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Government Reforms to Reduce Transaction Costs and Promote Private Sector Development

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Why is it that types of transactions that are taken for granted in modern economies are so conspicuous by their absence in so many developing countries? In most cases, it is because the costs and risks of entering into long-term contracts are much higher in developing countries than they are in the industrial world. These costs are largely a function of governance – the way in which governments supply and administer public goods and the way in which they regulate economic activity. When governance is weak, the costs of transacting (in other words, the costs of doing business) rise. Without governance reform to promote private sector development, growth and prosperity will continue to elude most developing countries.

The paper discusses transactions costs and the impact they have on the private sector, outlines ways in which weak governance contributes to high transactions costs, and discusses issues related to the reform of governance as it pertains to promoting private sector development. Romania's secured transactions reform and Peru's property rights reform are highlighted as two examples of successful governance reform that have had a strong impact on promoting growth and alleviating poverty in the countries where they occurred. It concludes that similar reform is the only option available for governments intent on promoting growth and development.

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Introduction

Over the past few years, opposition to reform has been growing in many developing countries. In particular, in Latin America, a series of crises has led to disillusionment regarding the ability of reform programs to bring prosperity. The Argentina crisis is only the most recent example of an early reformer experiencing severe crisis and halting or reversing earlier efforts. The policies associated with the "Washington Consensus," which involved privatization, trade reform, and macroeconomic stability, is now viewed in many developing countries, as well as among many "activists" as having added to poverty in the countries where it was implemented. In some quarters, globalization is considered to be anathema – promoting the worst evils of capitalism. The proponents of such views claim that it has destroyed jobs in the industrial countries and has led to the exploitation of low paid workers in developing countries.

These views, however, are misguided and ignore the facts. Countries where there has been genuine reform have, in general, performed well. For example, per capita income growth in Chile, one of the deepest reformers among developing countries, was among the top four worldwide in the 1985–2000 period. In many cases, the countries that have experienced the greatest problems, and that are held up as examples of the failure of market oriented economic systems are those where reform was incomplete there was a failure to follow through on initial reform efforts involving privatization and trade liberalization to ensure that markets worked effectively to allocate resources efficiently. Governance in the vital realm of economic activity failed to support market oriented reform, thus diminishing the impact of reform efforts and, in several cases, dooming them to failure.

It is only recently, however, that much attention has been paid among those concerned with economic development to analyzing the impact of governance on the efficient operation of markets. In particular, governance has a central impact on the way that markets are organized. In all developing economies, large informal sectors that operate primarily on a cash basis are the norm – this is one form of market organization. However, in most developing countries there is a marked absence of long term contracting. In most of these countries, business communities deal with people that they know and are reluctant to engage in arms length contracts that are the norm in countries like the United States.

Why is it that types of transactions that are taken for granted in modern economies are so conspicuous by their absence in so many developing countries? In most cases, it is because the costs and risks of entering into long term contracts are much higher in developing countries than they are in the industrial world. And these costs are largely a function of governance – the way in which governments supply and administer public goods and the way in which they regulate economic activity. When governance is weak, the costs of transacting (in other words, the costs of doing business) rise. Without governance reform to promote private sector development, growth and prosperity will continue to elude most developing countries.

This paper commences with a discussion of transactions costs and the impact they have on the private sector. It outlines ways in which weak governance contributes to high transactions costs. It then discusses in some detail issues related to the reform of governance as it pertains to promoting private sector development. It gives two examples of successful governance reform that have had a strong impact on promoting growth and alleviating poverty in the countries where they occurred. It concludes that similar reform is the only option available for governments intent on promoting growth and development.

Transactions Costs Defined

Transactions costs are the costs of organizing and conducting business activities. They determine the way economic activity is organized and have a powerful influence on business planning and investment horizons. High transactions costs also cause market failure – when the costs of transacting are high, markets do not function efficiently or even exist at all and it takes substantial resources to define and protect property rights and enforce agreements. In the extreme case, high transactions costs can result in total market failure so that some activities that are the norm in low transactions costs environments do not take place at all.

Another way of looking at transactions costs, is that they are the costs of arranging, monitoring, and fulfilling contracts. Examples of transactions cost include:

- The cost of buying and selling goods and services.
- The cost of raising finance and capital.
- The cost of securing and enforcing property rights.
- The cost of obtaining information regarding business associates and opportunities.
- The cost of forming and organizing companies.
- The cost of bankruptcy for creditors.
- The cost of entering into and enforcing contracts.
- The cost of hiring and dismissing workers.

- The cost of transporting, importing, and exporting goods.
- The cost of complying with government regulations and government representatives.

An emphasis on transactions costs can cast a different light on familiar problems. Transactions costs have significant fixed costs components. Consequently, the relative impact of high transactions costs is felt more by smaller businesses than by larger ones. This result has a powerful effect on the size structure of firms.

Transactions Costs, Institutions and Governance

Transactions costs and institutions are closely related. Institutions provide a structure within which business activity is organized. They determine the framework for the way in which businesses interact with their workers, their suppliers, their customers, and their financiers. Institutions determine the "Rules of the Game" which in turn affect the transactions costs faced by firms. If institutions are weak and transactions costs are high, they create perverse incentives that harm private sector growth. Weak institutions and high transactions costs provide a fertile breeding ground for corruption that has a corrosive impact on business activity.

Ultimately, the way that the private sector operates is determined by the incentives that the business environment and its supporting institutions provide to entrepreneurs. Who creates the incentives? The state and institutions that make up the governance structure do. Important elements of governance that affect institutions and determine the transactions costs that impact the private sector include:

- The legal system that provides the basis for contracting. This includes the commercial laws that determine how contracts are arranged as well as the court system that underpins the way in which contractual disputes are resolved.
- Regulations that govern business activity at both the national and local level.
- The extent to which government ownership affects business costs – electricity generation, telecommunications, and transport are the most common areas of state ownership.
- The enforcement of regulations.
- The viability of property rights for both fixed and movable property.
- The strength of the financial system that determines how businesses are financed.
- Broader governance issues such as the maintenance of macroeconomic stability, the neutrality of trade policy and its enforcement, and the ability of the state to educate its population.

All of these factors influence both short and long run business activity. Good governance is a central element in keeping the costs of transacting low, which in turn influence the organization of businesses and the way in which they function. The following sections outline in more detail the way in which transactions costs and governance influence business activity and how these costs might be reduced. First, however, it is worthwhile emphasizing the importance of private sector activity for economic growth and prosperity.

The Private Sector, Growth, and Prosperity

To achieve sustained growth in per capita GDP, the growth of private enterprises is critical solely by virtue of its dominant statistical position in practically all economies. Private sector growth amounts to the growth of total value added by private sector activities. Since the private sector produces over 85 percent of GDP in most developing countries, arithmetically there can be little divergence between the growth of the private sector and that of the economy as a whole.

Relationship Between Growth and Poverty
1981-1999

Countries where there has been:	Percent change in average incomes per year	Percent change in poverty rate* per year
Strong Contraction	-9.8	23.9
Moderate Contraction	-1.9	1.5
Moderate Expansion	1.6	-0.6
Strong Expansion	8.2	-6.1

* Poverty was defined as that portion of the population with an income of below a $1 per day at the beginning of each time period examined. The sample included 154 peiods of change for 65 developing countries with available data that met the selection criteria - of no survey methodology changes over the period examined.

Source: Easterly 2001. *The Elusive Quest of Economic Growth*, p. 13. The author used data from Ravallion, Martin, and S. Chen 1997. "What Can New Survey Data Tell Us about Recent Changes in Distribution and Poverty?" *The World Bank Economic Review* 11-2: 357-382.

The relationship between economic growth and poverty reduction has been controversial, with some observers claiming that growth, at least in its early stages, actually leads to a worsening of income distribution and, in the extreme case, an increase in poverty. There is, however, no empirical foundation to these views. There is growing evidence that growth improves the situation of people at all levels of income in about the same proportion. The table illustrates this clearly, showing that for the period 1981–1999 income growth is strongly correlated with poverty reduction. Without growth in per capita incomes, poverty will persist in poor countries. Governments intent on poverty-reduction must therefore create an environment that is conducive to growth. The most efficient means of achieving this growth is through the private sector. The private sector is therefore key to fostering growth and poverty reduction, creating employment opportunities for citizens, and lifting the poor out of poverty.

The private sector, however, will not flourish unless the business environment provides opportunities for profitable long term investment. Where risks are high, long term investment will not occur. Where equity investors have weak and uncertain rights, they will not buy shares, new offerings will not come to market, and valuable investment opportunities that could raise long run growth rates will remain without financing. Where lenders cannot collect their debts, lenders will not lend. Where intellectual property rights are not protected, cutting edge firms will be reluctant to make direct foreign investments. This list only touches the surface of issues that have been identified by both national and international observers as being critical for the long term growth on which poverty alleviation depends. Reform of the environment for private sector activity, not resource transfer, will ultimately be the key to the ability of countries in the region to sustain long term growth. Improving governance is a vital part of this effort.

A Policy Agenda for Improving Governance to Promote Private Sector Growth

The necessary governance for promoting private sector development includes a government agenda that emphasizes policy stability and policy credibility. Implementing this policy agenda appears to pose three core challenges for governments. The first challenge is to achieve greater policy stability and credible commitment that reform policies will not be reversed or that the extent of government interference in markets will not suddenly expand or that there will not be other sudden changes in the rules governing business operations. Governments and the politicians within them who wield power have a problem in making future commitments that will be believed. Governments cannot commit easily over time because they cannot bind subsequent political regimes. Through the strength of its relationships with member countries, both in the political arena as well as in ministries, the international donor community can help promote the continuity of policies that can mitigate against large shifts in priorities on the part of member governments that will adversely affect the private sector.

The second challenge is for governments to produce public goods rather than private goods. A priority for improving governance in developing countries is to identify the most important factors that influence private sector development and the public goods such as property rights, the legal systems and regulatory systems that affect the investment climate.

The third challenge is to improve the government's technical-administrative capacity. Even the purest pro-market policy requires government capacity to design and implement reforms and, just as important, to continue to administer the policy regime once reformed: fiscal, budget and monetary capacity; a regulatory (quasi-judicial) bureaucracy to administer the laws that deal with market failures; a technical bureaucracy to implement legal-framework laws (registries, licensing, financial regulation); and a judicial bureaucracy to resolve disputes between private parties and with the government. These tasks require a public service that is not only capable, but also is insulated from pressures that private-sector interests might exert for particular favors. The international donor community can assist in raising the governance capabilities in countries that request help.

In proposed reforms, what sets the boundary between the public and private sector? Under one stylization, the government would change laws, regulations, and public institutions to permit the private sector to operate with greater economic efficiency. The private sector itself would need no training or information in order to operate better. Rather, it would immediately and smoothly adapt to the business environment reforms undertaken by the public sector. The reformed public sector environment would permit more efficient private sector operation.

This strict division between the public and private sector, though, implies a perfect world – that experience has shown does not exist. There is a growing realization that both the public sector and the private sector operate in a suboptimal way. Not only does the private sector not always operate in a competitive environment that ensures that markets always provide the best solution, there is also a growing realization that the public sector often does not

behave in a disinterested impartial way that ensures that reforms are always carried out. There is thus an implication that the reform of institutions and laws cannot necessarily be entrusted to the public sector as it is now structured. In part, this realization is responsible for the frustration that many are feeling regarding the progress of reform in many developing countries over the recent past. It underlies their call for a reevaluation of policies.

Coordination Between Government Ministries and Agencies

Organizing a cohesive reform strategy that will improve governance for private sector activity is difficult. The reasons reflect a number of realities, the most important of which are:

- Most government employees, even at senior levels do not have a good understanding of problems facing the private sector.
- Factors that affect the private sector are wide-ranging. They span topics that affect macroeconomic issues (Ministry of Finance), financial sector issues (Ministry of Finance and the Central Bank), legal issues (Ministry of Justice), regulatory issues (Ministry of Commerce), infrastructure issues (Ministry of Transport), local regulation (Regional and Local Governments), as well as private sector groups such as associations of lawyers, associations of notaries, chambers of commerce, chamber of industry plus various NGOs. And this list is far from comprehensive. There is no natural forum that provides for coherent discussion of private sector issues.

A further difficulty is that each reform appears to raise new questions about the appropriate division of responsibilities between the private and public sectors. This puts an even larger burden on prospective reformers because the implication is that the distribution of responsibilities between the private and public sector will have to be determined during the project design and that it will be different for every project. That is, reformers must redesign the interface between the public and private sector in each area. Here are just a few examples:

- Bankruptcy: Should a state-run judiciary administer bankruptcy proceedings? Or should a non-judicial nominee of the judiciary? Or should creditors privately administer bankruptcy proceeding under a law that gives them the power to do so?
- Secured Transactions: Should a judiciary repossess and sell collateral? Should it order others to do so? Or should the law permit private parties to repossess and sell as long as they do not breach the peace? If so, should the penalties for incorrect repossession be enforced by the judiciary or privately by an arbitral court? How does a government convince the electorate that protecting debtors rights too strongly implies that only the well-off can borrow?
- Corporate Governance: Should corporations be regulated by institutions like public accounting standards boards and market regulators like the SEC? Or should we rely on freedom of contract and the right to sue to enforce laws relating to corporations. And should we permit private individuals to prosecute firms that violate these laws or should prosecution be left in the hands of a public prosecutor? If we rely on private individuals to sue or prosecute, who will enforce the award – the judiciary or private dispute settlement systems?
- Land Rights: Should a government set up cadastral mapping systems, or should laws be maintained that permit landowners or occupants to legally map their land? Should government or the private sector administer the real estate registry?

These examples represent only a few issues that are central to government efforts to improve governance for the private sector. They illustrate that identifying the problem as requiring changes in the duties and functions of the public sector leaves us with the important task of identifying the proper mix of public and private effort necessary to address the problem properly.

Training of Government

A difficult issue in designing reforms to improve governance arises from the training and incentives of the participants in this process. Many government employees have little idea of how business works, and it is not clear that it is a good investment to train them. After all, they chose to enter government and not private enterprise at the outset of their careers. Problems in training government employees to understand business could be partially circumvented by developing systems that make business regulate itself. Such systems require a careful analysis of the interests of the participants. On the one hand, the as-

signment of the business registries to the private Chamber of Commerce seems to have worked well in Colombia, where those registries work far better than similar registries elsewhere that are under the management of the government. On the other hand, considerable skepticism has been expressed in the United States about self-regulating boards for the New York Stock Exchange, doctors, and lawyers, particularly in view of the volume of malpractice suits. The problem of inadequate understanding of private sector issues on the part of government employees can be dealt with at least partially through coordinating mechanisms in which the private sector is represented.

State and Regulatory Capture

There is also the issue of regulatory capture, wherein regulatory bodies become the agents of the regulated parties. Sometimes this situation arises because the regulatory agency identifies with the industry; sometimes because there is a revolving door employment pattern between the industry and the regulatory board. Optimally, the solution is to allow the market to self-regulate as much as possible. Where market failure occurs, however, this arrangement is not a solution, and a regulatory body is a necessity. There are myriad options for establishing regulatory bodies. But as a rule, effective regulators withstand pressure through the backing of many interest groups, the wide publication of their actions, and a successful track record of operation in a country.

Improving Governance at Different Levels of Government

When government must change the legal and regulatory environment for business, what level of government should be involved in the reform? Practices seem to differ from country to country. Sometimes differences seem to rest on some economic logic. Often, though, these practices appear to have evolved for historical reasons peculiar to each country. In the United States, for example, UCC 9 – its secured transactions law – is actually not a law at all. Rather, it is model drafted by NGOs. Individual U.S. states and territories are free to adopt it, in whole or in part. Secured transactions claims are enforced in state and local courts. Security interests are filed in fifty separate state registries. By contrast, the U.S. bankruptcy law is a federal law that applies to all the states. Bankruptcy is enforced in federal courts. Corporate governance is determined by state codes, and corporate charters are filed in state registries. Different states permit different kinds of corporations. There appears to be no model and no national uniformity. Practices elsewhere in the world differ.

There is some evidence, however, that national solutions may not always be the best. Where the best solution can be found at a lower level of government, it would be possible to have coordination at the national level and execution at local levels. But, the political economy and operational problems in such project structures can be substantial.

Governance Reform: Assignment and Allocation of Responsibility

Borrowing from public finance, it seems natural to suppose that different legal environment issues may sit naturally at different levels of government. For example, it might make sense to establish and enforce building codes locally because climatic and topographical considerations vary with localities. Similarly, health standards in restaurants might be more easily monitored and enforced locally. As a broad rule, we know that the level of government that "internalizes" the most externalities is the most appropriate point of intervention. Understanding the broad rules for allocation and assignment of public responsibilities, however, does not give specific guidance on the questions such as whether there should be a real estate filing archive in every province or a single national real estate register. Answering those questions seems to require a specific cost benefit analysis that would compare different management systems and the incentives they produce for all concerned to operate efficiently, provide good service, and use the institutions at the optimum level. This is not a small task given the wide range of laws, regulations, and institutions that exist in all developing countries.

The Private Sector as the Primary Focus

An underlying theme for reforming governance structures to promote private sector development is that private markets allocate resources in a powerful and efficient way such that all levels of society can benefit from a growing and vibrant private sector. Competitive markets, by definition, are self-regulating, and government regulation and intervention should be directed toward establishing clearly defined market procedures, ensuring equal access to and open disclosure of information, and facilitating market transactions. Markets, however, do not operate in a vacuum and at times market failures, asymmetric information, and other problems require interventions to improve efficiency and resource allocation. When implementing a private sector strategy and dealing with the private sector it is important that reformers keep in mind a number of principles, namely:

- The time horizon for implementing policies to promote private sector development and their coming to fruition is long. Reformers need to take into consideration that successful investment climate reform requires a long time to be effective and they must factor this perspective to ensure the success of private sector policies.
- A powerful private sector development strategy recognizes that there are market AND government failures.
- In the case of governance reform to promote private sector activity, poor quality, or missing public goods will often be the prime focus.
- Getting the investment climate right – supporting this through technical assistance and advisory services – is the top priority. This action requires coordination within and between governments, the private sector and international donors.
- Countries can call on donors to assist in improving the investment climate through providing financing to achieve sectoral restructuring and reform.
- Like all change, governance reform is a continuous process that is never complete. Once the first round of reforms is underway there will be a need to go deeper. This step may imply skills upgrading or a different mix of skills within donor institutions.
- Upgrading governance structures to promote private sector development requires identifying the needs of the private and public sectors.

This is a formidable agenda – reforming governance structures to promote private sector development takes time, requires credible commitment on the part of governments that there will not be reversals, coordination between ministries and agencies and an upgrading of skills at all levels of government. Two recent examples of reform of the governance structure related to private sector development that have had a fundamental impact in the countries where they occurred are an illustration of what can be accomplished if policymakers are determined.

Secured Transactions Reform in Romania

The aim of the secured transactions reform was to improve access to credit by the poor by reforming the collateral framework to allow the pledging of movable property as collateral for loans. Two years after its implementation, it appears to have had a major impact on Romania's lending environment.

The first phase of the project was the implementation of a Law of Secured Transactions. The law was drafted with the support of the World Bank and incorporated provisions that permitted movable property, both tangible and intangible, to serve as collateral for loans. The second step involved setting up the filing archive to permit the law to operate by recording pledges of property and establishing priority regarding which creditors have the first rights to repossess and sell the collateral in the event of default.

Prior to the new law, credit in Romania was scarce and expensive. The Romanian financial sector was underdeveloped even by the standards of many transition economies and ranked near the bottom of Central and European economies in terms of financing private sector activities; in 2000 credit from deposit taking banks to the private sector amounted to the equivalent of about 9 per cent of GDP. Average real lending rates were high, but effectively there was very little arms length lending. Financial markets were distorted by subsidized credit that provided opportunities for arbitrage across different loan instruments.

Following the introduction of the secured transactions reform in 2001, the impact on lending in Romania has been dramatic. In the 18 months since the reform was implemented, there have been over 400,000 loans against which security interests have been registered. Over 100 banks have registered security interests in the filing archive. Since there are 38 licensed banks in Romania, the implication is that scores of non-Romania banks have been lending in the country against collateral and registering their security interests. Of the security interests that have been registered and are current, nearly 20 per cent represent non-bank secured loans. This is especially beneficial in rural areas that do not have bank offices. In addition, the geographic coverage has been extensive. There have been filings of security interests in 42 of Romania's 43 counties. The ratio of domestic currency lending to the private sector to GDP rose by 86% in the 2000 – September 2003 period and long term lending denominated in lei rose sharply from less than 20 per cent of total credit to nearly 40 per cent. Credit is granted not only to companies in urban areas but also in rural regions where such diverse assets as cows and tractors are taken as collateral. Access to credit by the poor has increased sharply.

Property Rights Reform in Peru

Peru's urban areas are surrounded by land owned by the government on which the urban poor have built dwellings. The government requested World Bank assistance to

formalize transfer of the land to those residing on it. The aim was to establish a national property rights formalization program.

The Peruvian government instituted a "Law to Promote Access to Formal Property," which supported the land transfer from the government to the urban poor. In addition, they created a new agency, Comisión de Formalización de la Propiedad Informal (COFOPRI) to implement the new law and created a separate registry for urban areas only – the Registro Predial Urbano (RPU) – an offshoot of the Registro Predial. COFOPRI was responsible for issuing titles and RPU for registering them. The main project objectives were to:

- Establish an effective market for urban property rights through legal, institutional, and regulatory reforms. This project component was designed to decrease transactions costs by improving property formalization and reducing the time and costs of property registration.
- Launch "effective and sustainable" agencies (RPU and COFOPRI) for implementation and maintenance of the registration and adjudication system. The project would achieve this goal through training and human resource management to build the involved agencies' institutional and administrative capacity.
- Ensure formal secure property rights for informal urban property. The project would accomplish this by documenting the conversion process, recruiting the necessary staff, and executing the process in the field. Ultimately, the project looked to register 960,000 properties and issue 805,500 titles in eight of Peru's urban areas.
- The methodology developed was revolutionary in that it eschewed the normal high technology methods of defining boundaries through satellite imagery. Rather it used a community based approach and, in addition, allowed registration of the property at the same time as the issuing of the title. The methodology was derived from that developed by Hernando de Soto [2000].

The project is now nearing completion. The urban poor can now more easily (both in terms of time and cost) obtain title to the land they occupy. By August 2002, the project had titled and registered about one million dwellings, in which 7 million people lived. The cost of registering a title was reduced from over $2,000 to $50, and the length of the process has been reduced from 15 years to 6 weeks or less [World Bank 2001]. A recent evaluation by APOYO, a Peruvian economic research company, estimated that the average value of a titled property rose by $925 and has increased overall assets values of the properties registered by at least $500 million [APOYO, 2003]. The impact could have been even greater if a financial market reform had been developed alongside this reform to allow the pledging of property as collateral – currently, owners of the new titles cannot borrow against their property.

An unexpected benefit of the titling program has been a substantial increase in the number of hours worked by owners of the newly titled property. With the strengthening of property rights they are more confident that they can leave their property unattended without fear of occupation [Kagawa, 2000, Field, 2002].

Conclusions

This paper has outlined some of the issues related to governance as it concerns private sector development. The evidence that there can be no prosperity without a dynamic private sector is strong. Yet in many developing countries, governments fail to provide a strong foundation for private sector growth, both by sins of omission and sins of commission. They do not supply the essential public goods that are the foundation of contracting, and they engage in activities which are far better left to private business.

This note has identified the issues that are central to promoting improved governance for private sector activity. It shows that the way forward is not easy and requires substantial coordination and commitment on the part of governments that take the path to reform. However, there is really no alternative to this path if the hundreds of millions of people that live in poverty in developing countries are to live lives that are not mired in the desperation of malnutrition, under-education, and lack of opportunity. Two illustrations of reform which have had a profound impact in the countries where they occurred illustrate what can be done if the will is there. Other developing countries would do well to follow these examples.

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