

# THE JORDAN TIMES

Tuesday, January 23, 2007

## Meeting de Soto

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A group of Jordanian economists attended a dinner last week with Dr Hernando de Soto, an internationally renowned economist from Peru, leader of one of the most important think tanks in the world and a world-recognised authority on the issue of property rights and informal market activities.

The meeting was powerfully inspirational.

De Soto's main thesis is that the foundation for the success of capitalism in the West was a clear system of property rights. Lack of such a system of property rights in developing nations makes it impossible for the poor to use their property as collateral for credit and expansion. Informal ownership or production, argues de Soto, should be made formal, giving squatters titles to the land they live on.

An informal market or economy refers to an activity that is neither taxed nor monitored by the government, and is not included in the government's GDP or GNP, as opposed to a formal economy. The size of the informal economy reaches in some developing countries as much as 60 per cent of the GDP. Informal activities include non-registration of businesses or property (street vendors, shops that avoid direct and indirect taxes, smuggling, etc.) for a variety of reasons, among which high taxation or red tape, low probability of persecution, and lax penalties.

De Soto conducted comprehensive research on property rights in countries, employing a team of 120 researchers. In Egypt, for example, he determined that a person who wants to legally register a lot on state-owned desert land must go through 77 bureaucratic procedures, and 31 public and private agencies, which would require 5 to 14 years of wasted time. Worse still, if one were to build a legal dwelling on what was formerly agricultural land, the time required would reach as much as 17 years.

Such bureaucratic impediments tend to lead people away from formalising their economic activity, as they are deterred by the cost in time and fees (known to economists as "friction costs") wasted in the pursuit of legalising the registration of their property. People would be willing to formalise their activity if fees and red tape became less costly.

De Soto's thesis is not without relevance to Jordan, even though property rights are properly enforced. Land or real estate registration requires no more than two hours and the fees for transferring property is set at 10 per cent of the estimated or declared property value, whichever is higher. So where is the relevance? In the dynamics at play between land and the productive sectors, such as industry.

While real estate faces little or no impediment in terms of formalising ownership, establishing productive entities, such as a factory or a company, is faced with many hurdles, including, in addition to time-consuming legalising processes and licences, excessive, numerous and ever-increasing taxes and fees, which hinder the development of investment in mega projects in the productive sectors. The situation has been slow to improve, according to several world gauges of competitiveness and business environment.

Therefore, while real estate rights are properly entered and registered within the formal economy framework, other forms of legally enforcing property rights are either developing lethargically or are easily lapsing into the informal sector — not registered. Either way, the productive sector suffers from two effects: a substitution effect whereby investment shifts to property; a de-formalisation effect where businesses tend to gravitate away from registering the full or part of their economic activity in sectors such as industry since the process in and of itself is costly.

Hence, the size of the informal economy, where people do not register their activities properly with the enforcing authorities, was recently estimated at 20 per cent of the GDP. In other words, the government loses revenues from 20 per cent of the economic activity in the country. And this trend is rising as the government seeks to increase tax percentages and impose more fees.

More and more smuggling of foreign made cigarettes is becoming prominent as the price of locally produced cigarettes nears the price of smuggled ones. A new phenomenon that is becoming prevalent is the smuggling of gasoline, as the government imposes greater fees and taxes on its sale in Jordan.

Of course, not only will the government lose revenues from the growth of the informal sector, the economy will also lose the opportunity to develop, as businesses stay small, unable to expand and grow. The overall impact is stunted overall economic growth.

Some argued in the past that the informal economy is a true manifestation of the free market system, since it avoids government involvement. However, this determination does not recognise the dynamics of the informal economy. Businesses that, in order to evade bureaucracy and taxation, do not hold proper records of their economic activities and achievements cannot borrow or use their collateral and success to leverage future expansion. Thus, they remain small.

The state does not benefit from their profits in the form of taxation and many countries — because they are unable to collect taxes from those businesses that do not exist in the formal sense — tend to increase tax rates. But in doing so, they are overburdening the formal companies and entities that are already paying taxes, which may lead those companies that are not doing so well to become informal as well, and a vicious downwards economic and development cycle is created.

In Jordan, where government revenue from direct taxes has been less than 4 per cent of the GDP, there is a manifestation of this phenomenon. The government is quick to increase tax rates and create new fees. In addition, indirect taxes, which are easier to collect, have been on the rise for years. Those who pay taxes pay increasingly more, and those who do not, never pay. It is no wonder that activity focused in the last year on the stock and real estate markets. The former went haywire when the regulatory institutions started to place monkey wrenches in the process, possibly to over-regulate

it, something legislators do very well (to the economy's misfortune) in other sectors. The same could happen to land transfer activities if similar meddling started.

The solution for Jordan's informal economy is threefold: 1) Jordan must reduce taxes so that the prize or gain from avoiding taxation becomes very small, and reduce red tape when it comes to the registration of productive activities, so that it is easy to become formalised; 2) increase the efficiency of monitoring infringements of the law so that the probability of being caught increases; 3) impose severe punishments on those who do not formalise. In other words, decrease the cost, increase enforcement, and increase the punishment. Consequently, people will have little incentive not to conform.

Such a solution will only work, however, if all elements are implemented in tandem.

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