

The Role of Property Rights in Economic Development that Benefits the Poor

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ABSTRACT

In many countries, insecure property rights hinder economic development and limit economic opportunities for the poor. Central government efforts to create formal systems of private property rights, however, often provide few benefits to low income people, sometimes increasing the number experiencing extreme poverty. To promote economic development that benefits the poor, formal property rights systems must develop in a way that is consistent with informal rights.

Recent research in the new institutional economics points to the vital role played by informal institutions in influencing the effectiveness of changes in formal institutions¹. The conclusions this article reaches are based largely on a review of the relevant literature from institutional economics, and a review of the existing research on the consequences of property rights reforms imposed by central governments and how those changes interact with changes in informal institutions.

This paper begins with a discussion of arguments in favor of government imposed property rights reform. Both economic theory and the historical experiences of high income countries imply that secure private property rights played an important role in creating incentives for investment that has led to economic growth and widespread prosperity. In light of this, governments in developing countries, with the encouragement of economic development organizations, have sought to encourage private ownership of land by issuing individual titles to landowners.

Though the arguments in favor of privatization of land and enterprises are persuasive, the impact of these programs on economic development and the wellbeing of the poor has often been disappointing. Evidence from African countries points to the failure of government sponsored land registration and titling programs to affect local land markets and enhance credit availability for the poor. This may reflect the fact that property rules implemented by governments are often inconsistent with local customs or not flexible enough to adapt to changing economic conditions.

The appropriate role for the government in reforming property rights may depend upon the historical situation. Rather than imposing change, the government's role in developing countries should be limited to supporting formal institutions, such as a judicial system, that develop locally, and are capable of adjusting their rules and decisions to a changing economic environment in a way that is consistent with social norms. Widespread economic growth that benefits the poor is more likely if new or reformed institutions reflect local beliefs of a broad cross section of the population, rather than being imposed by the political class. Property rights imposed by political and economic elites are more likely to perpetuate their privileged status while limiting the opportunities of others.

¹ See for example Jean Ensminger. "Changing Property Rights: Reconciling Formal and Informal Rights to Land in Africa" in *The Frontiers of the New Institutional Economics*, ed. John N. Drobak and John V.C. Nye, Academic Press, 1997.

INTRODUCTION

Secure property rights are vital to economic development and prosperity for the poor. This principle, which is widely recognized, has guided government attempts to privatize and formalize property rights in developing countries and in the transition economies of Eastern Europe and the former Soviet Union. Many of these attempts by governments to strengthen or reform systems of ownership rights, however, have not benefitted the poor, sometimes increasing the number experiencing extreme poverty. A major reason for this is that government imposed changes in property rights are often not consistent with informal rights. To promote economic development that benefits the poor, property rights must develop in a way that is consistent with existing informal rights.

Reforming property rights is an important issue for developing countries. Land is the most important income earning asset for many people, especially the poor, and property rights to land are often informally held. Informal property rights are recognized and enforced by the local community, but the nature and extent of those rights are not legally recognized by those outside that community (DeSoto). Efforts by governments to formally record property rights are premised on the idea that doing so will make those rights more secure. Where ownership rights to land and other assets are insecure, businesses, especially small enterprises, often are undercapitalized, operating as part of the informal economy. As a result, income and output of those firms is lower than it otherwise could be.

In high income industrialized countries, private property rights are widely respected and secure because they are based on a popular “consensus about the ownership of assets and the rules that govern their use and exchange” (DeSoto 171). Property rights to land and associated structures are formally recorded via either a system of deeds or registration (Arrunada 403). In many developing countries, property rights remain insecure, especially for the poor, in spite of government efforts to privatize state owned enterprises, reform the legal system, or publicly record land titles.

The next section reviews the importance of widespread private ownership of land and other assets and summarizes the arguments in favor of the central government imposing a system of formal private property rights. The third section of the paper discusses the consequences of government sponsored privatization and land titling programs. The fourth section discusses the

relation between the government and the private sector in the development of an effective system of private property rights. Following this, the concluding section discusses the importance of changes in property rights being consistent with informal rights and the challenges associated with achieving improvements that will enable the poor to share in the benefits of economic growth.

ARGUMENTS FOR PRIVATIZATION

Both economic theory and the historical experiences of high income countries imply that private property rights play an important role in creating incentives for investment that contribute to economic growth and widespread prosperity. Although economic growth does not always benefit the poor, without substantial increases in output per capita it is unlikely that the world's poor can experience lasting prosperity. Numerous studies demonstrate a relationship between the level of economic freedom and growth in real GDP per capita (Berggren). Private property rights are central to economic freedom because without ownership rights, voluntary exchange in markets would not be possible (Lawson 116).

Private property rights also benefit the poor more directly because access to secure property rights to land and other income earning assets increases the benefits to them of productive investment, which is one of the most important avenues to higher income. Besides increasing the incentive to invest, family owned land can be a source of economic security, and selling or leasing land can provide financial capital for those who migrate to cities. Ownership of urban land and dwellings also encourages greater investment, smaller families, and greater labor market participation (Galliani and Schargrotsky (2005), World Bank, 2006, 164-65). Besides land, the opportunity to own and operate a business provides an avenue of escape from poverty for some. If there are few obstacles to starting or acquiring a business, more businesses will be competing with each other to hire workers, which should result in higher wages and fewer people in poverty.

What are the essential elements of a system of private property rights? According to Omotunde Johnson, for a land tenure system to facilitate wealth maximization “property rights must be established and allocated” to specific individuals or groups, “must be easy to identify and verify”, and “must have legal and tenure certainty” (260-61) If a potential buyer or renter can easily establish the identity of the owner, exchanges that result in more productive use of the

land will be encouraged. If property rights are more certain and clearly defined, investments “on assets in, and assets attached to, land” will be greater and of longer duration (Johnson 262).

Similar principles apply to other forms of property besides land.

Ownership of an asset consists of “the right to use the asset”, to appropriate returns from it, and “to change its form, substance, and location” (Libecap 2003, 145). The third element includes the right to transfer ownership to others at a mutually agreed upon price, which is important because it gives the owner an incentive to maximize the discounted future value of returns from an asset over “an infinite planning horizon” (Libecap 2003, 145). This enables the owner to benefit from his property and still have the mobility to seek out alternative opportunities, such as may be obtained through migration to urban areas, which is an important way for rural residents to raise their incomes.

The ability of people to increase their incomes is enhanced by investment in physical and human capital. Property owners can invest more while still retaining ownership of their property if they can use the property as collateral for loans. Formal financial institutions are more likely to supply credit for investment if land and other assets can be seized in the event of failure to pay back a loan (Dam). When property rights are defined and enforced informally, there is no process by which financial institutions can foreclose on collateral (Woodruff 1216). By contrast, formal property rights systems provide the records that make it possible for lenders to place liens on borrowers’ assets, reducing risks to lenders from loan defaults.

Problems with Property Rights in Developing Countries

There are a variety of ways in which property rights systems in developing countries are inadequate, especially with respect to land and attached investments. Existing rights may be insecure and subject to expropriation either by other private agents or by the government. Ownership may not be clearly defined so that there is not a clear residual claimant of the net benefits from land and related resources. Rights are often incomplete so that the person or group who controls the land and possesses use rights to it is not permitted to sell it or is only permitted to sell it to people within a limited group, such as a tribe or extended family.

In some developing countries, farmers not only lack the right to sell or lease their land, but family members must continue to work the land if they are to retain control (Libecap 1986, 45-46). Uncertainty concerning the definition and legal enforcement of ownership rights

discourages optimal use of land, and investment in assets complementary to land. According to Johnson (263), this is a problem in many African countries, where ownership of different parcels is not clearly specified, boundaries are unclear and good records are unavailable. Interpretation of customary laws results in wide discretion on the part of administrators and judges, contributing further to uncertainty for those who might use the land productively.

Role of the Government

It is a commonly believed proposition of economics that governments must establish property rights before a market economy can function effectively. This was the impetus behind state sponsored programs to transfer ownership of enterprises from the state to private individuals during the transition to capitalism in former communist countries. It also gave rise to government efforts to register and provide titles to land in many developing countries.

Although property rights can be defined privately, it is costly to do so. The costs of privately defining property rights include costs of deciding how rights will be defined, costs of defending those rights, and costs of racing for property rights (McChesney). These costs can be avoided when government, rather than private parties, defines property rights. Because government is generally acknowledged to legitimately possess a monopoly on the use of force it can defend property rights at a relatively low cost (McChesney 231). Government can assign title to assets and avoid the costs associated with racing to obtain possession of land before the land is worth using (Haddock 777). In cases where increased demand for resources creates conflicts that are complex and costly to resolve, as happened among gold miners in Nevada in the 19th century, private parties sometimes recognize the advantage of delegating the task of defining property rights to government (McChesney 237).

Besides defining property rights, government can play an important role in the restitution of property that has previously been expropriated. This was an important component of the transition process in some post-Communist countries and may be a factor in developing countries, especially some Latin American countries.

PROBLEMS WITH CONVENTIONAL APPROACHES TO REFORMING PROPERTY RIGHTS

The evidence and theoretical arguments supporting the assertion that widespread and secure ownership of property contributes to faster economic growth and development that benefits the world's poor are almost irrefutable (Torstennson (1994), Johnson, McMillan, and Woodruff, Deininger). What is less clear is how to reform existing systems where assets are not privately owned or property rights are not clearly defined. Central government efforts to impose changes in property rights, whether by establishing a regime of formal private ownership or by redistributing rights, have often been unsuccessful.

Land titling programs

In regions that lack formal systems of property rights, such as many parts of Africa, governments have implemented a variety of programs to register land. Some of these have been compulsory and others voluntary (Place, Roth, and Hazell 25). Most land titling programs in Africa have not displaced customary practices and have had a limited impact on land markets, credit availability, and investment.

The first African colony to "initiate a nationwide effort to register land" was Kenya (Ensminger 176). This policy continued after independence so that according to one estimate, ninety percent of all land in farming districts had been privatized by 1993 (Okoth-Ogendo 79). Many other African governments also attempted private titling (Ensminger 177). Ensminger (178) summarizes evidence from country studies in Africa showing little or no empirical support for positive effects of titles on investment or agricultural productivity.

In Kenya, the failure of titling to make a difference in investment or yields can be attributed to the fact that most land in titled areas has reverted to customary tenure (Ensminger 179). Many who acquired land that was previously registered have not made the effort to register the land in their own names. What explains this failure of landowners to care about whether a title is in their name? It can be attributed to the fact that the formal titling system was not administered in a way that was consistent with preexisting informal rules of land tenure. Cumbersome bureaucratic arrangements that altered the distribution of benefits from land and changed the inheritance and other rights of extended family members were evaded as family

councils, elders, and other interested parties refused to report deaths and other relevant information to the courts (Ensminger, 181).

Unlike in other countries, land titling programs have had a positive impact in Uganda. In a study of one district, most “landholders indicated that they perceived important benefits” from registering their land (Roth, Cochrane and Kisama-Mugerwa 182). The demand for titles has increased due to factors such as growing population pressure and in-migration, along with the willingness of chiefs to sell unutilized land, which results in the eviction of existing landholders. Registration protects owners from eviction, regardless of whether the land is cultivated. As the land market develops, landholders have less confidence that tribal chiefs have the power and authority to secure their access to land. As property rights under the indigenous land tenure system are becoming less secure, registration increases security, thereby increasing incentives for investment. This assertion is supported by evidence showing that in Uganda, registration is positively associated with investments in fencing and continuous manuring of land (Roth et al, 193).

One factor that may contribute to their failure in many countries is that land titling programs emphasize individual rights even where communal rights are more common. Rural Africans often react strongly against titling land as individual property because “conversion of common family property to individual property may damage the political and social functions of the family as well as expropriating from other family members their common property rights” (Tabachnik). De Wit notes that in Mozambique, larger private farmers benefitted from titling programs by claiming and developing land that was not visibly being used but belonged informally to a rural community. Past attempts at land registration in Mozambique were largely unsuccessful because of an emphasis on registering individual rather than communal rights.

While land titling may be beneficial for large landholders, it is unlikely to be cost effective for smallholders in developing countries. Ensminger (182) cites a number of sources that demonstrate the high fixed cost of registering land titles in Africa. This explains why the owners of large parcels are more likely than the owners of small parcels to have and maintain titles to their land.

By making it easier to use land as collateral for loans, titles should lead to increased credit availability and investment, but this does not seem to be the case in Kenya, where in some areas “bank efforts to foreclose on land consistently meet with resistance or violence

(Ensminger 188). Ensminger (189) argues that the failure of land to effectively serve as collateral for loans is rooted in the failure of the formal property rights system to “give legal authority to the rights of all vested parties”, such as wives, widows, and sons. The government has recently changed formal land policy to better account for the rights of extended family members that are recognized by customary law (Ensminger 189-90). By increasing the number of rights holders who would need to agree to the terms of a loan, this change may make it harder to borrow from banks using the land as collateral.

Land registration does not seem to have affected credit availability in other parts of Africa, even in Uganda, though it appears to have had a positive effect on investment there (Roth, Cochrane and Kisamba- Mugerwa). Credit continues to be available in very limited quantities if at all because of financial markets that are not well-developed, particularly in rural areas, farmer reluctance to incur debt and potential buyers’ unwillingness to buy foreclosed land occupied by members of their community (Bruce, Migot-Adhalla, and Atherton; Migot-Adhalla, Place, and Oluch-Kosura 135). In Kenya, where land has been titled for a long period of time, active rural credit markets have not developed (Bruce, Migot-Adhalla, and Atherton 255).

While doing little to enhance the efficiency of land use, land titling programs have had some income distributional effects. When governments substitute formal private property rights for customary land rights, those who are educated and politically connected often gain at the expense of others. Barrows and Roth cite several studies documenting how land registration in Kenya, Nigeria, and Liberia “effectively provided a mechanism for the transfer of wealth” from less influential right-holders “to those with better social or economic positions” (274). Ensminger (191) argues that in Kenya, educated elites have advantages when disputes are resolved via the court system that they do not have when disputes are adjudicated by local land boards. When the British colonized India, they imposed changes in land tenure that created a new class of landlords who gained rights of sale and inheritance that had not existed before, while millions of others lost customary rights of access to the land and its products (Scott 48).

HOW PROPERTY RIGHTS DEVELOP AND EVOLVE

The above evidence concerning the consequences of conventional approaches to property rights reform implies that effective reform depends on a better understanding of the relation between changes in formal and informal property rights institutions.

Property rights, rather than being the result of government fiat, are best thought of as “a system of enforceable entitlements” that are created via “a process subject to economic laws” (Rapaczynski, 87). For a system of property rights to function effectively, a majority of the population must respect those rights, not just for moral reasons, but because they believe doing so is in their best interest (Rapaczynski 89).

Entrepreneurs play an important role in the process of defining property rights. “Property rights entrepreneurs recognize values unforeseen by others and capture those values by engaging in definition, enforcement, and exchange activities that allow them to capture rents associated with ownership (Anderson and Hill 122).” This process was illustrated in the American west, where rising land values made it profitable for settlers to devise ways to restrict entry to land they claimed. These efforts gradually became more organized as they formed private associations “to resolve internal conflicts over property rights.”(Anderson and Hill 126)

In most developing countries, customary land tenure systems govern land and resource allocation in rural areas. Customary land tenure systems are complex, specifying details such as which crops may be grown on specific land during the main growing season, how long a family may possess a particular plot of land, when the land may be used as common pasture, how many animals each family can graze, and who has the right to fruit from trees and to the various parts of fallen trees (Scott 33-34). In such an environment, property rights reform imposed by government could disrupt production and create severe hardship for some members of the local community.

Where customary land tenure systems exist, efficiency enhancing changes can occur without being initiated by the central government. There is considerable evidence to suggest that customary property rights systems evolve in response to changes in relative scarcity. According to Ault and Rutman (181), “communal land tenure systems in tribal Africa were generally sets of individual rights that had yet to be defined or exercised” because most resources were not scarce. Restrictions on the exercise of individual rights, which are often a part of customary law, may stop being enforced when economic conditions change. Tribal courts interpret customary law in

light of changes in economic conditions; as land becomes more scarce, peasants gain greater rights over the land they farm (Ault and Rutman 177-78).

Because of their dynamic nature, retaining traditional land tenure systems, particularly in Africa, may promote investment as much or more than if western style property rights were imposed. A rapid transition to freehold tenure involves high transaction costs, may have adverse income distributional effects and may be resisted by local communities. With private property rights, risk averse owners may be assured of adequate earnings without investing. With indigenous tenure regimes on the other hand, people have incentives to invest because investing in an asset often leads to the investor gaining an individual right to that asset that he would not otherwise have had (Sjaasted and Bromley).

In contrast with the flexibility of customary land law, government policy toward land has often taken one extreme approach or the other, either seeking to codify a system of customary tenure that is becoming outdated, or to impose a new system that is not consistent with existing customs. Following independence, the government of Tanzania officially adhered to customary law in its land tenure policies, restricting land transactions. This policy was not consistent with capitalist agricultural development which was occurring at that time, and the result was that land transactions were carried out in secret, resulting in cheating, insecurity and growing inequality (Feldman). Tanzania implemented a socialist land policy during the 1970s, which caused even more serious problems because it was inconsistent with existing informal institutions

Conditions Necessary for Property Rights to Change to Become more Efficient

If property rights are the key to economic growth and development, the fact that been the incomes of the poor have not improved much in many developing countries can be partly blamed on dysfunctional property rights systems. What prevents the evolution of rights in the direction of greater efficiency? Oppressive governments play an important role as do governments that cannot maintain order. Many countries with reasonably stable governments, however, also have problems with insecure property rights (Miles, Fuelner, and O'Grady 2005). This may reflect the fact that the transition from an existing property rights regime to a new one is costly and thus involves a collective action problem (Banner S360).

Reforming a property rights regime can result in widespread benefits, but also is costly. Those with the power to bring about reforms have an incentive to free ride, unless they can gain

a large enough share of the benefits to offset the costs of reform. This is more likely to be the case when the benefits of reform are unequally shared, with those bearing the costs reaping most of the benefits (Banner). This can be illustrated in the case of enclosure in England, where an efficiency enhancing reform benefitted large landholders at the expense of the poor who were not adequately compensated for the rights they lost. Had the benefits of enclosure been distributed more equitably, it would not have been in the interest of landowners to bear the costs.

To benefit from investment, property owners must have secure rights. Property rights are more likely to be secure and investment encouraged if government enforces property rights and contracts, particularly on behalf of the poor. Government, through its law enforcement agencies and judicial system, can more effectively uphold property rights where there is a strong moral order governing individual and group behavior (Winiecki (2000) 288-294). Without a well-developed moral order, transactions costs are higher and more resources must be devoted to protecting property from depredation by others. The lack of a strong moral order also reduces the efficiency and integrity of enforcement and adjudication of conflicts. An important question to consider in pursuing property rights reform is how to strengthen the moral order where it is weak as it was in most former communist countries.

Not only does the state play an important role in how it enforces property rights, but the state can act directly to reduce or violate people's property rights. As Rapaczynski notes, "the state itself is often the most significant threat to the security of property rights (92)". States often threaten the security of property rights through taxation and regulation, which can prevent owners from earning a reasonable return on investment. Property rights are more likely to be perceived as secure if pressure groups are effective in resisting excessive taxes and regulation.

Other institutions can play an important role in protecting property rights, such as an independent judicial system. Courts in developing countries are often highly inefficient, costly to use and corruptible (Rodrik 3). Although a package of judicial reforms may seem like the appropriate response to this problem, such reforms may not be feasible or desirable at present. Instead it may be better to rely on relational contracting, which, in the presence of an ineffective judicial system, has sustained rapid economic growth in Vietnam (Rodrik 4). Relational contracting is also practiced in African and other parts of the world. Efforts to strengthen judicial systems may actually reduce the incentive to behave well in relational contracts, since reliance on courts reduces the need to maintain a good reputation.

Whether partial or complete, if they are going to last and result in substantive change, market reforms must be perceived as legitimate and in harmony with existing customary rights. How a change in rights blends with “distributional norms affects its popular support and legitimacy” (Libecap 2003, 143). Highly unequal property rights regimes may be unstable. If a “property system is perceived to be closed” and “nonowners have few practical means of becoming owners,” then nonowners may not have enough incentive to maintain the system (Libecap 2003, 150). Those lacking access to property may prefer an incomplete specification of rights because it allows for greater redistribution.

Correcting Past Injustices

Because it has the power of the sword, intervention to correct past injustices in the distribution of property rights would seem to be an important role for the state. This is the rationale for the emphasis on restitution of property in the privatization programs of some former communist countries. When an extended period of time has passed, however, so that the original owner is no longer living, it is not clear that restitution is the best option. If the current occupant was not involved in stealing it from the original owner and has improved the property, then restitution of it to the descendants of the original owner would create an injustice which might be greater than the original injustice (Epstein 64).

In cases where the unlawful taking of property was widespread but occurred in the distant past, as in many Latin American countries, the attempt to restore property to its previous owners may create more problems than it solves. This is illustrated with the consequences of property rights restitution programs in Romania, where the difficulty of finding those entitled to receive land slowed the distribution of titles (Boettke, Coyne, and Leeson 241). Because many former landowners had died or moved away, courts had to resolve conflicts over how the land was to be divided among their relatives. This was a time-consuming process and contributed to an extended period of insecure property rights in rural areas. Thus Epstein argues that it may be better to accept existing ownership patterns even when their origin is illegitimate in order to promote security of property rights in the present (65).

Although formal property rights regimes like those of western countries may be ideal for promoting economic growth and development, it may be difficult or impossible to establish formal property rights regimes resembling those of western countries in some developing

countries. This does not mean that property rights cannot be reformed in a way that promotes economic growth that will benefit the poor. Such reform is more likely to come about when local customs are respected and grassroots organizations play an important role in its design and implementation.

CONCLUSIONS

For changes in property rights to be sustainable, those rights must be consistent with existing informal institutions. To codify the vast array of informal practices used in many developing countries would seem to be an exceedingly complex undertaking. Customs change and evolve over time in unforeseen ways to reflect changing circumstances. Customs vary from one locality to another because of differences in history, ecology, cropping patterns, kinship alignments and market opportunities (Scott, 35). Nevertheless, people develop conventions (self-perpetuating patterns of behavior) for interacting with others based on analogies with similar problems in light of what they know about how others respond to those problems (Sugden). The result is that people, even if they are not part of the same community, often share similar conventions or informal rules of behavior. In addition, modern transportation and communication systems have resulted in people in different locations sharing many of the same values and aspirations (De Soto 179-80). These shared values can help political leaders as they seek to identify unifying principles that are consistent with existing informal rules on which to base the rules of a formal system of property rights.

Nevertheless, the cultures and economic and political environments of developing countries are sufficiently unique that ignoring local customs and imposing a modern system of private property rights that imitates institutions in high income countries almost never works. People are likely to resist changes that are inconsistent with customs that have evolved over centuries. To the extent that the changes are forced upon them, the resulting disruption to existing social relations may be an important contributing factor to the political instability and conflict that characterizes so many developing countries, especially in Africa.

In recent years, some developing country governments have sought to reform their land laws to be more consistent with informal institutions. A good example of this is legislation which was developed and approved by the government of Mozambique following the multi-party elections of 1994 (De Wit). The new legislation recognizes the right of communities to

use and manage resources that they have occupied, even if the ownership of those resources is not registered. The legislation introduced the concept of co-titling as a way to register land that belongs to a community rather than to individuals within that community. The new approach still allows for the creation of individual land and resource rights, but rather than the central government creating individual rights, those rights must be created as the result of a process of consultation and negotiation with the community. Non-governmental organizations, donor governments, and multilateral organizations have supported this initiative. The new legislation also strengthens the rights of women, but in a way that may contradict customary law and could undermine its effectiveness and sustainability.

Another example of an approach that effectively takes account of local customs is in Botswana, where the government has devised non-freehold forms of tenure that differ from western tenure concepts (Nkwae). This reflects a desire of the government to maintain a system that facilitates widespread land ownership, rather than one that would result in only the urban elite being able to afford land.

Access to property rights will not instantly open the door of opportunity for the poor. Complementary changes may be necessary, such as improved infrastructure or better educational opportunities. Widespread access to secure property rights is important; but a property rights regime is unlikely to function effectively unless it develops in a way that is consistent with informal rights. This means that in some parts of the world, economic growth and development may be associated with property rules and institutions that develop in a very different way than they did in the west. As DeWit (10) points out “The law must become an instrument that is controlled by ordinary people and supported by government structures for its implementation”.

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