Should I own or should I lease? How relational analysis can help us understand the landscape of property rights

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Should I own or should I lease? How relational analysis can help us understand the landscape of property rights

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Abstract: *Starting from the recent literature on relational contracts in economics, we discuss the 2016 land reform proposed by the Kazakh government. The puzzle in this context is that farmers strongly, and sometimes violently, opposed reforms that would have allowed them to own, rather than rent, their land. Discarding alternative candidate explanations, we conclude that due to the rules on compensation for lawful expropriation, a relational contract that hinges on recurrent leasing dominates one in which the owner is exposed to the risk of expropriation. Our analysis reveals that policy changes cannot be considered in a vacuum. One must take into account the economic and institutional contexts.*

Keywords: *Property rights, land, relational contracts, institutions*

When faced with a choice between leasing and owning an asset you know well, and which is an essential input to your economic production, why would you choose the former? You should not! At least this is what conventional wisdom and economic theory tell us.

Ownership of a productive asset—the right to decide on the use of a resource, be that tangible or not, and the right to exclude others from accessing it—is preferable from both the individual and the social perspective. Consider the prototypical case of an entrepreneur who is about to invest in physical capital or develop new ideas. The entrepreneur's decision would be contingent on the returns that she believes that she could generate from her investment. If, for any reason, potential investors are limited in their ability to benefit from their investment, this will harm their investment activities by either reducing the level of investment or diverting funds to sub-optimal activities, such as defensive expenditures aimed at safeguarding what she believes is rightfully hers.

The need for an enforcer of the property rights is unarguable. In the Hobbesian social contract, that role is fulfilled by the sovereign state. In Hobbes's world, however, private individuals release all property rights to the state, but

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should they? Who is the most likely infringer of the property rights—a trespasser of the law or the protector of the law? One can easily see taxation as an infringement of property rights, given that it expropriates a share of the fruit of one's labor and capital. The obvious counterpart of this argument is that taxation raises funds for big projects of a public good nature, such as infrastructure, transport, education, and health, which, if not provided by the state, would be underprovided or would have restricted accessibility, which also impedes growth potential.

This is not to say, however, that the state has a say only as a protector of rights. Indeed, the state also influences economic activities via its regulatory role. If left to their own devices, entrepreneurs may end up making investments that injure the wider society by, for example, causing substantial environmental damages, making irreversible changes that affect the value of surrounding assets, or precluding access to the asset by other productive agents beyond what is economically justifiable.

Even with the most benevolent system of protecting property rights, however, "the notion that simply instituting an appropriate legal regime will establish a set of property rights that can undergird a modern economic system is deeply implausible, because most property rights can be only marginally enforced by the legal system" (Rapaczynski, 1996, p. 88).

The decision of whether to own or lease is not only influenced by pure economic and legal aspects. It is also undoubtedly steeped in rich cultural, political, and social connotations. Notable in this context are the large-scale extreme nationalizations in the early 20th century in the Soviet Union and other members of the Communist bloc and the subsequent large-scale organized privatization that most of these societies experienced in the 1990s.

With reference to land in Central Asia, private ownership is a relatively new concept. In the not-so-distant nomadic past of most Central Asian countries, and of Kazakhstan in particular, land was for communal use. No private property right over land existed. By contrast, property rights on livestock—which represented the key element of individuals' wealth—were well developed. Subsequently, Kazakhstan's experience within the Soviet Union meant that land was nationalized, thus belonging to everybody. A rich anthropological literature (see, for example, Jacquesson, 2010, 2012) describes how tightly-knit clan groups interact in the changing social landscape in Central Asia and govern common resources.

The insights from this literature, alongside the discussion above, should lead the reader to the observation that property rights operate within a complex context of interactions among various agents—owners, states, economic partners, and competitors as well as social links, often with conflicting interests; and they are embedded in social and cultural norms. The question of how the understanding of the complex nature of ownership can equip us to more accurately analyze individual choice of ownership and devise policies that support best outcomes is the topic of the current work.

Building on these premises, scholars in both law and economics now recognize and incorporate the complex and interactive nature of property rights in their analyses. In the context of law scholarship, Qiao and Upham (2015, p. 2480) write:

> For the most part, property rights evolve quietly and incrementally, which is hard to explain if we take exclusive rights as the core of property, or, to put it more generally, if we are focusing solely on the question of who owns the things.

These authors argue that to understand the evolution of property rights on rural land in China, one needs to employ a model of "relational property," which evolves from the legal frameworks of Singer (2000) for the social relation model and Macneil (1985) for the relational contract aspect. Their notion is defined as the structural and dynamic interdependence of human agents with respect to a particular asset. At the core of this concept is the realization that associated with a single asset there may be agents with decision rights on various aspects of the asset, and that, with the passing of time and the evolution of the value of the asset, these rights evolve alongside the relative power of the decision makers. When applied to the evolution of rural land ownership in China post 1990s, these relational property concepts enable the authors to rationalize a wide variety of ownership trajectories—timelines for the evolution of property rights—that are driven by variation in the interconnectedness and preferences of the agents associated with the specific asset, i.e. the land. Rather than being hampered by the impossibility of imposing structure on the seemingly chaotic systems of formal and informal property rights in developing and emerging economies, these authors argue that focusing on the social relations grounded by an asset or valuable resource will enable the organizational aspect of property rights to emerge organically.

In particular, they argue that their approach enables them to capture the smooth and incremental changes to the balance of power and the degree of involvement in decision making as far as an asset is concerned over time—an understanding that is impossible in the context of the well-defined and exclusive principles of a rigid framework, where the property rights are assigned to legal entities over partitions of the resource. As an example—relevant for many emerging economies—one can take the rural land reform in China where existing social networks enabled individuals and communities to convert the use of rural land from exclusively agricultural purposes to residential and non-rural production, by exploiting first their tightly-knit community to form a transaction platform, which was then opened to participants from farther afield. In other geographical locations, however, such transformation was not successful. The reason for that is the type of relation between key decision makers such as community leaders and local government leaders, as well as links with external entrepreneurs.

The above discussion highlights key features of the relational approach to property rights: (a) the existence of a socioeconomic link between agents in relation to an economic resource; (b) the fact that the time dimension is important for the interaction, be that in terms of its long-term prospects or of its repeated nature; and (c) the ability of the participants to shape the interaction in the absence of reliance on formal enforcement.

Encapsulating this relational framework in economics is achieved via the concept of a relational contract. In the past two decades, seminal contributions have helped develop the necessary theoretical tools and have discussed the relevant empirical evidence to enable economists to gauge the significance and prevalence of relational contracts (see, for example, Levin, 2003; Halac, 2012; Helper and Henderson, 2014; and Macchiavello and Morjaria, 2015). These analyses make clear that the time dimension is not only an important but indeed an essential feature of the environment for a sustainable relational contract.

To see this more clearly in the context of rural land use, let us consider a leaser (user) and a lessor (owner) who are required by an institutional setup to end their economic relation in a given period, a few seasons away. In such a situation, a self-motivated user and owner would want to extract as much value for themselves as possible from their current interaction. The knowledge that in no future moment will either of them need or depend on the input from the other party to generate economic value, automatically relieves them from any relational obligation and concern about the economic interests of the other side. Thus, for example, the user may plausibly refuse to pay the agreed fee in full, and the owner may impede access to the resource.

Such breaches of contract, one would argue, are only possible if there is no authority to enforce the terms of agreement between the user and the owner. In other words, the problem exists only in countries with weak institutions.

We would argue to the contrary. Even in countries with strong enforcement capability, an economic relation that builds on repeated interaction is more sustainable and achievable at a lower cost. In the context of land use—but not only then—the uncertain environment of production, the imperfect control over productive resources, and the complexity of the output create a context where the enforcement of the contract by a third party may be prohibitively costly.

For example, in sharecropping—an agreement where the landowner allows access to her own land to a farmer in return for a share of the crop yield—the level of the yield crucially depends on many factors such as the weather, fertilizer use, and agricultural methods. While the farmer fully controls some aspects, such as time, effort, and production methods, she may have at best limited control of others such as the impact of pests and diseases on crops. The farmer is thus exposed to all risks associated with the variability of output, while facing the certainty of all the costs of production. This could lead to situations where she takes actions that would be detrimental to the owner. Not investing sufficient time or applying fertilizers may indeed be suboptimal, but even more harmful would be the adoption of poor agricultural practices that might permanently reduce the future value of the land.

One way of trying to address the issue of motivation and control of inputs for the owner would be to reimburse the user—at least partially—for the cost of land use or to write an exhaustive plan of permissible practices. It is easily seen, however, that such an approach is infeasible if costs are not verifiable and the production environment is highly uncertain: Could one truly prescribe a watering schedule contingent on the weather or on the time that a farmer must spend on a field? Furthermore, when farmers know that the owner will pay for fertilizers, would they still choose the most cost-effective level of the input?

Not only are the steps of production difficult to enforce; in the case of perishable produce, a disagreement between the two parties about the quality of the produce may also be hard to resolve. Consider flower producers. One can observe the true quality of flowers only in a narrow time window after harvesting. If the producer and the owner or buyer were to disagree on any aspects of the quality of the output, and if they were to seek the opinion of a contract enforcer, it is likely that the time needed to report the breach would make it impossible to fairly verify the flowers' quality. Thus, it may be the prohibitive cost of enforcement and verifiability of either production plans or output quality that render relational contracts viable instruments for sustaining economic activities in developed and developing countries.

At the beginning of the discussion of relational contracts, we stated that the viability of the relational agreement depends on the long-term or open-ended nature of the economic relation. In an environment of uncertainty, it is precisely the prospect of a future gain and the opportunity for inflicting a future loss that discipline both parties in the relation. In the case of the farmer and the land owner, the opportunity to benefit from future yields would align the efforts of the two parties, on one hand, to adopt the most suitable agricultural practices and effort, and, on the other, to award to labor its fair share.

Many factors shape relational contracts: the degree and type of uncertainty, the presence of a commitment device to the relationship (such as investing in the relation specific assets—for example, housing for the farmer), the presence of competition (are other farmers or land owners open to entering an alternative relation), changes to institutional contexts that impact on the possible enforceability of a formal agreement, and the level of uncertainty. Many authors have studied how these factors affect the optimal behavior of participants (e.g. Macchiavello and Morjaria, 2017).

Going back to the question we started with: If farmers have a choice, should they own or should they lease the farmland? Translating the question into the language of relational contracts, we are asking decision makers to choose their role in the relation. In this relationship, who do we think obtains the highest payoff, the one who owns or the one who leases, and why?

This was the question that Kazakh farmers faced in Spring 2016 when the Kazakh government announced a reform that would allow auctioning of agricultural land, which until then could only be leased. The farmers responded with protests—in their thousands. In response to the protests, the government put the reform on a five-year hold, started a consultation process, and suggested that the main reason for the moratorium was to update the country's cadastre. So why did the farmers protest?

Certainty about the size of the asset, and a fair assessment of its value, are indeed essential for choosing one's side in a relation. So the cadastre update might be an important first step. Once the asset properties and valuation are known, any farmer who thinks that the value of the land is destined to increase should try to purchase the resource. Conversely, anyone who thinks that the value of the land will fall ought to consider leasing as the preferred option. The issue of land value aside, what other factors could have been of concern?

Clearly, a farmer may prefer owning land to leasing it. Indeed, ownership implies that when making investments with substantial setup costs and with returns that accrue after long lags, the user of a resource would benefit from the longer time horizon afforded by ownership, since this would allow an appropriate depreciation of the costs and would maximize benefits. Additionally, while land is classified as a renewable resource, its productivity hinges on the users' production practices. Therefore, continuous control over the land should be key to enabling the farmers to reap the full fruits of their labor over time and, potentially, over generations.

The above holds, however, only if (1) the farmer has access to the necessary financial capital, i.e., the choice is indeed real; and if (2) she trusts the process of sale. The farmer must have access to financial capital to acquire the land in the first place. The allocation of the land to its most productive users, therefore, depends on well-functioning financial markets. From this point of view, one may see the protests as evidence exposing the inadequacy of current financial intermediation to support the expansion of property rights.

Data from the World Bank's Global Financial Development indicators suggest that access to financial markets may not have been the reason for this protest (World Bank, no date). In Kazakhstan, private credit by deposit banks and other financial institutions as a percentage of GDP—an indicator often used to measure the depth of the financial sector—increased from less than 10% to about 50% between 2000 and

2009. Over the same period, this indicator among low- and middle-income countries increased from 17% to 26%. Despite the drop in the indicators value since 2010, the most recent data indicate that private credit still accounts for at least 36% of GDP in Kazakhstan. This value is still greater than the average for the reference group of countries.

Furthermore, institutions specializing in extending credit to the agricultural sector already exist in Kazakhstan. This of course is not to say that access to financial capital is without limitations. According to a 2013 OECD report, the agricultural sector struggles with low productivity. But one would think that rather than representing a significant obstacle to land privatization in Kazakhstan, the greater opportunities for investment and innovation that diffused ownership provides ought to be seen as a chance to increase productivity and ease financial constraints, making land purchase an attractive proposition.

Looking at the second issue—the sale process—the fear might have been that the people who end up owning the land will not be its best stewards. The people of Kazakhstan may well be justified in doubting any centrally-run privatization, given the bad press received by the 1990s wave of privatizations in terms of corruption and ineffectiveness. This, however, is unlikely to be the sole reason of the protest, since recent privatizations of large enterprises did not trigger similar popular outbursts.

One issue remains—the institutional context. What happens when property rights are *lawfully* terminated? There are clear cases when property rights over land may be lawfully terminated, for example due to "national interest" (sometimes called "eminent domain"). In these cases, the law states clearly the (limited) amount of compensation for the rightful owners.

Under the same circumstances, an individual who leases rather than owns the land is entitled to in-kind compensation in the form of an "equivalent" plot of land. The cases when rightful expropriation of land can occur do not differ in Kazakhstan from those in many other countries. What may be particular to an emerging economy is a dynamic environment that launches big infrastructure projects in the economy, maintains international links, and that attracts foreign capital. The "national interest" may be invoked more frequently than in more mature economies. This discrepancy in the compensation rights of owners and leasers may have been a non-trivial driver for the protests. Ironically, it may demonstrate that individuals perceive their access to land, and the possibility of their continued livelihood, as more protected when they lease the land than when they own it.

Given that the central object of the relation we are discussing is land access, it becomes apparent that in the institutional context discussed above, a leaser is paradoxically less likely to be excluded from the asset when compared to an owner. Thus, a relational contract that hinges on recurrent leasing dominates one in which the owner is exposed to the risk of expropriation. Analysis of the proposal for land reforms in Kazakhstan, and of the public response to it, reveals that policy changes cannot be considered in a vacuum. One must take into account the economic and institutional contexts.

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