

# Eviction threats and investment incentives

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## Abstract

We show that the effect of eviction threats on unobservable investment effort can be positive. We demonstrate this apparently counter-intuitive result in a model of tenancy where investment by a tenant in the current period raises the chances of doing well in the next period, and therefore retaining the job in the period after next period. If the tenant earns rents, the landlord can partly substitute eviction threats for the crop share as an incentive device. This makes it more attractive for him to elicit investment effort. However, there is a direct negative effect of eviction threats on the tenant's discount factor. We find conditions under which the former effect dominates and eviction threats can increase investment incentives.

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## 1. Introduction

One of the least controversial propositions in economics is that well-defined and secure property rights are important for encouraging investment.<sup>1</sup> In the context of agricultural tenancy, it is widely believed that tenants who have secure tenure will tend to invest more in the land, which seems to be a straightforward corollary of this proposition.<sup>2</sup> In fact, most

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<sup>1</sup> See North (1990) for a persuasive statement of this view. Besley (1995) provides a formal analysis of how improved property rights in land provides better investment incentives, and finds evidence for this using micro-level data from Ghana.

<sup>2</sup> This, for example, is the shared view of Johnson (1950) and Myrdal (1968), two economists with very different views on the effect of sharecropping on incentives to provide effort.

tenancy laws have security of tenure as one of their main components (see Appu, 1975; Hossain, 1982).

Yet, if one takes the point of view of optimal contracting, it is not clear why the landlord would choose to offer insecure tenure if it is bad for investment incentives. Indeed, there is considerable evidence showing that the landlord–tenant relationship is typically a complex long-term informal contract with eviction threats often explicitly used as an incentive device.<sup>3</sup> Moreover, if insecure tenure takes the form of long-term contracts with explicit performance-contingent firing threats, is it necessarily true that they are always bad for investment incentives?

In this paper we address these questions by analyzing a simple dynamic model of tenancy where the tenant chooses an unobservable action that raises the probability of high output in the next period. We will call this action *investment effort* as distinct from *current effort*, the latter being an unobservable action that raises the probability of high output in the current period.<sup>4</sup> We assume that the tenant is risk neutral but there is limited liability. So other than the fact that effort in our model affects output in the next period as opposed to the current period, the framework is very similar to models of sharecropping with limited liability.<sup>5</sup> Because of limited liability, the tenant must be given a minimum income level each period. Since output can be high or low, the landlord faces a trade-off between rent extraction and incentive provision. A fixed rent contract which is independent of realized output is good for incentives but because of limited liability, the rent that the landlord can charge in this manner would typically be low. A contract that charges a higher rent from the tenant when output is high (a sharecropping contract is one example) will be better from the point of view of extracting rents from the tenant, but it will come at the cost of some efficiency, as the tenant will supply a lower level of investment effort.

Given that the tenant typically earns some rents in such environments, the landlord can use eviction threats as an additional incentive device as in models with current effort (see Dutta et al., 1989; Banerjee et al., 2002). However, since the result of investment is realized with a one period lag, if the tenant is evicted with some probability during this period, he is going to enjoy only a fraction of the benefits from this investment in expected terms. Other things being the same, this would cause the tenant to supply a lower level of investment effort for the same crop share and this is precisely the reason why security of tenure is thought to be good for investment. But there is another, potentially positive, effect of eviction threats on investment that is not well recognized in the literature. Investment in period  $t$  raises the chances of doing well in period  $t+1$  and hence retaining the job and continuing to earn the rents enjoyed by an incumbent tenant in period  $t+2$ , just like current effort in period  $t+1$ . The prospect of losing these rents if he is fired, would, all

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<sup>3</sup> Banerjee et al. (2002) report evidence from a survey of 48 villages in West Bengal in 1995. They found that 80% of the tenants reported that landlords in their village had used eviction threats and 30% reported that they or their fathers were actually threatened. The reasons cited for the use of eviction threats include both low production (in 40% of the cases) and disputes with the landlord (in 55% of cases).

<sup>4</sup> Examples of such investments are experimentation with new techniques, care and maintenance of the land, or use of manure the effect of which lasts more than one period. In contrast examples of investments which are observable are installing irrigation equipment, building soil partitions, and planting trees.

<sup>5</sup> See, for example, Shetty (1988), Dutta et al. (1989), Mookherjee (1997), Ray and Singh (2001), and Banerjee et al. (2002).

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