

Measuring Institutional Performance in Business and Property Formalization

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Outline

Introduction

- Theory-based indicators & priorities
- Consider value & tradeoffs
- Allow for local adaptation
- Avoid measurement errors

Intro: Formalization reduces transaction costs by switching judicial rules

- History of 'unincorporated' cos. < 1844
- Market enhancing (i.e., liability) rules needed
 - ◆ Property rules in a civil (noncommercial) context
 - ◆ Liability rules in a commercial context
- Possibility of gaming around the rules → ex ante *publicity* used as a criterion by judges ex post
 - ◆ Informal publicity: movable property (possession)
 - ◆ Mixed informal and formal: e.g., agency law
 - ◆ **Formal publicity: real property, companies**

Theory of formalization institutions in business & real property

- Production function
 - ◆ **Costs → Process → Output**

Theory of formalization institutions in business & real property

- Production function of judicial inputs
 - ◆ Costs → Process → **Output → Courts → Contracts**
- Not crucial in “Entry”
 - ◆ E.g., company formalization irrelevant as entry barrier since 1673 (France), 1844 (UK), etc.
 - ◆ Serious entry barriers at industry and market level
 - ◆ Compute *Starting a Business* cost as a **% of company** revenue, instead of per capita income

I. Theory-based priorities

- De Soto & DB say formalization is valuable
 - ◆ But lack a theory as to why
 - ◆ In fact, focus on costs and mainly rent seeking (this explicitly in Djankov *et al.* “Regul of Entry” 2002 paper)
- However, should be for efficiency, not min. cost
 - ◆ Focus on costs
 - Sensible only if value secondary, sufficient or unaffected.
 - But value is a catalyst; often insufficient; often damaged
 - ◆ Focus on rent seeking misses that rent seeking is the price of specialization and it is also present in reforms

Consequence 1: If not efficiency, we should prioritize value—not costs

- Formalization is a catalyst: provides services that reduce transaction and enforcement costs, both private and public.

Consequence 2: Judges are the key users

- Registers produce judicial inputs
- Parties value registers' output only if judges use them for judicial decisions
- Firms or owners are not the main users for organizational purposes

II. Consider tradeoffs in institutions' *production function*

- Impossible with DB b/c it only considers:
 - ◆ mandatory
 - ◆ ex ante costs
 - ◆ directly paid by private parties
- It misses 3 key substitutions:
 - ◆ b/w mandatory and voluntary
 - ◆ b/w costs *paid* by public agencies and firms
 - ◆ b/w ex ante and ex post: due diligence

Consequence 3: Consider standard, not only mandatory procedures

- No difference b/w procedures being publicly mandated or privately imposed by professional monopolies
 - ◆ e.g., lawyers in MA, UK, AUS vs notaries in F
 - ◆ DIY conveyancing irrelevant in MA, UK, AUS
 - ◆ Independent lawyering mandatorily forbidden—e.g, in US by the ABA (a good example of highly effective *industry* entry barrier)

Consequence 4: Consider *private facilitators*

- When measuring
 - ◆ New indicators: cost of a shell company: in general, use market prices as indicators when available
- When reforming
 - ◆ Avoid creating new public facilitating bureaucracies (e.g., one-stop shops):
 - SLNEs: €5,560 in 2 days vs €800 in 2 hh
 - ◆ Open interfaces in public agencies to facilitate a variety of private intermediaries offering services with different levels of vertical and horizontal integration

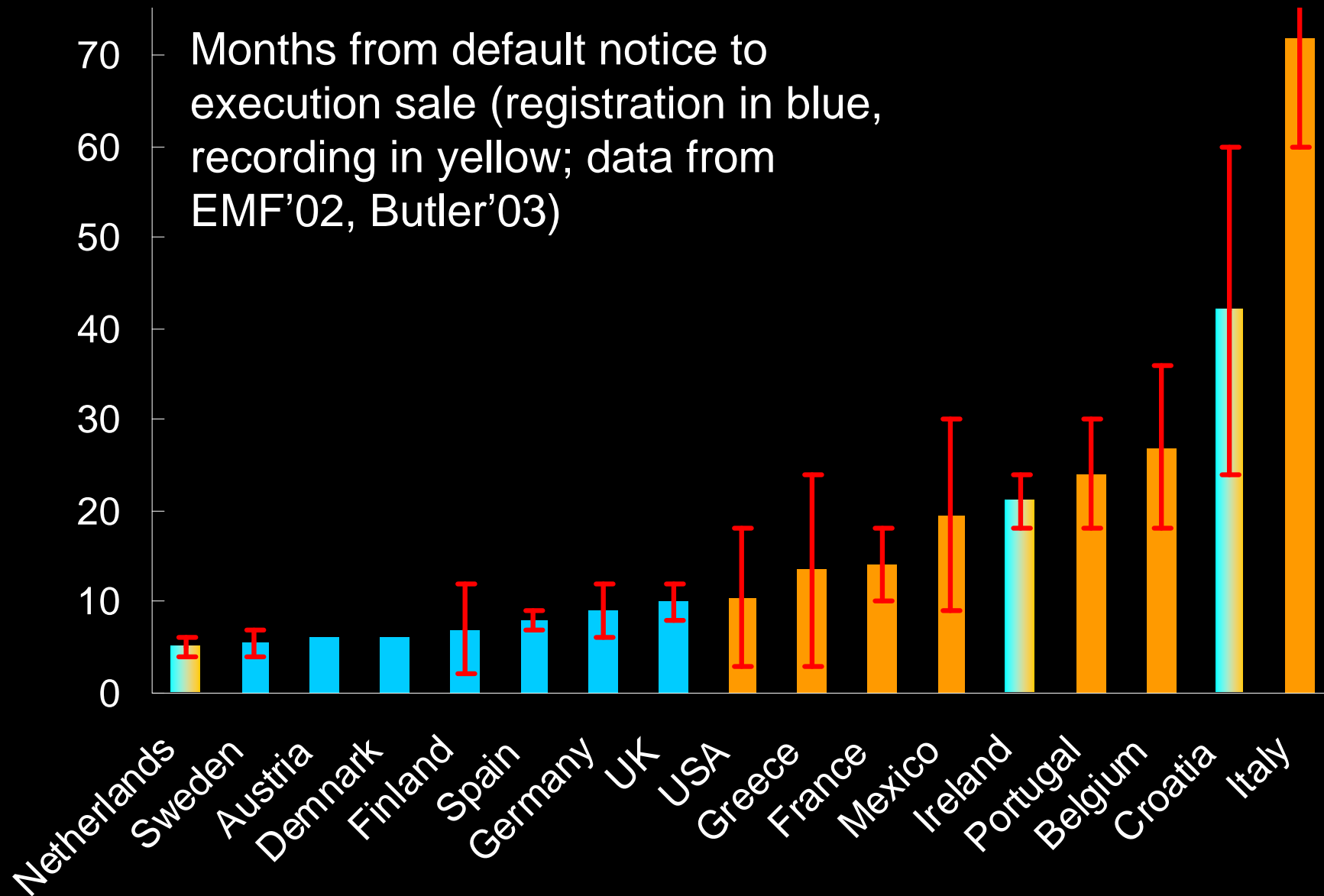
Consequence 5: Should measure all costs, not only those incurred ex ante

- It avoids bias against legal systems relying more heavily on ex ante control
- Example of ex post effects → NEXT

Ex post effects

	<i>Recordings</i>	<i>Registers</i>
<i>A. Performance of titling systems (EMF):</i>		
Mortgage adjusted price	1.04%	0.93%
Operating cost of mortgage provision for lenders, as a % of outstanding lending	0.59%	0.39%
Mortgage registration time, in days	37.19	13.40
Mortgage repossession time, in months	37.03	9.25
<i>B. Judicial performance (DB):</i>		
Number of procedures	32.50	32.25
Days since the plaintiff files the lawsuit until actual payment	658.00	423.25
Cost, in % of claim	21.48	19.58

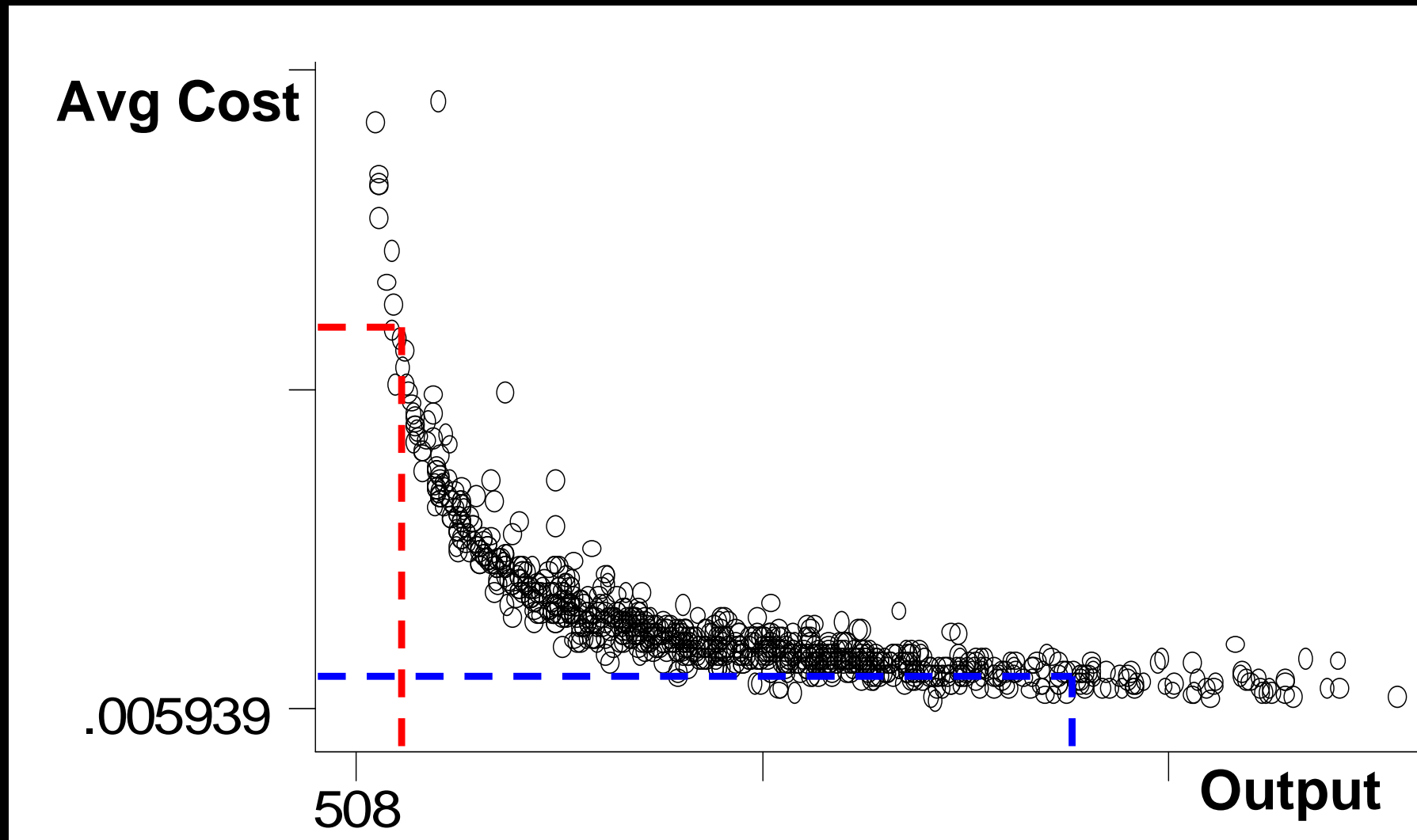
Substitution b/w ex ante & ex post costs in mortgage foreclosure



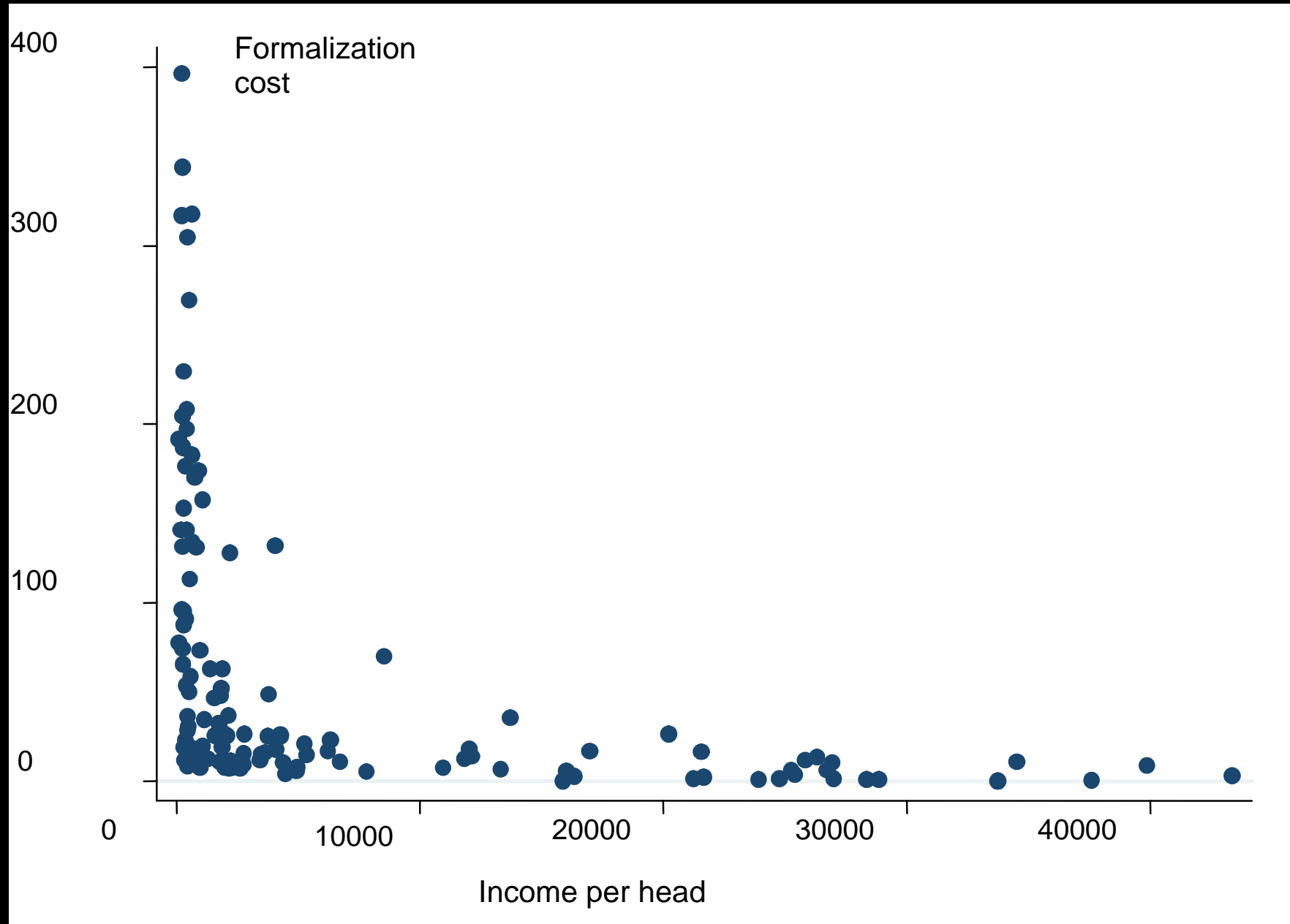
III. Local adaptation

- Need to consider the cost function in full
- E.g., emphasis on average costs hinders adaptation. It leads to
 - ◆ Forgetting demand and value
 - ◆ Capital intensive reforms that disregard demand, value and efficiency

Example 1: Economies to scale in Spanish registers



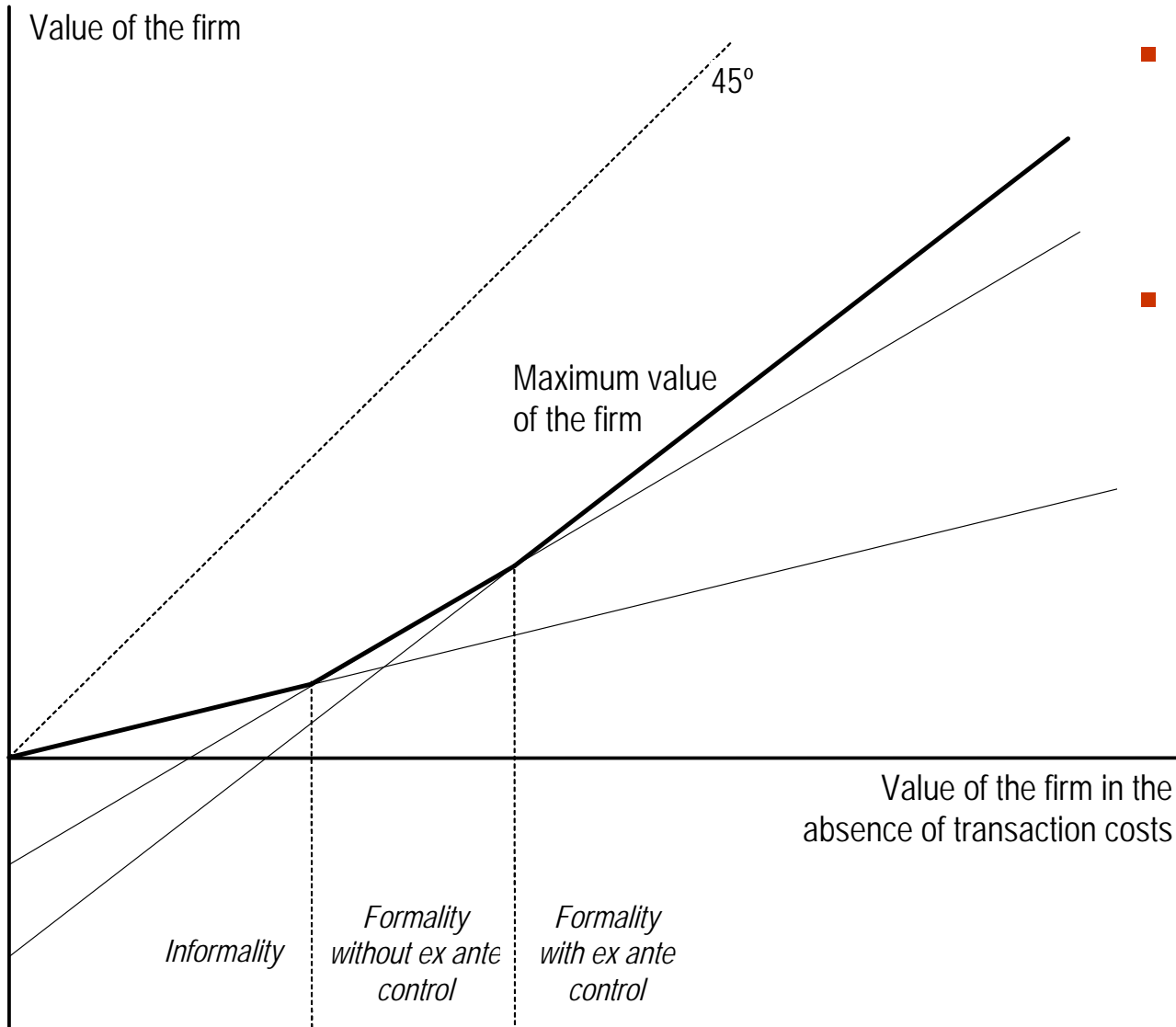
Example 2: Intl. cross section of DB data (income per head and starting business avg. cost)



Policy consequences of focusing on avg. costs

- No attention paid to fixed costs
- No attention to level of demand
- Two examples:
 - ◆ Peru titling effort spent a fortune to achieve little when compared to less formal titling
 - ◆ Spain: avg. subsidy of formalization in the one-stop shop was about €5,560 in the first 3 years
 - a shell co. can be bought in one hour for €800
- Waste, new bureaucracies, bad reputation of institutional reform

Consequence 6: Need of gradual and multiple formalization solutions



- Arruñada, B., and N. Garoupa (2005), "The Choice of Titling System in Land," *J. of Law & Econ.*, **48**(2), 709-27.
- Demsetz, H. (1967), "Towards a Theory of Property Rights", *American Econ. Review*, **57**(2), 347-59.

IV. Try to avoid and correct errors

- Prudence in case, qualitative, evaluations
 - ◆ E.g., DB systematically claims successes ... that turn out to be failures:
 - In my 2007 paper:
Afghanistan, Colombia, El Salvador, Spain
 - In Djankov's 2008 'response':
Bulgaria (?), Italy (?), Latin America, EU on notaries
- The “management by numbers” fallacy
- Measurement errors
 - ◆ The example of the USA
 - ◆ Over-reliance on lawyers—Able to see the forest?

An example of measurement puzzle

- *Doing Business* computes **1 day** for registering a business for state taxes in NYC
- What NY State says:
 - ◆ “If your business is required to be registered as a vendor, it must obtain a Certificate of Authority If your business makes taxable sales before it receives the Certificate of Authority, it may be subject to substantial penalties.

To obtain a Certificate of Authority, you must complete Form DTF-17.... and ***send it ..., at least 20 days before you begin operating your business***” (NYS DTF, Publication 20 (10/04), p. 19).

Consequence 7: Change in *Doing Business* 2009 ranking

- In 2008, USA ranks 9-14 in “Starting a Business”
- Applying DB methodology ‘correctly,’ USA would rank 94-98
- *What is this telling us about DB?*

Over-reliance on lawyers

- DB 2004:
 - ◆ 88.25% of informants were lawyers
 - ◆ Only lawyers informed 89 of 134 countries
- Are lawyers able to see the forest?

Surveying dogs



Concluding remarks

- Goal: 'national accounting' of institutions
- Survey & measurement not main error in DB
- Need to consider
 - ◆ Tradeoffs of cost & value
 - ◆ Tradeoffs of costs: ex ante/ex post, mandatory/voluntary, private/public
 - ◆ Adaptation to local demand & resources
- Prudence in evaluation, marketing & policy
- Governance → Legal systems impartiality

Thanks