Finafrica Bulletin



CASSA DI RISPARMIO DELLE PROVINCIE LOMBARDE

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AGRICULTURAL CREDIT AND THE SUBSIDY QUESTION

1. Introduction

A subsidy is introduced into a transaction when it is considered that the market forces do not reflect the true benefit of the transaction, and therefore, the introduction of a distortion is desirable. It is widely accepted that markets in developing countries, as elsewhere, rarely reflect overall economic costs and benefits, hence subsidies are frequently introduced (1). This paper, however, does not set out to debate the subsidy issue *per se*, and it does not deal specifically with the outwardly similar but clearly separate issue of income transfer. Rather it examines the implications for credit programmes of a government decision to subsidize, in some form, the production activities of small farmers. In particular it seeks to identify the most effective avenue for subsidy, whether or not a credit programme is operative.

A major point which should be made at the outset is that government resources available for providing subsidies are very limited and, of necessity, their allocation to this use means that some other government activity is deprived of funds. This is reason enough for care in operating subsidies, but it is also important to note that they can be a powerful economic lever and, as such, can do much harm if used unwisely.

2. Types of subsidy

Two main avenues for subsidy exist. The first is the direct subsidy, which means an alteration to the price structure of a farmer's actual transactions. These include the prices paid by the farmer for inputs and for direct production services such as credit (in this case the price paid is the interest charge, plus any commitment or other fee) and the price received by the farmer for his produce. An indirect subsidy, on the other hand, involves financial assistance, one or more steps removed from the transactions in which the farmer is engaged. Possibilities here include subsidization of the administrative costs of credit programmes and price stabilization schemes, and the provision of research and extension services. Assistance which has some features of a farm production subsidy, but which is more in the nature of development investment, includes the provision of infrastructural items such as roads, markets, clinics and schools.

(1) For example, a country faced with a possible food shortage may want to encourage increased supply by raising farm-gate prices in order to avoid spending foreign exchange on imports.

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3. Direct subsidies

Some forms of direct subsidy are very readily introduced by a government, especially in situations, not uncommon now in many countries, where the state is actively involved in credit programmes and even, in some cases, in input supply and produce marketing. Indeed, in the absence of a taxation system, these transactions provide the only direct financial contact between the farmer and the state, and for this reason may be regarded as a convenient avenue for subsidy (2).

Subsidized credit is probably the easiest of all subsidies to apply. Unfortunately, in most circumstances it is also the type which has most disadvantages. In this context the subsidy is direct, that is, it relates to the farmer's transaction in obtaining credit, his payment of interest. There is a certain amount of evidence to show that in many credit programmes the interest rate charged should be of the order of 25 to 30 percent, if all the costs involved (cost of capital, administration, losses due to default and inflation) are to be covered. In fact, of course, interest rates in small farmer credit programmes are very much lower than this and, indeed, are often lower than the rates charged in other sectors of the economy. This creates a dangerous situation, where it is likely that cheap farm credit will be siphoned off into investments which have little to do with developing the small farmer. The subsidy in this case does not affect production of this sector since it does not reach those for whom it was intended.

A second disadvantage associated with very low interest rates is the familiar argument that the farmer's investment policies may be thereby distorted since the true cost of capital is not reflected in the farmer's transactions. In this case a shift to more reliance on capital and less on labour might be expected. The disadvantages inherent in this are further compounded because such a shift in production factors usually involves an increased managerial task. Cheap credit may cause wasteful use of capital and even premature consumption, thus reducing capital formation at the village level.

(2) A further type of direct assistance is the « grant-in-aid ». This is given to an individual farmer as an incentive to increase production, and may, for example, consist of a sum of money to help with a capital project. Thus a grant-in-aid is similar to a subsidy. However, there are heavy administrative demands with the operation of grant-in-aid schemes, if allocation is to be fair and just; this is likely to preclude their use save in exceptional circumstances.

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Third, when interest rates are very low then demand for credit may well exceed supply, making rationing necessary. This need for rationing causes several major difficulties. Inevitably it places an extra burden on the administrative staff of credit institutions and, because of pressure from would-be borrowers, a situation exists where the chances of corruption are great, with a consequent harmful effect on staff morale. But the primary direct effect on small farmers is allocative, in that when rationing takes place the smaller man is likely to be muscled out by those who have more influence with the officials supplying inputs and credit. A related disadvantage is that when a low interest-rate policy has been in force, those officials who have the power to change interest rates may have personal reasons for keeping them low, reasons which are not connected with assisting the small farmer.

Fourth, there is always the danger that a credit institution lending money at a subsidized rate of interest is somewhat at the mercy of its political masters and may find itself insufficiently compensated. In these circumstances it faces the danger of decapitalization, it will almost certainly be forced into a situation where it concentrates on large loans to established farmers in order to economize, and it may find difficulty in raising capital, partly because of its inability to offer attractive interest rates on deposits.

Finally, subsidized interest rates have a tendency to hinder the integration of capital markets, thus decreasing the efficiency of the economy by restraining the transfer of resources.

Let us speak now of subsidies on inputs. Some circumstances justify the introduction of subsidized inputs. For example, although it is generally better to popularize the use of new inputs and technologies by demonstrating clearly their productivity and profitability in existing market conditions, it may sometimes be necessary to sweeten the pill by operating a well defined policy of reducing the cost of the inputs for a limited period of time. This has the effect of reducing the risk of the innovation to the farmer, and also reduces the working capital requirement during the introductory phase. Sometimes a government may decide to subsidize farming in a particularly disadvantaged area or region. In these circumstances a subsidy to cover transport costs may be in order. Also a government may seek to popularize a particular technique or practice by making it possible at a subsidized price. Thus tea and rubber replanting operations in Sri Lanka are heavily subsidized by the Government.

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Apart from the special cases noted above, however, subsidies on inputs should normally be avoided since they suffer from many of the disadvantages associated with operating farm credit at subsidized rates of interest. Thus there are likely to be allocative difficulties because of the need for rationing, and those with greater influence with supplying agencies are likely to obtain inputs more readily than others: it is not always the former group that can make the more productive use of the inputs concerned. Again, a direct subsidy on certain inputs, for example machinery, may lead to more reliance on capital as opposed to labour than is really justified at a given stage of development.

Finally direct subsidies on output prices are to be mentioned. A subsidy on output prices needs careful handling in order to ensure that the intended recipients receive the full benefit of the subsidy, and therefore that the subsidy has the desired effect on production. This is all the more important since this type of subsidy can be very expensive. In this connection since it usually involves the setting of a pre-planting price, with the marketed output being an unknown factor, the commitment by the government is open-ended. A further disadvantage associated with a subsidy on output prices is that when applied in areas where large farmers are interspersed with small, such a policy tends to increase income disparities. This may be an argument for applying an indirect subsidy in such circumstances. However, the upward adjustment of output prices, by means of a subsidy, can be very effective in encouraging production of certain types of farm produce in particular localities.

A subsidy on output prices is distinct from a price stabilization scheme. The latter sets out to remove or reduce the effect of price uncertainty by operating a fund which is credited when market prices are higher that the set farm-gate price, and debited when the reverse applies. Despite the distinction between the two types of intervention, a price stabilization scheme may involve subsidy. This may be direct, in that an output-price subsidy is fed into the stabilization fund, or, as is common, indirect in the form of a grant to assist with the costs of administering the scheme.

4. Indirect subsidies

The biggest advantage of an indirect subsidy is the fact that it is hidden. A peasant farmer, in receipt of what is clearly a subsidized item, perceives a

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hand-out and this in itself affects his attitude to farm production. The direct subsidy either strikes him as constituting bribery, thus arousing his suspicion, or makes him feel that he is being asked to participate in something which is less than serious. In neither case is his attitude towards increasing agricultural production improved. On the other hand, when government resources are directed towards the identification of profitable technologies, to the organization of extension, marketing and credit services and to the provision of necessary infrastructure such as roads, bridges and storage facilities, then the effect on the farmer and his attitude towards farm production is positive.

It is useful to point out that the subsidization of credit institutions' operations in remote areas, particularly when these bodies also provide a savings facility, can bring about indirect benefits to farm production through helping to commercialize the attitude of rural populations towards farm investment and production. In more remote areas this process might be termed monetization, but the essentials are similar to commercialization, as are the effects; for it has been amply demonstrated that increases in agricultural production are greatly facilitated by a perceived need for a cash income from farming.

Indirect subsidies, in the form of assistance designed to build up the viability of credit institutions are a feature of many government programmes. The most common type of subsidy here is the provision of loanable funds at concessionary rates of interest. If rates to farmers are kept high, then the spread between interest paid and interest received may be sufficient to enable the institution to be viable. On the other hand, it seems more common to seek to tie down interest rates paid by farmers. Thus when in 1971 the rate paid by the Thailand Bank for Agriculture and Agricultural Cooperatives (BAAC) to the Bank of Thailand was reduced from 7 to 5 percent, the rates for short and medium-term loans to farmers were reduced from 12 to 10 percent. Because of this tendency it may be more effective for government to assist banks and other credit institutions by providing other types of assistance such as: the payment of salaries of key primary cooperative society officials (as in Bangladesh), the free training of bank employees (as is the case with the Rural Banks in South Vietnam), free audit service (Vietnam). There are probably other types of subsidy to credit institutions, but a special note can be made of crop insurance schemes, such as that operating in Sri Lanka where, in 1969/70, 82,000 ha. of crop were insured. This scheme apparently

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has no direct link with a credit programme but it does rely heavily on a government subsidy.

Yet a further type of subsidy is government action which results in loan repayment obligations being waived. This has been done occasionally in Sri Lanka, for example, and has also been commonly employed in Greece. The dangers implicit in this measure are well-known to all bankers, but in some circumstances this type of action is forced, for example, by crop failure. When this is widespread and general, then a government can, of course, designate a given zone as a disaster area and take special measures, such as waiving loan repayment obligations. Designation of disaster area is done, for example, in Malaysia. If, on the other hand, only a few farmers have been affected then the crop failure is more likely to be due to poor management.

The only sound solution for this situation is preventive, not curative, in that a loan should not be given unless a farmer can be identified as being a sound manager at his technology and size level. But failures do occur and when this does happen then action leading to the re-scheduling of the defaulting farmer's debts to a long term loan could be taken.

5. Conclusion

Once a decision has been made to subsidize small farmers' production activities, the temptation to do this by offering loans at unrealistically low interest rates should be resisted. In certain cases a strategically aimed subsidy on output, or even in inputs, may be applicable but, in general, indirect subsidies, such as those paid to institutions providing farm services, and, in particular, forms of assistance which strengthen the viability of these institutions, are likely to be the most satisfactory type for the small-farmer sector.

Above all it is desirable to avoid the type of financial assistance which is granted on an *ad hoc* basis since this can lead, on the one hand, to corruption of those responsible for disbursement and, on the other, to distortion within the economic system. Whilst much progress has been made in the direction of channelling subsidies towards sound institution building and to other directly useful infrastructural-type development, scope still exists for an appraisal of certain practices such as the tendency to keep interest rates on farmers' loans unnecessarily low.

Richard A.J. Roberts

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LE CREDIT AGRICOLE ET LE PROBLEME DES SUBSIDES

RESUME

L'Auteur examine le problème des subsides à l'agriculture en faisant la distinction entre les formes de subside directes et les formes indirectes. Il exprime, en se fondant sur une série de considérations, un jugement défavorable sur les subsides directs et notamment sur le crédit accordé à des taux d'intérêt réduits.
Il serait préférable, à son avis, que les pouvoirs publics qui veulent soutenir le secteur agricole recourent aux subsides indirects et, en l'occurrence, aux services d'assistance technique et économico-commerciale gratuits en faveur des agriculteurs ainsi qu'aux investissements en infrastructures dans les zones rurales.

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