

ORER Letter

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The Creation of Property Rights in Peru Hernando de Soto

After establishing himself as a successful businessman in Switzerland, Mr. de Soto returned to his native Peru in 1979, when democratic reforms were promised by the socialist regime. Studying the diverse living standards among Peruvian communities, he found that the lack of secure property rights created a serious constraint on the economic well-being of his country's citizens. As founder and president of the Institute for Liberty and Democracy (ILD) in Lima, Mr. de Soto challenged his country's cumbersome and discriminatory means of legal real estate development. The ILD's system of property registry enables the Peruvian populace to acquire well-defined property rights and to exercise them to secure transactions. Mr. de Soto is also the author of the bestseller *THE OTHER PATH* (Harper and Row, 1989), which more completely details the economic importance of property rights to impoverished areas. He has been the subject of many articles in the popular press, including a January 1989 *READERS DIGEST* article and some recent articles in the *WALL STREET JOURNAL*.

A major difference between developing and industrialized countries lies in the effectiveness of government and the legal system in creating property rights and safeguarding their exercise. Governments of developing nations tend to ban or restrict these rights, or to leave them ill-defined, thereby failing to offer property owners protection from government or third-party interference.

Citizens must be able to gain government recognition of their property rights at a low cost, and such rights must be protected through well functioning and accessible legal institutions. When governments fail to meet these objectives, businesses suffer and inefficiency rises.

In January of 1990, a radically new system of property registration was inaugurated in Peru. This registry is a pillar in a three part ILD program to provide property rights to all Peruvian citizens. By providing legally binding proof of ownership, the registry enables citizens to improve their land with high-quality permanent buildings, even to offer their property as collateral for loans. The pop-

ORER News

Alumni Luncheon

The tenth semiannual luncheon for University of Illinois alumni working in the real estate field will be held at the Chicago Yacht Club on Friday, November 2. Peter R. Morris, Chairman of the Executive Committee of VMS Realty Partners, will share his "Reflections on the Current State of the Real Estate Industry." ORER again thanks Gene Stunard for arranging for use of the Yacht Club.

Alumni will receive more specific information in an upcoming mailing. Anyone wishing to make a reservation should contact Brenda Bishop at the Office of Real Estate Research.

Affordability Workshop

ORER Director Peter F. Colwell conducted a recent workshop concerning the availability of affordable housing. The workshop, held at the University of Illinois on August 10, brought together representatives of the academic, professional, and regulatory sectors of the Illinois real estate community. A summary of the topics discussed and the conclusions reached at this meeting will appear in the Fall issue of the *ORER Letter*.

Life Imitates ORER Letter

Real estate developer and U of I Adjunct Lecturer Don Rundblom has provided a timely example of the exactions discussed in the article on page 16. Rundblom has planned construction of a 62,000 square foot warehouse in an area of Orlando, Florida where infrastructure is already in place. He reports that he must nevertheless pay "impact fees" of \$57,000 in order to break ground.

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Peter F. Colwell, Editor
Joseph W. Trefzger, Associate Editor
Michelle A. Mahue, Staff Writer

Address correspondence to:

Brenda L. Bishop
304-D David Kinley Hall
1407 W. Gregory Drive
Urbana, IL 61801
Phone (217) 244-0951

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ular mortgage and credit insurance are the remaining elements of a program that facilitates the creation of property rights by building a bridge between the nation's financial institutions and the poor.

Informality

A daunting array of restrictions confronts the great majority of economically active Peruvians, known as "informals" because they operate outside the formal economic system. Only in rare instances does informality imply a general lack of compliance with laws; in most cases only certain specific legal provisions are violated (an example would be a food vendor operating without a permit). Therefore, though informal activities benefit the formal economy and are, in fact, necessary to the country in providing goods and services, they are not entitled to the full protection of the law. Informality is, in effect, a gray area paralleling the legal world, where people take refuge when the cost of legality outweighs the corresponding benefits.

The roots of informality, then, lie in overwhelming, cumbersome regulations imposed by government on business activity. These regulations, which present obstacles for anyone attempting to do business, are particularly burdensome for the nation's poor. This problem is due primarily to Peru's inadequate legislative system, under which ill-advised laws, often totally divorced from reality, are enacted behind closed doors by lawmakers ignoring the real interests of the people.

The same restrictions that confront urban "informals" are faced by rural coca growers. With more than 200,000 small farms depending on the income from coca cultivation, Peru supplies much of the raw material for the world cocaine markets. When their coca plants are destroyed without sufficient compensation, these farmers respond simply by starting anew elsewhere, expanding into ever more remote areas, looking to terrorist organizations for protection. While there are many alternative crops that are at least as profitable as coca, cultivation of these crops requires investment, credit, larger-scale production, and formal contracts with buyers. Without well-defined property rights, Peruvian farmers cannot

meet any of these conditions.

Efforts to measure informal activities have revealed the amazing entrepreneurial energy of the poorest segments of Peruvian society. In aggregate terms, the informal sector generated nearly 40% of the gross domestic product (GDP) in 1984, and supplied 60% of the total man-hours worked during this period nationwide. According to our estimates, by the year 2000, informal activities will account for over 61% of GDP, despite the fact that lack of access to formal institutions keeps the informal sector's average productivity equal to only one third that of the formal sector.

Informal Housing

One of the largest sectors of informal activity is the housing sector, which offers a unique illustration of the chasm between government regulations and the Peruvian reality. Slightly over 50% of all existing housing in the Lima metropolitan area, sheltering 53.6% of the city's population, was built informally (in violation of government regulations). Furthermore, less than 4% of all informal property in Lima has been titled to date.

One way to assess the importance of the investment in informal housing is to compare it with the state's efforts. During a period roughly between 1960 and 1984, the state's investment in housing for lower-income settlers amounted to a mere 2.1% of the informal investment in similar housing. As of 1984, total public investment in shelter, including construction of middle class housing, was only 10.4% of informal investment.

Compliance with all governmental regulations regarding formal housing is discouraged by the time and difficulty involved. For example, an individual wishing to obtain a land grant must comply with 207 administrative formalities, associated with 48 different government agencies, in a process requiring a minimum of 43 months to complete. Another 40 months is required for the applicant to obtain the necessary land development and building permits. Therefore, a total wait of nearly seven years faces the typical family attempting, through the formal sector, to establish a place to live.

In some cases, the waiting time can reach ten years. (Recently, the number of administrative formalities has been cut to 116, involving 27 government agencies. The length of the land grant process, however, has been cut only from 43 to 37 months).

These excessive delays demonstrate why the invasion and occupation of government and privately-owned land have come to represent the most effective alternative in providing shelter for the poor. The fact that, according to government statistics, there were 282 illegal occupations and only 3 official grants of government-owned land in Lima in 1985, and that seven out of each ten buildings constructed are informal dwellings, clearly illustrates the inoperability of Peru's housing regulations.

Making matters worse, rights to even duly recorded properties are not entirely secure, since corresponding data often are not processed correctly. Moreover, due to an ineffective bureaucratic system, owners who have legalized their dwellings, or who plan to complete necessary legalization formalities, find it extremely difficult to reap the benefits of government protection. Consequently, after 100 years of existence, the traditional real estate register provides documentation for less than half of all formal housing in the Lima metropolitan area.

In an attempt to evade government regulations, the informal economy reverses the development process. The informals' first step is to take possession of the land through informal occupancy or "squatting." The next step is to build a dwelling, installing infrastructure and developing the land through the approval and registration of a survey and final site development plan. The last step is the acquisition of property ownership through the legalization of title in accordance with municipal regulations. Obtaining legal title, then, is the last, rather than the first, step in the creation of new housing.

Communal Associations

The invasion and occupation of land is only one means of informally acquiring property. A second means is through illegal land sales arranged via agricultural

cooperatives. These associations were created by the Agrarian Reform of 1969, under which the government expropriated land and distributed it to peasants to farm under collective ownership.

As the danger of expropriation reduced property values, land owners colluded with settlers to transfer possession of land at prices higher than those offered by the government in forced takings, but lower than market values in voluntary transactions. The cooperatives, which enjoyed communal property rights, were the nominal purchasers, but they redistributed purchased land. By 1989, 75% of the cooperatives had freely and democratically

chosen to divide the land among their members. (Even small farmers who had been given land in the agrarian reform sometimes found it profitable to sell their land to cooperatives, despite government regulations against such sales.)

In other words, while farmers maintained limited property rights as members of cooperatives, they requested that they also be granted rights to individual properties and registered titles. However, while the farmers had opted for private ownership, the state only recognized the collective ownership of the cooperatives. Consequently, the popular housing that developed through these groups, with their special legal status, were considered informal in the same manner as illegal or squatter settlements. The creation of the new land register, explained in more detail below, allows for the legalization of these housing cooperatives and similar housing associations.

Economic Impact

The difficulties associated with this lack of secure property rights discourage investment in economically sound activities, eroding much of the value of the property. These problems, and the impos-

sibility of complying with government regulations, encourage a large percentage of new business activity to be carried out in violation of the law.

In other words, a government that does not recognize the transfer of property rights to another party produces two effects that jeopardize the well-being of its citizenry and the nation's overall economic development. First, owners fear that, at any moment, the government or another party may strip them of their property rights without their legal ability to challenge the confiscation. Under these circumstances, an owner is hesitant to invest in improving property or ex-

When their plants are destroyed without sufficient compensation, coca farmers respond simply by starting anew elsewhere, expanding into ever more remote areas,

panding the business in which the property is used. Thus, the inability to exercise rights undermines the value of property, unnecessarily aggravating poverty. The country also incurs opportunity costs, in terms of the loss of beneficial effects of the business that might have been carried on by the property owner. These economic costs are highly significant in light of an ILD study which found that, among comparable socioeconomic groups, over a period of ten years, the average value of houses with proper title was nine times higher than the value of houses without title.

The second negative effect caused by a lack of well defined property rights is the creation of a permanently stagnant market for property. Without secure title, nobody wants to buy property, because its transfer is not recognized as legally valid. The result is that those who can make the best use of a particular property are dissuaded from buying it. Thus, the potential seller loses as a result of his inability to profit from the sale of his property. The buyer also loses by having to look for another, less suitable property. In terms of lower levels of aggregate business activity and slower national

growth, Peru ultimately loses as well.

The absence of legal title to land and housing means the occupant has absolutely no security and no legal status. Furthermore, without legal protection or recognition, a dwelling may not be sold, rented, or mortgaged, so its inherent value as potential capital to generate new resources is lost. If, on the other hand, an individual can obtain legal title, thereby ensuring legal status and security, he can increase the market value significantly. As a result, the owner is able to get a better price in the event of a sale, and the sale can be financed by a lending institution on better terms for the owner.

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Therefore, even if a given property is not duly entered in the new land register, the mere existence of such a registration mechanism enhances the property's value. The register offers a buyer the chance to rapidly obtain possessor rights to the land and title to the corresponding dwelling built on such land.

A More Workable System

Securing property rights for those currently outside the law requires a new legal institutional framework that not only formalizes informal status but, at the same time, informalizes the formal sector. To serve this purpose, the ILD developed the popular mortgages system, comprised of the land register, the popular mortgage itself, and the credit insurance program.

As a cornerstone to its system, the institute recognized the set of extralegal norms present in the informal settlements. These norms, which to some extent regulated social relations, served to offset the absence of legal protection. However, the main function of the prevailing extralegal system and the informal housing organizations was to safeguard and enhance the private property

acquired through invasion or inhabitation, rather than to impose a system of collective ownership.

Property and Possession Registry

The new registry, which imposes less than one percent of the cost required by the previous system, is based on three main guidelines: simplification, deregulation, and decentralization. *Simplification* refers to the elimination of impractical formalities and of overlapping requirements, in an effort to lower unnecessarily high charges to the public. For example, proof of property tax payment is no longer required for registry, notarized build-

ing certificates may be replaced by standard printed forms, and records may be stored on a computerized system.

Unlike the traditional registration system, in which everything the applicant says must be proven by documentation, the new land register assumes that the applicant is telling the truth (presumption of good faith). Furthermore, the occupant of land is assumed to be the owner of any building constructed on that site. Based on the customs and extralegal standards studied by the ILD, the types of evidence required to verify land tenure are both realistic and easily obtainable by users of the new land register. Documentation requirements have been simplified to allow the personal verification of lawyers, architects or engineers to replace more formal procedures. The applicant must supply proof that he actually possesses the land and/or buildings. Acceptable proof includes written statements from neighbors or local residents' associations verifying tenure, receipts from payments for utility services, or local residency and loan agreements with building and loan associations.

Deregulation is the transfer of certain decision making powers, currently in the

hands of the real estate registry, to the individuals using the registry. The new land register replaces government bureaucrats with private inspectors, separates title registry from site development, and recognizes settlers' associations and user participation in the management of the land registry.

Similarly, *decentralization* describes the delegation of decision making powers to local registration offices, placing them in closer contact with existing problems. Because the previous registry was centralized in Lima, millions of Peruvians living outside the capital were denied access to the system. The creation of autonomous regional registers allows the entire registration process to be carried out within the area where the property is located.

The land register allows informal settlers to rapidly and definitively register their dwellings, in order to obtain legal recognition of their rights. By registering their property, citizens can exercise the rights inherent in property ownership: selling, leasing, or using as security for credit transactions. The single act of registration confers legal status not only on the land, but also on the building, which can represent as much as 80% of the total property value. Based on the growth rate of housing in the Lima metropolitan area, the ILD estimates that almost all property holdings in informal settlements will have been registered within five years.

Popular Mortgage System

Even with the establishment of the new property registration system, under which an occupant can legally document his possessory rights to land and any structures on the site, a mere occupant still could not mortgage land in his possession. While the right of an occupant is a mere "possessory" right, a landowner enjoys all inherent property rights, including those of use, enjoyment, disposal, and recovery. With this inequity in mind, and in an effort to provide economic benefit from large cumulative capital investments in informal housing, the ILD proposed a new type of mortgage for realty in informal settlements.

Unlike the conventional mortgage, which requires that the grantor hold legal

mortgage right, this "popular mortgage" system is based on tenure rights, duly recorded in the land register. The popular mortgage enables previously disenfranchised people to use the value of occupied land, and dwellings on such land, as security in obtaining formal credit. The money obtained may be used to fund small business start-ups or expansions.

Tenure rights extend to those with occupancy status the inherent rights of use, enjoyment, disposal, and recovery, creating a title that is free from formal registration requirements. The system thereby makes it possible to mortgage real estate without holding formal title. Furthermore, the presumption of ownership may not be contested by previous owners, whether private citizens or government.

The processes of establishing and administering mortgages have been simplified dramatically. Foreclosure was in the past accompanied by a long, tedious collection process. This slow-moving (three to four years) judicial procedure discouraged the granting of loans, because, by delaying their payments, delinquent borrowers could increase (at lenders' expense) the benefits of inflation and negative real interest rates. Loan maturities have since been shortened, and public auctions of mortgaged property have been simplified to prevent borrowers from obstructing the process.

The most important innovation with respect to foreclosures is designed to make the popular mortgage attractive to creditors. The creation of a new extrajudicial foreclosure system allows the parties to mutually designate a third party, such as a bank or a magistrate, to sell the mortgaged property in the event the borrower should default. As a result of these reforms, a foreclosure can be carried out within two weeks (in contrast to the 3-4 years required under a regular Peruvian mortgage).

Credit Insurance

In granting loans, financial institutions analyze not only traditional security devices, but also subjective qualifying criteria, such as verifiable formal sources of income. Yet more than 60% of Peru's citizens do not earn their incomes from

formal sources, so for legal purposes their incomes are nonexistent. Informal business owners are consequently prevented from qualifying as "good credit risks" despite the wealth generated by their income-producing activities.

To bridge the gap created by these subjective requirements for access to formal credit, the ILD has recommended a mechanism known as credit insurance. A local insurance company provides a guarantee on behalf of the borrower in return for a premium equal to 4% of the full amount of the loan. The lender is insured for the immediate recovery of a loan in the event of default, and therefore does not require an excessively high interest rate to compensate for risk. Under the present financial system, informal borrowers are accustomed to paying interest rates as high as three to six times the market rate.

Implications

Creating property rights will not only provide the key to the economic enfranchisement of the poor, but will also help combat the power exercised by terrorists and drug traffickers. Furthermore, granting formal title to those who have been deprived of such rights fosters political stability, by easing the social tensions between those without property titles and wealthy property owners. ■

The problems recognized in, and solutions proposed for, Peru by Mr. de Soto are not unlike some that have been noted by other observers in other regions. In the Fall 1989 ORER LETTER, economist Austin Jaffe discussed informal "self-help" in Eastern Europe, where a lack of private property rights has created a housing crisis. In a recent WALL STREET JOURNAL article, Canadian economist Tom Velk described the communal ownership practiced on U.S. and Canadian Indian reservations. The system prohibits individuals from selling "their" land or enjoying other private property rights, thereby contributing to poverty and unrest. Another recent WALL STREET JOURNAL piece told of black South Africans who have been moved by de Soto's writings to support "informality" as a means of fostering prosperity in their troubled nation.

AREUEA Focus On Auctions

The 1990 meetings of the American Real Estate and Urban Economics Association will devote a session to the topic of auctions. The session will be chaired by Kenneth Lusht of The Pennsylvania State University. An interview with Lusht, on the use of auctions in the Australian real estate markets, appeared in the Spring 1990 *ORER Letter*.

ORER Director Peter F. Colwell will present his paper, "The Value of Agricultural Land." Others presenting in the session will be Kerry Vandell and Timothy Riddiough of the University of Wisconsin; George Gau and Dan Quan of the University of Texas, with Theodore Sternberg of Vanderbilt; and Bruce Vanderporten of Loyola University in Chicago. Joining Lusht as discussants will be Michael Giliberto of Salomon Brothers and Norm Miller of the University of Cincinnati.

Rho Epsilon Officers

The University of Illinois chapter of Rho Epsilon, the professional real estate fraternity, has elected its Fall 1990 officers. The election was held following the final chapter meeting of the 1990 Spring semester.

Michael Teska, a joint MBA/Master of Architecture candidate from Evanston, is serving as chapter president.

Vice president is Chris Tierney, a senior from Bartlett majoring in LAS Finance/concentration in real estate.

Scott Richrath, a senior in CBA Finance/real estate from Elmhurst, is chapter treasurer.

The chapter secretary is Jeffrey Mitchell, a junior in LAS Economics from Alton.

The Office of Real Estate Research congratulates these individuals. Professor Roger Cannaday serves as the chapter's faculty advisor.