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**Comprehensive Agrarian Reform Program
and the Coase Theorem**

by

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I. Agricultural Backwardness

There are many reasons for the relative backwardness of Philippine agriculture and rural economy. Some of them are acts of God – typhoons, for example. Some are failures of the Philippine state – lack of irrigation and rural infrastructure. Others are the failures of well-intentioned policy, e.g., price distortions and the shortcomings of land reform law. Born more out of ideological ardor than of good sense, the Comprehensive Agrarian Reform Law (CARL) in the pursuit of a worthy political goal – the more equitable distribution of land assets and an economically progressive farm sector - has become sadly one of the roots of economic stagnation in the rural areas. Among the reasons are:

1. The fruits of land reform are most abundant when it (land redistribution) is done with dispatch. The longer it takes, the greater the cost and the paltrier the benefits. It took all of two years from 1950-1951 to effect a complete land reform in Taiwan. Land reform in the Philippines since PD 27 is now thirty years old. The Philippines has reaped the harvest of *uncertainty* and *noninvestment* in agriculture.
2. Where it has started or been implemented, the CARL (Section 27) has outlawed and, thus, effectively destroyed the legal *rural land market* and in its wake the formal *rural credit market*.
3. CARL has also outlawed the so-called “new tenancy contracts” and, in effect, outlawed leasehold, usufruct and other efficiency-enhancing arrangements.

4. There is no reason to believe that three hectares is economically viable *for all* crops.

Taken together, these have rendered CARL an economic liability. Let us examine the issues.

II. A Nexus of Markets

The rural economy is a complex nexus of interlinked markets. Each of them contributes singly and collectively to the overall productivity of the rural economy. Undermine one market and the others are degraded. None contributes more than the existence of a viable, and reliable *rural credit market*. Farming without credit is a subsistence and poverty trap. (HYVs, for example, require large investments in irrigation and fertilizer). The rural credit market is, however, intimately interlinked with the rural land market. Credit flows on the river of *security* and land is the most important *collateral*. If the land market is outlawed, land security cannot be priced or cashed and credit flows dry up. Consider, for example, what will happen even to urban credit market if the *land market* is outlawed. The urban economy will shrivel.

CARL has effectively destroyed the formal rural credit market by outlawing the rural land market. This absence of credit affects both landowners before actual land reform and beneficiaries after land reform. The former cannot get credit from banks once the farm has been declared a *land reform area*. Thus CARL, born of good intentions but very short of wisdom, has created a new underclass of the “landowning poor.”

III. Responses to the Section 27 of CARL

The continued poverty among many beneficiaries is the result of the various responses (or lack of responses) to the retreat of formal rural credit.

- (i) Since land is not tradeable, if the beneficiary or his / her heir is incompetent, unwilling or elsewhere more productively engaged (say, as a public school teacher in another town), the land becomes very unproductive. There is a saying, “Land belongs to him/her who can make it flower.” This is not only common sense. It also serves efficient allocation of land. CARL disallows this bit of wisdom.
- (ii) If the 3-hectare limit is not economically viable for a particular crop and soil quality, the beneficiary is condemned to poverty and eventual loss of the property to informal creditors.
- (iii) The market for land fortunately did not completely expire; it just went *underground*. The leasing and transfer of land is occurring everyday outside the law. Since these are illegal, they are brokered by powerful politically-connected local elites who can enforce these contracts outside the law. These may also intimidate or collude with some DAR officials to milk the transactions. Thus, the prohibition serves as a funnel of payoffs to political elites. Who pays? The buyers and the beneficiaries. In the underground economy, the powerful reap the harvest and the cost of doing business is prohibitive.
- (iv) Farmers can access informal sector credit, either (a) from informal lenders at very high cost (60% per crop season vs. 9.5% per six months from a bank in Maragol and Gabaldon in Nueva Ecija in 1998), or (b) by pawning all or part of their farm to creditors (₱100,000 per hectare for EP-covered land; ₱50,000 for CLT-covered land in the same area). Beneficiaries would rather default on Land Bank payments than private creditor dues. This, in effect, means that most farmer-beneficiaries will never reach EP-status and never will "own" their land.

- (v) Farmers also resort to *Porcentuhan* where workers (in truth, shareholders) pay 90% of gross output to owners! Since this is considered a *labor contract*, not a *tenancy contract*, it is not prohibited by CARL so it is argued. This is by far worse than a shareholder contract (60/40).
- (vi) Because formal credit cannot thrive in rural areas, it flees to the urban areas. So rural savings deposited in rural banks will be loaned to urban borrowers. The rural economy is starved. That is why that other knee-jerk reaction called *Agri-agra* designed to force a credit reflow does not move.
- (vii) Consolidation of land is happening outside the law with all sorts of subterfuges, one of which is just *forced idleness*.

Thus, the puristic infirmities of CARL adopted in the pursuit of equitable asset distribution and beneficiary welfare, have resulted in a dynamic which undermines these very goals in the long run. The message of this essay is that those worthy political goals of equitable asset distribution and a farm population invested with well-being and hope should still be pursued with a CARL that *is compatible with economic efficiency*. Otherwise, these goals are mere mirages and not sustainable.

V. Equity and Efficiency

There is a beautiful theorem in Economics called the Coase Theorem due to Nobel Prize winner Ronald Coase. It says that the *re-distribution of assets for equity's sake should not prejudice economic efficiency as long as those assets can be traded* in the market. CARL was passed to redistribute land from landowners to tenants. But it outlaws the market for land. It thus violates the second part of Coase Theorem and puts equity squarely at loggerheads with

efficiency (See Box 1). The offending provision is Section 27, which prohibits the sale, transfer or conveyance apart from inheritance of acquired lands for 10 years. In practice, even beyond ten years legal land transactions are still prohibited *until* the land has been fully repaid by beneficiaries.

Box 1: The Coase Theorem on Land

Pedro and Juan are two farmers. Pedro is landed, Juan not. Pedro can produce six tons of palay from a farm of one hectare and Juan can produce two tons of palay. The common sense law of efficiency says that “Land belongs to him / her who can make it flower,” If Pedro own the land, six tons are produced and efficiency is served. If Juan, being poorer, is granted by land reform the ownership of the land and he cultivates it, only two tons will be produced. The opportunity cost or foregone output is 4 tons. (a) If the farm is tradable, Pedro can either buy the land or offer to cultivate the land on lease and give Juan three tons of palay while he, Pedro, keeps the other three tons. The land now produces six tons – the flower (efficient) frontier! And both farmers are better off. (b) If the land is not tradable nor lease legal, Juan has to cultivate it and only two tons are produced everyone's loss. He may even leave it idle as not worth the bother and it produces zero. This is the Coase Theorem: Equity need not injure efficiency with tradeability!

This section should be amended or dropped altogether.

V. Outcome Versus Instrument

The *correct* CARL should pursue the long-run well-being of beneficiaries and a sustainable equitable asset distribution, which is the substance of the policy, and not just short-term ownership of a land title, which is only its instrument. Without the land market, the instrument does not conduit to and may even to sabotage the substance. Poverty is poverty whether a person is a title-holder, a tenant or a share-cropper. It will fan hopelessness and insurgency. And precisely because of the lack of reasonably priced credit, the beneficiaries not only fail the test of the substance but may slowly lose the very instrument, i.e., the effective ownership of the land passes to non-title holders. Section 27 is incompatible with CARL's goals over the long run.

VI. Restore the Rural Land Market for Sustainability

If Section 27 is amended to allow the sale, usufruct or mortgage of awarded lands to juridical persons, this would result in (a) land prices being *revealed*, (b) EPs and CLTs can then be priced and be used as collateral. Furthermore, (c) Banks or lenders who foreclose should be legally allowed to own more land than the CARL limit (otherwise, who will lend or buy?). These will restore the legal rural land market and, thus, the formal rural credit market.

Senate Bill No. 167 together with Senate Bill 168 (by Senator Sergio Osmeña III) is the closest to this ideal, correctly provides for (a) - (c) and resorts to a revived rural credit market for long-run sustainability of CARL goals. Senate Bill 2473 (by Senator Ralph Recto) correctly recognizes the problem, points out the futility of Agri-agra but is weak on default procedure. Senate Bill No. 1666 (Senator Juan Flavio Velasco) also recognizes the credit constraint problem and in response makes the Land Bank of the Philippines the guarantor of the mortgage to banks and

other lenders, which means that the state treasury ultimately bears the burden. House Bill No. 5511 makes Quedancor and LBP the guarantor of the mortgage from a state-provided fund of ₱5b.

The problem with the latter two bills is that (a) the government, expected to fork more, is perennially finance-challenged, (b) these government-dependent default procedures do not help restore the rural land and credit markets, which ensure long-term sustainability and (c) they may create moral hazard by eroding lender prudence if government promptly delivers or sap lender commitment if government does not. The betting is that government will not deliver beyond promises.

On the other hand, both Senate Bill 1666 and House Bill No. 5511 leave room for the control of land *reconsolidation* by reassignment of land only to CARL-qualified beneficiaries.

We feel that the land reconsolidation issue can be mitigated without the State being guarantor. Together, Senate Bill No. 167 and 168 promise real rather than cosmetic change and are worthy of support but still need improvement on this issue.

VII. Progressive Taxation To Deter Reconsolidation: A Two-Part CARL

Consolidation of land asset occurs over the long-run if the effective cost of holding on to larger and larger land is so far below the economic and political benefits. To tip the balance:

(a) A progressive tax on land should be adopted based on hectarage and prohibitive beyond, say, 500 hectares: from 0% x market value per hectare for farms from 1-3 hectares, say, to 20% x market value per hectare for farms of 500+ hectares. This has many advantages of which are: (i) a market-proxy value revealed by DAR acquisition record, (ii) large and especially idle landholdings will be very costly to maintain and (iii) it will help solve the fiscal deficit of

government. This progressive land tax will take the place of a second-round CARL application unless the consolidating owners themselves undertake a voluntary offer to sell or (VOS) or Voluntary Land Transfer (VLT). (iii) Thus, CARL effectively becomes a *two-part program*: Part one is the old CARL as we know it, without or with an amended Section 27; Part two is VOS or VLT with progressive land tax. This "new" CARL is efficiency-compatible and an improvement over both the state-sponsored and the purely market-based land reform (MLAR) such as the experimental PCT in Brazil. Part of the progressive tax proceed should accrue to LBP to finance CARL acquisition and services.

(b) The sale of CARL-awarded land may be subjected to a graduated capital gains tax (higher in earlier years) whose proceeds will all accrue to LBP to finance CARL-related services. Rancor among former owners and even other less fortunate beneficiaries simmers when an "underground" sale nets a beneficiary millions. The way out is to bring the sale above ground and hit it with a capital gains tax whose proceeds goes back to LBP to target CARL services. A capital gains tax is not anti-efficiency nor anti-market.

(c) A conversion tax is imposed if agricultural lands are converted to industrial/commercial use.

VII. Conclusion

It is hardly helpful to say that CARL has fallen very short because government has not delivered adequate support services. A CARL that is incompatible with economic efficiency quickly becomes a fiscal black hole. The reality is that state support to CARL will always fall short just as it falls short for education and other pressing concerns. We should look for remedies some other place. The challenge is to *make the paltry adequate*.

Land reforms' goal of more equitable land asset distribution is worth pursuing. There is also some evidence that long-term economic growth performance improves with a more equitable asset distribution. Unfortunately, CARL, as an instrument of land reform, has been rendered counterproductive.

The outlawing of the land market in the rural economy has rendered CARL subversive of its own worthy political goals and in places may have spawned a new under-class called the "landed poor." It is time to make CARL serve both long-term equity and economic efficiency. This will help support the prosperity of the rural area.

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