be helpful to encourage this process more widely through developing standard models of such arrangements.
- **Creation of a legal code that focuses on protection of property rights** and on the necessary incentives that can encourage entrepreneurs out of the illegal sector and into the real economy where they can raise funds from the local banks. In Peru there has been some success in bringing some 26,000 businesses into being properly registered. It would be useful to determine the broad lessons to be learnt from this success for other economies.
- **Development of standardised valuation procedures**; tradability of property needs agreement on the valuation techniques for valuing real property. Such valuation standards lower transaction costs for the poor and for small companies. Under the UNECE we are working on creating a standards between the various European and international bodies. These standards will also help the banking sector.

The Real Estate Advisory Group is a partnership between public and private sectors, and NGOS. The Land for Development Forum in Rome Italy 15 September 2002 will be the first time the property rights and land issues will be discussed with all the public and private institutions present and with the representation of every transition economy government. This will be an important occasion to support enterprise restructuring and at the same time alleviating poverty and creating an efficient and competitive industrial base.

