

## Foreign Investment in Agricultural Production: Opportunities and Challenges

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The recent surge in food and fuel prices has prompted countries with high dependence on food imports to try and lock in future food supplies through direct investment in agricultural production in other countries. The price surges also led to a wave of proposals to invest in biofuels investments in agricultural land. While such investment can provide large benefits, it also carries considerable risks both to investors and citizens in the locality of the investment. To ensure that investments provide broad benefits and effectively contribute to larger development outcomes, enforceable property rights and contractual agreements in many developing countries need to be strengthened. This Note considers how development partners can help countries create the pre-conditions for investment and proposes a governance framework to establish minimum standards for it.

### CONTEXT AND GLOBAL DRIVERS

It is widely agreed that the combination of increased demand for biofuels, increased incomes, and shifting patterns of demand will lead commodity prices to be higher and more volatile in the future than they have been in the past. Between January and May 2008, the price of rice increased from US\$389 per ton to

over \$1,037. Between January and March, wheat export prices increased from \$196 to \$440 per ton.<sup>1</sup> Countries' attempts to isolate themselves from these trends through measures such as export restrictions only worsened volatility. The price increases threatened food security and welfare among the poorest, particularly in countries that depend on food imports. In countries where the poor could no longer afford food, and where state budgets could not absorb the costs of increased subsidies, price increases raised the specter of social unrest. Food importers were compelled to explore alternative means of securing adequate food supplies, such as acquiring land or investing in agriculture in countries with abundant agricultural land. Food prices however were not the only force at play in increasing the demand for land. High fuel prices were simultaneously leading to greater demand for plantations on which to grow biofuel crops such as oil palm.

The availability of large amounts of unutilized or underutilized land in some developing countries together with fears about food supplies and a secular trend of shifting demand, has led to a re-emergence of the issue of direct foreign investment for commercial agriculture. Although reliable global figures are lacking, the magnitudes involved are very large. In Mozambique the World Bank estimates that applications for land by foreign investors amount to more than twice the total area of land that is cultivated in the country. Similarly large investments are reported to have occurred or are being negotiated in Brazil, Cambodia, Ethiopia, Sudan, Mozambique, Pakistan, and Russia. A variety of issues need to be addressed if such investments are to lead to substantial social benefits and contribute to rather than hinder economic development.

### SPECIFIC ELEMENTS TO BE CONSIDERED

Foreign direct investment that engages in sustainable commercial agriculture can generate significant benefits. Investing to bring hitherto uncultivated land into production can generate jobs and increase local incomes directly and through forward and backward market linkages that attract complementary investment. It can deepen export markets, improve access to technology, inputs, and output markets such as through



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bulk purchases or sales agreements. Direct investment and new agribusiness ventures can also help to diversify rural economies.<sup>2</sup> In the past many investments by agribusinesses relied on outgrowers for production and supply rather than direct land acquisition. More recently however, agribusinesses often see land acquisition as an essential element of investment.

For society to realize the potential benefits of large-scale land acquisition and to avoid common risks, two things are required. First, a variety of technical challenges that are associated with this kind of investment needs to be overcome. Failure to address the technical challenges associated with agricultural production, especially when the crops have a low margin, has often undermined the viability of such investments. Second, arrangements need to be in place for benefits to be shared in a way that is perceived to be fair by all involved. Access to infrastructure and services, handling of labor issues, contract enforcement, and links to markets are just some of the issues that are critical for the viability of any large scale land acquisition. A variety of means are available to reduce unnecessary risks to investors and to ensure that the benefits and returns to investment are shared with local communities.

**Agricultural and land use potential.** The large areas of suitable but unused or underused agricultural land in many developing countries naturally attracts the interest of outside investors. In Mozambique, Tanzania, and Zambia for instance, an estimated 12 percent of arable land is actually cultivated. In some regions such as Central Asia, land is abundant but water is extremely scarce. Establishing local land use plans to help bring the interests of communities and investors into line, and in a way that is consistent with sustainable resource use, is an essential element in ensuring that the most suitable land is selected for a given purpose. It can also reduce the danger that highly productive or ecologically sensitive land will be diverted to marginal uses, and provide investors with critical information on agro-ecological conditions on a given tract of land, and the status of existing rights to that land. The use of high resolution satellite imagery by the private sector has recently enabled countries such as India to

make significant advances in land use planning that could be adopted by other countries.

**Property rights.** Even in apparently land-abundant settings, there is little truly 'unoccupied' land. User rights are often informal and recognized through customs and traditions. To be able to respect and fairly compensate existing users at a larger scale, it may be necessary to record them and verify them on the ground. Whether land rights are held by individuals, groups, or the state, a sound investment climate requires them to be clearly defined and verifiable and transfers to be governed by clear and enforceable rules. In the case of group rights, mechanisms are required to facilitate decision making and enforcement between groups, and to provide clarity as to who is authorized to enter into agreements on behalf of the group. In areas where demand for land is likely to increase, systematic recording of local rights should include potential as well as actual land uses. Systematic recording is generally more cost-effective, pro-poor, and compatible with incentives than delineating rights in response to specific investment proposals. It increases accountability and transparency in the approval of investments and expands and improves available information for everybody.<sup>5</sup>

**Benefits sharing.** Public investment in infrastructure and complementary services is generally needed to fully realize potential benefits, and this investment relies on appropriate mechanisms for revenue-collection and sharing. If these mechanisms cannot be negotiated, public services and infrastructure are unlikely to materialize and local populations are unlikely to benefit from the development of the land holding. Failure to plan or negotiate with interested investors also makes it less likely that local communities will enjoy the potential direct benefits of development, such as employment and income generation. When the investment does generate employment, compliance to accepted standards for wages and working conditions becomes an important issue. Poor planning can easily lead to conflict between investors and those with existing user rights, while the lack of a regulatory framework or enforcement capacity can lead to a number of environmental hazards and overuse or misuse of the natural resource base.

## Dangers associated with large-scale land acquisition

While attracting investment is an important priority for land-abundant African countries, caution is warranted to prevent speculative investments or arrangements in which local land rights are lost or landholders are excluded from the benefits of the investment. Large-scale land acquisitions during commodity booms can be particularly detrimental to social and economic development, as evidenced in Central America during the coffee boom of the late 19<sup>th</sup> century when privatization of previously customary lands led to rapid land concentration. In countries such as Guatemala and El Salvador, the coffee boom led to the expropriation of land on a massive scale, followed by decades of conflict and civil war that undermined economic, human, and social development. By contrast, in Costa Rica and Colombia, increasing coffee prices fostered the emergence of vibrant smallholder coffee economies. Although the four countries started in very similar conditions, the latter now enjoy a per capita income double that of the former, rank much higher on the human development index, and have been democracies for more than 50 years rather than little more than a decade.<sup>3</sup> More recently, large land transfers to investors in Cambodia and Kenya failed to help modernize agriculture and instead generated conflict and allegations of corruption. In Cambodia, few of the large holdings, which are measured in tens of thousands of hectares, are used productively. In Kenya, "land grabs" by public officials reached systemic proportions between 1980 and 2005. One government report singled out land grabbing as "one of the most pronounced manifestations of corruption and moral decadence in our society."<sup>4</sup>



**Outgrower versus plantation.** Different contractual forms are appropriate for different types of investment and different returns to investment. Long-term leases tend to be more appropriate in situations in which land is abundant and investments in clearing and installation of infrastructure such as irrigation is required. Operations in these situations often entail large-scale mechanization and the production of bulk annual commodities. In situations in which land is less abundant, labor costs are low, and the quality of the product is a practical priority, contracts that provide producers with technical assistance and access to markets, specialized inputs and financial instruments are often preferred. This type of contract can generate substantial employment and other local opportunities, and enable farmers to manage the risks involved in producing nontraditional crops.<sup>6</sup>

**Contract enforcement.** The confidence among entrepreneurs and prospective entrepreneurs that contracts will be enforced and disputes will be resolved quickly, judiciously, and authoritatively is an essential element of a sound investment climate. Their alternative is to resort to unconventional channels of dispute resolution, often at high political levels, where decisions are seldom transparent and their results are often unsustainable. Investments that involve production for food exports can also be particularly vulnerable to policy changes, such as export bans on certain crops to stabilize domestic prices. Political risks relating to sudden shifts in policy have been common, particularly in areas that are chronically food insecure, and where exporting sizeable amounts of food can be acutely politically sensitive. Governments in these situations may be unwilling or unable to grant investors exemptions from policies that are politically popular or widely perceived as serving important purposes with regard to social welfare. In some countries this represents a risk even for very large investments, such as the acquisition of some 800,000 hectares of farmland in Pakistan by investors in the United Arab Emirates.<sup>7</sup>

## ROLES FOR DEVELOPMENT PARTNERS

Investments in commercial agriculture are a private sector activity. They are negotiated by the parties involved. Multilateral institutions such as the World Bank can however contribute in a number of ways to make such arrangements more likely and ensure they meet a set of minimum standards.

**Help countries establish secure property rights.** Many countries fail to realize the full benefits of outside investment because their institutions cannot define, enforce, or effectively negotiate property rights. The World Bank has long provided technical and financial support to help countries develop the institutions and instruments needed to secure land rights and to define land uses. Given the risks implied by the size and speed of current developments, this focus on long-term institutional development now needs to be complemented with an emphasis on fast, cost-effective, and transparent ways to secure local land rights. It also requires inclusiveness, and mechanisms to increase the voice of right holders, especially those such as women and herders, who have not traditionally participated in negotiations about investments. By providing information on land availability and use that is often unavailable at present, this will also yield significant benefits for investors.

**Reduce transaction costs and manage governance risk.** Many countries have centralized and complex processes for approving land acquisitions or ensuring compliance with planning norms. These increase costs to investors, and often end up fostering corruption and undermining the safeguards that many of the procedures are intended to provide. Decentralizing approval processes, within a larger framework of good land governance, increases accountability and the quality of investment, especially if potential investors subscribe to a set of agreed social and environmental standards. Land

### Does ‘modern’ agriculture require large farms?

An argument commonly used to advocate allocating large tracts of land to investors is that ‘modernized’ agriculture, especially in Africa, will by definition entail a transition from small holdings to large farms. The argument often includes a critique of “smallholder romanticism” as a source of naivety that distracts people from the hard economic realities of progress and growth, which rely on achieving economies of scale. This is a myth with little foundation in reality. While activities related to processing and marketing of agricultural produce are indeed characterized by significant economies of scale—the importance of which is further increased by phytosanitary restrictions—a large body of literature demonstrates that there are no economies of scale in agricultural production. All over the world, family-operated farms have been shown to be economically much more efficient than plantations operated by wage labor. This is one reason that even large agri-business firms often rely on outgrowers, and do so almost exclusively for produce that has to meet the highest quality standards. Smallholder production moreover has a massive employment effect that is not seen in the case of large mechanized farming. This employment effect is critically important for poverty reduction in situations in which non-agricultural economic growth is insufficient to draw workers out of the agriculture sector. A useful illustration of this relationship between farm size, poverty, and employment can be found in the contrast between Brazil and China from 1991 to 2001. During that period, China doubled its cereal yields based on a smallholder sector with an average plot size of less than 0.2 hectares, and in so doing raised some 400 million people out of poverty. Over the same period, Brazil achieved slightly lower rates of growth based on mechanized large scale farming – but the number of rural poor actually increased. The conclusion is that agri-business investments that require implicit subsidies in the form of unrealistically low land prices or exemptions from taxation in order to become viable are unlikely to be a good idea.

governance frameworks such as the Extractive Industries Transparency Initiative (EITI) or the Equator Principles established by the IFC for good practice in project financing can help reduce transaction costs for governments and investors in a way to ensure fair sharing and thus sustainability of benefits. Adherence to such principles could be used to establish eligibility for insurance coverage by MIGA against political risks, including those of creeping expropriation or export bans.

## BEST PRACTICES FOR DEALING WITH AGRICULTURAL INVESTMENT

**Assess economic viability.** Rigorous economic analysis of land-related investments is important for two reasons. First, many of the investments reported in the press appear to be motivated by non-economic factors, such as the security of food supplies. Many are located in places that may not be suitable for producing the commodity involved. Second, investors and some government bureaucrats may have an incentive to underestimate the cost of the land or other factors of production such as labor. If investments will not be economically profitable, this reality needs to be factored into the design of the contract so that both sides acknowledge it explicitly and form their expectations accordingly from the beginning.

**Ensure that reliable information on land rights and suitability is available.** Information about the land being considered and the claims of existing rights holders are principal concerns among most prospective investors, who understand the often very real risk that competing claims may surface when the acquisition is announced. Having a reliable land registry in place and effective land use planning goes far in addressing these concerns and in providing investors with the information they need to make rational decisions. Even in situations where the coverage of existing land use planning is currently limited, a number of countries have demonstrated the utility and cost-effectiveness of satellite images as reference material for consulting local communities about the precise areas they have claims to. This provides the groundwork for informed negotiation between the communities and interested investors with no ambiguity over the demarcation of the area or terms being discussed. It is also an ideal opportunity to generate basic land use plans.

**Allow direct negotiation between communities and potential investors.** Most countries now provide legal recognition (though often not automatic recording) of local land rights. This implies that direct negotiation between the parties, if necessary supported by awareness-raising and training of local communities, can help produce outcomes that are more suited to local conditions -and thus provide higher overall benefits- and have these shared in a fairer way. However, many countries still require that government first expropriate land to be used

for investment. This often leads to results that are quite similar to heavily centralized procedures for the approval of land transfers. It encourages political interference, disrupts negotiations, encourages corruption, and often produces outcomes entirely contrary to those that were envisaged. Where this is the case, the scope for transferring responsibility and accountability to the local level needs to be purposefully explored.

### Tax idle land and impose appropriate lease payments.

Many countries tax land-related investments but not the land itself. This may make sense in contexts in which land is relatively abundant. Elsewhere however, taxing unimproved land above a certain size or value can be an effective way to prevent speculative hoarding. Smallholders are easily exempted, and should be, especially when the costs of collecting taxes are likely to exceed the tax yield itself. To encourage collection as well as updating of valuations, a major share of such payments should accrue to local communities. Taxing land is far superior to most alternatives, such as making investors' land rights conditional on investment being undertaken. However attractive this may seem in theory, in practice it is extremely costly to enforce and very often lends itself to discretionary application.

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