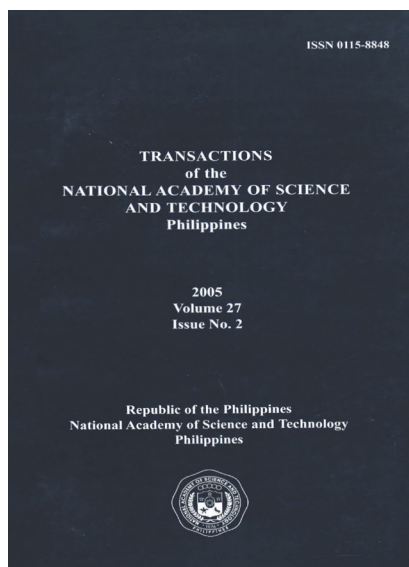


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## Amending the Land Reform Law

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## **Social Dimensions of Philippine Agriculture 2020**

### **AMENDING THE COMPREHENSIVE LAND REFORM LAW**

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Thank you very much. I am honored to speak before you today as a panelist on the social issues surrounding agriculture.

You already have been provided with ample data on the backwardness of the Philippine agriculture. While to a certain extent, this state of backwardness of Philippine agriculture can be attributed to natural calamities such as typhoons and floods, the greater part of the blame must be charged to institutional failures. The Philippine government has not only failed to provide proper irrigation facilities and farm-to-market roads, it has also failed to provide progress-enabling policies in the agricultural sector. Some of them are associated with great social engineering experiment called land reform.

The rest of my comments will focus only on land reform. This is touched on in Section 2.8 of the Philippine Agriculture 2020 authored by Academician Javier and Dr. Alberto Aquino. So, I will dwell on a few particular issues associated with the land reform law which may help put in perspective Agriculture 2020.

A comprehensive agrarian reform law has of course the social desideratum, equitable asset distribution, on its sails. This is, no doubt, very appealing. The equitable distribution of land assets it is argued will improve both the politics and the economics of the farm sector. This has two parts: better democratic politics as rural politics begin to be divorced from the grip of large landownership and greater farm-level efficiency as small landholders, energized by "ownership" work harder to make the land flower. The economic efficiency argument had for a long time the weight of econometric evidence on its side. Before 1987, studies appeared to show

that per hectare production of rice increased with a fall in farm size. In 1988, a study by Bhalla and Roy (1988) showed that when land quality was controlled for in the earlier studies, the farm size-productivity nexus reversed sign and robustly so. The economic efficiency argument for land redistribution disappeared. There may indeed be scale economic forces at work in farming. The political argument however remains and, given our legacy of insurgency based on land disputes, it may still be worthwhile to sacrifice economic efficiency for better democracy. But because of the way this project has been implemented in the Philippines, it has become a veritable millstone on Philippine agriculture.

The enabling law for land redistribution, the Comprehensive Agrarian Reform Law (CARL) was passed in 1987 and will be 20 years old in two years time. The fact that this has taken so long (20 years for CARL and almost half a century since the first land reform law, RA 27) means that our agricultural economy has suffered decades of ill-defined property rights and highly uncertain investment climate. This has led to virtual drought in private fixed capital investment in agriculture. This cost is incurred long before the area becomes a land reform area. But the cost escalates when the area becomes a land reform area.

I will focus on Section 27 of CARL.

(1) Section 27 outlaws any market transactions (the sale, rent, usufruct or other tenancy contracts) on land in all land-reform areas (that is after the area is declared a land reform area and before the tenant beneficiary has paid in full). After the tenant has paid in full he/she may sell but in a distorted legal market where the potential buyers are the landless who can't afford and can't borrow to afford. The delegitimizing of land transactions has virtually destroyed the legal rural credit market especially that associated with crop loans. The rural economy is of course a matrix of linked contracts and the rural credit market is intimately linked with the rural land market. If the land market is outlawed, legal credit also dries up since land asset no longer qualifies as loan collateral because the creditor can neither hold it (>5hectares is illegal) nor sell it. Well, if the beneficiary of land reform cannot access production credit, he and his land becomes unproductive.

As a result, the formal credit market has been supplanted by the underground credit market where enforcement of contracts is private (some illegal arrangement in the use of land as payment such as "posiyentuhan" which in the murky waters of DAR jurisprudence is not considered a tenancy

arrangement or mafia-style physical harm). A farm sector without a functioning credit market is a dead sector so the underground credit market is a savior. It has two very pronounced toll: First, it is a very high borrowing cost market. For example, 60% is the interest rate charged per crop season in Maragol and Gabaldon, in Nueva Ecija in one survey in 1998 vs. 9.5% every 6 months from the local bank. That makes for poverty-stricken farmers. Second, it also erodes the rule of law in the area. When law-breaking is the only way to survive, law-breaking becomes a way of life which spills over to other laws. Section 27 of CARL, in effect, imposed a permanent *credit crunch* in the rural sector.

In economics there is a beautiful result called the “Coase Theorem”, after Ronald Coase, Nobel Memorial Prize winner in Economic Science. The Coase Theorem is actually very intuitive, very simple. It says that asset redistribution to favor equity should not prejudice economic efficiency as long as assets can be readily traded in the market.

CARL violates the second part of the Coase Theorem and therefore militates against economic efficiency. For example, take the case of two people, Pedro and Juan. Pedro has the title to a piece of land L; Juan does not. Pedro produces 100 cavans of rice per hectare; Juan can produce 20 cavans per hectare (is less productive for whatever reason some of which will be treated below). Suppose, we redistribute land L from Pedro to Juan but do not allow any market transactions on land and do not allow other tenancy arrangement. Now Juan produces 20 cavans of rice per hectare instead of the hundred previously produced. Society loses 80 cavans per hectare! This is very economically inefficient!

If however, land can be traded in the market and other useful contracts are allowed, then Juan can for example lease the land to Pedro who proceeds to produce a hundred cavans of rice. He gives Juan 30 cavans per hectare as rent and keeps 70 for himself. Juan is better off and society is better off with 80 cavans per hectare more and economic efficiency is served. That is the Coase Theorem. And the Comprehensive Agrarian Reform Law (CARL) Section 27 has outlawed the Coase Theorem.

Land conversion from farm to urban in locations where that can be very lucrative has become a cash cow for the politically powerful people who can influence local DAR decisions and enforce contracts if need be outside the law (the Remulla syndrome). For this to happen, the farmer has to stop planting and leave the land idle. Furthermore, extant irrigation may have to be destroyed to avoid the legal restriction on irrigated land conversion.

Thus land transactions and consolidations are still happening but outside the law.

The second problem with CARL is the “entrepreneurship fallacy”. CARL mandates that all bona-fide tenants be awarded a parcel of land. Now, as lowly as society views farming in this country, running a farm is truth be told a complex entrepreneurial undertaking as many NGOs have found out which went into farming. The farmer-owner has to arrange financing, do the land preparation, procure the seeds and fertilizer, do the weeding, decide on the timing of planting, seeding and harvest, contract a buyer and negotiate the price and hope to God the weather cooperates. Since this climatic cooperation is a random event, the farmer has to arrange an insurance of some form or other. Only a small part of these had she/he the exposure to deal with. To think that the only barrier to farmer entrepreneurship is ownership of land is the height of fallacy! If the beneficiary doesn't have entrepreneurship ability, he may founder and may be better off as an employee. But with Section 27, he/she cannot legally opt out anymore. He is forced to be an entrepreneur! This can be remedied with the Coase Theorem which Section 27 bars.

There are many other reasons why the farmer-beneficiary may want to opt out. He/she may be physically incapacitated; he/she may feel that the best use of the land asset is to sell or mortgage it for a sum that will finance an OFW job for a child or the graduation thereof. In many rural areas, people no longer associate upward mobility with farming but with OFW remittance and for good evidence-based reason.

The third most glaring problem with CARL is a uniform land-ownership ceiling of five hectares across all crops. The assumption is that a farmer can become economically progressive at five hectares whether in rice, sugar, coconut, banana or whatnot. This is hardly warranted. There is a study (Fernandez and Nuthall, August 2001) that shows that sugar farms averaging 4 hectares on average lose P227 per hectare. They also produce the smallest tonnes canes per hectare (41 vs 52 for farms averaging 26 hectares). But even this arbitrary area ceiling problem can be remedied if Section 27 is abolished.

A fourth glaring problem is that most awarded lands are in a state of limbo called Collective CLOA (Certificate of Land Ownership Award). Under collective CLOA (which comprises about 2 million hectares and about 1 million farmers), beneficiaries cultivate parcels of land they are not sure of eventually owning. Thus the extra care and diligence expected of

an owner in the use of his land especially as regards permanent improvements such as tree planting may be discouraged.

There are several bills pending in Congress intending to address the contentious issue of how to provide credit to farmer-beneficiaries. The corollary issue is the collateralization of land assets so credit can start to flow. One approach is just simply freeing the rural land market. This involves lifting all restrictions on land transactions after land has been awarded. The beneficiary can simply opt to part with his land for an agreed fee that pays the liabilities of the land with the Land Bank plus a premium which represents a redistribution of wealth. This effectively takes out Section 27 of Comprehensive Agrarian Land Reform Law. This changes somewhat the philosophy underlying land reform: it becomes a transfer of property rights to redress the historical injustice, the “the original sin” of land being forcibly grabbed from original (indigenous) owners, and sanctioned by the state. What happens after that is a market outcome. This is the *Second Fundamental Theorem of Welfare*.

The second approach is to make the state a guarantor of all loans contracted by all the agrarian reform beneficiaries. This is a prescription for an orgy of moral hazard: the farmer borrows and use it for production or something else; the bank does not care either to collect or to check how it is used because the government will pay! There is no accountability anywhere! This is a prescription for a fiscal quagmire and endless rent seeking!

My own feeling is that the reform should be two parts: First, CARL should, if continued, be amended in one fundamental area: abolish all restrictions on land transactions after awarding. Second, the country should enact a law mandating a land tax graduated on the basis of land size.

Thank you.

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