

Property Rights Reform in Peru: Why Titles do not Increase Access to Micro-Credit

Laura McKechnie

Presidential Management Fellow

Peruvian economist Hernando de Soto claims developing countries have billions of dollars of financially and commercially invisible property and that formalizing property will generally increase access to credit and therefore participation in the market economy. Reforms influenced by his organization resulted in thousands of newly titled properties in Peru in the 1990s. Contrary to the mainstream assumption, I found property rights reform did not consistently increase access to formal credit, especially in urban areas where most of the titling took place. And while access to informal credit was seen in some circumstances, it was often linked to specific circumstances, such as building materials. On the other hand, a strong correlation was established by the research between poverty level and credit access. I propose lessons learned from the Peruvian case and recommend policy implications that would make future property rights reforms more successful.

Introduction

The well-known Grameen Bank of Bangladesh pioneered the idea of micro-credit in the late 1970s with the belief that, “credit is a cost effective weapon to fight poverty and it serves as a catalyst in the overall development of socio-economic conditions of the poor” (Grameen Bank, n.d.). By the early 1990s, this movement had gained momentum worldwide, including in Latin America. Some branded it the “new development solution” because it provided credit to the poor, who traditionally lacked collateral and were denied access to any loan because of the high default risks and transaction costs. A significant amount of recent worldwide research (for example Khandker, 2001 and Remenyi & Quinones, 2000) has provided evidence supporting the benefits of micro-credit (CGAP, n.d.). Micro-credit provides small loans, in group- or individual-schemes, and most often facilitates the purchase of equipment or other operating expenses for small businesses. In a group-lending scheme, physical collateral, such as a property titles (deeds in the United States), is usually not required. Nevertheless if one member of the group defaults, the entire group’s access to credit is damaged. In an individual-lending scheme, collateral is usually required to reduce the bank’s default risk. If the borrower does not have collateral, a bank will use moveable capital or a guarantor to secure its investment. Micro-credit, especially the group lending scheme, has been particularly effective in developing countries such as Peru, where formal property titles are scarce and informal markets make up a great portion of the economy.

Peru relies heavily on the informal sector, made up of small businesses and agricultural enterprises. Thus micro-credit, which is used by many of these poor entrepreneurs, is vital to sustaining much of the Peruvian economy. Millions in Peru do not have full access to any credit because they do not have the collateral needed to secure these financial transactions. Many poor Peruvians live and work on land without a property title or proper registration, which is defined as “informal property”.

Peruvian Economist Hernando de Soto postulates that in developing countries such as Peru, vast amounts of this informal property means billions of dollars of potential capital resources are financially and commercially invisible, and thus cannot be transformed into money to improve the productivity of society. Reforms influenced by his organization, *Instituto Libertad y Democracia* (ILD), changed the property system in Peru significantly in the 1990s, creating thousands of newly titled properties. Therefore, due to the importance of microenterprises and the recent property rights reforms, Peru represents an excellent opportunity to test the mainstream assumption that property rights reform will result in increased credit access. Scholars have recently hypothesized that property rights reform would inevitably lead to increased access to credit, and research in some countries around the world has proven this correct. Current studies from Peru in both urban and rural settings, on the contrary, do not consistently demonstrate this positive correlation. The studies illustrated reforms conducted in urban areas did not create any increased access to formal credit. And while reforms in rural areas did confirm this correlation, formal credit in these areas is extremely limited. Another countrywide study established new property titles increased access to informal credit only. Coincidentally, households who participated in the recent property rights reforms are among the most impoverished in Peru. Thus, although a strong relationship between property titles and credit access could not be confirmed, a correlation between poverty and credit access does exist. Therefore, it would seem that although de Soto’s reforms are an important step in the right direction, they might not be the complete solution to the problem.

De Soto’s Claims

In his two books, *The Other Path* (1986) and *The Mystery of Capital* (2000), economist de Soto claims macroeconomic reforms in developing countries have been unsuccessful because they assume people are able to use resources in the open market. This claim is based on classical

economist's¹ assumption that the capital engine powers the market economy. Markets have the power to create surplus value that can be traded to increase productivity. These economists believe capital can only enhance the productivity of society if it can be converted into intangible items, such as money (de Soto, 2000). De Soto proposes that legal systems in many developing countries have failed to keep up with the changing nature of societies. Law making ignores social contracts, which are informal relationships between citizens. As a result, property systems are unrealistic, inaccessible and bureaucratic. Thus citizens have little incentive to join the formal sector; they opt out because it is difficult to penetrate, not because they are trying to avoid paying taxes. As a result, vast amounts of informal property exist that lack property titles or proper registration and thus are financially and commercially invisible. In Peru, for example, of the total rural land holdings, only 19% are formal (de Soto, 2000)². To de Soto, a country without a national working property system has numerous problems. Capital transactions occur on an informal basis, and thus not recorded or documented. Property laws vary by town, and therefore are not recognized on a national level. Assets cannot be divided or combined to produce a higher mixed value. In general, because there is no centralized system that identifies and standardizes capital, assets cannot be used as collateral and transformed into money, which would enhance the productivity of society. This informal property system results in what de Soto calls "dead capital", which in Peru amounts to \$USD 74.2 billion (de Soto, 2000).

De Soto maintains the costs (socially and economically) of this system are high to citizens and government alike. Citizens lose because the cost of maintaining oneself in the informal sector is high. Because they live outside the law, they cannot hold government accountable for the provision of services. Governments lose because they cannot tax these informal properties. Moreover, positive government programs do not often reach the many poor in the country who are invisible.

De Soto affirms a strong, working property system reduces the cost of knowing the economic quality of assets and facilitates their transfer, enhancing productivity and unleashing the total potential of all citizens. Indeed, before making a loan, banks try to obtain information about their clients' moral hazard risk. And a credible property title often serves this purpose in developed countries³. De Soto reminds us, "the single most important source of fund for new businesses in the United States is a mortgage on the entrepreneur's house" (de Soto, 2000, p. 63). However, this transference of tangible-to-intangible capital cannot happen, de Soto believes, unless governments entice people into the formal sector by making the process easy, safe and cheap. De Soto's hypothesizes that the numerous reform benefits range from raising society's productivity to the economic empowerment of the poor. Logically, one of the ways to achieve these wide-ranging goals would be to give citizens

property titles so they have greater access to credit. In the case of the poor, this means increased access to micro-credit, since most poor lack access to traditional credit markets. And indeed literature, including Feder (1985), Besley (1995) and Carter (2003), supports this theorem. Their argument is, "formal property titles encourage lenders to use land as collateral by lowering the risk of collateral loss . . . thereby reducing the effective leverage ratio and increasing the net collateral value of land" (as cited in Field and Torero, 2003, p. 6). Based on the author's fieldwork with a rural micro-credit institution, this analysis would seem reasonable, in both rural and urban settings alike. Most borrowers the author interviewed did not have collateral, and thus were given very small micro-credit loans. Because their capital was invisible, they were unable to harness the economic potential of the market. Before exploring this link between property rights reform and micro-credit, an investigation of the micro-credit market in Peru is essential.

Micro-Credit in Peru

Case studies in Peru and other developing countries demonstrate the importance of small and medium enterprises to the overall economy. They facilitate the production process, provide employment and enhance income in both urban and rural areas. In interviews Villarán (as cited in de Janvry et al., 2003) found that Peruvian officials believe microenterprises as a whole employ 75% of the economically active urban population, while others estimate that they contribute 42% of the Peruvian GDP. The small and micro agriculture and livestock sectors are especially important, as they employ 23% of the economically active population and sustain 65.5% of the population (Llosa et al., 2001). For most poor citizens who have little savings and whose annual production yields little net profits, micro-credit is often necessary to finance basic operation, and is almost obligatory to purchase capital items. Credit financing is divided into three sectors: 1) Formal institutions, including banks and non-banking (credit associations) sources; 2) Semi-formal credit, made of both private and public sources that range from close cooperatives to NGOs⁴; and 3) Informal credit, loans from friends/relative, local stores, and pawnbrokers, where interest rates can run as high as 100%. (Llosa et al., 2001). What differentiates formal and informal lenders? If monetary costs are sufficiently high, formal lenders will use collateral to lessen the default risk of the loan. Conversely, informal lenders face lower monitoring costs and do not always rely on collateral. And indeed empirical evidence from other countries would support this finding. Hoff and Stiglitz (1990), Carter (1988) and several others (as cited in Valdivia 1996) also support the idea that formal lenders' belief about loan risk is greatly based on a household's land ownership. This was indeed the case for RED Rural, as a semi-formal institution run by the Peruvian government for which the author conducted fieldwork in August 2004. Recipients without collateral received smaller loans than did those

with collateral. Most of the people interviewed did not have collateral for their land and almost all (94%) said that the money received was not enough to improve their business. Only 2.7% of Peru's microenterprises have access to formal or semiformal credit, less than most other countries in the region⁵ (Westley, 2001), and for low-income populations, informal credit is the most significant (Llosa et al., 2001). Thus, for the majority of urban and rural microentrepreneurs, because their wealth is invisible and they do not have a title to their land, they do not have access to this potentially capital-transforming process.

Although access to credit is low in general, microfinance grew somewhat over the past two decades in Peru, although this growth did not stabilize. Access to credit increased from 17% in 1994 to 32% by 1997 (de Janvry et al, 2003). By the year 2000, it had decreased to 19% due to privatized government owned enterprises (including banks) and decreased government control of agriculture, all of which were not balanced with increased private "retail capacity". Banks are selective about the credit they offer, especially to microenterprises, because banks see them as having potentially high default rates, and because small loans mean high transaction costs. Agricultural microenterprises face even more discrimination. Global studies by Eswaran and Kotwal (1986) and Carter (1988) have established that small farmers are rationed out of credit markets (de Janvry et al., 2001).

While there is a significant demand for rural micro-credit in Peru, micro-credit's overall success has been extremely limited. This can be linked to internal factors, meaning those directly relating to the client or bank, such as loan conditions and client net worth, and external factors, meaning those out of control of the client or bank, such as market saturation or subsidized import prices. A client study of a rural micro-credit institution conducted by the author near Cusco, Peru, in June 2004 highlights several internal factors may have contributed to micro-credit's limited success in Peru⁶. While micro-credit interest rates are still well below extremely informal sources, such as *tiendas*, which can run as high as 100%, high interest rates prevented loan recipients from receiving substantial loans to improve their business⁷. Most agricultural loans were given out on an individual basis and thus were very small because clients lacked collateral to decrease the default risk to the bank. These small loans could only be used for subsistence purposes (such as buying seeds or renting a tractor), and were rarely large enough for recipients to be able to purchase equipment that could boost their income/production level. A cycle of dependency was thus created because loans were only large enough to cover operating expenses⁸. While there are many internal factors that prevent micro-credit's success, external factors such as macroeconomic conditions can be just as responsible for creating the right conditions for micro-credit to thrive.

Economic Reforms and Their Impact on the Micro-Credit

The success of micro-credit is highly dependent on the health of the country's financial sector and on the creation of complimentary financial reforms. In the 1990s President Fujimori's neoliberal reforms⁹ generally helped decrease macroeconomic instability of Peru (with the exception of the financial crisis in 1998) and led to improvement in the banking sector's policy framework. However, these reforms had serious negative impacts on the banking sector, and thus micro-credit. The privatization of government-owned enterprises resulted in less available credit, as private banks did not adequately fill in the gap left behind by closed government agencies. For example, the closing of the Agrarian Development Bank in 1992, which made the majority of agriculture loans prior to that time¹⁰, decreased the availability of agricultural credit considerably (Llosa et al., 2001).

Although it is easy to see the negative impacts macroeconomic reforms had on the micro-credit and agricultural sectors, explaining why any positive reforms failed to increase the potential of the rural microenterprise sector into the beginning of the 21st century is more difficult. Hernando de Soto (2000) claims macroeconomic reforms in developing countries have been unsuccessful because they assume people are able to use resources in the open market. He asserts millions of poor have invisible capital resources that lack a formalized property title. Thus, exploring the history of property rights reform in Peru may provide insight into why micro-entrepreneurs did not benefit from these reforms.

Property Rights Reform

Like micro-credit, many theorists have recently labeled property rights reform the "new development solution". The benefits of property rights reform can range from poverty reduction to increased productivity to improved governance. The main reason why international institutions and governments have been so focused on implementing reforms has been to facilitate economic growth. Rural sector growth is especially important to a developing country's overall economic growth. A recent World Bank report stated that in Latin America, rural communities contribute twice as much as officially believed to national development (World Bank, 2005).

Land tenure is seen by many as the foundation for economic activity and market functionality in capital markets. As de Soto and many others, including Feder (1985), Besley (1995) and Carter (2003) claim, visible collateral can lower the information costs that often limit development of the private financial sector. Lower information costs can mean less credit rationing and more credit access. Conversely, as recently as 60 years ago, scholars were questioning whether property rights reform established a clear, causal link to economic development. Understandably, many conditions must be present for the reforms to be successful. As Parsons (1956) (cited in Laporte, Petras & Rinehart, 1971) said, "It must be recognized that land reform is not a cure-all and that it can be productive of social and economic benefits only as

part of comprehensive development programs" (p. 475).

Characteristics

Although property rights reform has taken many different forms around the world, there are generally agreed upon characteristics that experts claim are inherent to successful reform efforts.¹¹

Hernando de Soto (2000) states there are five steps needed in order to transform a country's property system¹². These steps became the basis for property rights reforms in Peru in the 1990s and include:

- 1) Raise awareness – inform citizens about the importance of an inclusive legal property system and the need to include the poor in the political economy. Requires strong political leadership aimed at various constituencies.
- 2) Diagnose the problem – identify dead capital, people excluded from property system, extralegal norms and legal obstacles.
- 3) Design reforms – create a legal system that transforms existing laws and statutes into ones that are based on citizen norms and are accessible to majority of citizens.
- 4) Implement reforms – begin incorporating informally held real estate through massive registration campaigns.
- 5) Execute other recommendations that create capital – implement collection systems for credit and taxes; facilitate good governance by providing information about markets and property (ILD, n.d.)

De Soto believes this process will help to create a new legal environment that will thus empower the poor by bringing them into the legal sector and by making invisible capital visible. He also states the process must be top-down (meaning supported by the president/prime minister) in order for the reforms to consider both the poor and wealthy classes that exist in a country. Exploring the history of land reform in Latin America and in Peru region will shed light on this issue.

Land Reforms in Latin America and Peru

Land reform has been successful in some parts of the world, namely in Japan, Korea and India. Although land reform has taken place for more than 50 years in Latin America, its success is inconsistent because it has been guided by short term political objectives, the needs of beneficiaries were not taken into consideration, and it was undertaken in an already unfair system (Dale & McLaughlin, 1999). Most of Latin America was developed under the *hacienda* system, which created rich, Spanish-loyal *hacendados*, who ran their farms on an indentured servant model. This produced a vicious cycle of dependency and a class of impoverished people who were unable to register their land or gain independence.

Since that time, a cumbersome legal process, in addition to a perception of weak property rights and imperfect capital markets, has resulted in the relatively high existence of informal settlements¹³ in Latin America, leaving billions of dollars of wealth invisible to the market economy. In Peru, an applicant could wait 20 years before receiving a property title from the government and up to 10 years for title application completion. For this reason, only 19% of all rural holdings are formal (De Soto, 2000). Not only are there still a large number of informal settlements, but also it has been difficult for the rural poor to benefit from any property reforms that have occurred. The case of Peru can be used to highlight how de Soto attempted to rectify a history of unsuccessful land reforms.

In Peru, like many other countries in Latin America, only 20% of land originally had a clear title, which was based on Spanish colonial land grants. Early land reforms came in two phases, and were often politically motivated. The first phase included expropriation of land in the early 1960s, while the second encompassed land parcelization and restitution in the early 1980s. Overall, both sets of reforms were incomplete. Beneficiaries still faced numerous challenges, including lack of credit access due to high bank transaction costs as well as the loss of technical assistance, economies of scale in input purchases and the use of machinery. Some farmers overcame these market failures, but problems remained. Agrarian reform didn't view titling or registration as important, thus many landholders did not possess clear titles after the reform process ended (Lastarria-Cornhiel & Barnes, 1999). In addition, land was often given out based on political party affiliation. And because the reforms benefited medium size farmers, small farmers fared poorly, creating a structural poverty that has proven difficult to break. As de Janvry, Sandoulet and Wolford (cited in de Janvry et al., 2001) state, by 1990 only 15 percent of land reform beneficiaries had titles, although they received 53 percent of parceled land.

In response to these failures and in order to make millions dollars of wealth visible, Hernando de Soto and the ILD drafted reforms of 175 laws and 2,000 regulations affecting the property formalization process in the mid-1980s¹⁴. These property reforms¹⁵, called PROFORM, established possession rights¹⁶ and new registration procedures, legalized mortgages based on possession rights and authorized insurance companies to grant credit insurance. With strong influence from the ILD, a series of the laws in the 1990s changed the way Peru looked at property rights, affecting informal properties in both urban and rural areas. In 1990, Peru created a new property registration system, *Registro Predial*, to register informal settlements in urban areas. In just a short time it regularized 150,000 urban properties¹⁷. Then in April of 1996, Peru formed a new land-titling agency, *Comisión de Formalización de la Propiedad Informal* (COFOPRI), responsible for issuing land titles in urban and rural settings as well as overseeing legal and physical verification. Although the program was "national", early COFOPRI

massive registration campaigns began in metropolitan Lima, where half of the informal properties existed, with plans to decentralize to 10 provincial cities later (Kagawa, 2001). The program had much success in these areas, and by 1997, 228,000 properties had been formalized and 63,000 individual titles had been registered by COFOPRI (Kagawa, 2001). With the focus on urban property registration (only 11% of initial property registrations in 1993-94 were in rural areas), rural populations, including the indigenous who historically suffer from the worst poverty rates and access to land, remained impoverished and without titles (Lastarria-Cornhiel & Barnes, 1999). This was mainly because laws passed concerning titling in rural communities were never implemented. In the mid 1990s, however, positive changes began to occur in the rural sector. In 1995 the Peruvian Congress passed a law reaffirming the right of *campesino* and *nativa* communities to use the land tenure system of their choice for titling (either individual titling or collective titling¹⁸). In that same year, the Inter-American Development Bank provided a loan to Peru for \$USD 21 million for rural land titling and registration (IDB, 1999).

Reform Support and Critique

Theoretically, land reforms should have numerous benefits, but the results do not always occur in a way that property rights advocates predict they will. De Janvry et al. (as cited in de Janvry et al., 2001, 287) noted this distinction, "Parcelized farms in the reform sector do open the possibility of a successful, independent smallholder section . . . whether this sector will survive and create a thriving rural middle class is one of the greatest challenges of today's agrarian question". Data exists that supports the fact that ILD-influenced reforms did meet their basic goals, which are to title and register land. By 2000, 1,400,500 properties were formalized by COFOPRI and 1,033,000 individual titles were registered by *Predial* in the country overall (Kagawa, 2001). And, as of 2002, 4,188 of the 5,818 *comunidades de campesinos* and 1,175 of the 1,345 *comunidades nativas* had titles (Centro Peruano, n.d.). In addition, by 2002, the ILD claims its reforms allowed 6.3 million poor gain legal title¹⁹, brought 380,000 poor enterprises into the legal sector, increased tax revenues by \$300 million per year, generated 560,000 legal jobs, saved \$254 million in red tape costs and resulted in \$10 billion in net benefits to the poor (ILD, 2002). Additional non-quantifiable benefits include a reduction of child labor, land related conflict, and Shining Path recruitment (ILD, n.d.). Even critics like Lastarria-Cornhiel and Barnes (1999) admit that *Predial* represents a new approach toward formalizing land rights that is faster, simpler, less costly. "There is no doubt that the Registro Predial is a more efficient system than the traditional registration system" (Lastarria-Cornhiel & Barnes 1999, 2).

In spite of this, critics of the program itself are numerous. In 1995 when most of their research was conducted, Lastarria-Cornhiel and Barnes (1999)

criticized numerous aspects of *Registro Predial*. First and probably most important, land titling and formalization has not been consistent in all areas. It focused primarily in urban areas. Even in rural areas most of the agricultural titling has taken place on the coast where the majority of commercial agriculture lies (Plant & Hvalkof, 2001), leaving areas of extreme poverty, such as the sierra, without titles. Titling communal land, which makes up the remainder of the country, has been especially arduous. Indeed, almost all of the clients interviewed for the RED Rural Report, most of whom lived in *comunidades*, did not have a title. While it can be noted that titling has made significant headway in the late 1990s, extremely poor regions are not benefiting proportionally to other wealthier areas. Because the program was designed for urban areas, replication could be problematic because it focused on groups that were easy to formalize - squatter settlements governmentally recognized as legitimate communities before reforms took place. Second, the system was not decentralized or expanded past Lima as planned, except in Cañete. Third, there were problems with the registration system itself, which is still not computerized nor integrated with the cadastral system. Fourth, there was not full government support. This could perhaps be because the ILD offended government personnel in the early days of the program. Last, there was not full citizen awareness and support. Registration is not mandatory, and often citizens do not fully understand why it is important.

Concerning the rural reforms specifically, there are simultaneous critiques and praises noted by Plant and Hvalkof (2001). On the negative side, PETT only included components of titling of native community lands after it received pressure from indigenous organizations. This delay prevented them from gaining legal status until well after many other poor in the country. In addition, its titling component was not systematic in the beginning, but was developed on an ad hoc basis in response to landowner requests. In addition, some say it contributed to the escalation of violence and insurgency in the region. On the other hand, it is now recognized as a pioneering experience for the titling of indigenous lands. More than 60 communities had their lands demarcated and titled through a process that gave rise to an innovative model of community participation, which was incorporated into titling programs in the Peruvian Amazon. Therefore, while property reforms made significant gains in urban areas in the early 1990s and minor gains in rural areas later in the decade, unanimous support for the reforms do not exist.

Conclusion

Inconsistent Access to Credit

As cited above, de Soto (1989 and 2000), Besley (1995), Feder (1985), and Carter and Lointo (2003) have supported the positive correlation between property titles and credit. Yet studies in Peru from both urban and rural areas do not fully support this claim. In urban areas,

Field and Torero (2003), Lastarria-Cornhiel and Barnes (1999) and Kagawa (2001) all found that land titling does not increase access to *formal* credit from private sector lenders. For example, only 4.2% of urban families who have registered properties have obtained mortgage credit (Lastarria-Cornhiel & Barnes, 1999). There was, however, an increase in loan approval ratings by 9-10% for *informal* credit granted by KARPA, a building supply company that gives loans specifically related to construction (Field & Torero, 2003). As Kagawa (2001) summarizes, "... whilst there is a strong link between legal and physical consolidation, there is a weak link between legal and economic[,] despite institutional models influenced by de Soto claims that legal consolidation will lead to increased access to credit. The Lima study indicates that this is not occurring in the magnitude institutions expected" (Kagawa, 2001, p. 9).

In rural settings, in contrast, land titles did increase access to *formal* credit. Valdivia (1996) found that there was, "a robust positive relationship between collateral requirements and access to formal credit" (p. 1). However, this correlation did not exist with *informal* lenders (Valdivia, 1996).

A baseline study covering both urban and rural areas conducted by *Apoyo Consultoria* in 2000 also yielded similar results. Apoyo's survey considered 2,744 participants divided among 5 geographic regions who had one of the following title situations: a COFOPRI title, a municipal title²⁰, a deed, other documents or no documents²¹. Overall between 1997-99, 51% of those surveyed with a COFOPRI title had solicited credit, higher than the average of 42%. The credit acceptance level of COFOPRI was also slightly higher than average, 96.1% compared to the 93.9% average. On the other hand, COFOPRI households were less likely than all other groups to be approved for formal credit, 63.4% compared to the 66.3% average. And most of this formal credit, 44%, was from the *Banco de Materiales*. Thus, while COFOPRI property owners solicited more credit, it was more likely to be from informal sources, as they were 9-21% more likely to receive informal credit than those with other types of titles. These conclusions are in accordance with Field and Torero's research, which demonstrated that newly titled owners' access to informal credit did increase while access to formal credit did not.

In summary, when the research separated property titles between urban and rural areas, it consistently demonstrated property titles did not increase access to *formal* private credit in urban areas, while titles did increase access to *formal* credit in rural areas. In the case of *informal* credit, exactly the opposite was true: there was a positive correlation in urban areas and no correlation in rural areas. When the research was conducted on a national level, a newly issued property title usually meant increased access to informal credit, not private formal credit. Why didn't new property titles have the effects that Hernando de Soto intended them to have? Why weren't banks enticed to use collateral to reduce moral hazard problems

and information asymmetries? The *Apoyo Consultoria* study concluded that the property title itself was not the deterrent factor for credit. Statistics confirm that there is actually a slight decrease in credit acceptance after obtaining a COFOPRI title. For example, COFOPRI title owners had a 96.8% acceptance rate of credit before received their COFOPRI title and a 96.2% acceptance rate after they obtained their title. This clearly confirms that something besides a property title may explain increased access to credit.

The Wealth Factor

While the literature has proven inconclusive as to the positive link between property rights and credit, it does demonstrate a strong correlation between two situations, poverty and access to credit. *Apoyo Consultoria* found that while there was no difference between loan conditions for COFOPRI titles, there was a clear relationship between probability to access credit and poverty level. COFOPRI titles owners had the highest levels of poverty²² than any other title type. More than 93% were classified as extremely poor, compared to the 89.8% average. They also had the second highest poverty level (95.9%) in the poor category²³. Almost 50% of COFOPRI title owners said they did not solicit credit because they would not be able to repay the loan, 10-15% higher than those with other types of titles. Therefore, it can be concluded that the higher the wealth of the family, the higher the likelihood they would access credit. Valdivia (1996) also found that in Peru, poorer farmers will have less probability of obtaining a loan, and they will have to pay higher interest rates if they do, in fact, receive the loan.

Wealth differences have also been a factor in studies outside of Peru concerning the link between property rights and credit access. Carter and Olinto (2003) found that in Paraguay, while there was a positive relationship between property rights reform and credit, the effects differ across wealth classes. They report that wealth biases in rural credit market can mean that the smallest farmers could not see any increased credit supply as a result of tenure security. Eswaran and Kotwan (cited in Valdivia, 1996) also state that a wealthy household with collateralizable assets will have more access to credit than a less wealthy household. Therefore, while in most cases there appears to be no correlation between property rights and access to credit in Peru, it seems that wealth and credit access are highly correlated. Valdivia (1996) notes that while land ownership may be a good indicator of household wealth, "it appears to be an imperfect indicator of the probability that the household will fully repay the loan" (p.2).

Lessons Learned and Policy Implications

This paper did not intend to solve the great questions of the validity of either property rights reform or micro-credit. It simply tested Hernando de Soto's hypothesis by examining whether property rights reforms proposed by

de Soto's organization, the ILD, actually increased access to credit in urban or rural areas. Contrary to his and other mainstream perspectives, in Peru property rights reform alone was not strong enough to consistently increase access to *formal* credit. The only circumstance where it increased access to *formal* credit was in rural areas. And while access to *informal* credit was seen in both urban and countryside studies, this credit was often linked to specific circumstances, such as building materials, and usually comes with less favorable loan conditions. Nonetheless, these studies do not determinedly negate the de Soto hypothesis. That is because there appears to be a stronger correlation between wealth and credit access than property titles and credit access. Because recent property rights reforms in Peru focused on the poorest of the poor, the reforms may not have proven successful because of the low poverty levels of the reform beneficiaries. Overall, this case study can provide some interesting lessons that have important policy implications for land reforms and micro-credit development in other areas.

Lessons Learned

1. *Land reform is not the magic solution.* Land reforms are often incomplete, resulting in unfinished outcomes. In Peru, the registration and cadastral system still have systemic problems, which could be preventing registrations from going smoothly. In addition, registration is not mandatory, and while formal banks require registration in order to accept a title as collateral, there is a lack of citizen awareness about the importance of registration. This could be precluding property owners from getting the most from their new titles. Even comprehensive reforms can have negative effects, such as disrupting the political system or creating winners and losers, which has happened recently in Zimbabwe and Bolivia.
2. *Land reform by itself does not automatically mean increased access to credit.* Land reforms can have the potential to bring invisible properties into the legal sector. Yet, the success of these reforms is highly dependent on other reforms because, "Legally registered and titled property does not in and by itself give property owners access to credit . . . [the registration system doesn't] necessarily change other market factors or increase the supply of credit to low-income families" (Lastarria-Cornhiel & Barnes, 1999, p. 2). The poor that are receiving these titles are poor; they live on meager incomes and the monetary value of their homes and/or property is low. These situations do not suddenly disappear with a property title. There are also many circumstances out of the control of title owners that affect the success of these reforms, such as banks willingness to lend, macroeconomic instability and government support. In some cases, banks have even begun to adjust their criteria

for lending, and are more interested in stable employment than land titles (Gravois, 2005).

3. *Developing good institutions takes time.* Change cannot happen overnight. Reforms need supportive political and citizen backing, and they need time to become institutionalized. In Peru, there was medium support from government officials, and many citizens do not have full confidence in the validity of COFOPRI titles.
4. *Not all situations are the same.* Even just considering the research in Peru, it is evident that the impact of land reform can differ completely depending on the situations of the new title owners. For the people themselves, their socio-economic status, livelihoods, access to markets and prior land situation can hinder any theoretically beneficial land reform effects. For example, rural farmers may be less likely to receive credit from banks because of the perception by banks that they are "risky" investments.
5. *Access to micro-credit is not necessarily positive.* While many people in the development field see micro-credit as the "new poverty solution", it is still a loan. And for many, I would argue this loan is not seen as a business opportunity, but a necessary evil, something better than the other alternatives available (such as loans from stores with extremely high interest rates)²⁴. In addition, obtaining a micro-credit loan does not mean an automatic improvement in one's life or business. Often, micro-credit loans are not used for capital investments, which can numerous positive long-term effects. Having a loan often ties recipients to use any net profits for business investments only, not improvement in their standard of living.

The case of Peru demonstrates that not everything works as well in practice as it does in theory. De Soto's idea of bringing millions of poor into the legal sector may have been a novel one, but whether or not land titles can be used to transform invisible wealth into visible capital is yet to be seen. One critical commentator summarizes, "On the white board, de Soto's ideas flatter the imagination and sensibilities of Davos-types²⁵ (especially the American ones). But on the ground, it turns out that de Soto's ideas are doing very little to solve the actual problems of poor people" (Gravois, 2005, p. 1).

Policy Implications

There are numerous policy implications that result from the lessons learned in this case. The ones stated below merely scratch the surface, and should be considered in addition to the many characteristics highlighted in the World Bank Report (2003) and Dale and McLaughlin (1999). While they will not solve the legitimacy questions concerning property rights reform or micro-credit, they are suggestions that, based on this case study, could ensure property rights reforms are effectively implemented and

informal properties are brought into the legal sector:

1. Special attention should be paid to those who have traditionally been disadvantaged by previous reforms, such as former indentured servants, or those who have traditionally faced barriers to climbing the socio-economic ladder, such as indigenous peoples.
2. The government needs to demonstrate unfaltering support for property right reforms. De Soto recommends this support should be top-down, which would help ensure the needs of the poor are incorporated. This top-down support is absolutely necessary; if government is not supportive of reforms, citizens will not believe they are legitimate. Political bias or corruption should also be minimal, as it will decrease the legitimacy of these programs.
3. Reforms may need to be adjusted to fit regions or groups with specific needs. For example, communal landowners may need to be given special consideration, such as having the choice of individual or communal titling. De Soto recommends that laws be based on citizen norms, which is essential to making sure that moving into the formal sector is easy, safe and cheap for poor citizens.
4. Concurrent reforms, especially in credit markets, are necessary to ensure adequate access by new title owners to micro-credit. In general empirical studies, including Burce and Migot-Adholla (1994), and Feder and Akihiko (1998) (cited in Carter & Olinto, 2003) have supported the fact that investment impact is the weakest in areas where credit markets are weak and customary tenure institutions are strong. Carter and Olinto (2003) suggest that if land policy aims to achieve successful agrarian reform, it must have prior or at least simultaneous credit market reform. Credit reforms should include both promotion of credit access, which would increase the actual amount of credit available, and good credit market regulation, which would ensure that banks are using newly created collateral to lower information costs and decrease moral hazard. Regulation would also prevent banks from adjusting their lending criteria to other factors besides property titles, such as stable employment. While concurrent reforms are not the focus of de Soto's theory, he does briefly suggest that other reforms, such as collection systems for credit, are necessary to create capital.
5. Non-economic micro-credit services should be encouraged to ensure that micro-credit is working effectively. Research (for example Moser, 2000, and Daley-Harris, 2002) has begun to recognize that other factors may be necessary for micro-credit programs to realize their full potential. Loans are now combined with other social integration

programs, such as training, education, participation and social mobilization in an effort to maximize income and empowerment impacts (Sabharwal 2000). Because banks are often unwilling (citing financial incapacity) to provide these concurrent services, Bank-NGO partnerships could provide these needed programs. From his experience in the micro-credit field, M. Guadalupe says these partnerships are being implemented with much success currently in Northern Peru (personal communication, April 29, 2005). Savings programs have also shown to have positive results for increasing micro-credit effectiveness.

Sadly, although Latin America has made significant headway in its development efforts, today it is more unequal than ever. A World Bank study released in 2005 concluded that between the 1970s and the 1990s, Latin America and the Caribbean measured nearly 10 points more unequal than Asia and 20.4 more unequal than Eastern Europe using the Gini index of inequalities. With resources devoted to macroeconomic stabilization, there is often little money left for life-enhancing welfare programs. Progress, especially for the poor and indigenous, remains sluggish. Improvement can be made, but only if there is focus on the root of problem – poverty. Since poverty will not go away by itself, property rights reform and micro-credit have potential to help people help themselves, by empowering them to become part of the market economy. But only when these programs are implemented concurrently, and in conjunction with supporting services will there be any possibility that their objectives are reached.

References

- Apoyo Consultoria. (2000). *Encuesta de Línea de Base, Borrador del Reporte Final*. Proyecto Derecho de Propiedad Urbana, COFOPRI. Retrieved February 13, 2005, from <http://www.apoyo.com/acerca/cons.asp>
- Carter, M. & Olinto, P. (2003). Getting Institutions "Right" for Whom? Credit Constraints and the Impact of Property Rights on the Quantity and Composition of Investment. *The American Journal of Agricultural Economics*, 85(1), 173-286.
- Centro Peruano de Estudios Sociales. Retrieved March 2, 2005 from <http://www.cepes.org.pe>
- CGAP: Consultative Group to Assist the Poor. A World Bank Project. Retrieved February 13, 2005, from <http://www.cgap.org/>
- Dale, P. & McLaughlin, J. (1999). *Land Administration*. Oxford: Oxford University Press.
- Daley-Harris, S. (2002). *Pathways out of Poverty: Innovations in Microfinance for the Poorest Families*. Bloomfield: Kumarian Press, Inc.
- De Janvry, A., Sadoulet, E., McIntosh, C., Wydick, B., Luoto, J., Gordillo, G., Schuetz, G., Valdivia, M., Bauchet, J., Herrera, C.E., & Kormos, R. (2003). *Credit Bureaus and the Rural Microfinance*

- Sector: Peru, Guatemala, and Bolivia.* Joint project between the University of California at Berkeley and The FAO Office for Latin America. Retrieved January 28, 2005, from <http://www.basis.wisc.edu/live/credit/Credit%20Bureaus%20Peru,%20Guatemala,%20Bolivia.pdf>
- De Janvry, A., Gordillo, G., Platteau, J.P., & Sadoulet, E. (ed). (2001). *Access to land, Rural Poverty and Public Action*. Oxford: Oxford University Press.
- De Soto, H. (1986). *El Otro Sendero*. Peru: El Barranco.
- De Soto, H. (2000). *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*. New York: Basic Books.
- Field, E. (2002). *Entitled to Work: Urban Property Rights and Labor Supply in Peru*. Retrieved February 22, 2005, from <http://www.rwj.harvard.edu/papers/field/Field%20Do%20Property%20Titles%20Increase%20Credit....pdf>.
- Field, E. & Torero, M. (2003). *Do Property Titles Increase Credit Access Among the Urban Poor? Evidence from a Nationwide Titling Program. (Not final version)*. Retrieved February 22, 2005, from http://www.wps.princeton.edu/rpds/downloads/field_entitled_to_work.pdf
- Goff, J. and Mckechnie, L. (2004). *RED Rural Report: A Conglomerate of Rural Development Strategies*. Prepared by authors who were serving as ProPeru Service Corps volunteers for RED Rural Llusco-Santo Tomas, Urubamba, Cusco, Peru.
- Grameen Bank. Retrieved April 3, 2005 from <http://www.grameen-info.org/>
- Gravois, J. (2005). Hey, Wait a Minute: The De Soto Delusion. *Slate*. Retrieved April 17, 2005, from <http://slate.msn.com/id/2112792>
- Instituto Libertad y Democracia*. Accessed March 2, 2005, from <http://www.ild.org.pe/home.htm>
- Inter-American Development Bank (IDB). (1999). *Land Titling and Registration Project (PE - 0037) Executive Summary*. Retrieved February 13, 2005 from <http://enet.iadb.org/idbdocswebservices/idbdocsInternet/IADBPUBLICDOC.aspx?dcnum=46210>
- Kagawa, A. (2001). Policy Effects and Tenure Security Perceptions of Peruvian Urban Land Tenure Regularisation Policy in the 1990s. *International Institute for Aerospace Survey and Earth Sciences (ITC)*, Enschede, The Netherlands. Retrieved February 13, 2005, from http://www.ucl.ac.uk/dpu-projects/drivers_urb_change/urb_economy/pdf_infor_econo/ESFN_AERUS_Kagawa_Tenure.pdf
- Lall, S., Lundberg, M., Deichmann, U., Chaudbuty, N. (2002). *Diversity, and Commitment: Community Participation for Urban Service Provision*. World Bank Publication # 2862 Retrieved March 15, 2005, from http://wdsbeta.worldbank.org/external/default/WDSContentServer/IW3P/IB/2002/07/26/000094946_02071604225064/Rendered/PDF/multi0page.pdf
- Laporte, R., Petras, J., & Rinehart, J. (1971). *The Concept of Agrarian Reform and its Role in Development: Some Notes on Societal Cause and Effect*. Ford Foundation and Penn State University. Random House, Inc.
- Lastarria-Cornhiel, S. & Barnes, G. (1999). *Formalizing Informality: the Praedial Registration System in Peru*. Retrieved April 10, 2005, from the Land Tenure Center, University of Wisconsin, Retrieved March 15, 2005, from <http://www.wies.wisc.edu/ltc/rp131.html>
- Llosa, J., Gomez, R., & Shimizu, T. (2001). *Modernization of Agriculture in Peru in the 1990s*. Institute of Developing Economies, Japan External Trade Organization. Retrieved January 28, 2005, from ProQuest database.
- Plant, R. & Hvalkof, S. (2001). *Land Titling and Indigenous Peoples. (Publication # 346.0428 P282—dc21)*. Washington, D.C.: Inter-American Development Bank. Retrieved February 22, 2005, from <http://www.iadb.org/sds/doc/IND%2D109E.pdf>
- Sabharwal, G. (2000). *From Margin to the Mainstream: Micro-Finance Programmes and Women's Empowerment: The Bangladesh Experience*. Submitted in partial fulfillment for MScEcon in Development Management of the University of Wales. Retrieved March 15, 2005 from <http://www.gdrc.org/icm/wind/wind.html>
- Valdivia, M. *Ex-Post Costly Monitoring and Access to Credit in Peruvian Rural Economies*. Grupo del Análisis para el Desarrollo (GRADE), Lima, Peru. Retrieved February 22, 2005, from <http://www.grade.org.pe>
- Westley, G. (2001). *Can Financial Market Policies Reduce Income Inequality?* Washington, DC: Inter-American Development Bank Sustainable Development Department.
- World Bank (2003). Deininger, K. (ed). 2003. *Land Policies for Growth and Poverty Reduction*. Washington, DC: The World Bank and Oxford University Press.
- World Bank. (2005). *Beyond the City: the Rural Contribution to Development*. Retrieved February 15, 2005, from <http://www.worldbank.org/lac>

End Notes

1 For example, Adam Smith.

2 Because of the author's work in a rural micro-credit institution, and because poverty is more extreme in rural areas, examples using rural statistics will be used throughout the paper to highlight points made.

3 Although many micro-credit loans (especially those distributed in the group scheme) are not based on collateral, my assumption, based on my field work, is that collateral should nonetheless help improve the loan conditions for micro-credit, especially for individual loans.

4 A micro-credit institution, therefore, could fall into the formal category if a bank ran it, or the semi-formal category if an NGO or the Ministry of Agriculture ran it.

5 As compared to Bolivia's 27.83% and Chile's 6.86%.

6 The report includes conclusions from a survey of 35 clients of the micro-credit institution RED Rural, most of whom receive individual loans, in 11 small towns neighboring Urubamba. A copy of the report is available from the author.

7 Technically, the bank restricted the amount of the loan based on family income, but if interest rates were lower, families would be granted higher amounts from the bank.

8 From my field research in Peru, I would argue that unlike in the US, agricultural loans do not have a positive connotation in Peru. Most clients I talked to were not proud of the fact that they had micro-credit loans, and did not see them as a business opportunity as many farmers do in the US.

9 These are defined generally as a decrease in state involvement through privatization and a focus on improving macroeconomic stability indicators, by lowering fiscal deficits and controlling inflation.

10 By 1989, the Agrarian Bank had 230,000 borrowers, and 80.4% of these were small landowners and very small/small agriculture and livestock producers.

11 For a review of the literature on this matter, see World Bank, 2003 and Dale and

McLaughlin, 1999.

12 Dale and McLaughlin (1999) make similar recommendations to de Soto's, however they are more technical in nature. In addition, one step they recommend that de Soto does not is developing and/or improving a mapping and surveying system.

13 These are often called squatter communities, wherein residents occupy land and build temporary houses. Over time, they slowly build more permanent houses, demand services and government recognition, which they may or may not receive.

14 The ILD managed the property formalization program from 1988 to 1995 on behalf of the government. The purpose of this test period was to prove to the government that the program could indeed integrate vast amounts of extralegal property into the legal system. In February 1992 De Soto ended his relationship with President Fujimori due to fundamental political differences, but his original influence still affected the reforms. The government took over the process in 1995.

15 Reforms were aided by financial support from the US Agency for International Development and the World Bank.

16 Meaning property titles could be given based solely on occupation of a specific territory, not on ownership rights.

17 This number has been debated by critiques because some of these titles were simply a transfer from the old property rights system.

18 Collective titling is a process in which the community gains a title to its communal land and any further actions have to be agreed upon by a majority of the community. Sale or mortgaging of communal lands require the approval of a certain percentage of the community's general assembly.

19 Some experts question these numbers because for some properties, information was simply transferred from Registro de Propiedad Inmueble (RPI), the traditional registry, to Predial. This extent has not been revealed.

20 This refers to titles that were given out before the COROPRI titles by municipality governments.

21 Results were compiled from social welfare surveys conducted by ENNIV in 1997 and INADUR 1996.

22 These statistics come from Encuesta de Línea de Base Cofopri 2000, which uses the "integrated method" to measuring poverty. This is a new method that is based on the "line of poverty approach", which establishes that people who cannot buy a basic basket of goods are under the line of poverty, and people who cannot buy a basic basket of food for meals are under the line of the extreme poverty. But, the integrated method also incorporates: 1) the method of the unsatisfied basic need, which says that a "household" is poor if the head of the household is illiterate, the house's roof is made of straw, and the household lacks of drinking water; 2) households per capita expenses; and 3) the ability to pay for basic needs. For more information on the methodology of the Cofopri study, please see Apoyo Consultoria, 2000, p 18. (D. García, personal communication, April 29, 2005).

23 However, there were 30 or fewer observations for the highest level, without documents (100%), making this data less statistically significant.

24 Based on my interviews with campesinos in Peru.

25 The term is sometimes used to represent economists at the World Economic Forum (WEF) in Davos, Switzerland, who often support free market values.