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Market-Assisted Land Reform: Helping Solve a Debt Crisis

Many developing countries have unfairly promoted the interests of the politically powerful in rural areas with tax breaks, subsidies and other privileges. These have made large, mechanized farms artificially profitable at the expense of small family-operated farms, which are fundamentally more efficient. The huge fiscal cost of maintaining these farm privileges has proved unsustainable in many countries. They are now undergoing painful but unavoidable structural adjustment, which typically means abolishing farm privileges, raising interest rates, cutting government spending, and reducing inflation.

Such adjustment may precipitate a *farm debt crisis*. The abolition of subsidies and privileges tend to reduce the profitability of farming sharply. The impact is most severe on farmers who have borrowed large sums from banks , especially since real interest rates tend to be high during adjustment. In such circumstances, farmers and banks often band together to demand a government bail-out through generalized debt relief, and governments have often given in—Brazil, Colombia, Mexico. This is economically inefficient, and imposes an enormous fiscal burden on the government, slowing down the adjustment process.

Where land ownership is very unequally distributed, an alternative approach to tackling a farm debt crisis is through the use of market-assisted land reform. The World Bank is currently exploring this strategy, which can greatly reduce the fiscal cost of tackling the debt crisis, and instead convert it into an opportunity for promoting equity, raising productivity, and increasing employment and overall growth in farming.

Why Generalized Debt Relief is Wrong

In tackling a farm debt crisis, a distinction should be made between three sorts of farms:

- Prudent, well-managed farms, which are not overburdened with debt and will be able to ride out the crisis.
- Farms that are in trouble but fundamentally sound, and can be saved provided they restructure by shedding some land and other assets.
- Unviable farms, run by inefficient owners and maintained solely through subsidy programs. Such farmers need to cease operating altogether, selling all their land and other assets to meet their debts.

When a debt crisis occurs, all three categories of farmers tend to band together to demand write-offs. But this is unwarranted. The first category of well-managed farms needs no bail-out, and generalized debt relief will simply confer an unwarranted windfall on such farms.

Farms belonging to the middle category need restructuring. They need to negotiate some debt write-off by banks while paying the balance of their debt by selling some land and assets. Governments can help by subsidizing a modest part of the write-off in such cases.

The third category of farms are unviable, often because they are badly managed by large owners lacking motivation and skills. These include people who bought land as a speculative investment rather than for serious farming. Such people should sell all their land and other assets to meet bank dues. They should then cease operating, with their place being taken by small-

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holders, who are inherently more efficient. The government can smoothen the process though exit bonuses, retraining schemes and loans to farmers leaving the sector to help them start new businesses outside of farming.

Generalized debt relief is poor policy since it means the worst farmers keep going instead of exiting, land speculators get a windfall instead of being penalized, and efficient smallholders are denied a chance to buy more land. This is inequitable and inefficient.

Why, then, do so many governments announce debt relief? Landed elites are well organized and continue to have a lot of political influence, even after structural adjustment, so they are able to lobby effectively for such relief. In addition, banks join hands with farmers on this issue forming a formidable political coalition.

When a debt crisis occurs, the price of land usually falls rapidly. One reason is that farm privileges diminish significantly with structural adjustment, so the factors that earlier drove up the price of land artificially have now disappeared. The second reason is that land transactions shrink dramatically in a debt crisis and market liquidity falls. Banks find it is not worthwhile to foreclose on mortgaged farmland since no buyers are available save at give-away prices insufficient to cover loan dues. Interest rates are generally very high in a debt crisis, and good farmers will not borrow at high rates to buy land. Smallholders and landless workers would like to buy land, but lack cash and access to credit. So banks often claim that they will collapse if they do not get a government bail-out, with disastrous consequences for other sectors of the economy. Governments are afraid of letting a farm crisis escalate into a general banking crisis, and so may agree to bail-outs. However, this entails a prohibitive fiscal cost, so an alternative strategy is needed.

How Market-Assisted Land Reform Can Help

Conventional land reform takes the shape of the government or its agencies expropriating land, with or without compensation, and then distributing it to smallholders. This process is typically plagued by disputes and delays running into decades (Mexico's land reforms took 50 years to complete). This disproportionately penalizes the poor, who have high discount rates--that is, they greatly prize immediate benefits but attach virtually zero value to benefits that arrive after seven or eight years. Market-assisted land reform aims to facilitate the process of willing buyers striking deals with willing sellers, thus eliminating the usual delays and conferring immediate benefits on smallholders.

A key problem caused by a debt crisis is that the land market shrinks dramatically, since there are very few buyers or sellers. Market-assisted land reform will increase both the demand for and supply of land, and thus help resolve the debt crisis, in addition to improving equity.

Increasing Demand. In market-assisted reform, government grants are essential to target the poor, who otherwise cannot buy land. The grant can be 100 percent for small plots, and then decline on a sliding scale up to a certain maximum size, adjusted for land quality. Studies show that the landless have the ability to raise a fair amount of equity through relatives, friends and their own savings. Such co-financing by beneficiaries means that even a modest fiscal provision will go a long way in increasing the demand for land. Besides, the government will necessarily have to invest substantial sums in building rural infrastructure in the reform zones, and beneficiaries can contribute free labor as "sweat equity", further increasing their capacity to buy land. Finally, the government can give banks modest subsidies that may help cover transactions costs to increase their lending to beneficiaries.

Increasing Supply. Such a big increase in the demand for land would send land prices skyrocketing in normal times, but in a debt crisis land prices have already crashed and there is huge list of potential sellers inhibited only by the paralysis of the land market. Potential sellers can be converted into actual sellers through several steps, some of which have been outlined earlier in regard to the three categories of farmers:

- The government can give a modest subsidy to banks to write-off part of the debts of the middle category of farms, which can be salvaged with restructuring.

- The government can subsidize bank foreclosure of the mortgages of the third category of unviable farmers, provided this land is sold to individuals and groups who qualify for land reform grants.

- Exit bonuses, retraining schemes and loans to start new businesses can be offered to exiting farmers.

- The government can subsidize or guarantee pension schemes that offer exiting farmers an income stream comparable to what they would earn from farming but free from its risks and fluctuations.

In this manner, modest conditional subsidies can create a large number of buyers as well as sellers, and the moribund land market will become very active. Banks will be able to recover the bulk of their dues, and with the benefit of selective subsidies will ride out the debt crisis. The fiscal cost will be far less than for a generalized bailout, making more money available for funding beneficiaries and developing infrastructure in the reform zones.

In South Africa, calculations show that funding of these actions will achieve a real social rate of return of 28 percent. In addition, fiscal costs associated with market-assisted land reform will be only 78 percent of the of blanket debt relief.

Suggested Reading:

Johan van Zyl and Hans Binswanger. 1995. "Market-Assisted Rural Land Reform: How Will it Work?" In van Zyl, J., Kirsten, J. and Binswanger, H. *Policies, Markets and Mechanisms for Agricultural Land Reform in South Africa*, (Capetown: Oxford University Press).

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