Policy brief
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The importance of property rights for successful urbanisation in developing countries

In brief

- Many researchers have described Africa's unique form of structural transformation as "urbanisation without industrialisation."
- Africa's urbanisation also differs from historical patterns because it is occurring without a simultaneous development of land property rights.
- While the literature on institutional economics is large, few studies examine the role of property rights in creating well-functioning cities.
- To highlight this link, this policy brief presents an overview of the existing literature on economic institutions and how it can be applied to current trends in urbanisation.
- The authors conclude weak property rights in African cities are likely linked to reduced investment, inefficient labour allocation, and lower tax revenues.

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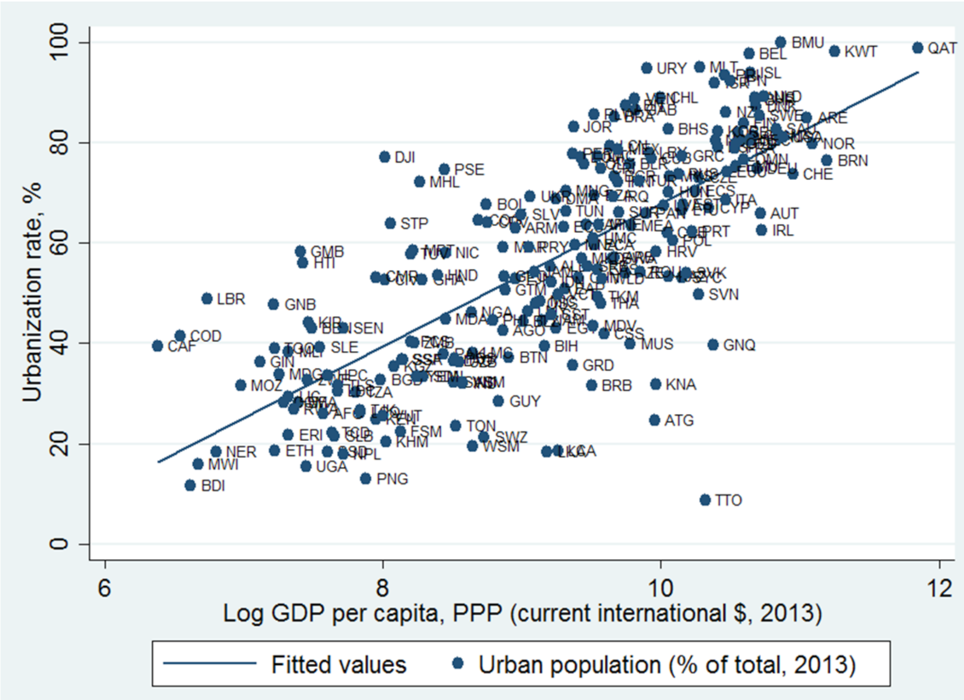
Introduction

Well-functioning cities are critical for economic development. Evidence from today's developed countries and rapidly emerging economies shows that urbanisation is an important source of dynamism that can lead to enhanced productivity and increased incomes. In fact, no country in the industrial age has achieved high income status without urbanisation, and there exists a strong association between per capita income and urbanisation (Figure 1). International evidence reveals that the elasticity of income with respect to city population is between 3% and 8% (Rosenthal, S. S., & Strange, 2004).

Figure 1: Urbanisation and economic development

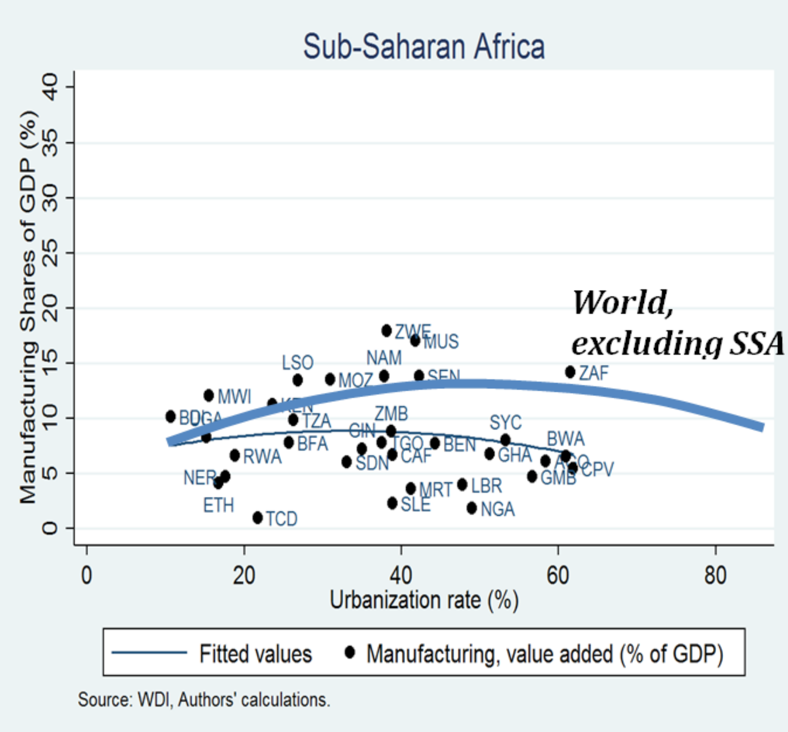


Source: Authors' calculations based on World Development Indicators (2015).

There are many benefits to larger cities which stimulate economic growth. Certain public goods—like infrastructure and basic services—are cheaper to provide when populations are large and densely packed together. Firms that are located near each other can share suppliers which lower input costs. Thick labour markets reduce search costs as firms have a larger pool of workers to choose from whenever they need to hire additional labour. And increased spatial proximity makes it easier for workers to share information and learn from each other.

Historically, such gains have been linked to structural transformation and industrialisation. But, few African cities are expanding their manufacturing sectors—at least, not at the same rate as cities in other regions (Figure 2). This has led many authors to describe Africa's unique form of structural transformation as "urbanisation without industrialisation" (Fay and Opal, 2000; Jedwab, 2013; Gollin et al, 2016).

Figure 2: Urbanisation and industrialisation



Source: Authors' calculations based World Bank Development Indicators, 2015.

Africa's urbanisation differs from historical patterns in another way as well: it is occurring without a simultaneous development of land property rights. As described by Cai, Harris, and Seinbuks (2016): there is now a trend in many low-income countries of "urbanisation without formalisation." Weak property rights—particularly in urban areas—can slow down the industrialisation process by making it harder for entrepreneurs to acquire land for emerging industries (Cai, Harris, and Selod, 2016). By contrast, secure property rights are believed to raise incomes by encouraging people to invest in both themselves and in different forms of physical capital (North, 1990; Acemoglu, Johnson, and Robinson, 2005).

While the literature on institutional economics is large, few studies examine the role of property rights in creating well-functioning cities. To highlight this link, this policy brief presents an overview of the existing literature on economic institutions and how it can be applied to current trends in urbanisation.

Institutions and economic growth

According to Douglass North (1990), institutions are "the rules of the game in a society or, more formally, the humanly devised constraints that shape human interaction." Institutions consist of both formal rules—like a country's system of property rights—as well as informal constraints—like customs, traditions, or codes of behavior. Throughout history many types of institutions have been created by societies to establish order and reduce uncertainty in exchange. Such "institutions provide the incentive structure of an economy; as that structure involves, it shapes the direction of economic change towards growth, stagnation, or decline" (North, 1991, p. 97).

Broadly speaking, there are two types of institutions that affect economic outcomes: property rights and contracting institutions. Property rights are the rules of society which enable people to keep the returns on their investments while contracting institutions are the rules which enable people to make contracts and resolve disputes. Secure property rights are important to the growth process because they encourage people to invest in physical and human capital, as well as technology. Similarly, effective contracting institutions facilitate the expansion of trade, thereby promoting greater occupational and geographic specialisation.

Coase (1960) was the first to make the crucial connection between institutions, transaction costs, and neoclassical economic theory. He viewed firms and markets as alternative means of organising economic activity. Specifically, a firm can either buy a product (or service) from another firm or make it by itself. Whether it buys the product or makes it depends on the relative cost of each activity. All markets involve costs and such costs affect market structure. Reliance on markets is more likely when: 1) there is little uncertainty; and 2) there are many firms (competition) and limited opportunities for opportunistic behavior. The neoclassical result of efficient markets occurs only when transaction costs are zero. In other words, institutions don't matter when bargaining is costless (that is, when there are no transaction costs). However, effective institutions—like secure property rights—matter when transaction costs are not zero.

During the early stages of economic development, the state does not typically enforce contracts which can lead to high transaction costs and limited impersonal exchange—that is, trade between people who do not know each other (North, 1991). But, as the size of the market expands, there is greater demand for effective institutions which lower transaction costs and reduce risk. Such contracting institutions are important to the growth process because they promote specialisation through the expansion of both local and distant trade. According to North (1991), the development of effective contracting institutions in Northern Europe during the medieval age was instrumental in stimulating the rise of cities, thereby promoting geographic specialisation and economic growth.

Property rights and investments

According to Besley and Ghatak (2010), property rights can be defined as "an owner's right to use a good or asset for consumption and/or income generation (referred to as 'use rights')." Importantly, this definition includes both the right to transfer property to an outside party and the right of the "owner" to engage in contracts with other parties for the temporary use of property.

Recently, De Soto (2000) has argued that the formalisation of property rights can provide individuals with collateral and thus access to credit which, in turn, can be used to facilitate other transactions. For example, an individual who would like to set up a firm might be able to access credit by using their house or other property as collateral. Although De Soto is a strong proponent of this link, the empirical evidence supporting such a relationship is weak.

While economic theory predicts that stronger property rights should lead to a higher rate of investment and economic growth, measuring this relationship is not straight forward. Econometric problems arise because property rights are intrinsically hard to measure and their allocation is usually endogenous. This leads to potential issues of reverse causality where improvements in the investment environment could lead to stronger property rights (because investors demand institutional change) rather than stronger property rights leading to greater investment (because investors face reduced uncertainty). To overcome this problem, there is now a growing literature which exploits changes in property rights across both time and space to understand how they affect investment. In the next section, we provide a short overview of this literature.

Property rights and urbanisation

Understanding the dynamic mechanisms through which stronger property rights affect investment is critical for policymakers to better manage the urbanisation process. To this end, there is now a growing body of empirical evidence which reveals how the formalisation of property rights—specifically land titling—can raise the level of investment in developing countries.

Housing and infrastructure investments: Galiani and Schargrodsky (2010) exploited a natural experiment in Buenos Aires, Argentina where squatters on private land were given land titles via an expropriation bill that compensated the previous landowners for their land. While some landowners agreed immediately to the compensation plan, others contested the legality of such a land transfer. Due to a lengthy legal process, some squatters received their land title before others. Importantly, the compensation claims made by different landowners were randomly allocated. This meant that the timing of formalisation could be viewed as exogenous. As a result, Galiani and Schargrodsky were able to measure the difference in investment between those squatters with land titles and those without. Their results revealed a causal link between stronger property rights and greater housing investment.

The results of Galiani and Schargrodsky suggest that an expansion of land titling in low-income countries could raise the level of investment in privately-owned housing. Low-quality housing is a large problem in African cities where more than 60% of urban residents currently live in slum housing (UN Habitat, 2012). Given the fast pace of African urbanisation, this percentage is likely to rise unless new policies are implemented which increase the rate of investment in private housing.

Implementing successful land titling programs, however, can be difficult. During the 1990s and early 2000s, several African countries proposed land reform programs which offered land titles to millions of poor households but few of these programs were successful. In some cases, the perceived benefits from obtaining a land title did not justify its cost. Recent empirical evidence from Tanzania, for example, reveals that the high price of formal titling acted as a barrier, preventing a broader expansion of the land registry in urban areas (Ali, Collin, Deininger, Dercon, and Sandefur, 2014).

Weak property rights affect not only the level of private investment in urban areas but also the level of public investment. When land rights are contested, it is difficult for urban authorities to invest in public infrastructure—like roads—due to the prohibitive costs associated with transferring land from private to public use. Transaction costs rise when public authorities face multiple land owners who demand compensation for the same piece of land or whose ownership must be contested in court. Weak property rights are one of the reasons why some African cities—like Kampala— face rising levels of traffic congestion and air pollution due to an outdated road network which cannot accommodate the rising volume of traffic.

Taxation: Well managed cities must have an efficient system of revenue generation in order to finance needed public investments. Collier (2016) notes that one source of revenue generation which is currently not being exploited by most African public authorities is the appreciation of land values in urban areas. As cities expand, urban land prices rise but few local municipalities take advantage of this growing source of tax revenues.

In this context, Kopanyi (2016) emphasises that property related taxes provide the highest potential for municipalities to raise their own-source revenues. In many cities in developing countries, these revenues already make up between 30% and 50% of local revenue collection (Franzen and McCluskey 2013). However, in most African cities, the income generated from land taxes is still far below its potential. Only a small fraction of property taxes is captured due to the current low level of land titling and registration. Thus, the creation of up-to-date property registers is a critical first step toward ensuring that municipal governments can finance the growing demand for infrastructure and public services.

Labour: Finally, stronger property rights can result in a more efficient allocation of labour. When property rights are insecure, workers are likely to allocate a certain amount of their time to guard property from expropriation (Besley and Ghatak 2010). Field (2007) finds evidence of such time allocation among urban households in Peru. She shows that an increase in tenure security, in the form of a title, affects a household's labour supply. This is because workers who have such a title no longer worry about eviction and are thus willing to seek work further away from their home. Field finds a significant effect on labour supply: it is equivalent to the addition of one full worker per week to the labour force over a four-year period. Complementary results are found by Galiani and Schargrodsky (2010) in their work on land titling in Buenos Aires. They find that an increase in land titling significantly increases household investment in human capital by lowering the fertility rate and improving educational outcomes.

Conclusion

Most economists agree that effective institutions, including secure property rights, are critical for sustained economic growth. Less agreement exists, however, on the exact mechanisms through which institutions stimulate growth. Few studies, for example, have examined the role of institutions in generating well-functioning cities. Weak property rights in African cities are likely linked to reduced investment, inefficient labour allocation, and lower tax revenues, thus lowering both the living standards and productivity of millions of African households.

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