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Broadening Access and Strengthening Input Market Systems

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The Unfinished Business of Liberalization: Making Markets Work for All

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The stakes are high

Honduras and Nicaragua, like most Latin American countries, undertook sweeping economic reforms in the 1990s aimed at increasing market orientation, openness, and competition. These efforts were especially dramatic in the agricultural sector, where land market liberalization initiatives were launched after three decades of heavy government intervention in support of land redistribution and rural credit provision in Honduras and more than a decade of land reform efforts under *Sandinista* rule in Nicaragua. In both countries, the market-oriented reforms were undertaken at the beginning of the 1990s and emphasized strengthening individual property rights to land, extending titling efforts (including privatization of cooperative lands), activating land rental markets and private credit markets, and removing the government from all forms of direct land redistribution efforts that did not involve market mechanisms.

After a decade of these liberal strategies, reforms are not achieving the comprehensive growth and equitable poverty reduction objectives they were designed to address. In fact, moderate economic growth in Latin America in the 1990s was accompanied by worsening income distribution, so that poverty—already widespread in rural areas—rose.

Newly collected household data from Honduras and Nicaragua help explain why poverty may be growing. Researchers find that liberalizing land markets is a necessary but insufficient condition for helping the rural poor increase productivity or raise incomes. An emerging neo-structuralist approach suggests that a dynamic rural financial market is critical to effective land market reform. Without repair of complementary rural financial markets, land markets tend to be biased toward wealthier agents and larger farms, which, in turn, harms efforts to create a level playing field, especially in what already are highly inegalitarian agrarian economies. If policymakers continue to focus their attention on land market liberalization without ensuring broad access to financial services in the rural sector, significant portions of the rural population are likely to be left behind.

Credit access is disproportionately rationed

Market-friendly reforms of Honduras, Nicaragua, and other countries were aimed at rejuvenating agricultural credit and land markets. How then is the land titling emphasis of the agricultural modernization efforts likely to affect credit access for rural households? According to the liberal story, it is not lack of land but lack of collateral assets that primarily impedes credit access for smallfarmers. Formal lenders (who have limited local information and thus are not efficient at screening and monitoring borrowers) require collateral to provide incentives for borrowers to minimize the probability of default. In this view, one of the most destructive legacies of Latin

America's original land reforms was the inability of beneficiaries to establish clear property rights over land, which led to their inability to fully collateralize and exploit their primary productive asset. In the liberal plan, this shortcoming is remedied by granting and registering freehold titles. Land title increases a farmer's ability to provide collateral, and tenure security increases his or her willingness to undertake fixed investment.

While improving the ability of poor households to use their land as collateral certainly is a positive step, it might best be viewed as a necessary but not sufficient condition to providing equal access to credit markets. Both supply and demand factors may leave land-poor households—even though they own some titled land—constrained in the credit market. The following are three possible reasons why a farmer with title to land does not receive a loan from the bank.

First, the price of the loan may be too high compared to the returns the farmer expects. "Price-rationing," caused by the interest rate on the loan being too high or the payment schedule being inappropriate, results in the farmer not being able to afford the loan and the lending institution allocating a loan to another individual with higher expected returns.

Secondly, formal lenders may not be willing to accept collateral below a certain minimum value because of the transactions costs associated with management of the loan and foreclosure and resale in the event of a default. That minimum threshold creates the potential for "quantity-rationed" outcomes, where the farmer would like a loan at the going interest rate but cannot secure it with sufficient collateral to generate a loan contract.

Finally, a land-poor household may have enough collateral to qualify for a loan but lack access to sufficient insurance to outweigh the risk of collateral loss associated with a bad outcome in the loan contract. As a result, a smallholder may be unwilling to take the loan contract because of the risk implied by collateral loss. This "risk-rationed" outcome is a form of non-price rationing that can hinder the operation of liberalized land markets. It is of particular concern on equity grounds since poorer households tend to be more sensitive to a given risk.

The evidence of credit market performance from Honduras and Nicaragua in the wake of agricultural modernization efforts suggests that, indeed, credit market activation is uneven—more effective for medium- and large-scale farmers, while smaller-scale producers face quantity or risk-rationing that impinge on their credit access.

As of 1999 and 2000, rural financial markets in the post-reform era do not provide formal loan access to the lowest quintile of the rural poor in either country, and a large proportion of households in this sector report being non-price rationed. As shown in Tables 1 and 2, approximately 2% of the lowest wealth quintile in Honduras and Nicaragua received formal loans; in this lowest quintile, almost 50% in Nicaragua and 60% in Honduras report being effectively non-price rationed in formal credit markets. Moreover, in both countries, the percent of respondents reporting non-price rationing falls steadily from those highs to around 13% in the top quintile, which reflects the severe wealth bias that is consistent with the neo-structuralist perspective.

Table 1. Formal sector credit rationing mechanism by collateral wealth quintile in Honduras

Total wealth quintile	Price rationed			Non-price rationed		
	with loan	without loan	total	quantity	risk	total
1	2%	38%	40%	40%	20%	60%
2	18%	40%	58%	22%	20%	42%
3	20%	40%	60%	22%	18%	40%
4	27%	43%	70%	12%	18%	30%
5	45%	42%	87%	5%	8%	13%
Sample	*21%*	*40%*	*61%*	*22%*	*17%*	*39%*

In Nicaragua, it appears as if formal sector loans to agriculture are, at best, only in the early phases of development and growth, as even in the top quintile only 14% of the households reported having formal loans, compared with 45% of respondents among the top quintile in Honduras. Clearly, formal loans are not playing a fundamental role in helping fuel land market activity. Yet, are other sources of loans substituting for banks in this role?

Landownership is not a panacea

Property rights reform also may improve the efficiency and equity of agriculture via the fortification of land sales markets. The logic is as follows. Defining freehold titles establishes clear, individual rights to a parcel, including the right to sell it. Establishing a property registry permits buyers to examine the history of a parcel—including the existence of competing claims and liens—and to defend their acquired rights. The overall effect is to reduce the costs associated with land sales. This, in turn, enhances efficiency by promoting the flow of land to more efficient households who are willing to pay for it and by increasing investment in property because of the prospect of increased resale value.

Table 2. Formal sector supply-side credit rationing by collateral wealth quintile in Nicaragua

Total wealth quintile	% of households with formal loan	% of households without formal loan that would have…	
		…positive supply	…no supply
1	1.9	50.2	47.9
2	4.5	61.7	33.8
3	4.5	71.6	23.9
4	4.5	75.6	19.9
5	13.6	74.2	12.2
Sample	*5.8*	*66.7*	*27.5*

Non-borrowing households were asked: "If you applied, do you think a bank would approve your loan application?"

Stronger incentives to invest and greater ability to secure finance (via the collateral value of titled land) mean that land-poor households who own some land can become more active in land sales markets and purchase the additional land (perhaps in increments) they need to become more productive. Land purchases may provide the basis for additional credit access that can over time be used to facilitate expansion of the operational farm size of the household.

Comparing changes in landownership in both Honduras and Nicaragua in the pre-and post-reform periods demonstrates, however, that the largest absolute gains occur both at the very bottom of the farm size spectrum, with previously landless households moving to holdings of around 2 *manzanas*, and at the top of the farm size spectrum in Honduras, with farms over 60 *manzanas* apparently accumulating additional land in the post-reform era.

Quantity rationing or high transactions costs in credit markets could imply the existence of a minimum collateral wealth threshold for the activation of the credit access benefits outlined above. Households with land endowments—even if titled—that are not well above that threshold are perhaps unable to use credit markets to finance fixed investment or purchase much additional land, because formal lenders are not interested in managing their loans due to the transactions costs associated with enforcement and collection of collateral. In the absence of insurance markets, a poorly performing market for consumption credit also dampens the willingness of poor households to pay for land since land is not well-suited for consumption smoothing. Activated land sales markets are therefore unlikely to lead to more egalitarian land distributions and may be regressive in that they may increase sales of the land-scarce to relatively land-abundant households that have better credit access.

Depending on the underlying distribution of land, the critical threshold for credit market access, and, in particular, the extent of credit access associated with collateralized land, the impact of titling could be to further polarize the land and income distribution in the rural sector. Without fundamental attention to credit markets, the neo-structuralist vision suggests that, at best, land-poor households will struggle to purchase land as a means to improve their situation, and, at worst, will be more likely to sell out to more competitive agents in land markets.

Conclusion

Using newly assembled panel data sets that span the pre- to post-reform eras in Honduras and Nicaragua, this brief examined the operation of credit and land markets, two arenas where the impacts of the reform on land access are played out. From the analysis, it is clear that more productive and more egalitarian economies resulting from synergies between credit and land markets that the liberal perspective hypothesizes have not emerged. While there is evidence that land markets have become more active in the wake of the reforms, credit access remains strongly skewed against poor households, and the dualistic agrarian structures remain unaltered by the reforms, which is

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consistent with the emerging neo-structuralist perspective.

Reasons for the failure of the liberal reform expectations include the possibility that the reforms simply need more time before their full effects will be felt. It also may be that the reforms remain incomplete or non-credible. Receipt of a private land title may not provide the type of tenure security anticipated. It is also possible that despite the legal changes, land in Central America continues to be burdened by heavy historical baggage. Land is not a typical asset. The eviction of peasants and foreclosure of their land upon default, although legal, simply may be socially unacceptable for lenders, blunting the expected credit market effects of the reforms.

While the argument always can be made that reforms need more time and must be more extensive, pragmatically any policy regime has a limited time to produce results. The baggage of history as a constraint to the operation and credibility of policies is no less real or important than other types of constraints. Continued stagnation of the agricultural sectors and rising rural poverty are leading to disaffection with and pressure to shift away from liberal policies in much of Latin America. If market-mediated reforms are to work, they must take more seriously the full set of market failures and problems that limit reforms in specific markets.

In Honduras and Nicaragua, financial markets continue to be biased toward wealthier households. These biases constrain the ability of poor households to exploit their potential competitive advantage in land markets. In response, Latin American countries could maintain course and accept that the benefits of the liberal policies will be limited in scope. Conversely, they could return to the illiberal, state-centric rural development policies of the past. Alternatively, it may be time to return to the difficult issue of invigorating rural financial markets. While considerable progress has been made in promoting financial market access in urban areas through microfinance institutions (MFIs), much less has been done to strengthen agricultural lending in rural areas or to advance the design of risk management and other institutions needed to stabilize MFIs in the face of the peculiar challenges of rural economies. While it would be unwise to underestimate the difficulty of this task, the costs of inaction may be higher, both in terms of the welfare of the rural poor and the fate of liberal policies in Latin America.

Suggested reading

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