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Ethnic divisions, contract choice, and search costs in the Guatemalan land rental market



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ABSTRACT

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This paper shows how ethnic diversity in a context of weak property rights enforcement can result in market segmentation. The paper analyzes how contract enforcement problems affect the joint decision of partner and contract choice by landlords in the land rental market in Guatemala. The empirical method allows partner choice to be determined not only by the characteristics and relative scarcity of the specific landowner and tenant, but also by the characteristics of other potential tenants. The results show that landowners without formal title are more likely to restrict their partners to tenants from the same ethnic group. Partner choice is found to be less important for renting with interlinked land-labor contracts. *Journal of Comparative Economics* 42 (1) (2014) 1–18. Paris School of Economics and INRA, France.

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1. Introduction

Ethnic diversity and polarization are often believed to negatively affect growth. This is not only motivated by many examples of violent and destabilizing ethnic conflicts in different parts of the world, but also by cross-country growth evidence showing a relationship between ethno-linguistic diversity, poor public policy performance, and economic growth (Easterly and Levine, 1997). While evidence exists of both positive and negative effects of ethnic diversity on economic policies and outcomes, Alesina and La Ferrara (2005) hypothesize that the benefits might be more relevant for richer societies, while the costs dominate in poorer countries.

An important explanation of why ethnic diversity could affect growth negatively in developing countries is that many informal enforcement mechanisms only work within the ethnic group. Collective action regarding group credit repayment (Karlan, 2007) or regarding funding of public goods (Miguel and Gugerty, 2005) might be more difficult in ethnically diverse groups because of the lack of social sanctions as enforcement mechanism. Greif (1993) documents how contract enforcement within a specific ethnic group of traders, based on information sharing and reputation effects, can explain their business success. Platteau (2000) points out that contract enforcement through this type of multilateral reputation mechanism is facilitated by the common cultural and linguistic background of members from the same ethnicity. It allows them to better reveal and signal their intended plan of actions and to learn about other's intentions. While there exists a fair amount of evidence on the importance of contracts within ethnic groups for access to credit and trade (Fafchamps, 2000; Biggs et al., 2002; Fisman, 2003) evidence on the effects of ethnic diversity on enforcement of agrarian contracts is scant.

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This paper analyzes the relationship between ethnic diversity and agrarian rental contracts in Guatemala. It analyzes the joint partner and contract choice in the land rental market in a context of property rights insecurity, and shows that property rights enforcement can explain market segmentation along ethnic lines. As such, it relates to [Boucher et al. \(2005\)](#), [Gine \(2005\)](#), and [Vranken et al. \(2011\)](#) who analyze the relationship between land rental market activity and property rights; [Macours et al. \(2010\)](#)'s analysis of participation and partner choice in tenancy markets; and [Conning and Robinson \(2007\)](#) who offer a model of tenancy reforms that accounts for landlord's anticipation that tenants might become squatters. This paper contributes to this literature by focussing on the link between property rights and the joint decision of partner and contract choice in the tenancy market.

The empirical analysis shows that plots without formal property rights are much more likely to be rented out to members from the same ethnic group. We test whether the observed patterns are also consistent with discrimination of indigenous tenants by all landowners, and find no evidence supporting this alternative hypothesis. Ethnic diversity in the absence of strong institutions and formal contract enforcement, might then have negative effects on growth not only because informal enforcement within ethnic circles of confidence might lead to a second-best allocation, but also because the resulting exclusion might lead to more ethnic tensions, inducing further insecurity of property rights and possibly violent conflicts.¹ Alternative mechanisms to enforce property rights with members of a different group might be necessary to help breaking this vicious circle.

This paper sheds light on such a mechanism by analyzing the choice between two different types of contracts. Landowners chose between fixed rent and interlinked land–labor contracts. The results show that matching along ethnic lines is less important for interlinked land–labor contracts, suggesting that the implicit enforcement mechanism the interlinked contracts entail, might decrease the (perceived) need for assortative matching. To the extent that interlinked contracts can be considered suboptimal in a first-best world, this finding indicates that property rights insecurity in the presence of ethnic diversity may affect efficiency not just through sub-optimal partner choice, but also through suboptimal contract choice. In this perspective, this paper is related to [La Ferrara \(2002\)](#) who shows that ethnic heterogeneity not only affects access to credit, but also influences the organization of production. It also relates closely to [Lanjouw and Levy \(2002\)](#), who show that lack of formal or informal property rights limits the range of people one can transact with in the urban land market, and therefore impedes the allocation of properties to households who would value them the most.

The empirical strategy in this paper relies on estimating the landlord's choice of partner and contract-type jointly. [Ackerberg and Botticini \(2002\)](#) pointed out that many results in the empirical contract choice literature might be biased because they include both landlord and tenant characteristics, without accounting for endogenous matching between landlords and tenants. They suggest using an instrumental variable approach, with a matching equation in the first stage. They implement this for their analysis of the relationship between tenant's risk aversion and contract choice. [Pandey \(2004\)](#) and [Bellemare \(2006\)](#) follow a similar approach in their studies of contract choice. In these papers, the matching equation estimating the relationship between landlord and tenant characteristics does not depend on the characteristics of the other potential tenants in the market. This paper proposes an alternative methodology that allows for matching to be determined not only by the characteristics of the specific landowner and tenant of the match, but also by the characteristics of the other potential tenant-types using a nested logit framework.

To illustrate the methodological contribution, the paper compares the findings of the nested logit approach with those obtained using Akerberg and Botticini's instrumental variable approach on the same data. In contrast with the IV approach, the nested logit allows to account for several tenant characteristics, and for the relative scarcity of each tenant-type. Accounting for the characteristics of other potential tenant-types might be important because not only the number of potential tenants of a certain type, but also the scarcity of the next-best type determine the potential trade-off the landlord faces when choosing a tenant. Differences in search costs among tenants are likely to matter as land rental activities in Guatemala often surpass community borders. For landlords this implies that the pool of potential tenants to consider is often large, but that search costs might be involved in finding a suitable partner. Matching is hence likely to be influenced by differences in search costs between different types of tenants. The nested logit results show that the relative scarcity of different tenant-types indeed is strongly related to partner choice. The empirical comparison of the two approaches demonstrates in turn that the nested logit allows to derive stronger conclusions regarding contract choice than the IV, possibly because the characteristics of other potential tenant-types are better accounted for in the partner choice. In addition, the nested logit also allows deriving conclusions on the importance of partner choice for different types of contracts.

While the methodology discussed above is general, we use it in this paper to investigate the relationship between ethnic diversity and contract enforcement. Anecdotal evidence, as well as indicators based on expert opinions, suggests that lack of contract enforcement, including property rights enforcement, is a very serious concern in Latin America. Indicators of procedural complexity for contract enforcements (including eviction of a residential tenant), developed by [Djankov et al. \(2003\)](#) and now widely used to compare countries, show that many Latin American countries, and Guatemala in particular, score extremely badly. This paper therefore not only broadens the existing evidence on ethnic diversity and contract enforcement, from credit or trade contracts in Africa towards agrarian contracts in a Latin American context, but also sheds light on an important and sensitive policy issue.

¹ This paper does not provide direct empirical evidence of the feedback effect, but provides supporting anecdotal and historical evidence. The effect of ethnic exclusion from favorable contracts on property rights insecurity has also been documented in many other places (see [Chua, 2003](#) for an overview).

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