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Viewpoint

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To Buy or Lease?

Farm revival in Eastern and Central Europe

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Buying, selling, and mortgaging farmland are still rare in Eastern and Central Europe. Not surprisingly, given the level of risk in many of these countries, short-term transactions, especially leasing, are more common. These short-term transactions do almost as well as land sales in allocating resources. Making them more secure by improving simple registration and enforcement systems and increasing public access to information on what's for rent and at what price would do much to help revive the farm sector.

Sales slow to pick up

A recent World Bank-sponsored survey of private farmers in Eastern and Central Europe found a generally low level of sales and a high level of short-term land transactions compared with more mature markets such as the United Kingdom (figures 1 and 2). In Hungary and Poland, which have allowed private ownership of farmland since 1987 and 1981, leasing is widespread. In Bulgaria and Romania, where landownership has been allowed only since 1991, little or no farmland has been sold yet because sales are still legally restricted. Informal lease transactions predominate in both these countries, though the numbers are still very low.

Given the desperate need to restructure farms in Hungary and Poland, the volume of land sales is surprisingly low. Evidence from other transition economies suggests that leasing is preferred there too—even when selling land is allowed. An Estonian survey on attitudes toward land privatization revealed that only 2.4 percent of those who own land plan to sell it, and that 11.6 percent were willing to lease their land. A preference for renting rather than selling land has also been observed in eastern Germany.

FIGURE 1 SALES OF FARMLAND, 1991-92
(annual average percentage of survey area)

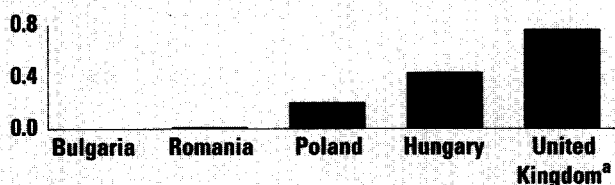
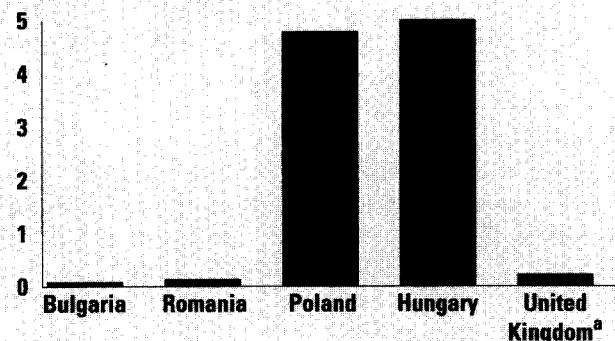


FIGURE 2 LEASING OF FARMLAND, 1991-92
(annual average percentage of survey area)



Note: The United Kingdom is included as a benchmark for land transactions in industrial countries.

a. Data are for 1992.

Source: World Bank 1994.





TABLE 1 FARMERS WILLING TO USE OWN LAND AS COLLATERAL FOR A LOAN (percent)

	Albania	Bulgaria	Hungary	Poland	Romania
Yes	19.6	40.5	16.0	14.4	26.0
No	61.7	42.5	70.0	66.4	66.2
Undecided	18.3	13.6	12.2	17.3	7.8
No answer	0.4	3.3	1.7	1.9	0

Source: World Bank 1994.

The Bank-sponsored survey also shows that land is rarely used as collateral. When private farmers in Albania, Bulgaria, Hungary, Poland, and Romania were asked whether they would

Informal agreements dominate at the early stages of transition, leasing dominates at later stages, and an expanded set of options, including sale and purchase, becomes available in developed markets.

be willing to use their land as collateral, most said no (table 1). Moreover, banks are reluctant to accept farmland as collateral—although some will accept centrally located urban land.¹ The survey indicates that the more market-oriented the banks, the more reluctant they are to enter into the high risks currently associated with farming. When banks do lend to farmers, they tend to make only short-term loans (not for land) and they prefer movable property such as crops, animals, and personal assets as collateral. Only in Poland were banks willing to lend to farmers to buy land, prob-

ably as a result of the greater experience with private landownership in that country.

The uncertainty effect

Most transition economies have yet to fully establish the “rules of the game” and the “institutional infrastructure” for land markets. Many countries, especially those of the former Soviet Union, even have yet to make a clear and credible policy commitment to private property rights to land (including the right to transfer). While other countries, such as Estonia, have recognized and protected such rights, they are still wrestling with conflicting land claims—between original owners and current users. And although some countries, such as Albania, Armenia, and Romania, have moved quickly to distribute public land to individual owners, they have yet to develop the substantive and procedural legal mechanisms to facilitate buying and selling.

In the current economic environment few farmers or investors want to buy farmland. They are uncertain about the viability of agriculture. They lack access to long-term finance. Owners are reluctant to sell because high unemployment, the collapse of social programs, and the lack of savings mechanisms mean that private owners want to hold land as a fallback, subsistence option. Moreover, members of collectives are constrained by a farm restructuring process that makes it difficult, if not illegal, to sell land to outsiders.²

While the reluctance to buy and sell is understandable, the need to revive the farming sector is important and urgent—agriculture currently accounts for about 27 percent of employment and 15–20 percent of GDP in the region. More secure leasing can help.

Leases are efficient

On both equity and efficiency grounds, short-term leases are frequently perceived as “second-best” tenure options compared with owner-operated arrangements. Yet, although

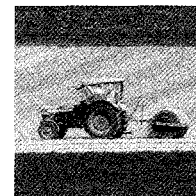
long-term leases and ownership are crucial for creating the right incentives for long-term investment, short-term leases seem to be preferred during periods of economic instability. Recent theoretical and empirical work has shown that these leasing arrangements may be more efficient under conditions of high risk aversion, imperfect information, high enforcement costs, lumpy inputs, imperfect credit markets, or missing insurance markets—conditions that are common in transition economies.³ Leases work well in these circumstances because agreements frequently take place between neighbors and within communities, substantially lowering the cost of information and of formal contract enforcement. The leases make it easier to adjust the size of farming units in a way that reflects changes in the relative cost of land, labor, and finance. Short-term leases are also likely to ease common anxieties about corruption, speculation, and mass dispossession of farmland by absentee landlords. And finally, because leasing allows short-term and repeated transactions, uncertainty about the market value of future production is less of a problem.

Leasing arrangements are important not only as mechanisms for farm restructuring, but also as catalysts in developing mature land markets. Price signals obtained through short-term contracts provide the information on land value and risk assessment that potential buyers and banks need, and thus help to strengthen land markets.

Policymakers often prescribe land titling as the necessary catalyst for “jump starting” markets. But national titling programs can take decades to complete. As important as titling is for the long-term development of land markets, it is neither necessary nor sufficient to permit farmland transactions in the short to medium term.

Typically, policymakers can expect to see an evolving pattern of land transactions. Informal agreements dominate at the early stages of transition (Bulgaria, Romania), leasing contracts dominate at later stages (Hungary, Poland), and

an expanded set of contracting options, including purchase and sale, becomes available in developed markets (United Kingdom). This pattern is consistent with the gestation period required for stabilizing the macroeconomic environment and developing institutions to reduce enforcement and information costs. These institutions become increasingly important as parties move from short-term informal agreements to agreements entailing up-front commitments and longer investment horizons.



BOX 1 TITLES AND LEASES IN THE BALANCE

There are two main differences between property rights transferred through title and those transferred through a lease agreement: property rights transferred through title are perpetual while those transferred through lease are time-bound, and property rights transferred through title usually encompass all ownership rights (mainly the rights to possess, use, transfer, and derive income from property) while those transferred through lease agreements encompass only a subset of such rights. Short-term leases typically include use rights only. The longer the term of the lease and the more rights the lease agreement transfers (including transfer and mortgage rights), the more leaseholders' rights come to resemble those of titleholders.

What to do?

Although these short-term leasing arrangements are frequently informal, they need not be. Simple measures to reduce information and enforcement costs can go a long way toward widening the scope of transactions beyond the immediate community and increasing security of tenure. At a minimum, contracting parties need to know who owns what.

A proper set of policy measures to promote short-term land transfers should include:

- **Field adjudication and registration of land rights.** Adjudication and registration are necessary prerequisites of formal land transac-



tions. (Even collective farms should be encouraged to delineate plots for each member. Members of the collective do not have to work independent of one another, but should have the option of doing so or of engaging in tenancy arrangements with one another.) Officers trained in simple surveying techniques and legal principles could provide adjudication in the field, settling disputes and demarcating boundaries in the presence of all concerned. The adjudication process results in a preliminary register of land rights.⁴ Titling is, of course, more secure than simple registration of rights. But experience in developing countries shows that at this stage the accurate surveying and precise coordinates associated with titling do little to increase security of tenure and reduce disputes, but add substantially to the time and cost of registration.

- **Removing the legal restrictions on leasing land.** These restrictions, put in place to stop “speculation” and “profiteering,” have received less attention from reformers than restrictions on land sales even though they are potentially more distortionary during transition.
- **Removing rent controls and formula-based lease prices.** Several countries allow the leasing of privatized land, but still regulate rents through price ceilings or formula-based estimates. Such restrictions, typically applied for tax purposes, defeat the crucial function of tenancy-based contracts as market signals.
- **Developing decentralized mechanisms for monitoring lease-based contracts and providing public information on opportunities, going rates, and model contracts.** These could range from bulletin boards for announcements by prospective lessors and lessees to more sophisticated mechanisms for collecting and providing information.

Implications for World Bank work

World Bank projects with credit line components targeting individual legal owners of farmland or requiring their active participation in project design and implementation are likely

to experience delayed disbursement because it takes so long to create secure, transferable, and mortgageable titles. A better option is to design projects that:

- Facilitate short-term land transactions through simple registration, enforcement of rights, and provision of market information.
- Provide the legal and institutional means through which individuals and communities could opt for more formal rights and secured transactions in the long run.
- Introduce titling programs as a long-term strategy, beginning in localities that demonstrate better potential for land markets (such as urban areas and village centers).

¹ Some banks have designed creative instruments that allow the use of centrally located urban land as collateral. In Estonia, for example, despite the lack of a properly functioning mortgage registration system, several commercial banks created a shared computer database for mortgaged real estate. This reduced the chances of fraud through multiple mortgage loans using the same collateral.

² Here, *collective* refers both to privatized *sovkhoses* and to *kolkhoses*. The distinctions are not important for the purposes of this Note. Unlike the owners and operators of industrial and commercial corporations, who tend to be separate parties, collective farm members tend to be both the operators and the would-be owners (Brooks and Lerman 1994). Farm restructuring would require devolving decisionmaking power to individual members and delineating individual rights to specific plots of land (even if production is collective).

³ Research shows leasing contracts to be generally more efficient than sharecropping or wage contracts in reducing incentive problems. See Binswanger, Deininger, and Feder (1993) for an excellent review of the literature.

⁴ Entries in such a register can be challenged in court during a specified period.

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