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LAND MARKETS IN DEVELOPING AND TRANSITION ECONOMIES: IMPACT OF LIBERALIZATION AND IMPLICATIONS FOR FUTURE REFORM

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Well-functioning land markets can, in principle, contribute to broad-based rural development in several ways. First, where the ownership distribution of land differs from the optimum operational structure, land markets can transfer land from less to more productive producers and thus increase productivity. Second, transferable land rights make it less costly for rural residents to take jobs in the nonfarm economy, something that is likely to boost the off-farm sector. Third, transferability of land increases investment incentives because those who make such an investment can enjoy the benefits even if they are no longer able to personally use the land. Finally, the ability to transfer land at low cost will reduce the transaction cost of accessing credit and can, if there is effective demand for credit, increase credit supply.

Past literature has discussed the potential of land markets and the different contractual options open to participants (Sadoulet, Murgai, and de Janvry; Hayami and Otsuka) as well as the performance of such markets in specific regional contexts (Carter and Salgado; Rozelle and Swinnen; Deininger 2003). For many rural households, land is, however, not only a production factor but also a key asset, implying that, over and above their impact on efficiency of land use, land markets will have far-reaching impacts on equity. In fact, concern that, in the presence of imperfections in other markets, unmitigated operation of land markets would lead to undesirable equity outcomes, has traditionally provided a justification for government intervention. To assess whether such intervention could be justified and, if yes, what form it might take, empirical investigation of both the equity and efficiency implications of land markets is needed. Providing a summary of such evidence is the goal of this paper.

The next section reviews the conceptual foundation of agricultural land rental and sales markets, highlighting the importance of tenure security, the changes brought about by broader economic growth, and differences between rental and sales markets. The "Empirical Evidence" section presents a summary of empirical evidence from different regions regarding the potential and pitfalls of land markets and their development over time. The section "Implications for Policy and Research" draws out conclusions with respect to the scope for, and the limitations of, public land policy and avenues for future research.

Conceptual Foundations

Without significant economies of scale, and in the absence of imperfections in other markets, e.g., for credit, land rental markets will improve efficiency and equity. A large literature has demonstrated that unmechanized agriculture generally does not exhibit economies of scale in production, even though economies of scale from marketing may in some cases be transferred back to the production stage (Binswanger, Deininger, and Feder). Even at higher levels of mechanization, there are rarely economies of scale beyond what can be managed by the operator's family. The need to supervise hired laborers implies that owner-operated farms are generally more efficient than those relying on permanent wage workers (Otsuka, Chuma, and Hayami).

At the same time, a number of factors, including credit rationing and the scope to use land as collateral to overcome informational imperfections that are inherent to credit

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markets, may increase the purchase price of land over and above the present value of agricultural profits. Where access to credit is important and land is the main collateral available, greater credit access by large farmers can lead to the appearance of a positive relationship between farm size and productivity, possibly counteracting the supervision cost advantage of small owner-operated farms (Kevane, Mathijs and Swinnen).

Especially if rent is paid on an annual basis, rental requires limited initial outlays of capital, provides less scope for divergence between land prices and the productive value of the land, and is associated with lower transaction costs than land sales. This, together with participants' ability to adapt contract terms to prevailing market imperfections at least to some extent, implies that rental can be a flexible way to transfer land from less to more productive producers, which may also provide a stepping stone for tenants to accumulate experience and possibly make the transition to land ownership at a later stage.

The literature has long pointed out that rental arrangements based on fixed rather than share rents are more likely to maximize productivity (Hayami and Otsuka). Poor producers may, however, not be offered fixed rent contracts due to the risk of default. Where this is the case, sharecropping has emerged as a second-best solution. In theory, sharecropping contracts could be associated with inefficiencies, which might be reduced by government intervention. In practice, losses associated with such contracts were found to be small and improving on them through government intervention proved to be difficult, if not impossible (Shaban; Nagarajan, Quisumbing, and Otsuka). The alternatives open to potential tenants, in particular rural wage rates—which are in turn affected by access to infrastructure and nonfarm economic development, do generally have a more important impact on the equity impact of land rental contracts (Mookherjee and Ray).

Although transfer of use rights through rental markets can go a long way to improve productivity, only the ability to transfer ownership allows use of land as collateral for credit. The performance of sales markets is, however, affected by three factors. First, a number of variables including participants' expectations regarding future price movements, macroeconomic instability, subsidies to agriculture, the ability to use land as a collateral in credit markets, and selective tax breaks and differential credit market access by different groups of agents, all create scope for increasing the price of land beyond the present value of profits from agricultural production (Carter and Zimmerman). This will make it difficult for poor but efficient producers to acquire land through the sales market (Carter and Mesbah). Second, in risky environments where small landowners do not have access to credit markets, land sales markets will be thin, prices can fluctuate considerably, and distress sales of land by poor but technically efficient producers can occur with negative equity and efficiency impacts can occur (Kranton and Swamy; Bidinger et al., Cain). Finally, the fact that per-unit transaction costs incurred in land markets generally decrease with the size of the land transferred and are often further increased by transaction taxes, can result in market segmentation or push transactions into informality (Carter and Zegarra).

Empirical Evidence

The general conclusions discussed in the foregoing section, and the importance of government policies in shaping the outcomes from land sales markets, are supported by empirical evidence. In particular, secure and clearly assigned property rights provide the basis for active rental markets in many developed countries and have also proven critical in transition economies. Rental is associated with informational and cost advantages over government-sponsored land reallocation in East Asia where there is evidence of ill-functioning credit markets increasing the scope for distress sales. African cases show that, where access to land is not too unequal, broader economic growth can lead to a rapid increase in efficiency-enhancing rental transactions and at the same time illustrate the importance of secure land rights for the development of the off-farm economy. In Latin America, macroeconomic liberalization had a similarly clear impact on the extent of land market transactions even though this was in many cases insufficient to overcome a legacy of unequal land distribution and access.

In industrialized nations, rental markets often cover large shares of cultivated area, up to 70% in some cases (Swinnen). In the United States, the share of renters increased from 35% in 1950 to 43% in 1992, much of which involves sharecropping (Dasgupta, Knight, and Love). Secure individual land rights allow households to enter into long-term contracts that do not appear to be associated with reduced investment incentives; to the contrary many tenants prefer rental to land purchase given its lower capital requirements and greater flexibility (Bierlen).

In most Central and Eastern European (CEE) countries, the post-communist transition implied that land plots were restituted to original owners who often did not want to be involved in farming. Rental played an important role in the initial transition and, even where secure long-term land rights are now well established, remain of great importance where macroeconomic uncertainty, together with shallow financial markets continue to impede development of rural land sales markets.

By contrast, well-functioning and efficiency-enhancing land markets have been slow to evolve in many countries of the Commonwealth of Independent States (CIS) where land was privatized in the form of "paper shares" rather than plots that can be physically identified and exchanged. Collective managers' privileged access to output or input markets implies that in these instances most "rental" transactions consist of the transfer of land shares back to the former collective (Csaki, Feder, and Lerman). There is, however, evidence that in situations where land has been physically redistributed, as in the Kyrgyz Republic, even small endowments of land can make a significant contribution to welfare and reduce the variability of consumption. Moreover, efficiency-enhancing markets for temporary exchange of land are slowly emerging (Deininger and Savastano).

East Asia illustrates how government intervention in land markets, even if it worked well earlier, may be overtaken by more decentralized mechanisms. In China, administrative reallocations provided, until very recently, the main mechanism to transfer land between producers. However, an increase in the demand for land transactions due to off-farm migration made reliance on administrative mechanisms increasingly difficult, in addition to drawing attention to possible inefficiencies associated with the discrete nature of redistributions and the informational imperfections related to the fact that village leaders often lack the information (or the incentives) to identify producers who are most productive. This is visible in some of China's poorest provinces where land rental market participation increased from 2.3% of producers in 1995 to 9.4% in 2000 (Deininger and Jin 2003). Recent national estimates put rental participation in 2001 at about 10% of households (China National Bureau of Statistics). Advantages of decentralized transfers include greater flexibility, improved efficiency and equity, and less scope for politically motivated interference. Comparing the outcomes achieved by both mechanisms confirms that decentralized allocation brings greater efficiency gains than administrative transfers. In view of high levels of unsatisfied demand (22.4% of households indicated that at the current market rate they would be willing to rent in), this suggests that better rental market functioning could increase productivity by between 7% and 12% (Deininger and Jin 2002).

A similar increase in decentralized land rental transactions is apparent from Vietnam: while only 3.8% of rural households participated in land rental in 1992, 15.8% did so in 1998. More productive households are more likely to rent and to engage in land purchases, illustrating that, with economic development and emergence of off-farm opportunities, rental markets can increase holding sizes and welfare among those who, for various reasons, do not migrate. At the same time, households that experienced unexpected shocks have a higher tendency to engage in distress sales, especially if credit market access is limited (Deininger and Jin 2003).

Given their more unequal land ownership distribution, several South Asian countries have, in addition to efforts at redistributing land beyond a certain size, imposed tenancy laws that combine rent ceilings with the award of semi-permanent rights to tenants in an attempt to improve cultivators' welfare. Although such measures can provide short-term advantages to sitting tenants, they are likely to cut off the supply of land to the rental market and reduce incentives to undertake land-related investment (Basu and Emerson). Due to political resistance, effective implementation remained limited and positive initial effects are reported for only one state, West Bengal (Banerjee, Gertler, and Ghatak; Rawal). However, as second-generation problems related to restrictions put on transferability by beneficiaries of these reforms are beginning to emerge, possibilities for modification of tenancy legislation are more widely discussed (Saxena).

Large differences in land market activity across African countries can often be directly traced to past interventions. Rental markets that include long-term transactions that are in many respects equivalent to sales, are very active in West Africa, even though they remain mostly informal (Amanor and Diderutuah). In East and Southern Africa, colonial policy had long outlawed such markets (Deininger and Binswanger). Still, there is evidence that market activity can increase with greater nonfarm opportunities and economic liberalization. In Uganda, the share of households renting in land increased from 13% in 1992 to 36% in 1999 and there is clear evidence that, by transferring land to poor but more able producers, greater market activity contributed to increased equity and allocative efficiency, contrary to what is observed in land sales markets (Deininger and Mpuga). Where restrictions on rental markets remain, their removal could contribute to better land utilization and accelerate development of the economy. In Ethiopia, farmers who had taken nonfarm jobs perceived a significantly higher risk of land loss through redistribution than those engaging in self-cultivation (Deininger et al.).

In Latin America, a perception of weak property rights and a history of land rental market restrictions imply that rental markets are often less effective in transforming a highly unequal land ownership structure into a more egalitarian operational distribution of land than one might expect. Macroeconomic liberalization during the 1990s led to a significant drop of land prices, and, in some cases, better performance of land rental markets in much of the region. At the same time, the level and amount of transactions often appear to lag well behind the potential and the areas transacted remain small (Deininger, Zegarra, and Lavadenz). Insecure property rights and the possibly high costs of enforcement imply that virtually all land rental is short term, in many cases with close relatives where enforcement without recourse to formal authorities is possible (Barham, Carter, and Deininger). Nonetheless, interventions to increase the security of property rights and eliminate rental restrictions can have a significant impact not only on land market activity, but also on governance, as illustrated by the case of Mexico (World Bank).

Implications for Policy and Research

Review of an emerging empirical literature on the functioning of land markets provides evidence that, contrary to fears that land markets would systematically disenfranchise the poor, rental generally improves productivity and equity. The fact that in many cases this potential is not fully realized suggests that policy interventions to address constraints that limit the duration or outreach of land rentals can improve productivity and equity. Such constraints include large differences in initial endowments, ill-functioning markets for other factors, high transaction costs, and doubts about tenure security or recognition of land transfers. The extent to which any of these factors is amenable to policy intervention varies, but finding ways to ensure tenure security and reduce the transaction costs of transferring land use rights is a key issue in most parts of the developing world.

Evidence on the impact of markets for permanent transfers suggests that, as one would expect, land sales markets are less likely to improve productivity and equity and may, under certain circumstances, reduce one or both of these objectives. Although this has often been used as a justification for imposing limitations on land sales, doing so will have a number of negative side effects. Even if well implemented, such restrictions have almost invariably ended up weakening property rights, increasing the cost of land transfers, and driving transactions into informality. As the benefits from transferring land will become more relevant with economic development and specialization, the cost of such restrictions is likely to increase over time. Providing other safety nets may be a cheaper option to ward off distress sales and destitution than outlawing land sales, especially in view of the fact that such restrictions need to be enforced by a bureaucracy that may itself develop into a source of rent seeking. Thus, with very few exceptions such as farm size limits in the thousands of hectares to limit speculative acquisition in the case of rapid structural change, the costs associated with such measures far outweigh possible benefits; therefore there is little to recommend such restrictions as an effective tool for policy.

While this suggests that there is little justification for restricting the functioning of land markets, it also implies that, in developing country situations characterized by a highly unequal land ownership distribution and multiple market imperfections, land markets may not bring about a distribution that will maximize productivity within a time frame that would be consistent with broader social goals. In such cases, government programs to improve access to assets by the poor can be justified on equity and efficiency grounds although experience illustrates that successful conduct of such programs is not easy. In Colombia, for example, land rental was still more effective in transferring land to productive and land-poor producers than the government's land reform program (Deininger, Gonzalez, and Castagnini). This suggests that where such programs are to be implemented, they should build on and complement land transfers by private agents rather than trying to substitute for them.

Most research on land markets thus far has focused on outcomes at any given point in time, implying that there is still considerable scope for exploring the impact of land market arrangements on longer term outcomes. Research to address this issue could explore the interaction between land rental and sales markets and the role of land in the asset portfolio of poor rural households. Better understanding and more specific evidence of the impact of land ownership and access on levels and variability of consumption, on productive investment, and on the ability to acquire other agricultural or nonagricultural assets would not only be desirable to expand our knowledge on the functioning of land markets but also help provide evidence on the impacts of specific assets.

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