SAIS Review vol. XXVII no. 2 (Summer–Fall 2007)

The Importance of Property Rights to Development

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This article explores the difference that the institution of property rights has made to the economic and political life of developed countries and the promise it holds for developing countries. By shaping the incentives of individuals and undergirding the institutions of society, a strong property rights regime lays the foundation for growth, freedom, and overall well-being. For individuals, property ownership entails opportunity, responsibility, and economic freedom. For society, these translate into investment, innovation, the possibility of widescale exchange, and even improved governance.

Development begins with individuals. Consider a small-scale entrepreneur. In order to grow a business, an entrepreneur must devise ways to increase productivity, acquire or develop new technology, invest in employees and equipment, and plan for the future. Whether the entrepreneur ultimately succeeds will depend on the resources employed, the availability of markets, and the stability of society, among other things. Yet it is the individual who has the power to innovate, make decisions, and pursue goals. A development policy that unleashes this power, motivating constructive individual behavior, is the most likely to achieve sustainability.

What can motivate an entrepreneurial spirit in individuals? More than any other single factor, a sound property rights regime can do this. Property ownership induces individuals to undertake effort and risk that they otherwise would not. Or as former Secretary of the Treasury Lawrence H. Summers put it, "In the history of the world, no one has ever washed

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This article explores the difference that property has made to the economic and political life of developed countries and the promise it holds for developing countries. By shaping the incentives of individuals and undergirding the institutions of society, property lays the foundation for growth, freedom, and overall well-being. The route to better property systems lies through improved governance and regulatory reform.

The Influence of Property Over the Fates of Nations

The divergent histories of Spain and England from 1500 to 1700 illustrate the decisive importance of property rights to long-term development. The Spanish monarchs built and maintained an empire on the strength of revenues from New World treasure and commerce in the Low Countries. However, they failed to create a domestic environment that could sustain future growth. Within Spain, the monarchy primarily taxed sheep—which roamed across the countryside—and failed to institute a system of agricultural property rights. Pressed by the expense of warfare and the revolt of the Low Countries, the Crown increasingly confiscated property from commercial, industrial, and agricultural interests and unilaterally repudiated its debts. These burdens deterred productive activity and innovation, leading to long-term decline.[1]

The English monarchy, like the Spanish, had limited respect for private property, made grants of monopoly privileges to royalty, and presided over guilds regulating production. The Tudor and Stuart monarchs also sought to expand their tax revenues but never acquired the absolute power to do so. Parliament fought the Crown on behalf of merchants and the gentry for the right to determine taxation, for the elimination of monopolies, and a property rights regime grounded in law. Parliament's eventual victory meant that the government would continue to receive revenues but would henceforth defend property rights instead of expropriating property. More than that, civil and economic liberties were expanded. The subsequent development of competitive markets and strengthening of economic incentives for innovation in the eighteenth century set the stage for the Industrial Revolution.[2]

The European powers successfully exported many features of their political economic systems and institutions to several of their colonies. Those countries that inherited strong property rights and other fundamental institutions of a market economy prospered while other countries that lacked them—regardless of European cultural influences—experienced slow or negative economic growth.[3] This is not exclusively a Western phenomenon, as can be seen from the Korean experience. Starting with similar endowments at the time of the Korean War, South Korea and the North adopted radically different economic systems. Subsequently, the South thrived by respecting

property and encouraging markets, whereas the North, which abolished private property, languished.

In the developed world, the role of property as a foundation for economic growth is commonly taken for granted because it is omnipresent and generally secure. By contrast, the effects of the absence of property are acutely felt in many developing countries. These effects are typically manifested by a disproportionately large level of informal economic activity. In the informal sector, people still have possessions, but these possessions are not formally recognized and therefore not protected as legal property. "They have houses but not titles; crops but not deeds; businesses but not statutes of incorporation."[4] Consequently, people in this sector—mainly the poor—cannot leverage their assets for growth.

Research by the Institute for Liberty and Democracy has documented the costs of informality and the amount of undercapitalized assets held by the poor. In Lima, Peru, a house with a title is valued at nine times more than a similar house without one. A street vendor in Lima must pay a premium of between 98 and 495 percent for real estate compared to formal merchants just to acquire an uncertain, extralegal right to occupy his or her place of business.[5] Informal homeowners and traders—who account for a majority of Peru's housing and businesses—remain at risk of eviction. Despite such costs and risks, the poor around the world have amassed an estimated U.S. $9.3 trillion in real estate without legal ownership.[6]

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The Benefits of Property to Individuals and Society

Owners of formal property enjoy numerous benefits, which allow and encourage them to engage in socially productive behavior. Property ownership affords the exclusive right to determine the best use of one's assets. The security and freedom from interference that property rights entail induce owners to invest in and improve their property. Another significant property right is the right to transfer property, which makes it liquid and a source of capital. This means an owner can improve a property, knowing that he or she can later sell it and reap the added value. It also means a home can be mortgaged to provide start-up capital for a small business. A buyer benefits, too, from better information about an acquisition and the certainty that the transaction will be honored. Finally, a well-defined property system frees an owner from wasting time and resources on establishing rights to use a property and resolving disputes over it.[7]

Property provides an essential foundation for market economies. Without formal property, contracts are impossible to settle and transactions may be reliably completed only among parties who personally know and trust each other. Under strong property rights and contract enforce-

ment, exchanges may occur between strangers and across long distances. In addition, property ownership documents provide information about who controls which assets. These advantages in turn expand choices, facilitate specialization and economies of scale, and generally expand economic productivity and efficiency. Other features of modern market economies, such as joint stock corporations and sophisticated private capital markets, also depend on the definition and enforcement of basic property rights.

In addition to efficiency gains in production and exchange as well as higher rates of saving and investment, it is increasingly recognized that property has a profound impact on innovation. The enormous growth of market economies since the industrial revolution has been driven not simply by gains in efficiency but by rates of innovation unmatched anywhere else in history. Markets, in turn, have spurred competition over innovation in addition to their commonly understood role in creating price competition.

One key way they do so is through inspiring and rewarding entrepreneurship. Entrepreneurs change the economic landscape by introducing new firms, technologies, products, and business methods. Property gives entrepreneurs the freedom to try new things, market their innovations, and earn profits that offset the risks and investments they undertake. Without the prospect of winning a competitive advantage, entrepreneurs will not assume these risks.[8]

The distinction between innovation and invention must be stressed. Inventions can occur in various kinds of economic systems, may be motivated and funded in different ways, and can occur as the result of research and experimentation or pure accident. On the other hand, entrepreneurs, and market systems more generally, excel at *innovation,* which involves bringing inventions to market, adapting technologies for practical use, and improving business processes and products in myriad ways, often incrementally. For example, medieval China produced countless inventions of tremendous potential, including paper, porcelain, movable type, gunpowder, the spinning wheel, a mechanical cotton gin, and ship technology. Unfortunately, the government frequently expropriated inventions and private wealth, in turn discouraging innovative, economically productive behavior. That these remarkable inventions were not widely applied and failed to spark growth of any historical consequence is likely attributable to government expropriation.[9]

Leading Chinese producers of consumer goods struggle to establish respected brand names because of piracy.

In contemporary China, businesspeople have begun to identify a need for stronger protection of intellectual property rights (IPRs) to sustain recent growth and open new avenues for dynamic businesses. While foreign companies have complained of weak safeguards against intellectual piracy, domestic producers have likely suffered more from this weakness. In par-

ticular, leading Chinese producers of consumer goods struggle to establish respected brand names because of piracy. The inferiority of imitation goods compromises the reputation—and the marketing investment—of the original creators. A better system of IPRs would afford higher quality products for consumers and opportunities to move up the value chain for producers. An IPR system promotes the most social benefit in terms of innovation and technological diffusion when combined with a full range of competitive markets. China has already joined international conventions on IPRs, but needs to improve on administration and enforcement.[10]

Property and Institutional Development

Although property can be credited as the leading catalyst for growth, it must be accompanied by rule of law in order to function. That is to say, property rights must be established and respected by government and fairly enforced through a legal system. The case was made strongly by Jeremy Bentham: "Property and law are born and must die together. Before the laws there was no property; take away the laws, all property ceases."[11] In this way, property cannot be instituted in isolation from good governance and justice. Conversely, the widespread desire for property and the economic benefits it brings creates powerful demand for the development of governance and legal institutions. In other words, property reform can encourage the development of a range of important institutions. "Property may be regarded as a tree of which social institutions are as branches growing from a trunk that it puts forth."[12]

As a core institution, property changes individuals' behavior in fundamental ways. To put it differently, property (combined with competition) channels a common desire for material gain into socially productive behavior. This is the essence of Adam Smith's notion of the invisible hand.[13] Thus, entrepreneurs are encouraged to take risks and be creative about ways to improve production and serve their customers. To repeat the Lawrence H. Summers quote, "In the history of the world, no one has ever washed a rented car." In contrast, owners are made to be accountable for their possessions and be careful how they handle them. Everyone who is given an opportunity to own some property acquires a stake in society.

What's more, secure property rights can discourage rent-seeking, a behavior manifested when producers seek privileges, protection, and resources from the government in a bid to shield themselves from competition. This behavior burdens the government and shifts resources away from their optimal productive uses. In its extreme, it can smother private initiative and foster an unhealthy dependency on government. Instituting secure property rights can divert the rent-seeking attention of producers away from government and toward efficient and innovative activities. When a multitude of private producers enjoy secure property rights and government ownership is limited, fair competition ensues.[14]

Sovereigns, too, change their behavior when constrained to respect property rights. Historically, sovereigns made little or no distinction be-

tween their private holdings and public land and revenue. They could arbitrarily reassign or expropriate private land and wealth. This changed with the evolution of modern property systems, which roughly paralleled the evolution of constitutionalism. Governments could no longer violate civil liberties. They had to rule by and respect laws, consequently being held accountable by taxpayers. Taxpayers and property owners would henceforth dictate the appropriate division and use of public and private properties.

Since then, the world has witnessed both the expansion and destruction of political and economic freedoms, but property has been recognized as a fundamental right in the Universal Declaration of Human Rights, Article 17. Property serves as a pillar of democracy in four ways. It provides protection for the security and civil liberties of the individual. Second, it limits governmental control of economic resources while fostering pluralism and competition. Third, it requires and is associated with constitutionalism and the rule of law. Finally, it makes possible opportunities and prosperity that give individuals a stake in democracy and enhance democratic legitimacy.

The Transition to Formal Property Systems

Property is by its nature an exclusive right. The extension of this right beyond an elite class serves to include the majority of the population in the formal economy—indeed in the global economy. In developing and transitional countries, the creation of a fair, effective property system expands opportunities and breaks down hurdles to growth. Creating such a system involves much more than devising a comprehensive, consistent set of laws and regulations. Laws must be harmonized with local customs and economic realities and backed by the necessary degree of administration and enforcement.

In Russia, for instance, international experts were brought in to craft a state-of-the-art corporate law when state-owned enterprises were privatized. Because this law and others were not enforced, the privatization had perverse effects. The new controlling owners, who took advantage of political connections, stripped the assets of the privatized corporations while the rights of minority shareholders were ignored. Small business owners in Russia were also denied secure property rights, since the buildings they own must be leased from the government. In this environment, corruption expanded and undermined the development of an independent, legitimate private sector.

In many developing countries, the property laws on the books have been written from the perspective of those already inside the formal economy. Consequently, these laws neglect the reality of the majority of economic activity in the informal sector. In these countries, the expansion of regulations and heavy-handed enforcement usually fails to achieve its intended objectives. This only pushes more economic activity underground and makes it harder for informal entrepreneurs to join the formal sector and make a living.

Hernando de Soto found an elegant solution in Indonesia to the problem of defining adequate property rights for the informal majority. He discovered that each time he crossed an invisible property boundary in the rice fields, a different dog would bark. So by listening to the barking dogs, one could map out existing property boundaries. De Soto's insight is that people everywhere establish local conventions for their property needs. By investigating these conventions and integrating them into formal law, their holdings can be converted into assets with value that extends beyond the immediate community. Laws founded on local norms and conventions enjoy greater legitimacy as well practicality and thus are better recognized and enforced.[15]

It has in fact proven possible to expand legal ownership on a large scale by issuing titles for homes and deeds of incorporation for businesses. Since the 1980s, reforms have allowed 6.3 million poor Peruvians to acquire legal ownership of their real estate, according to the Institute for Liberty and Democracy. ILD further estimates that formalization of 380,000 businesses generated 560,000 new jobs and raised annual tax revenue by $300 million.

Entitlement has encouraged families to invest more in their houses. At least 40 percent of newly entitled households in Buenos Aires have installed relatively high quality walls and roofs. These families also invested more in the education of their children.[16] Residents of Peruvian urban squatter settlements invested in housing renovation at a 68 percent higher rate after receiving title.[17] Possession of a title, though, has not necessarily resulted in increased access to bank credit, which often depends on income from a formal job.[18] Although these findings suggest mortgages may not become a primary source of financing for entrepreneurs in poor countries, it should be recalled that property rights, not credit, play a crucial role in determining entrepreneurs' levels of investment.[19]

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It should be clear that formalization of housing and businesses benefits the poor via greater reliability and security of these assets. This formalization also raises new and worthwhile challenges. Further institutional developments and adjustments will be required to facilitate exchange of property, contracts, extension of credit, resolution of bankruptcies, and effective enforcement. It is this complex of institutions, combined with liberalization, that makes possible the emergence of a true market economy. The granting of basic property rights, however, is absolutely necessary and an excellent place to start.

Programs to Strengthen Ownership and Reduce Informality

The Center for International Private Enterprise (CIPE), an affiliate of the US Chamber of Commerce, assists private sector organizations around the world that advocate for stronger property rights and a better business climate. In focusing attention on property rights reform, CIPE promotes the institutional foundations of both free market economies and democratic political systems.

CIPE's programs encompass much more than the definition of property rights through titling and business incorporation. These rights can be defended and exercised only when complementary institutions are in place. For instance, a statute of incorporation would not benefit the owners of a business if excessive licensing requirements inhibited the actual operation of the business. The value of ownership to businesses can be compromised by regulatory burdens, government harassment, corruption, inefficient courts, and weak corporate governance. CIPE addresses these various institutional failings in order to strengthen ownership, reduce informality, and encourage entrepreneurial growth.

The best way to approach these complex problems, in CIPE's experience, is to involve representatives of formal and informal businesses in the identification of reform priorities and mobilize them around solutions that benefit the business community as a whole. A concerted advocacy campaign gets the attention of policymakers and builds momentum for reform.[20] CIPE has helped private sector leaders undertake a wide variety of campaigns to resolve property-related issues—three of these campaigns are described below. The common elements of these efforts have been a focus on advocacy and local ownership of the reform process itself.

Russia

Small and medium-sized enterprises in numerous Russian regions faced difficulties in gaining access to nonresidential building stock. Although many factories and buildings had been privatized, the land on which they rested was still owned by regional or municipal authorities intent on maintaining a revenue stream from rental payments. Rents were high, lease agreements short-term—typically one year with no guarantee of extension and no option to buy—and lessees saw no incentive to invest in the maintenance and repair of premises. In Primorsk region, for example, one in three businesspeople cited renting property as the most labor-consuming and expensive task they faced. Steep increases in rental rates, a lack of sound procedures to calculate rent, no accounting system for repairs, and unfair practices in contracts rendered the property market opaque and strongly detrimental to business activity.

From 2003 to 2005, CIPE brought together business associations and leading individuals in eight regions to develop a series of business agendas for improved private sector growth. Participants worked with colleagues from their region to identify common obstacles and key development objectives. They then mapped out strategic coalitions to address individual issues with regional public officials.

The Krasnodar coalition, to cite one example, submitted a model agreement on the rental of municipal premises, featuring provisions for the cost of capital repair and preferential extension of rental agreements for tenants in good standing. The coalition also proposed the establishment of an accessible municipal property registry and economically justifiable, competitively based rates for rental of municipal property. Specialists provided technical assistance to entrepreneurs on leasing documentation. The coalition pushed for the revision of municipal leasing rate factors, which were lowered for some entrepreneurs, such as small trading businesses. Elsewhere, the Primorsk coalition successfully campaigned on behalf of small businesses for the cancellation of a 250 percent increase in rental rates in Vladivostok.[21]

Montenegro

An economic think tank and CIPE partner, the Center for Entrepreneurship and Economic Development (CEED) analyzed the business registration process in Montenegro. This analysis exposed the need to simplify the registration process, make it less costly and less time consuming, and reduce the amount of capital required. CEED established that it took 45 working days or more to register a firm, through a maze of institutions and at the discretion of government bureaucrats. In addition, firms had to re-register every year. CEED widely distributed its study "Barriers to Doing Business in Montenegro" among the private sector and policymakers, and successfully advocated for changes through the working group appointed to draft the new Enterprise Law. "Barriers to Doing Business" earned CEED a 2005 Templeton Freedom Prize for free market solutions to poverty.

The Enterprise Law—largely drafted by CEED—was passed in January 2002. Under the new law, it now takes four days and one dollar to register a firm, whereas previously it took 5,000 dollars. A firm is automatically re-registered if not called within one day by the government. Today over 15,000 entrepreneurs and 14,500 other legal entities have registered. CEED helped over 4,000 companies register free of charge.[22]

Kenya

In Kenya, millions of smallscale entrepreneurs and workers in the *jua kali* sector supply goods to local markets using predominantly manual labor and little capital, often making do with handmade tools. Local authorities continually harass these small businesses by arbitrary arrests, chasing them from their temporary business locations, confiscating their goods and tools of trade, causing property damage, asking for bribes, and at times, even assaulting the entrepreneurs. As business owners are unable to secure ownership over their shops and land, they have difficulty accessing credit. Cumbersome laws and regulations further inhibit the growth of *jua kali* businesses.

To protect themselves from government abuse and improve the conditions under which they operate, *jua kali* businesses have banded together and formed their own associations. Several of these associations have capitalized

on skills and strategies their leaders acquired during a workshop held by CIPE in Nairobi in 2004. They have subsequently improved the professionalism of their organizations and enhanced benefits for their membership. Normally, *jua kali* operators are expected to pay many taxes that they cannot afford, as well as obtain multiple licenses for the same business. However, the associations have negotiated single licenses for their members at a reasonable cost.

Participating associations from the 2004 workshop have joined together to form a new grassroots coalition, the National Informal Sector Coalition (NISCO). NISCO has advocated that the government allocate titled land to members, renovate shed structures housing *jua kali* businesses, and provide basic utilities such as water and electricity. So far, besides government commitments to financing and procurement opportunities, NISCO has obtained a large hawkers market in Nairobi, expected to be completed by the end of 2007. The President of Kenya presided over the ceremony launching the market.[23]

From Informal to Formal: "Top Ten" Priorities

During a workshop hosted by CIPE at the November 2000 assembly of the World Movement for Democracy, participants generated a list of ten priorities to legalize the informal sector and to tap its growth potential. These priorities outline a set of integrated measures to develop property rights regimes, allow owners to make good use of their rights, and improve democratic governance. While the problem of informality involves more than just property rights, it takes an integrated, institutional approach to solve these problems.

1. Instituting transparent, inclusive decisionmaking procedures and providing regular opportunities for the public to comment on existing and proposed laws and regulations.

2. Clarifying and streamlining legal and regulatory codes by eliminating duplicative, superfluous laws that increase the cost of doing business and invite corruption.

3. Making private property rights accessible to all citizens, clearly defined, and strongly enforced.

4. Simplifying business permits and licenses and making them affordable so that becoming part of the formal economy is within reach for entrepreneurs of modest means.

5. Reforming tax systems in order to encourage profitable economic activity and promote widespread compliance.

6. Overhauling labor laws to allow for more flexibility.

7. Reforming economic systems through improved corporate governance legislation to encourage open markets rather than crony capitalist systems. These include adopting internationally accepted accounting

principles, standards of disclosure, and anti-trust & anti-conflict of interest measures, as well as prohibiting insider trading and overhauling bankruptcy laws.

8. Reforming excessively bureaucratic government agencies and strengthening their administrative and enforcement capacity so that laws and regulations are administered and enforced efficiently, effectively, and inexpensively.

9. Making available to all citizens such business-related information as how to obtain a license or permit, how to start a business, how to form commercial entities, and how to run a business.

10. Bringing about a high quality, efficient, and cost-effective infrastructure essential for a democratic, market-based system so that entrepreneurs benefit from joining the formal sector.

Conclusion

There is a growing consensus among development agencies, academic experts, and developing country governments that fundamental institutional reform has to be built in partnership with local agents of change, especially those in civil society and the private sector. Certainly, CIPE's experience in developing countries, like that of many others who support democratic and market oriented reforms, validates the idea that civil society and the private sector have to be the drivers of reform. They can provide pertinent information about how new rules and institutions will affect them, and who can build political support for beneficial changes.[24] They must take ownership of institutional reform to establish a well-governed, growth-oriented environment.

As has been shown, the development of an effective, fair property rights system has broad, positive ramifications for development. Across different eras and different parts of the world, the formal institution of property has been an essential element of sustainable growth. It has also contributed to the development of other institutions of good governance. There is, however, no single property regime that can fit all societies. Property systems are complex, and therefore must be adapted to local conditions, not simply dropped in place. Cultural and historical factors influence what may be acceptable. Because property laws must be enforced in order to be effective, they must be aligned with the judicial system and other relevant institutions and laws.

What should be kept in mind in devising any property system is that property must be dynamic, not static. Property is not simply treasure that can be stored away, like gold in a vault. Gold does not generate new wealth or improved well-being; rather, productivity gains and innovations do. As a dynamic asset, property enables the creation of new investment and wealth. Similarly, property is not simply extracted or redistributed from one party to another. It plays an essential role in expanding the total wealth available in socially beneficial ways.

To have a complete, functioning market system, other key institutions must be in place, such as the legal system, contract law, laws that ensure competition, and even representative political institutions.

A strong property rights regime should be regarded as a key component of sustainable, long-term growth, not a short-term panacea. To have a complete, functioning market system, other key institutions must be in place, such as the legal system, contract law, laws that ensure competition, and even representative political institutions. There are costs in instituting property reform, including administrative costs and disputes to resolve. Still, the process of establishing a property system and overcoming these challenges can itself help a society to develop. Every society begins from a different point, but all societies can benefit from respect for property and the promotion of investment, commerce, and innovation.

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