



# THE WAR OF NOTARY PUBLICS

Do you know what would happen if Peru lost  
the war over state reform?

# THE WAR OF NOTARY PUBLICS

**DO YOU KNOW WHAT WOULD HAPPEN IF PERU LOST  
THE WAR OVER STATE REFORM?**

This book is the work of the *Instituto Libertad y Democracia*  
with the collaboration of:

Luis Aliaga  
César Burga  
Alberto Bustamante  
Fernando Cáceres  
Ana Lucía Camaiora  
María del Carmen Delgado  
Mario Galantini  
Luis Morales  
Enrique Pasquel  
Víctor Andrés Ponce  
Gerardo Solís





# EXECUTIVE SUMMARY

## 1. WHY ARE NOTARY PUBLICS AGAINST THE DEMOCRATIZATION OF PROPERTY AND BUSINESS?

Until the last Board of Directors, the inner circle that controlled the Association of Notary Publics of Lima relentlessly conspired to maintain the *status quo* and to block the reforms proposed that would enable the poor to access the legal ownership of their property and business. This Association had been struggling to defend its monopoly, that is, the privilege that notaries have of charging handsome sums of money to bear witness to asset-based transactions – without providing any safety – at a cost that only the well-to-do can afford.

True to their tradition of defending legal norms that benefit only a minority, over the past twenty years notaries have continuously attacked the reforms that benefit the poor. The last attack adopted the ruse of paying an economist to distort the reforms that affect their direct interests and to discredit the ILD, the institution they consider to be at the root of such reforms. <sup>1</sup> Legislative Decree 495 and 496 enacted by President Allan García in 1988 and the last reforms for administrative simplification in favor of the excluded issued in 2005 2006<sup>2</sup>.

## 2. WHY DO NOTARIES OBSTRUCT THE ECONOMIC USE OF PROPERTY?

An asset can only acquire added value if it is put in circulation. In order to generate value and wealth the asset must be taxable for loans and liquidity, its sale, rent, be divisible to accept partners and open to investment, or be represented in titles or for using it for any other purpose as a means of generating an economic income for the owner.

Many obstacles raised by the notaries' inner circle in addition to numerous other loopholes in the Peruvian legal system obstruct the poor from mobilizing and adding value to their assets. The high costs of public notary services, their overwhelming presence in all matters involving red tape procedures, the excessive professional qualifications in order to be admitted

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<sup>1</sup> Webb, Richard; Beuermann, Diether and Revilla, Carla. *La Construcción del Derecho de Propiedad. El caso de los asentamientos humanos en el Perú*. Association of Notaries of Lima, 2006.

<sup>2</sup> For further information, see the Introduction and Chapter 1 of this book.

as a candidate to become a notary public, their number (limited and closed), their fees and collections, their lack of accountability for the truth of the contents of the facts that they bear witness to and certify (see example in Annex 2), the finger pointing distribution of opportunities in the association of notaries itself, their hunting grounds in addition to a captive territorial market hampers the poor from using their assets in order to generate wealth.

### 3. WHAT IS THE CONSEQUENCE OF THE CURRENT MODUS OPERANDI OF NOTARY PUBLICS?

The efforts deployed by notary publics, their lobbies before Congress, attacks on those who advocate the reform of the system as well as the sabotage of reforms that allow the poor to access the legal ownership of their property and businesses lies entangled and buried in the basements of the ministries and have resulted in the following:

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|--|---|
| <ul style="list-style-type: none"> <li>➤ <i>Less investment (p.19)</i></li> <li>➤ <i>Worse housing (p.19)</i></li> <li>➤ <i>Lower rate of school attendance (p.21)</i></li> <li>➤ <i>Fewer job opportunities for women (p.21)</i></li> <li>➤ <i>Less birth control (p.21)</i></li> <li>➤ <i>Less access to credit (p.23)</i></li> <li>➤ <i>Less access to electricity and drinking water (p.24)</i></li> <li>➤ <i>Worse performance of the civil defense system and</i></li> </ul> | <ul style="list-style-type: none"> <li><i>greater impact of natural disasters (p.25)</i></li> <li>➤ <i>Less access to insurance (p.31)</i></li> <li>➤ <i>Lower public safety (p.32)</i></li> <li>➤ <i>Lower household income-generating capacity (p.34)</i></li> <li>➤ <i>Fewer formal jobs (p.34)</i></li> <li>➤ <i>Lower tax collection (p.35)</i></li> <li>➤ <i>Lack of information and safety to access national and international markets (p.35)</i></li> <li>➤ <i>More social exclusion (p.36)</i></li> </ul> |
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### 4. WHY DID THE PUBLIC NOTARIES REACT THE LAST TIME?

Over the last year, the Executive Branch and Congress have taken a series of measures to democratize the legal ownership of property and business and to restrict the monopolist privileges of notary publics. In reaction, the Notary Publics tried to block the enforcement of these measures and in doing so, thought that the ILD would be an easier target than the authorities. The notaries think that the ILD is the only driving force behind

these reforms and overlook the fact that lately society at large has become increasingly aware of the need to implement them.

As a promoter of reform, the ILD is accustomed to arousing criticism and being under fire, a reaction we usually consider to be natural scholarly discrepancy and fair play. But, in this case, we have decided to answer the profit-driven mock defense set up by the former Board of Directors that supported a regime that actually excluded the poor.

## **5. HOW CAN WE HELP TO EXPAND THE SERVICES OF ITS MEMBERS AND MAKE POPULAR TRANSACTIONS SAFER SO THAT THE USERS AND NOTARY PUBLICS ALIKE CAN INCREASE THEIR WEALTH?**

Notary public duties need to be modernized to enable them to generate a considerable value by helping to identify individuals, regularize property and constructions, resolve conflicts, process non-litigious cases, enforce contracts and liabilities, simplify administrative procedures, and act as an alternative to cumbersome legal processes in addition to reducing the costs of legal transactions, amongst others. Public Notaries should address these matters and not hamper the access of the poor to property and business ownership.

Moreover, the younger generation of notaries should be given more opportunities. This includes relaxing the requirements to act as notary thereby enabling all public notaries to efficiently compete against each other and not make the income level of a notary depend his or her seniority or geographical location as has been the case.

Let us not forget that until a few decades ago the leading Notary Publics enjoyed a lifelong appointment and a hereditary status. Despite the fact that notaries associations have evolved over the years they have not kept pace with the major technological breakthroughs of the end of the XXth century and the beginning of the XXIst. Undoubtedly, this is partially due to the fact that such associations cling to feudal practices and institutions, but especially because these are rooted in the old traditions of the *cabildeo* currently known as lobbying, political favors and an income-based approach.

If new perspectives continue to be ignored awareness will grow about the possibility of challenging the performance of notary publics since this is contrary to free competition and therefore any citizen could be justified in filing a claim in keeping with Peruvian and international laws on grounds of free competition and human rights as has happened at the United Nations, the European Union and other developed regions.



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Report of the *El Comercio* newspaper on Saturday, January 27, 2007

#### **ANNEX 3**

December 17, 2004 ILD Press Release

# INTRODUCTION

## 1. THE ATTACK ON THE DEMOCRATIZATION OF PROPERTY AND BUSINESS

Despite the fact that the inner circles of the Association of Notaries attacked the business and property formalization system it has evolved throughout twenty years on the basis of the ILD institutional design. It started in 1988 when President Alan García enacted Legislative Decrees 495 and 496 on the Property Registry of Shanty Towns and Popular Land Developments, Popular Mortgages and Credit Insurance. In 1989, it was strengthened with the principles and instruments of Law N° 25035 on Administrative Simplification and the Unified Business Registry that extended the benefits of economic democratization to business activities. In 1991, the Government of Alberto Fujimori included agricultural areas in the system through Legislative Decree 667 that established the Rural Property Registry for the titling of farm plots. In 1996, the system was strengthened and expanded through the creation of the Committee to Formalize Informal Property (COFOPRI) that received the technology and resources of the former programs. And the Special Project of Land Titles (PETT) covers the system specified in the former norms.

This system has benefited more than ten million Peruvians<sup>3</sup> – among other things – when it took away the privilege of the notary publics that obliged people to resort to them when they needed to access or transfer property.

In 2006, COFOPRI registered more than one million and a half of properties benefiting more than seven million Peruvians. The new system that substituted notary publics and the old red tape procedures reduced the time to access a title from nearly eight years down to two months and the average cost to formalize a property dropped from US\$230 per family to US\$35. As a result of these reforms the value of these properties increased, access to credit was easier, more women had access to property (and currently represent 54% of the owners) and were able to access the labor market, school attendance went up and beneficiary incomes improved. Furthermore, according to competent military authorities and to Abimael Guzmán himself these measures helped to empower the poor and was an important part of the strategy to overcome terrorism in Peru.

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<sup>3</sup> See Annex 3.

The ILD considers that the current system does not contain all the mechanisms of the original design to capitalize and free the poor. However, as compared to the old procedures protected by the notary publics great progress has been made. One piece of evidence is that, as compared to what other developing countries have, this system has been recognized by the World Bank and the United Nations as an international success story, an opinion shared by other international organizations and independent studies<sup>4</sup>.

The inner circles, however, did not sit there idly and twiddle their thumbs. In a few years, they were able to revert some of these reforms and recover their former privileges that harmed the rights of the poor. At that time, the ILD, the Bar Association of Lima, the Ombudsman, COFOPRI and other institutions warned the public about how these measures excluded the poor from property ownership and pooled their efforts to file legal action before the Constitutional Tribunal in an attempt to put a stop to this offensive.

Today, the government has started to once again dismantle the measures prompted by the notaries' inner circles. As a means of protection, the Association of Notary Publics of Lima decided to finance a study to discredit the idea that the legal system should be attainable for all citizens and the institution they consider is responsible for reforming a legal system that has showered them with so many privileges in the past, the ILD<sup>5</sup>.

## **2. CRITICISM OF THE NOTARIES**

In brief, the criticism of the consultancy hired by the notary publics can be grouped in three categories:

- There is no evidence that the formalization system has actually helped the poor.
- A property right entails having the feeling of safety because the individual is the holder of an asset. This right is earned gradually. Firstly the expectation of the squatters to acquire a right on the plot they occupy, followed by the legal right acquired through possessing a title and then the right acquired after duly registering the property in public registry. At present, the poor do not need this third stage of property rights and, in some cases, they do not even need the second stage.

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<sup>4</sup> See quotes in Chapter 2.

<sup>5</sup> Webb, Richard; Diether Beuermann and Carla Revilla. *La Construcción del Derecho de Propiedad. El caso de los asentamientos humanos en el Perú*. Association of Notaries of Lima, 2006.

- The poor need a different legal system from that of the wealthy. The registration and formalization is all right for those who live in the traditional districts. Today the inhabitants of human settlements only need non-registered titles and extralegal mechanisms to protect their property rights.

### **3. THE ANSWER**

Had the essay only provided criticism, we would not have been greatly concerned. Since Hernando de Soto published “The Mystery of Capital”, at the ILD we have gathered an estimated one thousand articles in English each year on its ideas (these articles are available for those interested and are on file at our offices). Of these, no more than 3% is criticism and we usually consider these remarks to be habitual academic discrepancies that should not spur any major reaction. However, the essay paid for by the Association of Notaries of Lima actually defends a system that deprives the poor from the benefits of property rights, the market and wellbeing enjoyed by a small handful of Peruvians. This is why we decided to answer.

The ILD response continues to reveal the following:

- A property and business formalization system that begins with registration and encourages people to maintain and update it as foreseen in the reform laws of Peru do benefit the poor. It mainly provides:
  - Greater investment (p.19)
  - Better housing (p.19)
  - Higher rate of school attendance (p.21)
  - More jobs for women (p. 21)
  - Better birth control (p.21)
  - Greater access to credit (p. 23)
  - Greater access to public utilities (p. 24)
  - Better functioning of the civil defense system and a lower impact of natural disasters (p. 25)
  - Greater access to insurance (p. 31)
  - Better public safety (p. 32)
  - Higher family income (p. 34)
  - More legal jobs (p. 34)
  - Higher tax collection (p. 35)

- Information and safety that help to access domestic and foreign markets (p. 35)
- Less social exclusion (p. 36)
- The essay financed by the notaries has applied a mistaken and limited concept about the meaning of property rights. Property entails much more than the property security. This concept is the reason why most third world asset formalization programs fail.
- All Peruvians must have access to one same legal system. This is the only way in which the poor will be able to overcome poverty and have the possibility of doing business and progressing in domestic and foreign markets.

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## CHAPTER 1

# **WHY HAVE THE PUBLIC NOTARIES ATTACKED?**

### **1. AN OLD FIGHT**

For those who are familiar with ILD proposals in Peru—administrative simplification, the formalization of property rights, the simplification and harmonization of business registries, access to public information, the democratization of government decisions, the ombudsman, etc.—the struggle against these proposals is well known since they involve legal mechanisms to include the poor in a modern market economy (reducing transaction costs and increasing the benefits of legality) aside from the resistance to change of the more traditional notary publics in Lima as well as their incapacity to adapt and change because their economic interests are at stake.

During the nineties, an innovative property formalization system was put into place that helped an estimated three million urban and rural properties to become formal and benefited an estimated eleven million Peruvians. The ILD has calculated that only as concerns the urban properties and businesses more than US\$ 9.4 billions<sup>6</sup> was earned as net benefits.

In part, this program has been successful because the unnecessary costs to register the transfer of property were eliminated. One of the main costs involved the obtaining the signature of an expensive public deed before a notary public. Transfers could be made by using a low cost registration form certified by any lawyer. The forms were much cheaper – safer and more user-friendly – and were used to record subsequent transferences, mortgages and other acts in the public registry. This evidently did away with the old privileged monopoly of the notary publics at the expense of the poor who were unable to do business because of the contrivances of a particular group of people.

However, public notaries were reluctant to compete and wanted to retain full control of collections for these transactions. The Association of Notaries filed suit on grounds of unconstitutionality against the use of registry forms. This legal action filed before the Constitutional Tribunal, – thanks to the defense taken up by the ILD, COFOPRI, the Ombudsman

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<sup>6</sup> See Annex 3.

and other entities— was declared null and void and the effectiveness and legality of the forms was recognized<sup>7</sup>.

The notaries returned fire. During one decade, 72% of Peruvians preferred using the form to authenticate their contracts since it was cheaper than and equally as safe as notarial deeds. In fact, barely 0.016% of the registrations made with the form were the subject of legal claims, while 0.046% of the registrations done through public instruments were contested through the Judiciary.<sup>8</sup> However, despite these circumstances in 2002 the notaries promoted a law that entered into force in 2004 and that eliminated the forms signed by the lawyers and gave them back the monopoly of bearing witness to the authenticity of a document. The registration costs of a transfer were tripled and the monthly number of transactions registered dropped considerably.<sup>9</sup>

## 2. A NEW THREAT

On December 17, 2004, the *Instituto Libertad y Democracia* (ILD) issued a press release warning the citizens at large about the progressive deactivation of the Land Property Formalization System created in 1988 through an initiative to eliminate the legal mechanisms that allow for the inclusion and maintenance of land owned by Peruvians, particularly the poor, in a market economy.

The press release underscored that this initiative contained a series of legal provisions that had gradually made the Commission for the Formalization of Informal Property (COFOPRI) lose importance and has also eliminated the registration forms authorized by lawyers, a mechanism designed to document any transaction concerning a plot of

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<sup>7</sup> However, through other norms the notaries were able to restrict the use of the forms and oblige that they be accompanied by their signature. Law 27755, in force since 2004, eliminated the use of the forms signed by a lawyer and the authentication service of transfers in Peru has once again become a monopoly of 540 notaries (138 in Lima), raising the cost to remain in formality. The notaries do not want the forms to be used and the poorest Peruvians have to decide between paying much more for public deeds or going back to informality.

<sup>8</sup> See: Amicus Curiae Ombudsman's Report concerning the lawsuit on grounds of unconstitutionality of the notaries. Lima, June 13, 2003. page 22. According to the report "according to the figures provided by the Urban Property Registry (through document Oficio N° 233-2003-SUNARP-RPU/JEF of May 16, 2003) there have been 283,025 registrations in this Registry up to the first quarter of 2003 of which 204,694 were made on Registration Forms and 78,331 were Public Deeds. Of the 204,694 registrations done on Registration Forms, 33 are lawsuits (15 civil and 18 criminal), that is, only 0.016% of the total. While the 78,331 registration made through Public Deeds, 34 became lawsuits (29 civil and 5 criminal), that is 0.043% of the total".

<sup>9</sup> Although the tendency was clear since the law was adopted, subsequent figures revealed that 16% less events were registered thereafter (See Section 14 of Annex 1).

land in a safe, simple and low cost manner. The elimination of the registration forms has led to a considerable increase of transaction costs by restoring the monopoly of public notary deeds.

This communiqué, furthermore informed the public that the Bar Association of Lima was about to present a bill to reintroduce the registration forms signed by lawyers with a view to giving the poor the best support possible to access ownership once again.

In response to the initiative of the notaries and its serious consequences, the then Special Pro Investment Congressional Committee presided by Dr. Jorge del Castillo, issued document Oficio N° 01-2005/2006-CR-CEPI dated August 18, 2005 submitting a bill to the President of the Congress of Peru, amongst others, on Additional Mechanisms to Access Property and Remain in Formality. As has been pointed out in said document:

***“the purpose of the norms contained in the Bill is to include measures that bring about a quick beneficial impact on the formalization of property”.***

One such measure is to restore COFOPRI functions and the registration form authorized by lawyers.

In the line with the aforementioned Bill, during President Garcia’s second term in office a series of legal provisions were issued in an attempt to restore the right of Peruvians who own property, to obtain and keep a registered title. We wish to highlight some of the following provisions:

- Law 28923 (Law on the Special Temporary Regime of Urban Property Formalization and Titling) restores COFOPRI's functions, in an exceptional manner, to implement urban property sanitation and titling procedures for plots that are informally occupied.
- Supreme Decree 023-2006-VIVIENDA creates the National Council to Promote Access to Popular Property in charge of creating the necessary conditions to allow the inhabitants to access legal security that results from effective titling.
- Supreme Decree 032-2006-VIVIENDA amends the construction permit procedure, based on the principles of speed, effectiveness and simplicity.
- Supreme Decree 033-2006-VIVIENDA establishes that the Ministry of Housing in coordination with local governments and through Ministerial Resolution determines the guidelines or actions to be followed in order to facilitate and simplify the



- Supreme Decree 034-2006-VIVIENDA declares that activities that promote a mortgage market are of national interest and creates a Coordinating Committee to propose the necessary legal norms required to encourage the development of a secondary mortgage market.
- Supreme Decree 036-2006-VIVIENDA adopts the simplified procedure of the construction statement and construction division of a plot and rooftop building of new housing units by legally accepting the simplified registration form.
- Supreme Resolution 265-2006-PCM that launched the program “*TLC Hacia Adentro*”- “Internal Free Trade Agreement” will provide norms to help informal businesses become formal and will allow property owners to keep their legally gained rights, through mechanisms that keep an eye on costs to make sure they remain at reasonable levels.

As a result of this renovated reforming impulse, we should not be surprised that barely a few weeks ago the Association of Notaries of Lima publicly presented a document that intends to minimize the benefits of the property and business formalization system and grind it to a halt. Essentially, the most traditional notaries of Lima are trying to maintain the *status quo* to avoid harming their economic interests, at the expense of excluding the poorest Peruvians from the benefits of legality.

Instead of openly discussing how they can contribute more efficiently to property and business formalization in Peru, they preferred hiring a consultant to try to demonstrate that notary fees are not as high as the ILD claims and also to harm the reputation of its ideas and minimize the beneficial effects of property formalization. However, as we shall see in the next chapters, they failed.

We wish to point out that the reaction of the conservative notaries of Lima is a far cry from that of the notaries in other countries such as El Salvador where the property formalization program designed by the ILD for the government of that country was backed by the active participation of most of the 4,500 local notaries. The program in El Salvador not only benefitted hundreds of thousands of clients from the marginal communities and regularized pirate plots (squatters claims), but also allowed the enforcement of Land Peace Agreements signed in 1992 by giving titles to 35,000 ex-soldiers of the *Frente Farabundo Martí para la Liberación Nacional (FMLN)* and the Armed Forces of El Salvador (FAES in the Spanish acronym) and contributed to the

formalization and reconstruction of 26,000 houses destroyed by the 2001 earthquake.

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## CHAPTER 2

### **WHAT ARE THE BENEFITS OF PROPERTY RIGHTS?**

The essay financed by the Association of Notaries of Lima denies the importance and favorable effects of the registry, its information network and the instruments it provides to govern several variables such as asset appraisal, home renovation investments, access to loans, employment, etc. to the point of being irresponsible.

Consequently three surveys were carried out between 2000 and 2004 and charts containing the final figures are presented, with no further analysis, that demonstrate that even settlement inhabitants without a title to their plot of land have had more access to sanitation services than those with a title from COFOPRI, as if that fact—explainable from several standpoints, such as political will, the age of the settlement, geographic location, etc.— could disqualify the importance of having a registered title when private agents are expanding public utilities under normal market conditions.

In the next pages, we will demonstrate how formalization reaps huge benefits for the poor. We will discuss the conclusions that the essay has extracted from a few surveys that cover extremely short periods of reform enforcement and we wish to mention that they are a very important part of the reforms planned by the ILD but have not been fully implemented yet in Peru. Aside from this, we also provide international evidence and studies.

#### **1. PROPERTY RIGHTS FOSTER INVESTMENT AND INCREASE THE VALUE OF REAL ESTATE: WORLD EVIDENCE**

The essay financed by the Association of Notaries of Lima mentions that the beneficiaries of the formalization program have not invested more in their homes than property that have other types of titles. Their sole basis of judgment is the three surveys, as mentioned before. The figures contained in the essay have not been interpreted. They describe them and forget that if they are correct they are understandable because numerous other variables are lacking. Moreover,

despite using these figures it is doubtful that they are truly representative.

If, in effect if it were true that Peruvians who benefited from the property and business formalization programs do not have better incentives to invest in their property, we would be considered to be a completely exotic case and set apart from the rest of the world. The reason why is that studies from different sources in a number of countries reveal that what is happening is quite the opposite of what the essay financed by the Association of Notaries claims.

According to the World Bank, recent surveys in Poland, Rumania, Russia, Slovakia and Ukraine reveal that the businessmen who believe that their property rights are safe reinvest between fourteen to forty per cent more of the income that those who have the opposite opinion. Moreover, it was discovered that in Ghana and Nicaragua the farmers invest up to eight per cent more on their land when their property rights are safe.<sup>10</sup>

Furthermore, the World Bank has compiled several studies that describe that the value of rural land in Brazil, Indonesia, the Philippines and Thailand increased by forty three to eighty one per cent after they were given titles. As concerns urban land, titling increased property value by fourteen per cent in Manila, by twenty-five per cent in Guayaquil and Lima, and by fifty eight per cent in Davao<sup>11</sup>.

As concerns China, the different studies conducted by the World Bank indicate that the combined effects of titling and price liberalization increased farm production by forty-two per cent between 1978 and 1984. It has been estimated that half of the increase is due to the allocation of private property.<sup>12</sup>

The World Bank also estimated that the greatest investment of the Thailand farmers who received property titles increased their production by fourteen to twenty-five per cent more than the amount made by those who did not have a title. And in Viet Nam, rural households who had clearly established property titles dedicated more than seven per cent of additional land to their crops, which in a few years time helped them to increase their income. On the other hand, as has been pointed out by the World Bank, in the shantytowns of Lima practically half of those who have titles have invested in home renovation and restoration.<sup>13</sup>

The World Bank also stresses that even the landless poor can benefit when property rights are safe. The owners with unsafe rights are usually much more reluctant to rent their properties because they fear

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<sup>10</sup> World Bank. *World Development Report 2005. A Better Investment Climate for Everyone*. p.79.

<sup>11</sup> Op. Cit. p. 80.

<sup>12</sup> Op. Cit. pp. 80-81.

<sup>13</sup> Loc. cit.

that their tenants will gain full control over this property and that they will not have any legal means of recovering it. In the Dominican Republic, for example, the effect of establishing safer property rights increased the rental of land by 21%. The percentage of the poor who pay rent increased by 40% and the rented area grew by 67%.<sup>14</sup>

Another very interesting study on the effects of titling was done by Galiani and Schargrodsky<sup>15</sup>. More than twenty years ago, a group of squatters occupied several plots of land in the outskirts of Buenos Aires. The government was able to give titles to only some of the squatters. The group that got a title was not different from the other group that didn't and the plots of land had the same characteristics. Galiani and Schargrodsky studied the difference in behavior of both groups of individuals.

Among other things, the researchers discovered that those who had a property title invested more in their houses, since they knew that nobody could steal their investment from them. In the case of those who had property titles the number of houses with good quality walls increased by forty per cent, while the number of good quality roofs increased by forty-seven per cent. Field discovered similar results in Lima. According to his study four years after having received the title there was a seventy-eight percent increase of the rate of household renovation.<sup>16</sup>

## **2. MORE EDUCATION, LESS CHILD LABOR, MORE JOBS FOR WOMEN AND BETTER BIRTH CONTROL**

In another study, Field discovered that titling is linked to a greater supply of employment. Those who live in untitled properties have to devote time to the community protection mechanisms for their extralegal houses. Moreover, they usually have plot boundary conflicts and fewer legal resources to protect themselves against theft. As Field has stated, this explains why the forty-seven per cent of those without a property title in the group being studied hire a watchman for their plot and invest an average of thirteen hours per week for home protection. In the case of the families who received a property title, Field discovered that after having secured a higher level of security on their property they were able to devote more time to find and access better job opportunities outside of their homes and therefore increase their level of income.

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<sup>14</sup> Op. Cit. pp. 81-82.

<sup>15</sup> Galiani, Sebastián y Ernesto Schargrodsky. *Property Rights for the Poor: Effects of Land Titling*. En: [http://economics.uchicago.edu/pdf/Galiani\\_022706.pdf](http://economics.uchicago.edu/pdf/Galiani_022706.pdf)

<sup>16</sup> Field, Erica. *Property Rights and Investment in Urban Slums*. In: <http://www.economics.harvard.edu/faculty/field/papers/FieldinvestJEEA.pdf>

Those who most benefited were usually the women who stay at home to take care of the informal dwelling<sup>17</sup>.

Galiani and Schargrotsky also discovered that the size of the families with titles was smaller on average. Apparently, the explanation is that if they have a property title they will enjoy a more protected old age and therefore will not need to depend as much upon their children as retirement insurance. The poor do not usually have a retirement pension or a means of income for their old age. In this case, the only people willing to take care of them will be their children. This is why the only plan they have to “protect their retirement” is to have as many children as possible. But if the person has a property right then he or she can retire with greater ease. In this case, the person can live in peace because they have a roof over their head and sometimes a means of income, which makes them less dependent on the number of children they have as a means of support.

Field’s investigation on the titling process in Lima confirms the findings of Galiani and Schargrotsky. She discovered that the households in Lima with property titles had lowered their fertility rates by twenty two per cent.<sup>18</sup> If we can generalize the findings of these researchers in Argentina and Peru, securing a property right is an additional means of reducing the rampant birth rate that prevails in the third world and that aggravates the problem of poverty and also helps the state services to satisfy the needs of more people.

Galiani and Schargrotsky also found that the households that had a property title invested more in their children’s education. Field also discovered that the titling program benefited the children of families with a title. According to the study, these families are less likely to send their young children off to work, apparently because they have higher incomes because they can work longer hours outside of their homes and depend less on the income of child labor.<sup>19</sup>

Finally, the Peruvian experience of COFOPRI reveals that the property titles have a major impact on the situation of women and have been one of the main factors in narrowing the gender gap. This can be clearly seen in the distribution of credit. Although the male gender has a greater share in consumer credit, women owners have taken the lead in

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<sup>17</sup> Field, Erica. “Entitled to work: Urban Property Rights and Labor Supply in Peru”. En: [http://www.economics.harvard.edu/faculty/field/papers/Field\\_COFOPRI.pdf](http://www.economics.harvard.edu/faculty/field/papers/Field_COFOPRI.pdf)

<sup>18</sup> Field, Erica. “Fertility responses to land titling: the roles of ownership security and the distribution of household assets”. En: [http://www.economics.harvard.edu/faculty/field/papers/Field\\_Fertility\\_05.pdf](http://www.economics.harvard.edu/faculty/field/papers/Field_Fertility_05.pdf)

<sup>19</sup> Field, Erica. “Entitled to work: Urban Property Rights and Labor Supply in Peru”. En: [http://www.economics.harvard.edu/faculty/field/papers/Field\\_COFOPRI.pdf](http://www.economics.harvard.edu/faculty/field/papers/Field_COFOPRI.pdf)

credit for micro businesses with 54% versus 46% for men, thus revealing the consolidation of the female share of this segment<sup>20</sup>.

### **3. MORE ACCESS TO CREDIT**

According to the World Bank, Thailand farmers who benefited from the formalization programs obtained 50% to five times more credit from banks and other formal financial entities than farmers without a title but with land that had similar characteristics.<sup>21</sup>

Similarly, according to COFOPRI figures an estimated 198 thousand title recipients had received loans for an estimated amount of US\$ 300 million between 1995 and 2002.<sup>22</sup> The information used indicated that the loans had helped to increase the economic activity and employment of low-income urban areas.

If property is not registered, it cannot be mortgaged as collateral for a loan. This is why property titles are so important for the purpose of accessing credit. However, the effects in terms of credit could have been greater if we were to understand, as is explained in the next chapters, that the registration is simply the gateway to the property and that Peru still needs to implement a number of legal reforms to enable its citizens to use their assets fully to access credit.

### **4. MORE ACCESS TO PUBLIC UTILITIES**

In a study done by the ILD in 1995, we determined that there is a link between the access to public utilities and the formalization of property.<sup>23</sup>

In those days, the electrical distribution companies in the United Kingdom charged 93.4% of the power distributed as compared to barely

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<sup>20</sup> *Cofopri al día*. Newsletter April 2006.

<sup>21</sup> World Bank. *World Development Report 2005. A Better Investment Climate for Everyone*. p. 10.

<sup>22</sup> COFOPRI. *Peru Urban Property Rights Project*. COFOPRI, November 2002.

<sup>23</sup> ILD. *A Strategy for Commercializing Proform and Businessform*. ILD In House Document, May ,1995.

66% in Peru. In the United Kingdom, 5.5% was lost due to technical flaws, 1% due to non-technical flaws and 0.1% due to a lack of payment. In Peru, 8% was lost due to technical flaws, 13% due to non-technical flaws and 13% due to a lack of payment.<sup>24</sup>

In Peru 85% of the losses due to non-technical flaws and lack of payment are related to extralegality. Human settlement dwellers resort to different practices in order to obtain electricity. The most well known custom is a clandestine connection that steals power from nearby sources. Some settlements have only one meter that supplies electricity to all the houses in no particular order or control. In some cases, the inhabitants without a household connection reach an agreement with their neighbors who do to secure an illegal supply of power. The point in common in these cases is that there is only one client's name attached to the meter. Therefore, it is not clear who should pay or who should be punished if the meters are tampered with.

In opposition to the comments made by the notaries in the essay, an updated registry is of essence because it would do away with anonymity by linking the asset to the holder and therefore it would be easy to match the name of the client to the meter and therefore who is responsible for payment and who will be affected when the power supply is interrupted if the meter is tampered with or damaged.

This is similar to the situation of water. When a single neighborhood waterspout is transformed into individual household taps, the temptation to tamper with the meters and not pay for utility services quickly disappears.

Furthermore, the standardized registered data enables public services companies to plan the expansion of their networks through coordination with formal land development processes, instead of dealing with squatters who do not plan ahead and take into account the need for space to lay cables and pipelines for household connections in an orderly manner.

According to the ILD calculations on that date if the losses in Peru would have dropped from 34% to 14% thanks to formalization, the electricity companies would have saved US\$ 300 millions , a major portion of which was passed on to Peruvian consumers.

## **5. BETTER FUNCTIONING OF THE CIVIL DEFENSE SYSTEM AND LESS IMPACT OF NATURAL DISASTERS**

Formal property sets the groundwork to improve the functioning of the civil defense system and to minimize the impact of natural disasters. In effect, once property is registered in a system with a view

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<sup>24</sup> Source: Ministry of Energy and Mines, Cenergía, Manweb pLc, ILD.



to consolidating information on assets owned by each person, incentives are created to provide for the physical safety of the property unlike a notary or public deed. The registry – when well conceived and implemented – is an information system that begins the transformation of the physical assets into property enabling it to become a mechanism to access credit, obtain security or an income, etc. By doing this, the registry creates an awareness of the value of the good in the individual, and this prompts a greater investment to foresee the events and circumstances that can affect this value.

In effect, we have verified that in countries that have such a registry as a basis for property rights, there is a greater possibility to foresee events – such as a natural disaster – that may harmfully affect the value of property. Since most of the natural disasters are foreseeable to a certain extent, so much so that today it is possible to determine in advance if a hurricane is going to hit a specific area or if there is a high risk of a volcanic eruption. Even in the case of *tsunamis* or tidal waves, local inhabitants can be warned a few minutes before the impending disaster strikes. Similarly, as regards the analysis of the historical and geographical features registry certain areas can be spotted where there is a greater risk of flooding or an earthquake. But this is feasible if there is a registry that integrates property into a one sole system that disseminates the information and consequently, raises the awareness of citizens about the value of registered property. Let us take a look at some cases that support these ideas.

According to the Red Cross<sup>25</sup>, the reason why the number of victims of hurricanes is so low in the US is because the government has the capacity to foresee the phenomenon. Meteorological centers allow US citizens to be informed of the danger with an anticipation of 3 to 5 days. While deaths resulting from hurricanes in the US are extremely rare (what happened with Katrina was unprecedented in the history of natural disasters in the US), in Haiti an estimated 17,000 people have died from the same causes over the past seventy years. The reason is that Haitians never realize that a hurricane is heading their way. Incredibly, due to mass media, US residents find out that Haiti will be hit by a hurricane while Haitians do not have a clue of what is going on.

Since there are several types of foreseeable disasters, the possibility of avoiding the loss of human lives and material damage is greater. However, to a great extent this depends upon the existence of public service networks.

As has been mentioned before, formal property is of essence enabling public service companies to lay their networks. Once there is formal property, these companies know how to identify the users,

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<sup>25</sup> See: <http://www.ifrc.org/publicat/wdr2005/chapter2.asp>

localize debtors with collateral, establish the controls on leaks and develop procedures to sanction users if they have tampered with or damaged the meters, or even shut them down. Moreover, a formal property system reduces the theft of services since the owners are encouraged to take care of them and are responsible for losses. All this explains why public services—telephone, Internet, electricity, water and sewage – are usually more poorly distributed in places with no formal housing. As De Soto declares, “with formalization the public utility providers can convert each household into a reliable terminal”.<sup>26</sup>

Evacuation is another way of avoiding the loss of human lives and material, and this greatly depends upon the existence of adequate transport routes. In areas with high rates of extralegal housing, it is often more difficult to find adequate roads and paths to carry out a large-scale evacuation, since the governments expand the road network as a function of urban planning. Extralegal housing is precisely characterized because it overlooks planning and therefore the extralegal settlements are usually not located in places that have easy-to-access traffic routes. It is enough to see the narrow streets of a shanty town, such as the steeply crowded slopes of some *favelas* or the few access routes of a *villa miseria* to realize that there hardly is a possibility of fleeing these places in case of a disaster. All of this restricts the possibilities of evacuating the population and reducing the eventual costs of an event of this nature.

On the other hand, as has been mentioned before, we must bear in mind that when people have access to formal property they take pains to invest in improving their homes. If there are better quality and safer houses, the possibility of suffering damages during a natural disaster is considerably lower (evidently, this does not happen in the minority extralegal sector that builds houses with some major resources). Very often it is the constructed houses – and not the earthquakes – that kill people. In effect, registered property helps to verify compliance with construction standards that make houses safer, to begin with, because the registry also provides information on these houses and may make certain liabilities demandable which would be otherwise impossible to do if there were no such information system. In countries where there is no registration system, or at least it is not a widespread practice, these standards cannot be enforced. When there is no access to a registry precarious illegal houses are built. According to the U.S. Geological Service, the main reason why the damages and deaths caused by an earthquake are greater in some places around the world is poor housing

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<sup>26</sup> De Soto, Hernando. *El misterio del capital. (The Mystery of Capital)* Empresa Editora el Comercio, 2000. p.219.

construction.<sup>27</sup> And the same happens with floods, *tsunamis* and hurricanes. According to the report of US President W. Clinton before the United Nations, in Banda Aceh many buildings built in compliance with technical specifications survived the *tsunami*, while makeshift and precarious houses and buildings were wiped off the map.

A few years ago, we witnessed another case in Cajamarca. For some time the Ticsani Volcano has become active once again, and has been producing numerous tremors and is now at risk of erupting. The strongest tremors were an estimated 4 degrees on the Richter scale and happened on Saturday, October 15, 2005. As a result, 471 houses were destroyed and 379 had seriously damaged structures. Although the mass media did not report any deaths, ten people were known to have been wounded.

However, an earthquake of this magnitude should not have caused such a problem. According to the Geological Survey of Canada, an earthquake of three or four on the Richter scale can be felt, but it should not cause any damage.<sup>28</sup>

One example is the impact of the 1977 hurricane that hit Acapulco. The hotels along the coastline and downtown were affected a bit, while the poor settlements located in the surrounding areas were destroyed and it took several months until the situation was under control.

The reason why a low degree tremor according to the Richter scale destroys the homes of an estimated one thousand Peruvians, while in other countries most people would just have to re-arrange their living room adornments, is basically because of poor housing construction. This situation is the same all over sub-developed countries.

As has been seen, the existence of poorly built houses is linked to a lack of formal property, and therefore it is only natural to deduce that the families that inhabit these houses are much more vulnerable when a natural disaster hits.

Furthermore, another public service that affects the loss of human lives in the aftermath of a natural disaster is drinking water and sewage, which as has been mentioned before, depends upon clearly defined property rights.

Many victims do not die as a direct result of the disasters but rather due to infections and epidemics in the aftermath of the areas hit by the natural disaster. As the United Nations has pointed out, the bullet does not kill you, but the hole it leaves does. The possibility of reducing the impact of these diseases basically depends upon the access to drinking water and the presence of a sewage system.

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<sup>27</sup> See: <http://earthquake.usgs.gov/faq/effects.html>

<sup>28</sup> <http://www.pgc.nrcan.gc.ca/seismo/eqinfo/richter.htm>

Once again, extralegal houses are characterized by not having access to such services. As concerns the victims of Aceh, for example, the nearest source of water is more than one kilometer away from these houses.

Moreover, the extralegal areas are far from hospitals and medical posts and squatters usually encroach on land with no prior planning to make provisions for a health post or center. What is more, the government may not be interested in investing in a health center for dwellers when nobody knows if they will continue to live there since they are often evicted. This is why the possessors of extralegal houses who needed emergency medical attention after the disaster had much more difficulty in getting it.

We also have to bear in mind that clearly defined property rights allow cities that have been hit by a natural disaster to quickly recover. After the post disaster reconstruction work begins people need capital. In the worst cases, after a disaster the only possession people still have is the ground under their feet. If they are formal owners of the land, they can apply for a loan backed by the property title. With this money, they can start to rebuild their homes, workshops and sales shops.

However, as is explained in the next chapter, it is much more difficult to access capital if you do not possess formal property since the applicant cannot deliver property as collateral for the loan. Therefore, in the illegal or extra-legal world, the assets the survivors of natural disasters have left are not used as collateral to access the capital they need to reconstruct the ruins. This is why countries with a high degree of extralegality take longer to reconstruct ruined homes and buildings.

In countries in which the law establishes extremely bureaucratic, cumbersome and expensive procedures to establish a guarantee the reconstruction process is delayed even for those with formal property. The housing and business reconstruction will have to wait until all red tape procedures are met as specified by law, and then people will have the privilege of securing a loan.

Furthermore, the reconstruction process means that individuals and companies in charge of repairing the damages or building a new home or building will enter into contracts. If the State does not have the capacity to enforce these contracts, and if as a consequence the people can only resort to extralegal institutions for this purpose, there is a greater risk of breach of contract. The greater the risk, the fewer the reconstruction contracts. With less reconstruction contracts, the recovery process of the cities takes even more time.

Another problem that devastated cities have to deal with is how to reconstruct the system that demonstrates who owns what. In New Orleans, for example, an estimated 60,000 volumes that contain the

records of one century of mortgages were damaged by the flood.<sup>29</sup> Moreover, officials at Meulaboh, a town located 150 miles south from Banda Aceh, found around four hundred damaged property titles.<sup>30</sup> If the formal property system cannot be reassembled, the reconstruction process will be seriously affected.

Formal and registered property rights reduce the impact of these events. In the first place, if there is a property registry then there is something to reconstruct. A damaged registry is better than none at all.

In the second place, once the property has been registered, the information on the titling of the good is disseminated in parts contained in a number of documents. This is why, despite the fact that the records have been lost or destroyed, the information on the property can be reassembled based on documents such as public utility bills, insurance and rental contracts, guarantee and transference of goods contracts, amongst other legal instruments that contain information that has been recorded. In the worst case, all those documents can be used to file an adverse possession process in which the period of possession demanded by the law can be verified and therefore the owner can recover the status of legal ownership.

In the third place, this information recovery process could be efficiently speeded up and simplified if there is a computerized registry system in place. Quite different from book keeping and handling paper documents this system is not exposed to alterations or being destroyed and can be stored in “back up” files.

Finally, clearly defined property rights reduce post disaster violence episodes. Nam Khem is a small fishermen's cove in Thailand. According to *The New York Times*, after the *tsunami* hit the area, the owner of the Far East company – nicknamed the “Big Boss” – sent groups of armed men to occupy the land occupied for decades by some 50 families. Far East had coveted the land for some time and had plans to build a seaside resort there, but the possessors – who did not have a property title – did not allow the company to do so. After the *tsunami* had razed the land and destroyed their homes and shops much like a giant bulldozer, “Big Boss” hatched the idea of using violence to get control of the land.<sup>31</sup>

Curiously, in developed countries violent outbreaks after a natural disaster are few and far between, while in under-developed countries

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<sup>29</sup> Krolicki, Kevin. “New Orleans home market uncertain”. In: *Reuters*, October 22, 2005.

<sup>30</sup> Aglionby, John. “Losing the plot”. In: *Guardian Unlimited* April 19, 2005. <http://www.guardian.co.uk/elsewhere/journalists/story/0,,1463181,00.html>.

<sup>31</sup> Mydans, Seth. “Devastated by Tsunami, Villagers Fight Builder for Land”. In: *The New York Times on the Web*. March 12, 1995.

devastated areas are turned into war zones. Once again, formal property is at the bottom of the explanation.

As Fanal pointed out, if there are no property titles, people know that the State will not sanction them if they encroach on other people's land. Moreover, they know that the networks of extralegal institutions that formerly protected the possessors of the land have disappeared.<sup>32</sup> As in the case of Nam Khem, the communities of extralegal owners that would protect each other have very probably disappeared and after the disaster the possibility of using private violence in defense of possessions is very limited and it stops being a real threat. This creates a scenario that encourages individuals with more resources and political influence to carry out a new squat on these lands and to ask the State to recognize them as the legal owners. This opens the door to violence.

What happens in places where there is formal property? Well, to begin with, "new squatters" do not appear, since they know that the formal owner can ask the State to defend his rights. This is why, violent clashes for the possession of a plot of land are usually very rare.

The existence of formal property reduces the number of criminal acts after natural disasters because delinquents can be easily localized. As de Soto mentioned, "formal property registries that are continuously updated can provide the police with the necessary information to keep the peace. One of the main characteristics of the marginated people who live in developing countries and the inhabitants of former soviet countries is the lack of a place of business. When a crime is committed, the police have no registry, or clues or other data usually described on the property registration card to hunt down the main suspects who are on the run".<sup>33</sup>

All these reasons explain why Third World countries suffer the consequences of a terrible natural disaster much more than First World Countries.

## **6. BETTER ACCESS TO INSURANCE**

Insurance systems help people to estimate potential losses from accidents, attacks or natural disasters and to minimize their costs. Moreover, once the tragedy has occurred, the amount collected from the insurance policy can be used as the capital required to begin the housing, business and shops reconstruction process.

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<sup>32</sup> Fandl, Kevin. "Dead Capital and the Sea: Post -Tsunami Relief for the Southeast Asian Informal Economy". *Yale Journal of International Affairs*. Summer-Fall 2005. page 83.

<sup>33</sup> De Soto, Hernando. *El misterio del capital*. pages 219-220

Hurricane Katrina is one example. According to a US congressional report, it is estimated that the private property was covered up to an estimated amount of US\$ 30 billions (as in the case of 9/11 the insurance covered an estimated US\$ 32.5 billions).<sup>34</sup> In Sri Lanka, quite the contrary, a bare 1% of the people affected by the *tsunami* were insured. Therefore, only a small fraction of the 93,000 houses destroyed could be rebuilt thanks to the money paid by the insurance company.<sup>35</sup>

¿Why is insurance more widespread in developed countries? One important factor is the existence of formal property. If people are not formal owners then it is highly improbable that they have home insurance. In the first place, since there are no major incentives to invest, the extralegal house is usually makeshift and is not worth the insurance. In the second place, it makes no sense to insure this good if the dwellers are at risk of being evicted at any moment. In the third place, insurance companies do not enter into contracts with individuals with no known place of business and who are difficult to contact at any given time – nor to collect sums of money from – on grounds of breach of contract. Hence, in the extralegal world, there are no private mechanisms to spread the risk and there is even a scarcer possibility of obtaining the funds to recover losses.

On the one hand, insurance companies play a very important role in generating information that is also useful for disaster prevention. In general, people are hardly informed about certain dangerous events. For example, they may not know that a certain area is more in danger of being hit by a natural disaster or that homes and buildings built out of some specific material may be particularly dangerous.

The insurance companies in turn have a considerable amount of relevant information. In the first place, they have the means to hire researchers who produce the data. In the second place, they have the incentives to produce the data, since the more data they have on the risks of the insured party, the more they can draft contracts that are more efficient and reach higher profits. Thus, these insurance companies usually have much more information than any individual could have on the risk of living in a certain area, or building with certain materials. This data is then transferred to the individuals through the price of the insurance premiums. In high-risk hurricane areas, insurance premiums against hurricanes are much higher. Likewise, certain construction methods that increase the probability of a fire or make a house less safe can also raise the premium.

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<sup>34</sup> <http://www.cbo.gov/ftpdocs/66xx/doc6627/09-06-ImpactKatrina.pdf>

<sup>35</sup> RMS Special Report. “Estimating Losses from the 2004 Southeast Asia Earthquake and Tsunami”. *Risk Management Solutions*, 2005.

Through these mechanisms, people can obtain more information on the dangers of building in certain danger zones or using inadequate construction material or techniques.

Unfortunately, as possessors of extralegal houses, they encounter greater difficulty in obtaining insurance coverage, nor do they benefit from the information that these companies manage concerning the danger of living in specific areas.

## **7. MORE PUBLIC SAFETY**

Where a criminal or a group of criminals hides and hangs out is of essence if you want to catch them. This would be much easier if the houses had proper addresses and if there was a homeowner's registry. This information would allow the police to track a suspect down. Without this information, delinquents can easily seek refuge in anonymity. The production of information useful for police purposes is the secondary effect of a formalization program.

On the other hand, by establishing private property rights people no longer have to resort to violence in order to protect their possessions. Without property, they fall prey to the mafia or community patrols. These options involve violence to protect people's possessions and place them under constant risk.

An easy access to the property usually dissuades people from violently squatting on land, or the violent eviction of squatters as well as depending upon land traffickers and their mafias.

Moreover, we must not forget that in an extralegal economy business deals are preferably carried out in cash since informal businessmen avoid leaving a trail of their businesses or shops that do not have the proper legal permits and licenses, or because to evade taxes. The use of cash to do business obviously increases the chances that these entrepreneurs become targets of criminal assaults.

Finally, let us not forget that the property formalization system was part of the strategy in the fight against terrorism in Peru. In the war plan for 1986 entitled "*Rematar el gran salto con sello de oro*" Sendero Luminoso or Shining Path as it is known in English, declared it had begun to formally recognize land, houses and businesses throughout Peru and to give titles to owners as a way of gaining the support of the poor. They were doing what Mao Zedong had done in the 40's in China and Ho Chi Minh had done in Viet Nam in the 60's. Sendero had begun to grant and enforce property rights in the rural areas of Huánuco, in the Alto Huallaga Valley and in the highlands of La Libertad. Furthermore,



they organized the squatters and the titling of the shantytowns such as Raucana, Vitarte and Huaycán.<sup>36</sup>

The Maoist group called Sendero Luminoso sought legitimacy among the poor – paradoxically – by giving them property, which in those days the State was unable to do. Sendero was defeated through an intelligence operation against the inner circle and by waging war on its troops in the jungle. But these victories against terrorism would not have been possible or sufficient if Sendero had not been defeated in the minds of people and at the level of ideas. This was done by making the legitimacy of the State evident through the defense of poor people’s property rights since they had constructed extralegal housing and to prove that the poor did not need Sendero to stand up for their rights.

## **8. HIGHER FAMILY INCOME**

According to Field, families possessing houses formalized by COFOPRI had raised their income level by working up to 45 hours per week.<sup>37</sup> By applying the legal minimum salary when the estimate was made, the figure is an estimated US\$ 118 of additional monthly income per family<sup>38</sup>.

Supposing that only half of the 45 hours of employment per week available were used for paid work, one family could benefit from an additional income of up to US\$ 708 per year. Bearing in mind that the property of 1.3 million families was formalized by COFOPRI during a 7-year period, the ILD has calculated that the net benefits (measured in additional net salaries of the beneficiaries of registered titles) could reach a capitalized value of US\$ 2.017 billions.<sup>39</sup>

## **9. MORE LEGAL JOBS**

ILD studies indicate that, on average, companies that became formal in the 1991-1994 period generated 1.45 jobs per business. For the workers, the net benefits of these jobs was US\$ 2,553 billion, expressed in capitalized value.<sup>40</sup>

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<sup>36</sup> De Soto, Hernando. *El Otro Sendero*. El Comercio S.A. Publishers page 22.

<sup>37</sup> Field, Erica. “Entitled to Work: Urban Property Rights and Labor Supply in Peru”. page 24.: “The long-run, or “steady state” effect of the program, reflected in the estimated effect on households with the maximum number of program periods, is an average increase of 45 hours of employment per week across the entire target population of squatters – roughly the same as one full-time worker being added to the labor force”.

<sup>38</sup> For more information, see Annex 1.

<sup>39</sup> See Annex 1.

<sup>40</sup> See Annex 1.

In order to estimate the number of new workers 1.45 was multiplied by the accumulated number of formalized businesses from 1991 to 1994 and then the total amount of workers up to 2002 was kept constant.

Apparently, the workers receive the minimum salary (US\$ 118 per month) but they only work 6 months a year, on average. From this result, 55% was subtracted as the opportunity cost of the hours of work. Starting from 1995 the net benefit was subtracted at a rhythm of 10 percentage points per year in recognition of the negative effect of the gradual numbers of more and more people interested in getting a remunerated job on the amount of this additional income.

## **10. HIGHER TAX COLLECTION**

ILD estimates that between 1991 and 1994 the average increase in gross tax collection per formalized company was US\$ 797.<sup>41</sup>

In order to estimate the contents of the net benefit (profits) implicit in taxes paid by formalized businesses, the ILD assumed that the Government would apply these resources to carry out current and investment activities for different groups of society; this would represent additional net benefits for those groups, and the amount could be similar to the amount of resources used for those purposes. This is the generally applied assumption when estimating the net benefits of an activity from the perspective of the country as a whole.

The US\$797 was converted to net collections by subtracting 25% of the gross income as a collection cost. As of 1995 the amount additionally collected was reduced at a rhythm of 10 percentage points per year to take into account the negative effect on the magnitude of the collections due to the market exit of some formalized businesses or because they went back to extralegality.

The resulting net benefits were US\$ 3.304 billions, expressed in capitalized value.

## **11. INFORMATION AND SAFETY TO ACCESS NATIONAL AND INTERNATIONAL MARKETS**

Without formal property, it is not possible to fully access national or international markets made feasible through trade agreements or to

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<sup>41</sup> See Annex 1.

benefit from of the most favored nation clause negotiated by Peru with the WTO, in bilateral investment treaties, the Andean Community, potential free trade agreements and others. The possessors of extralegal housing can only do business with people they know and trust enough to do business with without any guarantee.

Without formal property, it is not possible to identify the Peruvian owners and match them to their assets and tradable goods or the latter with the corresponding addresses and these linked to specific liabilities that guarantee the fulfillment of national and international contracts. There is no information on who is who, what assets they have and where.

Without formal property, it is impossible to give loans to Peruvians, because there is no way of identifying each person individually or their assets, and make them legally responsible for their debts. Thus, they will not have the necessary capital to trade in the country and abroad.

Property formalization helps to reduce the risks and cost of doing business with Peruvians because standard information on their assets and businesses is available. Moreover, it allows the assets of Peruvians to be used as guarantee in exchange for liquidity.

Lastly, a properly implemented property formalization process identifies the property of Peruvians and public service terminals can exact a rate of payment in exchange for the supply of power, water and other public services required to increase scale and productivity.

## **12. LESS SOCIAL EXCLUSION**

The greatest problem of the attack financed by the Association of Notaries of Lima is that it defends the position of having one right for the poor and another right for the wealthy. Informal property for the former and formal property for the latter. In this manner, it becomes a justification for exclusion.

The world in which individuals who earn a meager income access a different right, unfortunately already exists. It is the world we live in.

The legal framework applicable to all is so expensive that even people who can afford it have had to create mechanisms to tackle it. In Peru, foreign investments and large companies have obtained different tools to fully enjoy property rights that entail much more than a simple certification recorded in the public registry. As of the 90's – at least for some – the remaining legal building blocks were established to enable the property of a huge sum of Peruvian assets to attract enormous amounts of capital:

- The Constitution of 93 – and its Articles 62 and 63- protected investors with “Contratos Ley” (a contract with the State which is protected by a law of the Congress) and included dispute resolution with the State through arbitration. Thus, their property is safeguarded from state bureaucracy, mercantilist laws and judicial corruption.
- Then, other safeguards to property were created mainly thanks to Legislative Decree 662 and 757 as well as the subscription of twenty-nine Bilateral Agreements to Promote and Mutually Protect Investments.
- Among other things, these legal mechanisms protect the property of investors against expropriations, the instability of the tax and labor framework, state discrimination and the guarantee of the free transference of profit abroad.
- Furthermore, investment insurance, such as, MIGA and OPIC, can be contracted in order to protect their property.
- The large development of agribusiness exports that we are currently witnessing in places such as Ica would not have been possible if the private property of the businessmen would not have been guaranteed.
- In 1991, Legislative Decree 653 repealed the Law of Agrarian Reform and guaranteed private property on rural property and Legislative Decree 667 – upon the initiative of the ILD – simplified the registration process. In 1992, the Special Project for the Titling of Rural Land and Cadastres (PETT) registered more than one and half million pieces of property. Without these norms, investors would not have had the certainty that their property was safe and nobody would have been keen on investing.

These instruments protect and allow the property of the large investors to be used according to standards that resemble those of the domestic law of developed countries, but frequently they do not exist, change or are not complied with in Peru.

The development of this legal framework for the protection and use of property rights of large investors has allowed them to generate great wealth in the country. Under the protection of the legal stability agreements signed in 1993 and 2002 US\$ 14 billion dollars investments have been made.<sup>42</sup>

However, these property rights are the privilege of a chosen few. Congratulations to them, but everybody else should be able to profit as well. If full access is not guaranteed to everyone’s property in Peru, we

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<sup>42</sup> Source: Macroconsult.

will continue to be a country in which the majority is excluded from progress and development.

At present, the poor, in the best of cases, have only had access to one of the building blocks of property: the registry. And today the notaries are even trying to block this. The mere fact that the notaries are doing everything they can to take away from the poor the only piece of security is immoral. Instead, we should really be concerned about how to enforce a respect for the other rights of the poor.

The essay financed by the notaries should not be entitled “The construction of property rights” since it actually calls for the opposite that is, the destruction of this right and advocates a system that excludes the poor and deepens the division in the country between the few who are able to get ahead in life and the rest that are asking for a necessary and radical change of the price.

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## CHAPTER 3

# WHAT IS REALLY A GOOD PROPERTY RIGHTS SYSTEM?

### 1. THE COMMON MISTAKE: TO THINK THAT IT IS ONLY MATERIAL SAFETY

A major part of the problems of the essay financed by the Association of Notaries of Lima stems from the mistaken notion about what a property right is. The essay points out that having a property right on a good means securing its material security. Basically, this means realizing that nobody can take it away from you.

According to the consultancy of the notaries the property stops there. It is no more than the low, medium or high security that what is yours is yours. This security would result from squatting, the title or the registry. And this is not entirely false. But, having property goes far beyond that.

Being an owner means being able to use the good you own beyond its physical purpose. It is not only a matter of having things, but being able to use them for different purposes, beyond their immediate physical purpose. This can be achieved through the representation of these things in documents. But this does not happen in developing countries. In these places there is “(...) a faulty possession: the houses of the poor have been built on plots with inadequately defined property rights, their businesses are not incorporated with clearly defined responsibilities and their industries are hidden from the eyes of financial and investment agents”.<sup>43</sup>

In developed countries, the situation is the other way around. As has been described in the *Mystery of Capital* “In the Western World any plot of land, any construction, any piece of equipment or inventory deposited is represented in a property document which is the visible sign of a vast hidden process that connects these resources to the rest of the economy. Thanks to this representation process, the assets can adopt a parallel life to material existence. As such, they can be used as collateral for loans. (...) These assets can also be a link to the owner’s credit

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<sup>43</sup> De Soto, Hernando. *El misterio del capital*. p. 79.

record, provide an accessible domicile for debt and tax payment collections, be a platform to set up reliable and universal public services, and be a basis upon which to create value (for example, mortgage backed bonds) that can be discounted and sold in secondary markets. This process explains how the western World injects blood into its assets and, in doing so, generates capital”.<sup>44</sup>

In other words, having property means representing things on paper or other instruments. It is the path to tax, sell, rent, divide or use assets for any purpose that can give the owner an economic benefit.

## 2. THE SIX BASIC FUNCTION OF PROPERTY

In order for property to be property, a good property rights legal system must fulfill six main basic functions that go far beyond simply giving material security to assets owned by individuals and providing the benefits described in the former chapter:

- **Fixing the economic potential of assets:** Representing in writing – titles, contracts or other documents – the most important economic and social characteristics of the assets. This written representation specifies the interests of the owner and third parties, defines responsibilities, provides information and establishes the rules and mechanisms regarding the obligations involved. The potential value of the assets is precisely its capacity to be represented in universal titles that can be easily transferred which allows not only its physical use but also a parallel life as a capital mobilizer.
- **Integrating dispersed information into one system:** by gathering the dispersed extralegal agreements on property into a sole, consistent and systematized system of representations that operates under a large national consensus. Consequently, access can be gained to larger markets through the sole legal system with titles and standardized registries.
- **Making assets fungible:** by representing them in a manner such that they may be easily mobilized, be more accessible to the market and have greater functions. This involves standardizing the definitions and representations of assets to facilitate: a low cost measurement of the asset’s attributes, the combination of assets to attain a higher value, the division of assets into shares, the

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<sup>44</sup> Ibid. page 81.

objective appraisal of shares, and share transaction records, amongst others.

- **Making people accountable:** Changing the legitimacy of property rights by agreements based on politics enforced only at the level of local communities, due to the legitimacy and protection of property rights under the impersonal rule of law. This de-massifies shareholders because it links each asset to its owner/s and therefore each individual can be identified and localized and is deprived of the freedom of anonymity. Moreover, citizens become more confident about using property to create an additional guarantee concerning the fulfillment of trade or financial contracts.
- **Networking people:** Creating the institutional framework to connect, at a low cost, all the assets and their holders with the expanded market and with other agents for a series of purposes and also to develop projects. All this can be achieved through the registries, chains of companies, and other business integration systems, a number of services, amongst which are the fiduciary and insurance services that lower the risks and transaction costs.
- **Protecting transactions:** Assuring not only the assets but also their economic use, through mechanisms that provide market information on how the representation of these assets has evolved, as well as the owner or creditor of another, creating a chain of good faith and trust for buyers, investors, and third parties in general which will give the asset a greater exchange value.

The objective of the property formalization is to add an economic dimension to the physical asset that will enable its owners to use the representation of the property, not only to safeguard property rights, but also to generate a number of economic functions that go beyond possession and that link them to the world of finances and capital, if that is what they want.

### **3. LEGAL BUSINESS PROPERTY RIGHTS ARE ALSO REQUIRED**

In order to allow property to fully achieve the six basic functions as described by de Soto we have to look well beyond the simple titling and registry. The six basic effects of property are made a reality, in most cases, through enterprise, the economic vehicle of modernity to



extract the greatest possible value of an asset. Without enterprise, it would not be possible to get the best out of property.

In order to organize a business, the legal system must give the entrepreneurs a series of economic instruments that facilitate the division of labor, asset and risk management and leverage of their net worth to obtain credit and capital. This does not only involve how the business partnership of a company has been established, but also all the regulations that govern its functioning from its incorporation, operation and legal exit of the market.

In order to divide labor productively, the company must have the necessary means to:

- Maintain all the functions of the company under one coordination and control system to be applied for the division of labor and to organize the labor force in keeping with the needs of the business and the application of standardized norms.
- Clearly explain to everybody, including creditors, investors, managers and workers, that the company is a separate and independent entity from its owners, therefore the rights of each party are protected even in case of death of its founders, the change of owners or the liquidation or bankruptcy of the business.
- Have access to limited liability making the information on the property of the equity involved in business transactions transparent.
- Define the managerial responsibilities and functions in order to hire qualified professional managers.
- Present their financial statements and profit and loss statement based on official, standardized and simple accounting practices.
- Access standardized organizational structures per type of business that lowers the cost of accessing information on the business and on the companies it does business with.

If the law recognizes the property title but does not furnish the legal tools required to use it for economic and business purposes including the goals-based approach business tools as listed, despite the enormous importance of the title, it is practically useless. It is only

useful as proof of a precarious security as was described in the essay financed by the association of notaries.

## **5. IF PERU INTENDS TO EMBARK ON THE DEVELOPMENT OF ALL PERUVIANS THEY HAVE TO LEARN HOW TO EXERCISE THEIR PROPERTY RIGHTS IN THE DOMESTIC AND FOREIGN MARKETS**

We have understood that property cannot acquire its true value if the assets cannot be sold, rented, used as collateral, represented in titles, etc. However, all these operations need someone to do business with, aside from family members and friends.

The six functions of property cannot be fully achieved if there is no possibility of free trade with all the domestic and foreign markets opened by the WTO, the Andean Community and the eventual free trade agreements.

In order to achieve this, it is of essence that the property system that protects the assets of the poor be linked to domestic and foreign trade in a manner such that the owners can:

- Be responsible for their obligations through the clear establishment of their rights on assets of the company itself.
- Demand – and that they be demandable – their rights and liabilities through the Judiciary or the recognized legal alternative dispute resolution system.
- Contract providers and clients who are not known to them, as well as with the State.
- Import and export.
- Publicize without fear of being detected.
- Generate a complete business record through the appropriate registry of all the contracts as well as the fulfillment of business debentures.
- Obtain credit from the financial system, without the risk of involving a good part of proprietary capital and through simple and standardized procedures.

If it is impossible to trade in these terms, then domestic and foreign trade will continue to be the privilege of a chosen few wealthy

individuals and the poor will continue to be marginalized from progress and globalization.

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## CHAPTER 4

# **LEGAL TOOLS TO MOBILIZE THE ASSETS OF THE POOR IN DOMESTIC AND FOREIGN MARKETS**

The essay of the notaries presumes that the ILD only talks out on the issue of titling and registration, despite the fact that in all its publications and proposals it points out that aside from the narrowly defined property tool, other legal tools are also required in order to enhance the use of assets owned by individuals to put the main mechanism in movement: legally incorporated companies that are not within the reach of the poor.

The title and property registry are only the gateways to the right. They are a necessary albeit insufficient condition.

In this section, we explain each tool. We furthermore demonstrate how the essay of the notaries committed a mistake by believing that property rights can only be built with the expectant right on land that has been squatted on, titling and the registry.

### **1. THE GATEWAY: TITLING AND REGISTRATION**

The titling and property registration systems are only the gateway to property. Many people believe that a formalization program consists of delivering titles and property registration. This conclusion is the main big mistake made by the consultants hired by the Association of Notaries of Lima.

If you have legal ownership of an asset then you can use it for purposes other than its physical use. For example, if you are the owner of a house this means that you can use it for many more purposes than simply living in it. You can rent it out to a tenant, set up a business in it or deliver it as collateral for a loan. In fact, most of the inhabitants of developing countries own things: they have a plot of land or their homes, a small workshop or shop, or harvest they market as a means of income. They may have tangible goods, but, they do not have the property right to them and cannot create wealth from them.

The difference between the physical asset and the property is key. The former is worth the price paid according to its possible uses but the

latter multiplies its value when it is used as a leverage tool. Let us take a look at the matter through an example from the *Mystery of Capital*: “Consider a mountain lake. We can think about this lake in its immediate physical context and see some primary uses for it, such as canoeing and fishing. But when we think about this same lake as an engineer would by focusing on its capacity to generate energy as an additional value beyond the lake’s natural state as a body of water, we suddenly see the potential created by the lake’s elevated position. The challenge for the engineer is finding out how he can create a process that allows him to convert and fix this potential into a form that can be used to do additional work. In the case of the elevated lake, that process is contained in a hydroelectric plant that allows the lake water to move rapidly downward with the force of gravity, thereby transforming the placid lake’s energy potential into the kinetic energy of tumbling water. This new kinetic energy may then rotate turbines, creating mechanical energy that may be used to turn electromagnets that further convert it into electrical energy. As electricity, the potential energy of the placid lake is now fixed in the form necessary to produce controllable current that may be further transmitted through wire conductors to faraway places to deploy new production (...) The additional value we obtain from the lake is not a value of the lake itself (like a precious ore intrinsic to the earth), but rather a value of the man made process that allow us to transform the lake from a fishing and canoeing kind of place into an energy-producing kind of place”.<sup>45</sup>

Similar to the case of the lake transforming its waters into energy through the intervention of Man, physical assets can also be transformed into something else through the intervention of Man. In the former case, this can be done by building a hydroelectric power plant. In the latter, the case is much more complex, because we do not need only one sole element— for example, the hydro electrical power plant – to carry out the transformation process of the physical asset. As we have mentioned before, we need an entire set of legal rules that facilitate this conversion. One of these rules is the registry. Registration is like the main entrance to a house. Perhaps it is not the most important feature of the house – since an engineer would explain that a sound foundation is - but, nonetheless you still need to enter the house to get inside it. A property system without the registry is like a house without a door. You can always try to access the benefits of a good property system (such as credit, for example) through the window, but this is just too complicated for most people. After all, it is dangerous to climb through a window to get into a house: you risk taking a bad fall, being mistaken for a burglar by your neighbor and getting arrested by the police, or simply that the

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<sup>45</sup> De Soto. *The Mystery of Capital*. pp. 37-38.

window is 3 meters above ground and too high to reach. If we declare that the poor can have unregistered property (or at least don't give them this option) we are actually pushing them towards the windows of the legal system. Most of the time they will not enter: and this explains the high rates of extralegality in third world countries. Other times they will, but, under terrible conditions, for example, through loans at shylock interest rates and under violent execution methods.

It is clearly understood that most people do not build sturdy houses. It can have a magnificent mahogany front door placed on the walls of a roofless house made out of straw mattresses. But if we then say that the door is not important, then that is a different matter. We have already demonstrated how the registry has generated important beneficial effects in so many countries that have different cultures around the world (Poland, China, Brazil, and the Philippines, just to mention a few). Some of these effects include access to credit, which explains that the registry actually is a tool that helps to raise capital. The registry is important and very much so, to such an extent that it is an indispensable tool to change assets into credit and investments. However, it is not the only tool and, in most cases, is not sufficient to make raising capital possible, at least not in the amounts needed by businessmen in developing countries.

Once we understand that the registry is only a link in the chain of ownership, we can begin to see what it can be used for.

The first thing that the title and the registry provide is safety to individuals. The possessors of property know that – with certain exceptions specified in the law – nobody can evict them from their houses or take away other goods and belongings.

The title is useful because it determines who owns the asset. The registry is useful because nobody can claim that they do not know who the title holder is. Once the property has been registered nobody can legally claim that they did not know who the owner is. Thus, people can go on their ways and enjoy life, invest in their homes, spend less time to protect their homes, seek jobs outside their homes, send their children to school and plan the future.

The title and registration that function adequately are also powerful information tools. In the first place, squatters of human settlements have no addresses. Titling is one step in the direction towards an identity mechanism.

The registration, also records standardized data on assets and their characteristics. The standardization allows us to easily compare their characteristics and spot the one needed for a particular purpose. Furthermore, it facilitates access to information by public service companies to expand their networks or real estate companies to build housing projects and shopping malls.

Lastly, titling and registration are the first legal requirements to establish a mortgage backed loan. Without them no property can be legally bought, housing improved or business started. Without these, the poor would only be able to resort to the usury of the extralegal moneylenders, family loans or the limited amounts of micro credit.

Thus, titling and registration are indispensable to improve the living conditions and to do business. But, this is not enough. They are only the gateway to property and legality.

## **2. LEGAL TOOLS TO ORGANIZE BUSINESS**

Once you have acquired a registered title you have entered the world of formality. If you have nothing else then you have entered tied and handcuffed and blindfolded.

In order to use the value of the assets they have to be exploited, transformed, converted into something more valuable, sell them or rent them. In brief, to provide the good with all possible economic purposes the human mind can think of.

The way in which this is done in a modern economy is through enterprise. That is, production units that combine talent, skills, assets and information of different people to produce an income for all those involved. And, evidently, the income will be greater as more talent, skills, assets, information and people are combined more efficiently.

The legal system offers a series of tools, described hereinafter, such as legal personhood, limited liability, transferable shares, liability standards of workers and administrators or default rules.

Unfortunately, most companies in our country have no access to these legal tools because the cost of legality is prohibitive. In Peru, for example, only 2% of businesses have legal personhood, limited liability and use the share system. This means that only a small minority fully benefits from formality and can fully enjoy their property. The rest are companies that operate extralegally (81%) or that are registered but do not use these legal tools (17%)<sup>46</sup>.

These companies, in a good measure, do not access these legal tools because in Peru the legal incorporation of a business is really expensive. Part of this cost also has to do with the payments that the law mandates before notaries.

The ILD investigated how much it costs to incorporate a small business with the following characteristics<sup>47</sup>:

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<sup>46</sup> Does not include the informal farming businesses nor those involved in contraband and drug trafficking. Source: National Household Survey 2002.

<sup>47</sup> Source: ILD. *Evaluación Preliminar de la Economía Extralegal en 12 Países de Latinoamérica y el Caribe. Reporte de la Investigación en Perú*. ILD – IDB, 2005.

- The company has been set up by two partners.
- The manner of partnership is a closed corporation.
- It is a bakery in a legally developed popular district of Lima.
- The case does not include authorization to post advertisements, nor register the commercial name. It does include the registration of the company's name for the purposes of its incorporation.
- The company had three workers at the beginning of the licenses and permits procedure.

The cost of this operation – that must be extremely simple – is US\$1,563, an amount that most Peruvians cannot afford. Once the company is incorporated, other costs such as regulations and tax costs have to be paid in order to operate legally. It is not rare that most poor people in Peru are discouraged from operating legally. Let us see which legal tools they are deprived from using:

### ***2.1. Legal personhood***

The legal personhood status is used to create a new legal entity with a separate amount of equity of the owners.

If a company has not acquired legal personhood, the creditors of the owners can collect their dues from the net worth of the company, which is ultimately equivalent to the partners' equity.

This generates two major results. The first is that the cost to access credit for the business will be higher. This, since its creditors will have to be informed not only about their credit risk, but also their partners credit risk, since the company's net worth used as collateral for credit applications could be affected by their personal creditors<sup>48</sup>.

The second is that the cost of setting up the partnership is also higher. Since the company's net worth may be affected by the personal creditors of the owners, they will have to make sure that the partners do not accept personal risks that may affect the business. This increases the risk and cost of the business partnership<sup>49</sup>.

### ***2.2. Limited Liability***

First, limited liability protects the shareholders equity vis-à-vis business creditors who can only collect on the debt through the net

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<sup>48</sup> Hansmann, Henry, Reinier Kraakman and Richard Squire. "Law and the rise of the firm". European Corporate Governance Institute. Law Working Paper No. 57/2006, January 2006.

<sup>49</sup> Ibid.



worth of the company. On the one hand, this protects the personal creditors of the shareholders, who will only have to be concerned about the credit risk evaluation of the latter and not of the business, thus reducing the cost of personal credit. On the other hand, this limits the investment risk of the partners, and consequently, the business risk.<sup>50</sup>

Second, limited liability allows the companies to split their different lines of business in order to access credit. Certain creditors may be seasoned experts in evaluating the creditworthiness, of a grocery distribution company, for example, but are incapable of doing the same for the grocery producer companies. Therefore, in order to access a loan both activities can be split into two different legal entities.<sup>51</sup>

Third, limited liability also reduces the cost of monitoring the workers. The investors have to invest resources in this activity, have to hire supervisors, auditors, determine comptroller, decision-making and safety procedures, etc. If all the investors' equity were at stake, this need to monitor the agents would be greater, and therefore more money would have to be invested for monitoring purposes. Limited liability reduces the exclusive risk of the amount invested, by reducing the agency costs, and operating costs of the company and therefore, the division of labor costs.<sup>52</sup>

Fourth, limited liability reduces the monitoring cost of the other partners. If there is no limited liability, the creditors of the company will demand that the partners that have the largest personal equity pay their debts, since it is easier to collect from somebody who has many assets than from somebody who has few. Hence, in the extralegal scenario that operates without limited liability, each partner must be concerned about monitoring the personal equity of the other investors to make sure that they do not become de-capitalized and to not be left as the most "attractive" debtor for the company's creditors. Limited liability destroys this need and therefore eliminates the monitoring cost of the other investors' personal equity.<sup>53</sup>

Fifth, limited liability creates incentives to prompt administrators to perform efficiently. When there is limited liability, the value of the shares depends exclusively on the company's assets, without taking into account the personal equity of the shareholders. Consequently, limited liability helps manager who administrate— to determine the value of the company's assets – to use an important measurement mechanism: the value of the shares in the market. Managers know that in a limited

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<sup>50</sup> Easterbrook, Frank and Daniel Fischel. *The Economic Structure of Corporate Law*. Harvard University Press, 1991.

<sup>51</sup> Ibid. See also Hansmann, Henry y Reiner Kraakman. "What is corporate law?" In: various authors, *The Anatomy of Corporate Law*. Oxford University Press, 2004.

<sup>52</sup> Easterbrook, Frank and Daniel Fischel. Op. Cit.

<sup>53</sup> Ibid.

liability company the price of the shares will basically reflect their performance as managers. This will motivate them to develop a more efficient management since the investors will qualify the quality of the managerial performance with relative ease based on the value of the shares on the market and can fire them or reward the manager depending upon his or her performance. Moreover, if the price of shares drops too much they know that this may generate the opportunity for some group to buy a large number of shares at a low cost and that way can gain control of the company in order to change the management and salvage the company.<sup>54</sup>

Sixth, limited liability allows company shares to be converted into fungible assets. The value of a limited liability company basically depends upon the value of its shares. The value of a business without limited liability, quite the contrary, depends upon the personal equity of its shareholders, and therefore the greater the personal wealth, the greater the economic support of the company. Therefore, the shares of a limited liability company are fungible and homogeneous. They all represent the same portion of value of the company's assets. Contrarily, if the company is not limited liability, then each share will have a different value. Anybody who wants to determine the value of a specific share will have to find out how the value of the company fluctuates after selling this share and the old shareholder whose equity was the support, has been set apart. In this manner, without limited liability the shares will no longer be fungible and easily tradable, and this will increase the costs for shareholders to determine the value of a share.<sup>55</sup>

Seventh, limited liability can diversify the investment risk. One fundamental tool of any investor in a modern economy is risk diversification. Limited liability allows an investor to diversify his risk by investing in different companies. If there is no limited liability, diversification would not be feasible since the investor's personal equity would back any investment.<sup>56</sup>

Eighth, limited liability helps to make the best investment decisions. Business administrators may chose to invest in different risk graded projects. Often, high-risk projects offer higher returns. Without limited liability, the shareholders would not allow their administrators to take this type of risky decision, in spite of the fact that their expected rate of return is greater, since they would place at risk their personal equity. Hence, no risky albeit efficient investments will be made.<sup>57</sup>

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<sup>54</sup> Ibid.

<sup>55</sup> Ibid.

<sup>56</sup> Ibid.

<sup>57</sup> Ibid.

### ***2.3. Transferable Shares***

Transferable shares are used to exploit the company's hidden capital. In the same way that property registration allow the good to acquire a parallel life, the existence of fungible shares has the same effect on the companies. The existence of freely transferable shares allows them to be delivered as guarantee to access credit or to sell shares if there is need for cash.

Moreover, transferable shares allow the company – as an economic unit – to continue functioning irrespective of the fact that the original shareholders want to continue as such or not. Instead of selling their business assets, they can sell their personal shares if they want to. This not only allows the company to survive, but also allows the shareholders to secure a better income, since they are not only free to sell several of their assets, but also their brand, their client portfolio and the know-how included in the business structure.

Moreover, freely transferable shares provide the possibility of diversifying investments and giving the company the flexibility to access capital by issuing shares.

Lastly, transferable shares also allow for specialization and the division of labor. This is based on the existence of individuals who have different skills and abilities in different types of jobs. One of such activity is being an entrepreneur in a specific field. Some people have a knack for manual activities, sales or managing human resources—therefore these activities can be efficiently distributed – while others are naturally inclined towards investments. What is more, some people are better at investing in certain items than others. For example, some people are thoroughly familiar with the food market, but hardly know a thing about manufacturing toys or fine clothing apparel. This is why, markets will be more efficient and dynamic if investors focus more on business items they have been trained to spot and know how to handle well.

This is possible if companies have transferable shares that can easily transfer corporate control and property to others who have more expertise in a given field of activity.

### ***2.4. Accountability standards of administrators and workers***

If you are not really sure about what each person can do and what you can demand from him or her in the company you cannot organize the work. Although you can try to specifically mention the rights and duties in a contract, nobody can foresee all the contingencies of a labor relationship and unexpected problems always crop up. If a problem has

not been taken into account in a contract the law specifies the different standards to be applied. These standards specify for example, the cases in which the employee is disloyal, swindles, or simply breaches his duty. In this way, the rights and duties of employees are clearly defined and it is possible to organize work, divide tasks and specialize the company's field of activity.

Consequently, the company's daily tasks can be performed by adequately trained and specialized managers, to focus on the necessary decisions required to develop a productive process and to apply the expertise of individuals to each task.

Clearly defined delegation of functions also allows third parties to enter into contracts with the company.

## ***2.5. Default rules***

Companies struggle with common problems. For example, what happens when there is a tie in the votes? Can a shareholder send a representative to a general assembly? Can the majority shareholder decide that the company should sell him the most important shares? Can the majority of shareholders decide to liquidate the company?

Not all companies can foresee these problems and agree how to solve them. This happens in particular with businesses that hardly have resources and cannot afford to hire a lawyer for advice.

As a result of these problems, the partners could be stuck in endless discussions about what is right and this could hamper the business's performance. This possibility also increases the cost of becoming partners since if these problems actually harm the company it makes the business more risky.

This is when business law plays an important role – both those mentioned by law as well as those emanating from jurisprudence -. Its main purpose is to gather a series of default rules that are applied when the partners have overlooked the solution to a problem in the company's bylaws nor have determined who is the title holder of the right discussed in this case. In this manner, the transaction costs required in order to incorporate a company are reduced (because the partners know that an unforeseen problem will not lead to an endless conflict between them) and when unforeseen problems arise they are promptly dealt with (since it is no longer necessary to incur in the costs to negotiate a solution, since the default rules specified by law should be applied).<sup>58</sup>

These types of partnership also are standards that help the rest of the world to clearly and simply identify the company's organizational structure.

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<sup>58</sup> Ibid.

### **3. LEGAL TOOLS TO TRADE IN DOMESTIC AND FOREIGN MARKETS**

We have mentioned that having property means being able to represent things on paper or other instruments to tax, sell, rent, divide, or use them for any purpose that generates an income to the owner. But if there is nobody to sell, rent or give the assets to as collateral, these things are useless.

In order to accomplish the six effects of property referred to by de Soto people need to carry out transactions with as many people as possible. In poor countries, to the contrary, most people only do business with their relatives and close friends, and this does not allow them from fully using the assets that the legal system recognizes as their property. This is also another reason why Peru does not have a market economy, but rather an archipelago of independent and isolated markets.

The reason is that the cost of the law impedes the poor from accessing the legal tools that would enable them to operate in broader markets, amongst which are the following:

#### ***3.1 Identity mechanisms***

Nobody hires an anonymous person. In order to carry out a transaction with somebody you know a bit you need to be able to identify that person in some way. The person must have his or her name printed on an official ID card, an address and a taxpayer's identity number, if this is the case. All titles and registries incorporated by the law help people to identify another person whom they do not know in the market to do business with. Otherwise, how would the property be used as a development mechanism if you cannot use it for business purposes?

Let us imagine how much an extralegal company that lacks a legal identity, company name and place of business has to cope with. Extralegal businesses do not have the necessary information to fill in the formats required to do business in a country. They do not have official documents that endorse this information. Without this, they cannot fill bills of lading to export to foreign markets that may lead to free trade agreements. If the company name, place of business or powers of attorney have not been duly registered, the only option to is sell on credit to family members and neighbors, and, if it sold for export, contraband.

These deficiencies oblige the businessman to operate in a small universe of providers and consumers as an island in the archipelago of

the Peruvian market. Thus, the capacity to reduce unit costs per volume of production and to diversify shrinks dramatically, thus impeding the use of economies of scale and scope. Without the possibility of accessing less expensive and diverse inputs, using state of the art technology and third party know-how, accessing sources of funds, or establishing joint business opportunities, the critical mass required for specialization and to improve productivity, the best Peruvian entrepreneurs will be condemned to a back-breaking poverty.

Advertising is another important identity mechanism. A bill board or fliers are the first mechanisms to identify yourself in the market. But, most poor entrepreneurs in Peru operate in extralegality; they are forced to hide inside their homes and go without using publicity in order to avoid detection by the authorities. According to the United States Small Business Administration, outdoor advertising of small businesses attracts two out of three clients.<sup>59</sup> This is the amount of clients that the extralegal businesses lose.

### **3.2. Information systems**

Information systems are additional tools regulated by law that facilitate the accumulation of capital. In fact, the asymmetry of information between those who give out and those who receive credit – the debtor always knows more than the creditor about the formers capacity and intention to pay the debt – is one of the most important obstacles to access credit. In effect, according to the 2005 United Nations Report on World Trade and Development, one of the main obstacles to introduce a credit-based economy in developing countries is the lack of reliable credit information systems.

As a result, money lenders have no means of distinguishing who is a good or bad debtor and therefore everybody ends up paying a higher average interest rate that represents the total risk.<sup>60</sup> In other words, good debtors subsidize bad debtors. In addition, when bad debtors realize that their bad credit record with a specific creditor is not going to jeopardize their possibilities of accessing credit from other creditors in the future – as has happened in many third world countries – they will be tempted to default or become over indebted more easily. Finally, all this point towards the same direction, inadequate risk analysis and a greater cost of credit.

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<sup>59</sup> De Soto, Hernando. *El Otro Sendero*. El Comercio Publishing House , 2005. page 220.

<sup>60</sup> Barron, John M. and Michael Staten. “The Value of Comprehensive Credit Reports: Lessons from the U.S. Experience”. Credit Research Center, McDonough School Business, Georgetown University, February 2000.

An adequate flow of credit information results in several beneficial effects, particularly for the businessmen who have fewer resources, and who are easy prey to expensive credit. One of these effects is that the money lenders deepen their knowledge about the market characteristics of credit applicants. More information means healthier credit portfolios and therefore, cheaper credit. Another effect is that it promotes a “culture of paying back loans” which according to many, is totally lacking in third world countries. How do we expect these people to pay back their debts if they are not held accountable for defaulting because it is very difficult to publicly report this bad behavior? A good credit information system will make the debtors more disciplined and will sieve out of the system individuals who default on loan payments. Finally, this system dissuades debtors from becoming over-indebted.<sup>61</sup> This encourages interest rates to go down and therefore increases the possibility of accumulating capital.

There is broad evidence that testifies to the above. By comparing countries on the existing correlation between the volume of credit and default ratios, it has been discovered that credit placements have grown and the credit risk has dropped and is lower than in countries that share information on the creditworthiness of debtors.<sup>62</sup> In like manner, after having studied a sample of credit institutions in 129 countries during a period of 25 years, we have been able to conclude that, thanks to crossed evidence and to studying the reforms, that creditors rights and the mechanisms to share information on credit are meaningful and quantitatively important statistics to develop private credit, especially in poor countries.<sup>63</sup> It is overwhelming sad to see that those who are harmed most by a lack of a good information system are people with meager incomes and small businesses.<sup>64</sup>

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<sup>61</sup> Jappelli, Tullio and Marco Pagano. “Role and Effects of Credit Information Sharing”. Centre for Studies in Economics and Finance – Università Degli Studi Di Salerno. Working Paper No. 136. April, 2005.

<sup>62</sup> Jappelli, Tullio and Marco Pagano. “Information Sharing, Lending and Defaults: Cross – Country Evidence”. Centro Studi in Economia e Finanza. Dipartimento Di Scienze Economiche – Università Degli Studi Di Salerno. Revised version, March, 2000. According to the authors, the positive relationship between the size of the credit market (understood as the total credit to the private sector as a percentage of the GDP) and the amount of credit information available would be the same despite other institutional and economic variables such as the size of the country and its growth rate, respect for the rule of law and legal protection of creditors rights.

<sup>63</sup> Djankov, Simeon; Caralee Mc Liesh Caralee and Andrei Shleifer. “Private Credit in 129 Countries.” Revised version January, 2006. Available at: <http://www.nber.org/papers/W11078>.

<sup>64</sup> This has been made evident in the study undertaken by Love and Mylenko in 2003. Love, Inessa and Nataliya Mylenko. “Credit Reporting and Financing Constraints”. World Bank Policy Research Working Paper 3142. October, 2003.

A credit information system that includes information of these sectors will provide them with considerable benefits. By having the possibility of building a solid reputation among several high and low risk creditors and debtors, they can capitalize their reputation to access the best credit conditions (at lower interest rates, less response time, longer repayment periods, and greater access to financial services aside from waiving the demand for collateral<sup>65</sup>).

### **3.3. *Guarantee system***

One essential legal tool to access credit is a good guarantee system. The explanation is simple: when somebody is given a loan and does not have the legal means to guarantee the return of the resources granted, the credit risk is so high that the loan will either not be granted or will be granted, but at a considerable higher rate.

A guarantee system allows moneylenders to reduce the credit risk because they now have a good (that usually belongs to the debtor) that they can execute (in most cases only by them) to insure the payment of the debt. Thanks to the guarantee, the creditor can transfer to the debtor the risks linked to default. In fact, the greater the value of the guarantee, the less the risk for the moneylender.

What we usually ignore is that the best guarantee system that makes creditor collections feasible immediately improves the situation of individuals in need of capital. The reasoning is quite simple. If a debtor is unable to pay back the debt, the smoother and quicker credit collections of creditors can be made, the better the conditions to grant the loan.

To make this become a reality a guarantee system must be incorporated into the legal framework specifying a series of characteristics. In the first place, an efficient system of real guarantees must establish mechanisms to include simple guarantees, free from costly legal requirements, on all types of goods and in favor of all types of agents, without any exceptions. In the second place, the rules governing the system must be clearly spelt out as concerns the order of priority or precedence of rights on the goods given in guarantee, including those mandated by law, in such a way to easily determine which creditors have the best right on the good and to protect the creditors from hidden encumbrances. In the third place, the legal framework must establish an efficient publicity system that enables potential creditors to be reliably informed about the guarantees and encumbrances on a good, and to ensure their level of

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<sup>65</sup> Rozycki, Valerie. "Credit Information Systems for Microfinance. A foundation for further innovation. Centre for Micro Finance". Working Paper Series. Institute for Financial Management and Research. June, 2006.



priority vis-à-vis third parties, in a simple manner and at a low cost. The system must guarantee to the title holder of the guarantee that it used the aforementioned publicity system to hire, and this it will not be affected due to reasons unknown or that could not be known at the moment of accepting it.

On the other hand, the system must allow for the creation of guarantees on all types of goods, as such floating guarantees, on rotating inventories, on future goods, on undetermined goods, etc. It is also important that this system of guarantees be backed by an interconnected and easily accessible registration system throughout Peru. However, a registry that shares this information with all the offices of the country, the guarantees, guarantees on immovable property, for example, will actually not be used because it will be possible to deliver a vehicle as a lien as well as registration offices that may exist. In this scenario, nobody in his senses would accept a vehicle as guarantee for a loan. Finally, the legal system must allow for the quick and inexpensive execution of the guarantees in case of default either under legal or extralegal execution schemes.

The lack of an adequate legal framework as concerns guarantees harms economic investment and growth since it assumes that there is a reduced supply of credit for the private sector and that it is concentrated in a few large debtors. Small and medium businesses will continue to confront a series of restrictions to access funds, because their credit applications are rejected by the traditional financial system, or the conditions to grant credit are too burdensome. This impedes the accumulation of capital and encourages the productivity of the corporate growth and development.

### ***3.4. Forced market exit system***

The forced market exit system is another important legal tool that facilitates the use of corporate assets.

In a business that is in a crisis its creditors know that the company will not be able to pay all its debts, and therefore there is a mad rush to collect. It is like the law of the jungle where the strongest survive, each person takes whatever he can and at the end, some creditors will have collected on their loans; other will have done so, but too late, and other will not have collected a penny. It does not matter if the person has or does not have a guarantee on a piece of equipment owned by the company. If there are several people with similar types of guarantees and other creditors without guarantees but with a legitimate right to claim their collections, my credit will be at risk.

How do we solve this problem and what does it have to do with the possibility of raising capital? Disorder can be avoided by

establishing certain rules for collections on loans well beforehand. For example, creditors – and not the owners of the company in crisis - must take control of the company, at least until the crisis is over. The owners can be very honest people, who have a genuine concern to pay back their debts, but other less scrupulous may also be involved and they may split the few goods owned by the company between themselves instead of making them produce to pay back the company's debts.

Another example is the order of collections. If the creditors know without a doubt, the order of collections when a debtor company enters into a crisis, they could estimate the risk of lending money to the company much better. They will not make a mad dash to pick the corporate assets apart.

Thus, the companies that operate in legality benefit from the rules that govern the market exit system that provides creditors with more safety and information. They can offer more credit under better terms.

The forced market exit system is an important tool to avoid the bankruptcy of companies whose operating value is higher than its liquidation value. The legal system may oblige the creditors to study if it is worthwhile to liquidate the company or if it is more convenient to set up a restructuring plan that would help to collect full payment on debts and allow the company to continue operating. Outside of the legal system, creditors will monitor their debt and try to collect whatever they can, often partial payment or liquidating companies that could have otherwise continued to be active.

### ***3.5. Contract execution system***

In order to enter into a contract with an unfamiliar person both parties must trust each other and have good will. This may be the case with one's relatives and friends, but not with unfamiliar people. In this case, someone must ensure that the contract will be fulfilled and will be enforced if there is any resistance to said fulfillment. This someone is the legal system.

In Peru, however, the legal system is a weak guarantee for contract fulfillment. As an example, according to the *Instituto Apoyo*, in Peru only 2% of the micro and small business owners interviewed admitted that they have used the joint purchase modality to buy supplies or tools, basically because they fear they may have difficulty in paying or with the delivery. On the other hand, only 17% pointed out that they

joined others in order to satisfy peaks in demand, because they feared conflict would arise after having reached the agreement.<sup>66</sup>

This is partially due to the fact that the system created by law to fulfill contracts does not work. For example, according to the survey mentioned before involving small and micro businessmen, 80.8% stated that there is a need to secure the support of an institution to resolve conflicts with other people, for instance suppliers, clients or other businessmen.<sup>67</sup> However, in the past six months, 6.6% of them had filed lawsuits before the Judiciary for dispute resolution.<sup>68</sup> The most evident reason was that 93% of those interviewed considered that the Judiciary functioned very poorly indeed.

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<sup>66</sup> Eyzaguirre, Hugo and Carlos Calderón. “Poder Judicial y micro y pequeña empresa. Impacto y posibles soluciones” Lima, Instituto Apoyo. Pages 72 and 73. Also see: Diez Canseco, Luis. “Stare Decisis. Intercambios Comerciales y Predictibilidad.” In: *Revista de Economía y Derecho* No. 2.

<sup>67</sup> Eyzaguirre, Hugo and Carlos Calderón.. “Poder Judicial y micro y pequeña empresa. Impacto y posibles soluciones” Lima, Instituto Apoyo, page 50.

<sup>68</sup> Ibid. p. 49. Diez Canseco, Luis. “Stare Decisis. Intercambios Comerciales y Predictibilidad.” In: *Revista de Economía y Derecho* No. 2.

## CHAPTER 5

### **FORMALIZATION FIGURES IN PERU**

In the essay financed by the notaries, they declared that the figure of US\$ 9.4 billion dollars of net benefits generated by the property formalization program that the ILD estimated for the 1991-2002 period is exaggerated. The flippancy of this remark and the superficiality of the work are made evident on the following pages and have been summarized in these four points:

- The figures have not been adequately interpreted. The ILD clearly pointed out that the net benefits of the formalization added up to US\$ 9.4 billion dollars because they included the net benefits of property titling and registration as well as business formalization. The consultants of the notaries only considered the topic of property.
- They misunderstood the essential property rights concepts. The consultants of the notaries declared that only property that did not have title COFOPRI formalized them were actually benefited by the formalization. In the estimated they overlooked the property that already had some type of title when COFOPRI formalized them and did not take into account that most of these titles had flaws and did not grant full legal security for a number of reasons: the property rights of holders overlapped and did not match the rights registered, the division of plots had not been registered and several of them had been contested. In Peru, some properties have been titled up to 20 times since the Conquest, however poverty still prevails. In order for a title to provide an economic function to the property, it must be adequately registered and the records must be updated. If this is not done, then the records lose their value.
- People have not understood that the reduction of formalization costs is a benefit for owners of formalized property. The consultants of the notaries mistakenly declare that this is simply a decision adopted by the State to subsidize the titling and registration. The ILD demonstrates that prior to the reforms, a person had to pay US\$ 230 to formalize property. After the

reforms, the poor only had to pay US\$ 35. The balance was US\$ 195. A large amount for a human settlement dweller.

- Despite all their efforts, the consultants cannot deny that the legal monopoly of the notaries raises the formalization cost of the poor.

These points have been developed in greater detail as follows <sup>69</sup>:

## **1. THE FIGURES HAVE BEEN INADEQUATELY INTERPRETED**

In a press release on December, 2004, the ILD established that the net benefits of property and business formalization in the period of 1991-2002 accounted for US\$ 9.4 billion dollars.<sup>70</sup> The consultants of the notaries did not bother to ask the ILD for information about the conceptual framework, the scope and methodology applied and preferred speculating about where this figure came from. They miscalculated and since the sum did not add up, they preferred to declare that the ILD figures were exaggerated.

The problem is that since they did not take the trouble to carefully read the information delivered by the ILD they did not bear in mind that:

- The amount estimated by the ILD (US\$ 9.4 billion dollars) includes the net benefits generated by the property titling and registration (1.3 millions in the 1991-2002 period) and **furthermore** the amount generated by business formalization (400,000 companies).
- The US\$ 9.4 billion dollars, in rounded numbers, are the result of **adding** the net benefits obtained by the new owners due to the increase of the value of their formalized property (US\$ 1.531 billions ); the additional net income obtained by the new owners because they were able to increase their hours of remunerated work (US\$ 2.017 billions ); the savings of the new owners due to the reduction of property formalization costs (US\$ 98 millions ); the savings of the owners of the formalized companies due to the reduction of business formalization costs (US\$ 141 million dollars); the additional net salaries received by the new workers of the formalized businesses (US\$ 2.553 billions ); and the additional net taxes paid by the formalized businesses (US\$ 3.304

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<sup>69</sup> Annex 1 studies in greater detail the opinions of the consultants of the notaries on ILD figures.

<sup>70</sup> See chart in Annex 1. Net benefits of the 1991-2002 period were capitalized per up to 2002 at an annual rate of 12%.

billions ). The investment and operational costs required by the Formalization System were **subtracted** (US\$ 214 millions).<sup>71</sup>

- The essay stated that the ILD makes a mistake by including as a benefit the amount of loans backed by COFOPRI titled property. As concerns this point, it is important to explain that the essay is mistaken, since the ILD **did not** include the amount of the loans in the US\$9.4 billions figure, as has been said. They simply interpreted those additional amounts of credit received by the owners of formalized property as a reasonable measure of the magnitude of the opening to credit brought about by the formalization. This is evident when you see Chart B in Annex 1 in which none of the net benefits it contains accounts for the amount of loans guaranteed by COFOPRI titles.
- The consultants of the notaries pointed out that the ILD does not explain the meaning of the net benefit or the gross benefit when it estimates the benefits linked to the increase of the value of formalized property. This is not true, because the classification between net and gross benefits was of essence to build the flows of benefits and costs that accounted for the US\$ 9.4 billion dollars of net benefits generated by the Property and Business Formalization Programs.<sup>72</sup> In effect:
  - The increase in the **gross** value of the formalized property was converted into the **net** value (**net** benefit) and the cost assumed by the owners to improve their houses was subtracted from that amount.
  - The additional **gross income** earned by the new owners because they could work more hours for pay was converted into **net** income (**net** benefits) and the opportunity cost of the hours of work and economic resources exclusively required to carry out these tasks were subtracted (additional costs such as transportation, clothing and food, amongst others).
  - The **net** benefit (savings) obtained by the new owners when the property formalization cost was reduced was estimated as the difference between their willingness to pay and the new formalization cost.
  - The **net** benefit (savings) obtained by the owners of the formalized businesses when the business formalization costs were reduced was estimated as the difference between their willingness to pay and the new formalization cost.

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<sup>71</sup> The benefits and costs of the 1991-2002 period were capitalized up to 2002 at an annual rate of 12%.

<sup>72</sup> See Annex 1.

- The additional **net** salaries earned by the new workers of the formalized businesses were estimated as the difference between the additional gross salaries and the opportunity cost of the hours of work and the economic resources exclusively required to perform the job (additional costs such as transportation, clothing and food, amongst others).
- The additional taxes paid by the formalized businesses were converted into **net** taxes collected and the collection and additional oversight expenses of the government was subtracted.
- The study states that it is not clearly understood how the ILD estimated the amount of additional net benefits obtained by beneficiaries of registered titles earned by working longer hours and getting paid more. In order to obtain this result, the ILD took into account the research done by Field<sup>73</sup> that indicates that the families that live on property formalized by COFOPRI have increased the number of hours on the job up to 45 hours per week. In order to maintain the results at conservative levels, the ILD assumed that only 50% of this additional time available for work was dedicated to activities earning the minimum wage (US\$ 118) in those days. Then a bit more than half of the result obtained was subtracted as an approximate measure of the opportunity cost of the hours of work and the economic resources required to perform the job (additional costs such as transportation, clothing and food, etc.).
- The essay of the consultants of the notaries declares that the observation made by the ILD about the fact that one of the benefits of formalization was to enable the small children of families with formalized property to devote more hours to attend school, is mistaken. However, the ILD simply took the study done by Field as the basis<sup>74</sup> that indicated the one of the potential effects of formalization was the 28% reduction of the probability that young children of the beneficiary families had to work. Assuming that for a minor the natural alternative to work is going

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<sup>73</sup> Field, Erica. “Entitled to work ...”. p. 24.: “The long-run, or “steady state” effect of the program, reflected in the estimated effect on households with the maximum number of program periods, is an average increase of 45 hours of employment per week across the entire target population of squatters – roughly the same as one full-time worker being added to the labor force”.

<sup>74</sup> Ibid: “When families with many potential workers are excluded, we observe that obtaining a property title reduces the average likelihood of children entering the labor market by 2.2 percentage points. According to this estimate, the implied program effect on child labor force participation among families with 1–6 working-age members amounts to a reduced likelihood of roughly 28%”.

to school, the ILD described the potential effect established by the aforementioned study. However, the ILD did not convert this evident social benefit into equivalent currency and this is why this positive effect was not included in the calculations of the net benefits of the formalization programs.

- The essay stated that the ILD estimates are exaggerated with respect to the increase of costs imposed by Supreme Decree 005-2001-JUS that establishes the engagement of municipalities in the property titling and registration process in human settlements. However, the calculation is very simple: without the engagement of the municipalities, it would have taken COFOPRI an estimated seven years to formalize the 1.8 million properties that exist, at a rhythm of 267,000 properties per year. However, the additional administrative steps stemming from the engagement of the municipalities increased the total term up to an estimated 15 years, because the rhythm of the formalization slowed down to an average of 121,000 properties per year. This means, that the ILD declared that the engagement of the municipalities in the formalization process would require COFOPRI to work eight additional years to formalize the 1.8 million extralegal properties and the owners of this property would have to pay an additional US\$ 527 millions for that concept.

## **2. ESSENTIAL CONCEPTS ON PROPERTY RIGHTS HAVE BEEN MISUNDERSTOOD.**

- The consultants of the notaries state that **only the property that was never titled benefited from the formalization** (and this is why their value increased). Due to this, they discarded from their calculations the properties that had already had some type of title before being formalized by COFOPRI. Unfortunately the consultants did not understand that if the access to formality could be achieved through any type of title (such as those delivered in the past by several municipalities, public entities and even SINAMOS), Peru would be the most formal country in the world. In effect, field work carried out by the ILD indicated that numerous properties in the country had been given up to 20 titles each or more since the conquest.
- The consultants of the notaries **overlook the fact that extralegality is not due to a lack of titles but rather titles that have flaws**. Therefore by not including the properties with flawed titles as beneficiaries (all the property in extralegal areas) the amount of benefits they estimated (US\$ 523 millions) severely



under estimated the benefits of formalization. In turn, the ILD estimate (US\$ 1,531 millions) explains these benefits much better.

- The essay mistakes the sensation of security expressed by property owners in the surveys with the full legal security of a good title. Consequently, it overlooks the diversity of problems stemming from the titles delivered throughout Peruvian history (overlapping rights, inconclusive expropriations, mistaken names, non-processed inheritance claims, extralegal construction, etc.). The titles must be corrected before in order to be able to be registered and then at that moment the property will have the legal security required to be used in a broad and modern market. History also reveals that in Peru titles have suffered from the effects of hyperinflation.

### **3. FORMALIZATION COST REDUCTION HAS NOT BEEN UNDERSTOOD AS A BENEFIT FOR FORMALIZED PROPERTY OWNERS**

- The essay states that the **reduction of the formalization costs does not benefit formalized property owners** but rather is simply the result of a State decision to subsidize titling and registration. The following reason explains why ILD does not agree with this opinion: before the reform, the property formalization cost was very high (US\$ 230) and was an insurmountable barrier for the poor who were unable to more (US\$ 84). However, the cost reduction introduced by the new system<sup>75</sup> was so important (US\$ 195) that the new cost to formalize property (US\$ 35) represented a considerable savings. The ILD only considered as a net benefit per family, the difference between the willingness of the poor to pay (US\$ 84) and the new formalization cost (US\$ 35). That is US\$ 49. This represents only about 25% of the total cost reduction in the property formalization cost.
- The notaries essay stated that **the additional tax payment does not benefit the owners or society**. The ILD disagrees because this opinion clashes with the generally accepted economic analysis applied to estimate the net benefits of an activity from the viewpoint of an entire country. The ILD estimated the content of the net benefit (profit) implicit in taxes received by the Government from formalized businesses, for which purpose it

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<sup>75</sup> The time required for the formalization procedure was shortened from 94 months to 2 months.

assumed that it would invest these resources in favor of society and the poor. This would represent additional net benefits for these groups, and this amount could be similar to the amount of resources applied for this purpose.

- The essay considers that the ILD calculation concerning the value of property **is probably the result of an over evaluation bias**, since it is based on the survey of formalization beneficiaries<sup>76</sup>, which raises the question: “If you were selling your house, how much do you think you could sell it for after bargaining the value?” The essay affirms that it can be clearly seen that the variable classified as the value of the house is the **supply price of the mortgage** since it is the **bidder’s** perceived value. On this point, there are two relevant comments to be made:
  - In the first place the ILD **did not** use the aforementioned survey to calculate its estimates;
  - In the second place, it **does not** agree with the interpretation of the essay concerning this matter. The truth is that the survey asks the interviewed person to speculate about the possible **demand price** of his house; not the **supply**. But, apparently, the essay considers that the **bidding price** is offered by those who **want to buy** the house, when in reality it really is the **demand price**. In turn, the **bidding price** is the price of those who **want to sell** the house. Due to this mix up of basic concepts, the ILD does not understand what over-valuation bias is being referred to in the essay of the notary consultants.

#### **4. THE LEGAL MONOPOLY OF THE NOTARIES UNDENIABLY RAISES THE FORMALIZATION COST OF THE POOR**

- The press release published by the ILD on December 17, 2004, explains that the return to the monopoly of the notaries as of June, 2004 considerably increased the legal costs to buy, sell, rent, inherit or donate property. The ILD maintains that the average cost per deed is about S/.400. The consultants of the notaries estimate that the average cost per deed fluctuates between S/.250 and S/.420, the latter for a property purchase-sales deed involving a home selling for S/.10,000. An astounding sum as compared to

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<sup>76</sup> Survey of the World Bank-Apoyo Consultancy Study, question number 67.

the registration form signed by a lawyer (S/.100) used in the registration system of the poor.

- Moreover, the ILD calculated that the number of monthly transactions performed on registered property had fallen from an average of seven thousand each month to four thousand. This means, a reduction of three thousand per month. Using updated figures from SUNARP as of January, 2006, the essay ratified this decreasing tendency, although the estimated reduction in this case was about 1,100 transactions per month.

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# CONCLUSIONS

## 1. THE COST OF LOOSING THE WAR

In this document, we have demonstrated that the legal system defended by the notary association hampers the poor from benefiting from:

- Greater investment
- Better housing
- Higher rate of school attendance
- More jobs for women
- Better birth control
- Greater access to credit
- Greater access to public utilities
- Better functioning of the civil defense system and a lower impact of natural disasters
- Greater access to insurance
- Better public safety
- Higher family income
- More legal jobs
- Higher tax collection
- Information and safety that help to access domestic and foreign markets
- Less social exclusion

We have also demonstrated that the reason why this matter is sensitive is that the current government is promoting a series of initiatives that are the first rung on the ladder towards democratizing property and would do away with the privileges which the Association of Notaries has enjoyed for so long.

## 2. THE MISTAKES MADE BY THE ATTACK

In this document, we have explained how the essay financed by the Association of Notaries applies an incomplete and limited concept of property rights. Securing property rights is much more than having security on the house. Being an owner means being able to use the good one owns beyond its immediate physical purpose. It is not only about

having things, but also being able to use them for different purposes. In other words, having property means representing things on paper and other documents; it is the path to be able to tax, sell, rent, divide or use them for any purpose that may allow the owner to gain an economic benefit.

The essay has also attempted to describe what the ILD calls “extralegality” but with such little success that we have hardly commented about the quality of the substance of this work. The essay not only contains huge mistakes and omissions as concerns the calculation and interpretation of the figures (as has been commented in Annex 2), but what is worse, as concerns the analysis of the social conditions of poverty in Peru it only describes the categories of “expectant right”, “legal title and “registered title”, in an attempt, as has been mentioned by the authors, to “approach a better empirical interpretation of property rights in human settlements”.

The truth is that it is a frustrated attempt. In the first place, it is not original because it is a gross synthesis of categories that the ILD used even before the publication of *The Other Path (El Otro Sendero)*. And, in the second place, because it does not take into consideration the different types and levels of extralegality required to determine the value of formalization. There is no mention, for example, of the different categories of business extralegality that there are (essential for the true construction of a property rights system), nor much less of other strategies of the poorest who atomize their assets, mortgage their untitled land under terrible financial and personal safety conditions, hire workers, hide from authorities, solve their disputes, or protect their equity from the risk of their businesses.

These concepts are already being used in Latin America, Africa, the Middle East, Asia and Europe.

### **3. A NEW VISION ABOUT THE ROLE OF NOTARIES**

The reaction of the conservative notaries of Lima is a far cry from that of notaries of other countries with whom the ILD has been encouraging reforms to help the poor access the benefits of formality.

The property formalization program designed by the ILD for the government of El Salvador, for example, had the active participation of a good part of the 4,500 notaries in El Salvador. They authenticated the property titles of most of the beneficiaries. The El Salvador program, which began in 1991, not only benefited the hundreds of thousands of inhabitants of marginalized communities and extralegal plots of land, but it also enabled the enforcement of the Peace Agreement signed in 1992 by giving property titles to 35,000 former soldiers of the *Frente*

*Farabundo Martí para la Liberación Nacional (FMLN)* and the Armed Forces of El Salvador (FAES). Additionally, the program helped make possible the formalization and reconstruction of some 26,000 houses destroyed by earthquakes in 2001.<sup>77</sup>

Moreover, in the Bill that creates the program for the capitalization of property and business assets that the ILD designed for the Government of Haiti in 2002 (*Program National de Capitalisation Des Actifs en Haïti*) – it was proposed that the notaries of Haiti adopt a leading role in order to facilitate the access to and permanence of these assets in formality and to give popular transactions more security.

Another example is about notaries (*escribanos*) in Argentina, who adopted a leading role in the execution of the property regularization program created in that country during the 90's to facilitate the regularization of houses inhabited by people with meager resources<sup>78</sup>. In the case of the Province of Buenos Aires, both the processing the regularization procedure as well as the program administration fell into the hands of the so called "*escribanos encargados*", thereby creating the so called "*Registros Notariales de Regularización Dominial*" (RNRD)<sup>79</sup> or Notarial Registries to Regularize Property. Although the procedure could be improved, it must cost less, and should eventually be widespread.<sup>80</sup> It is undeniable that thanks to the work carried out by these notaries and to the expansion of their services over the past 10 years that some 160,000 low income families have been able to register their occupancy rights in the Province of Buenos Aires.

The performance of notaries in El Salvador and Argentina<sup>81</sup> is a good example of how the notaries can discover innovative ways to more

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<sup>77</sup> Instituto Libertad y Progreso, Presidency of the Republic of El Salvador.

<sup>78</sup> Law N° 24.374/94 ("Ley Pierri"). For this purpose, a procedure was established for notaries to declare "usucapión" (adverse possession of the property for a specific period of immediate possession, also characterized as *good faith*).

<sup>79</sup> Aside from enacting Decree N° 2815/96 in the Province of Buenos Aires, the Secretariat of Land and Land Development of the Ministry of Government signed an agreement with the Association of Notaries, by which it assumed the administration of the financial resources for the system's functioning. The notaries were given the task of verifying, titling and registering the possession in the property registry, and this automatically becomes property once the 10 year period has elapsed without any counter claim to the property by third parties filed before the Judiciary (Art. 8 of Law N° 24.374/94, amended by Law 25.797/2003)

<sup>80</sup> Despite this progress, to date, only 10% of the estimated potential one million beneficiaries have been covered. Among the main restrictions of the system we can mention: the individual and not massive nature of the procedure; the difficulties to obtain proof of possession as foreseen in the law; and the delay in processing by the Directorate of Land of the Sub Secretariat of Land of the Province, amongst others.

<sup>81</sup> In February, 2006 only in the Province of Buenos Aires there were 2,116 active notaries and 2,345 in the Federal Capital.

people to use notaries and also to facilitate the access of the poor to property and business.

As concerns Peru, the redefinition of a notary's duties must be geared towards generating considerable added value and assist the masses through a novel, long term, sustainable strategy. A good way to begin would be by fully exercising the important attributes that the law has conferred upon notaries in recent years — formerly only in the hands of judges and public officials — linked to topics of national interest, such as the identification of individuals, the regularization of property and the constructions, dispute resolution, the processing of non-litigious processes, default of contract and liabilities, the simplification of procedures and the reduction of transaction costs.

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## ANNEX 1

# ILD FIGURES ON THE BENEFITS AND COSTS OF FORMALIZATION IN PERU

On December 17, 2004, the ILD published a press release presenting a summary of its capitalized net benefit estimates generated by the property and business formalization programs in Peru, between 1991 and 2002, that represented US\$ 9.4 billion dollars. It also included the negative effects of measures that granted privileges to the notaries and raised obstacles to the formalization program.

As a result, the Association of Notaries of Lima financed the essay *The Construction of Property Rights* that criticized the ILD figures (see **Annex I**) and unsuccessfully tried to understand the origin of the US\$ 9.4 billion in benefits generated by the formalization programs between 1991 and 2002. This failure can be explained in part by the fact that their approach was based on false assumptions and it used an incomplete conceptual and factual framework, not to mention the fact that it tried to add figures that are not compatible.

In effect, the figures chosen in the essay represent heterogeneous magnitudes estimated for different purposes and this is why the result simply did not fit. These misunderstandings could have been avoided had the authors of Annex I asked the ILD for the relevant information instead of speculating about the method and assumptions we used.

**Chart A** reproduces **Chart 13** of Annex I of the essay. According to this chart, the ILD can only explain US\$ 6.644 billion<sup>82</sup> of the US\$ 9.4 billion estimated as the consolidated figure for the net benefits of formalization. The balance (**US\$ 2.756** billion) has been qualified by the essay as “an unexplained amount”.

### CHART A REPRODUCTION OF CHART 13 OF THE ESSAY

#### Chart 13 Formalization benefits according to the ILD (million of US\$)

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<sup>82</sup> The truth is that the sums of the CDP in Chart 13 do not add up since the “total explained” according to that chart is US\$ 6.674 billion and not US\$ 6.644 billion as the book affirms.



<b>Type of Benefit</b>	<b>Amount of Benefits according to the ILD (million s of US\$)</b>
Greater value of formalized property	2.200
Greater labor income of formalized owners	3.200
Credit obtained by formalized owners	690
Savings in costs of formalized owners	254
Additional tax payments of formalized businesses	330
<b>Total explained</b>	<b>6.644</b>
Amount not explained	2.756
<b>Total benefits according to the ILD</b>	<b>9.4</b>

As concerns this point we wish to make the following comments:

- a) The item “total benefits according to the ILD” included by the authors of the essay in Chart 13 refer to the US\$ 9.4 billion net benefits estimated by the ILD that calculated the **gross** benefit flows, costs and **net** benefits for the 1991-2002 period and capitalized these amounts up to the year 2002 at an annual rate of 12%. These figures represent the **capitalized** amount of the net benefits generated throughout the **12** former years for the year 2002.
- b) On the other hand, the figures on Chart 13 of the essay to try to recalculate the US\$ 9.4 billion were **not used** by the ILD to obtain net benefits. They really are the estimated figures without including the effect of time and its specific purpose was to highlight the relative importance of different effects of the property and business formalization.

**Section 1** describes the criteria used by the ILD to estimate the net benefits of formalization (US\$ 9.4 billion). **Sections 2** and **15** describe the procedures used to estimate the other figures mentioned in Annex I of the essay.

## **1. Estimated net benefits of the property and business formalization system for the 1991-2002 period**

The ILD estimated that the net benefits generated by the Property and Business Formalization Programs in the 1991-2002 period was US\$ 9.4 million after having covered all the investment and operational expenses these programs need. **Chart B** presented below contains the results of the estimate and **Chart B-1** at the end of this report presents an itemized list:

### CHART B

#### ESTIMATED NET BENEFITS OF THE PROPERTY AND BUSINESS FORMALIZATION PROGRAMS IN PERU, IN THE 1991-2002 PERIOD 1/

(US\$ Million )

Item	Capitalized Values up to 2002
<b>BENEFITS</b>	<b>9,643.3</b>
Net benefits due to the increase of the value of formalized property	1,530.6
Additional net salaries of title holder beneficiaries	2,016.7
Reduction of property formalization costs	97.6
Reduction of business formalization costs	141.3
Net salaries of new formal workers	2,553.3
Additional net taxes of formalized businesses	3,303.8
<b>COSTS</b>	<b>213.6</b>
Investment and operational costs of the Formalization System	213.6
<b>NET BENEFITS FOR THE 1991-2002 PERIOD CAPITALIZED UP TO 2002 APPLIED AN ANNUAL RATE OF 12%</b>	<b>9,429.7</b>

1/ Formalization of **1.3 million extralegal** property and **400,000** extralegal businesses.

- 1.1 The item **Benefits of Chart B** indicates that the sum of the capitalized values of the benefits generated by the Property and Business Formalization Programs is US\$ 9.643 billion. This figure represents the **net benefits** obtained by different groups of economic agents with respect to the Property Formalization Program. In order to estimate the relevant net benefits for the

country the investment and operational costs required for those programs described in Section 2 presented below, must be subtracted.

The following assumptions were applied to calculate the flows of benefits generated by the Property and Business Formalization Programs throughout 12 years(1991-2002):

- a) To estimate the first item of benefits (**an increase value of formalized property**) two complementary effects were considered whose relative magnitude was based on information obtained by the ILD in interviews with program beneficiaries:
- It was estimated that “pure” capital” income was 6% (US\$ 960) of the average value of a property, as the exclusive effect of the greater legal security obtained by the registered title. This additional benefit was applied to all the formalized property in the 1991- 2002 period but was reduced five percentage points per year throughout the period to take into account the negative effect which the gradual increase in the number of properties with these characteristics will have on the value of a formalized property.
  - As of 1996 US\$ 3,200 was added per property (20% of the average value of a property) to bear in mind the effect exclusively induced by the investments in improvements done by the owners on their formalized property<sup>83</sup>. This gross benefit was converted into net benefit by subtracting the improvement costs estimated by the ILD to be 90% of the additional value generated by the improvements.

Chart B indicates that the capitalized value of the incremental flow of the value of formalized property is US\$ 1.531 bn. This figure was obtained by subtracting from the capitalized gross benefit (US\$ 6,272 billion) the amount of capitalized improvement costs (US\$ 4.741 billion).

- b) To estimate the second item of benefits (**additional net salaries obtained by the beneficiaries of registered titles**) the ILD applied the research done by an economist from Princeton University <sup>(84)</sup> that indicated that the families who live on

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<sup>83</sup> Information gathered by the ILD in formalized areas which indicated that the monetary value of the improvements represents between 20% and 40% of the value of an average property (US\$ 16,000).

<sup>84</sup> Field, Erica. “Entitled to work...” ; page 24.

formalized property had been able to work longer hours, up to 45 per week.

In order to use conservative figures, it was estimated that only 50% of this additional time available for work was used for remunerative activities with a minimum salary (US\$ 118 per month) which represents an additional US\$ 708 per year per family. Fifty-five percent was subtracted from this gross benefit as an estimated measure of the opportunity cost of the hours of work and the economic resources required to carry out these tasks (additional costs such as transportation, clothing, food, etc.).

The resulting net benefit was reduced as of 1996 to a rhythm of five percentage points per year to recognize the negative effect that the gradual increase of the number of people interested in obtaining remunerated jobs on the magnitude of this additional income.

Chart B indicates that the capitalized value of the flow of additional net salaries obtained by the beneficiaries of registered titles is US\$ 2.017 billion.

- c) The ILD estimated that the **costs per family to formalize its property dropped** on average from US\$ 230 to US\$ 35 particularly due to the fact that the time required to complete the procedure was reduced from 94 months to 2 months. The resulting average reduction in the formalization costs of a property was US\$ 195.

In the original situation, the formalization cost was so high that it became an insurmountable barrier for many families; this is why the willingness of these families to pay formalization costs was lower than the cost demanded by the system. However, the ILD estimated that the new system reduced the cost so much that it lowered the new formalization cost as compared to the average willingness to pay per interested families. Therefore, in order to estimate the net benefit per family only 25% of the average reduction was taken into consideration (US\$ 49) and this figure was multiplied by the formalized property per year throughout the 1991-2002 period.

Chart B indicated that the capitalized value of the flow of costs “really” saved through the formalization procedures of property is US\$ 98 million.

- d) Moreover, the ILD estimated that the **costs that a businessman should have incurred in to formalize his business** in the 1991-

1994<sup>85</sup> period had dropped by an average of US\$ 500 due to fewer complications of the process. In order to estimate the net benefit per business a type of reasoning similar to that of the case of property was applied and 25% of the average reduction (US\$ 125) was taken into account; this figure was multiplied by the number of formalized businesses per year throughout the 1991-1994 period. As of 1995, the number of formalized businesses stopped increasing.

Chart B indicates that the capitalized value of the flow of costs saved by companies through the business formalization procedures was US\$ 141 million.

- e) ILD studies indicate that, on average, the formalized businesses in the 1991-1994 period generated 1.45 jobs per company. In order to estimate the number of **new workers** that factor was multiplied by the accumulated number of formalized businesses up to 1994 and after the number of workers remained constant up to 2002 because the number of formalized businesses did not continue to grow.

The assumption was that the workers receive a minimum salary (US\$ 118 per month) but they only work six months per year on average. From this result 55% was subtracted from the estimated opportunity cost of the hours worked. As of 1995 the net benefit was reduced at a rhythm of 10 percentage points to take into account how the gradual increase of the number of people interested in securing a remunerated job will negatively impact additional income.

Chart B indicates that the capitalized value of the flow of additional net salaries obtained by workers hired by formalized businesses increased to US\$ 2.553 billion.

- f) In order to estimate the contents of the net benefit (profit) implicit in the **taxes** received by the Government from formalized businesses, the ILD assumed that the government will apply these resources to carry out current and investment activities in favor of several groups of society; it furthermore assumed that the value of the net benefits received by these groups would be equivalent to the amount of net resources applied for these purposes.

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<sup>85</sup> The simplified business registration system established by the ILD encouraged **382,100** businesses to become formal in the 1991-1994 period.

It is worthwhile mentioning that it is a generally accepted and applied assumption when estimating the net benefits of an activity from the point of view of a country as a whole.

ILD indicated that the average increase in the gross collection of taxes by formalized businesses between 1991 and 1994 was US\$ 797. This figure was converted into net collections subtracting 25% as the collection cost of the gross income. Starting from 1995 the amount collected was reduced at a rhythm of 10 percentage points per year to recognize the negative effect that the market exist or the return to extralegality of some formalized businesses will have on the magnitude of collections.

Chart B indicates that the capitalized value of the flow of additional net taxes collected by the State is US\$ 3.304 billion.

- g) **The consolidated capitalized values** of the benefits recently described and included in the Benefits Section of Chart B have been calculated at US\$ 9.643 bn. As has been indicated above, this figure represents the net benefits obtained by different groups of economic agents with regard to the Property Formalization Programs. In order to reach the estimate of the relevant net benefits for the country investment and operational costs of the programs should be subtracted.
- 1.2 The item **Costs on Chart B** indicates that the sum of the capitalized values of investment and operational costs of the Property and Business Formalization Programs is US\$ 213 million. This figure represents the costs incurred by the Formalization System established for that purpose. The assumptions used to calculate the flow of the investment and operational costs generated by the Property and Business Formalization Programs throughout 12 years (1991-2002) were as follows:
- a) It was estimated that the **average property formalization cost** was US\$ 60. This figure was multiplied by the number of formalized businesses each year in the 1991-2002 period to generate the flow of costs for this concept.
  - b) The **estimated cost to formalize a business** was US\$ 40. This figure was multiplied by the number of businesses that became formal each year throughout the 1991-1994 period to generate the flow of costs for this purpose.

- c) US\$ 2 million per year was also included to cover the operational and administrative **fixed costs**.
- 1.3 The flows of **benefits and costs were capitalized** up to 2002 using an annual rate of 12%, which was considered as a reasonable estimate of the annual minimum economic yield that should be demanded from an investment financed with public funds.
- 1.4 The capitalized **value of net benefits** (US\$ 9.430 billion or US\$ 9.4 billion in round numbers) is considered as a measure of net income obtained by the country, after having covered all the relevant costs. This result is, of course, identical to that obtained when you subtract the capitalized value of the costs (US\$ 213 million) from the capitalized value of the benefits (US\$ 9.643 billion).

## 2. **The higher value of formalized property**

Using information generated by the World Bank, the ILD estimated that up to December, 2002 the greatest legal security granted by the COFOPRI titles have induced the title holders to improve and finish building their homes and therefore this raised the value of the formalized houses to an estimated US\$ 2.200 bn. The CDP book affirms that this figure is plagued with mistakes and restrictions.

The ILD used the following procedure to make its estimates:

- 2.1 Information was provided by the World Bank that indicated that up to 2000<sup>86</sup> the value of one million titled properties up to that date by COFOPRI had increased a bit more than US\$ 1.700 billion due to the legal security provided by the formalization; that is, the average increase in the value of a titled property was US\$ 1,700.
- 2.2 In order to update the estimate up to the year 2002, the ILD multiplied the average additional value (US\$ 1,700) by 1.3 million plots that already had been given titles by the end of 2002, thus obtaining a total increase of US\$ 2.200 billion of the value of the 1.3 million titled properties to that date.

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<sup>86</sup> Panaritis, E. "Do property rights matter? An urban case study from Peru". The World Bank, Global Outlook, International Urban Research Monitor, April 2001.

- 2.3 This estimate is, of course, a gross figure that does not take into consideration the passage of time and was specifically used to illustrate the relative importance of the formalization effect on the value of titled property. Therefore, it makes no sense to try to directly link it to the estimated net benefits contained in Chart B that were calculated on a yearly basis and finally expressed in capitalized value applying assumptions consistent with conventional economic procedures.
- 2.4 According to Chart B, the 1.3 million titled properties acquired an additional value that in 2002 reached a capitalized value of US\$ 6.272 billion. This means that each property acquired an additional value of approximately US\$ 4.847. However, Chart B also recognizes that the owners of the titled properties invested in home improvements at a capitalized value of US\$ 4.741 billion in 2002 or an approximate investment of US\$ 3,664 in each property.
- 2.5 Thus, the net benefit associated with the increase in the value of titled properties was estimated by obtaining the balance between the US\$ 6.272 billion and the US\$ 4.741 billion. The result (a total of US\$ 1.531 billion or US\$ 1,183 per property) is part of the US\$ 9.430 billion total net benefits estimated in Chart B.

### **3. Number of owners who benefited because their formalized property was worth more**

The essay affirms that the ILD committed a mistake when it determined the number of owners who benefited from a higher value of their formalized property since it included all the formalized property and not only those without title deeds when the formalization process began.

The ILD **disagrees** with this statement. It considers that only the property that has title deeds that have been duly registered in the sole registration system that provides total juridical security may be recognized without market restrictions or penalties and therefore may be used best by their owners.

Since the property located in extralegal areas covered by COFOPRI do not have these legal security characteristics and cannot be transferred without restrictions or penalties, aside from the fact that some may have been recognized or protected by municipal governments or former central governments, the ILD classified all that property as extralegal.

Consequently, the total values estimated by the ILD and linked to formalization will be inevitably higher than the amount estimated in the



essay that has only taken into account property without a title deed or any other deed in its calculations.

This discrepancy is the results will be maintained while there are differences of opinion with respect to the importance of possessing one sole title deed that grants clearly defined, safe and transferable property rights.

#### **4. Gross and net benefits and subjective bias**

The authors of the essay assert that the ILD does not furnish an explanation about the definition of the net benefit or gross benefit when it estimated the benefits linked to the higher value of formalized property.

This is not so, because the distinct classification of net and gross benefits was of essence in order to calculate the flows of benefits and costs to estimate the US\$ 9.4 billion net benefits generated by the Property and Business Formalization Programs. This is made evident when studying Section 1 of this document and that is why we will not repeat the relevant arguments.

On the other hand, the essay affirms that the ILD estimates on the value of the property “probably contains an over valuation bias which is the normal behavior of any owner who wants to sell his property”, since it is based on question 67 of the questionnaire of the survey conducted by the World Bank -Apoyo Consultoría.

Question 67 reads: “If you were selling your house how much do you think you could sell it for after having bargained its price?”. The essay states that it can be clearly seen that the variable classified as the value of the house is the **supply mortgage price** since it is the perceived value of the **bidder**.

Although the ILD **did not use question 67** of the survey to make its calculations, it considers that it is appropriate now to indicate that it **disagrees** with the interpretation made in the essay concerning this question. Apparently, the surveyor asked the beneficiaries of the formalization for their opinion about the purchase offers made by people interested in buying their house (presumably those who make the request) and have made an offer. For example, the person interviewed is asked to speculate about the possible **demand price** of the house.

If the objective of the question had been to know the opinion of the person interviewed about the supply price of his house, the question would have read more or less like this: “If you were selling your house, what is the minimum sales prices you would be willing to accept?”

Apparently, the essay considers that the **supply price** is **supplied** by those **by who want to buy** the house; it is really the **demand price**.

The **supply price** is the price **asked for** by those who have the house and want to **sell it**.

In view of this misunderstanding of basic concepts in the essay, the ILD decided to not comment the matter.

## **5. Comments of the essay on the econometric methods used in the study conducted by the World Bank -Apoyo Consultoría**

The ILD has refrained from commenting the statements made in the essay concerning the econometric methods used by the study of the World Bank -Apoyo Consultoría since it considers that any criticism should be addressed to them.

## **6. Higher Family Income**

The ILD used data from a study done by an economist from Princeton University<sup>87</sup> who indicated that families who possessed houses formalized by COFOPRI had been able to work longer hours of up to 45 hours per week. By applying the minimum salary at the moment of the estimate, this represents about US\$ 118 of additional monthly income per family.

a) The gross figure estimated by the ILD to illustrate the importance of this benefit was obtained as follows:

- Assuming that only half of the 45 hours per week available for work are devoted to remunerated work it has been estimated that one beneficiary family could obtain an additional income of US\$ 708 per year.
- This assumption is equivalent to supposing that only 50% of the beneficiary families of formalization set aside 45 additional hours per week for work and that they were entirely applied to remunerated jobs. Consequently, up to a certain degree, the assumption reflects the distinction made by Field between beneficiaries who already had some type of title deed and those who did not at the time of the COFOPRI formalization process.
- The 1.3 million families that have property that has been formalized by COFOPRI have received the title deeds to their houses throughout 7 years; that is, at the beginning of the first

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<sup>87</sup> Field, Erica. "Entitles to work...". p. 24.: "The long-run, or "steady state" effect of the program, reflected in the estimated effect on households with the maximum number of program periods, is an average increase of 45 hours of employment per week across the entire target population of squatters – roughly the same as one full-time worker being added to the labor force".

year no title deeds had been granted and by the end of year seven, 1.3 million title deeds had been delivered. It can be said that, on average, 650,000 families per year earned an additional income as a result of having formalized their property. Therefore, the 1.3 million families will have received additional income up to US\$ 3.200 billion in the seven year period (US\$ 708 per year x 650,000 families per year x 7 years).

b) In order to obtain a more detailed estimate that also takes into account the passage of time, the ILD converted the additional income into the flow of additional net benefits of families with formalized property owners. The procedure, (explained in Section 1.1.b) was as follows:

- Apparently, only 50% of the 45 hours of work per week available were used for remunerated jobs earning the minimum salary (US\$ 118 per month). Consequently, it has been estimated that a beneficiary family could earn additional income of up to US\$ 708 per year.
- It has been estimated that 55% of that gross benefit would cover the opportunity cost of the hours of work and economic resources exclusively needed to carry out these tasks (additional costs such as transportation, clothing and food, amongst others).
- After 1996, the resulting net benefit (45% of the gross benefit) dropped at a rhythm of 5 percentage points per year to take into account the negative effect that the steady growing numbers of people who want a remunerated job will have on the magnitude of this additional income.
- The result was the capitalized value of US\$ 2.017 billion that represents net benefits, measured in additional net salaries, obtained by the beneficiaries of registered title deeds.

Previous explanations address the arguments of the essay concerning the segment of beneficiaries mentioned in the study of the economist from Princeton University<sup>88</sup> and the monetization process of the study's results.

## 7. Access to credit

The ILD **did not include** the amount of loans guaranteed with property titled by COFOPRI as one of the benefits of the formalization program, as the essay speculates. It simply interpreted additional

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<sup>88</sup> Ibid

amounts of credit received by owners of formalized property as a reasonable measure of the magnitude of the opening to credit generated by the formalization. This is made evident when reviewing Chart B in which none of the net benefits contained therein included the amounts of loans guaranteed by COFOPRI title deeds.

The indication of the ILD concerning the 198,000 COFOPRI title beneficiaries had received loans for an estimated total of US\$ 300 million between 1995 and 2002 is the official information published by COFOPRI<sup>89</sup>. The information used affirms that the loans had helped to increase the economic activity and employment in low income urban areas.

Access to credit was facilitated by the legal reforms proposed by the ILD and implemented by the Government. In effect, several banks of the country affirmed then that registering a mortgage backed loan in the registry especially created for the formalized areas (RPU) demanded one third of the time needed to do the same operation in the traditional Public Registry<sup>90</sup>. It was also claimed that the debts registered in the RPU had a recovery rate of 91%, similar to the 90% rate observed between owners of houses located in traditional urban areas.<sup>91</sup>

Estimates linked to the little time it took to register a mortgage in the RPU and the high recovery rate of the loans registered in the RPU were interpreted by the ILD as indicators of the advantages already being perceived by financial intermediaries that had contacted the owners of real estate assets that had been incorporated into legality.

On the other hand, the ILD agrees with the essay about the fact that a loan is not a free handout. It is obvious that a loan must be paid back and if the borrower does not have the ability or the luck of choosing another profitable investment option, he may ultimately lose the assets he used as collateral. In the case of a secured loan backed by property titled by COFOPRI it is probable that some of the activities financed with these loans is highly profitable and others were a complete disaster. It is highly probable that the borrowers obtained a broad range of net benefits when they invested the loan. However, it is important to stress that the ILD did not include the amount of COFOPRI property title secured loans as one of the benefits of the formalization program.

The ILD considers that a loan is only a means to obtain the resources that a business needs to operate and eventually, to grow. By using the loan to satisfy the needs for working capital or physical capital the business can use available resources much better. The loan allows

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<sup>89</sup> COFOPRI. "Peru Urban Property Rights Project". COFOPRI, November 2002.

<sup>90</sup> Banco del Trabajo, 2002.

<sup>91</sup> Superintendence of Banks and Insurance Companies, October, 2002.

the business to reduce costs or increase income, thereby increasing its profits. Consequently, the customary manner of estimating benefits generated by a loan is to estimate the additional net profit to be gained in the economic activity that received the funds, once the loan has been paid back. Evidently, it would have been a huge mistake to consider the amount of the loan as a measure of the benefit that it could generate. In reality, the loan is not a benefit but rather a cost for the borrower business.

## **8. Red tape cost**

When estimating the red tape cost of a family to formalize property, the ILD included costs **in cash** (payment for permits and licenses or red tape handling costs) and the **opportunity cost** (cost of waiting to obtain the corresponding documents). The simplified system applied by COFOPRI reduced both types of cost but did not fully delete them.

In effect, the ILD estimated that the costs paid for by a family to formalize its property had dropped, on average, from US\$ 230 to US\$ 35 especially because of the time required to completely process the document was shortened from 94 to 2 months. The average reduction in the formalization costs of a property was US\$ 195.

In the current situation, the formalization cost was so high that it was an insurmountable barrier for many families; this happened because the families were only willing to pay for a lower amount as compared to the amount demanded by the system. However, the ILD estimated that the cost reduction introduced by the new system was so significant that it made the new formalization cost drop to a lower level as compared to the average payment of families who seek property formalization.

By estimating the net benefit per family the ILD did not include all the formalization cost reductions because as has been mentioned in the former paragraph, this would have involved an over evaluation of the relevant net benefits. Instead of this only the 25% of the average reduction (US\$ 49) was taken into account and this figure was multiplied by the property formalized each year throughout the 1991-2002 period.

The resulting net benefits were US\$ 98 million, expressed in the capitalized value. These net benefits are part of the US\$ 9.4 billion net benefits generated by the Formalization Programs that have been described in Section 1 of this Annex.

## **9. Legal employment**

As has been indicated in Section 1, the ILD studies indicate that on average, businesses formalized in the 1991-1994 period generated 1.45 jobs per company. In order to estimate the number of new workers this factor was multiplied by the accumulated number of formalized businesses from 1991 to 1994 and then the total amount of workers was kept constant up to 2002 since the number of formalized businesses has not increased since 1995.

Apparently the workers receive a minimum salary (US\$ 118 per month) however they only work for 6 months a year, on average. Fifty five percent was then subtracted from this result as an opportunity cost of the hours of work. Since 1995, the net benefit was reduced at a rhythm of 10 percentage points per year to take into account the negative effect that the gradual increase of people looking for a remunerated job has on the magnitude of this additional income.

The resulting net benefits were US\$ 2.553 billion expressed in capitalized value. These net benefits are included in the US\$ 9.4 billion of net benefits generated by the Formalization Program, an estimate of which is described in Section 1 of this Annex.

## **10. Tax payments**

In order to estimate the contents of the net benefit (profit) implicit in the taxes paid by formalized businesses, the ILD assumed that the Government would use these resources to carry out current and investment activities in favor of several groups of society; this would represent additional net benefits for those groups and the amount could be similar to the amount of resources applied for these purposes. This is a generally applied assumption when estimating the net benefits of an activity from the viewpoint of the country as a whole.

ILD estimates indicated that the average increase in gross tax collection per formalized business between 1991 and 1994 was US\$ 797. This figure was converted into net collections and 25% of the net income was subtracted as a collection cost. Since 1995, the additional amount collected dropped at a rhythm of 10 percentage points per year to take into account the negative effect of market exits or return to extralegality of some formalized businesses on the magnitude of collection.

The resulting net benefits were US\$ 3.304 billion expressed in capitalized value. These net benefits are included in the US\$ 9.4 billion net benefits generated by the Formalization Programs an estimate of which has been described in Section 1 of this Annex.

## **11. Work and study for the children**

The study done by Field<sup>92</sup> indicates that one of the potential effects of formalization was the 28% reduction of the probability that minors of beneficiary families would have to go to work. Presumably, the natural choice for a minor is either going to work or going to school, and the ILD described the potential effect discovered by the aforementioned study as a positive effect since it means that the minors of families with formalized property could devote more time to go to school.

However, the ILD did not try to convert this evident social benefit into its monetary equivalency and therefore this positive effect **was not included** in the estimate of the net benefits of the formalization program.

## **12. Delay and additional formalization costs**

On this point, the essay agrees with the ILD: Supreme Decree D.S. 005-2001-JUS issued in March 2001 increased the formalization costs. This conclusion relieves us from having to make any additional comment on this matter.

## **13. More expensive notary procedures**

On this point, the essay basically agrees with the ILD: the reinstatement of notaries to the formalization process as of June 2004 considerably increased the legal costs required to buy, sell, rent, inherit, bequeath, or donate property.

## **14. Registered property transfers (second acts)**

The information gathered by the ILD – from SUNARP and COFOPRI officials – to draw up the Press Release of December, 2004 indicated in a preliminary manner that the number of monthly transactions performed on registered property is dropping from an average of 7 to 4 thousand per month; this represents a monthly reduction of 3,000 (43 percentage points of reduction).

Using SUNARP figures updated to January 2006, the essay ratifies this decreasing tendency although the reduction estimated here was approximately 1,100 transactions per month (a 16 percentile point

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<sup>92</sup> Field, Erica. “Entitled to work...”: “When families with many potential workers are excluded, we observe that obtaining a property title reduces the average likelihood of children entering the labor market by 2.2 percentage points. According to this estimate, the implied program effect on child labor force participation among families with 1–6 working-age members amounts to a reduced likelihood of roughly 28%”.

reduction). Consequently, the essay draws conclusions which are similar to the ILD's, although adjusted to current figures.

## **15. Additional costs to access a property title deed**

The ILD estimated that before the Supreme Decree 005-2001-JUS, that established the participation of municipalities in the extralegal titling and registration processes located in human settlements, COFOPRI would have required about 7 years to formalize the 1.8 million of current extralegal properties at a rhythm of 267,000 properties per year.

However, the additional administrative steps stemming from the participation of municipalities in the process extended the total term up to an estimated 15 years since the rhythm of formalization was reduced to an average 121,000 properties per year. Therefore, the participation of the municipalities in the formalization process means that it would take COFOPRI 8 additional years of work to formalize the 1.8 million extralegal properties.

The extension of the formalization term directly affects the properties in different ways depending on the order in which they have been processed for formalization. In effect, since the time needed for formalization has doubled, the properties that would have been formalized in the first years now take 2 years; they have a one-year delay. The property that would have been formalized in the second year would complement the process only around the fourth year; another two year delay. The property that would have been formalized in year seven would conclude the process by year 15; an eight year delay. In order to describe the situation of an average property the simple average of the situations described was calculated as well as the calculations for an average four year delay.

The cost for a family to wait an additional four years (US\$ 293) was estimated by calculating the difference (in the real value) that perceiving the added value of the property formalization now means (US\$ 925) or having to wait another four years to perceive it. By using a 10% discount rate per year, it has been estimated that the formalization of 1.8 million of extralegal property in new conditions stemming from D.S. 005-2001-JUS would mean that the owner of this property would have a potential cost of about US\$ 527 million for this concept.