ASIA-PACIFIC RESEARCH AND TRAINING NETWORK ON TRADE

POLICY BRIEF

BRIEF NO. 56 | SEPT. 2018

Is Loan Waiver a Panacea for Rural Distress?

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Introduction

On the eve of elections in India, farm loan waiver became one of the major election promises. Recently, the winning Janata Dal party in the state of Karnataka, India fulfilled its pre-poll promise and announced a farm loan waiver of up to $4.79 billion (with a cap of $2,817 per family).[2] Starting last year, Karnataka is the fifth state (after Uttar Pradesh, Punjab, Maharashtra, and Andhra Pradesh) to have implemented farm loan waiver programmes.[3] Another poll-bound state Rajasthan also announced farm loan waivers, while in Chhattishgarh, the main opposition party Indian National Congress promised farm loan waivers if voted to power. As a result of farm loan waivers, there is a likelihood that during fiscal 2018-2019, India's fiscal deficit may widen to $16.17 billion. During 2016-17, the total amount of debt relief programmes announced by governments of Uttar Pradesh, Maharashtra and Punjab amounted to $10.85 billion or 0.5% of India's GDP in 2016-17 (Kundu, 2017). If all the states in India were to waive 50% of their farm debt, it would cost 1% of India's GDP (in 2016-17 prices).

The small farmers and loan waivers

Unfortunately, the real benefit to small and marginal farmers (with less than 2

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[2] Going by current exchange rates (late September 2018), $1 roughly equals to ₹71 (Indian Rupees).

[3]There are 29 States in India.

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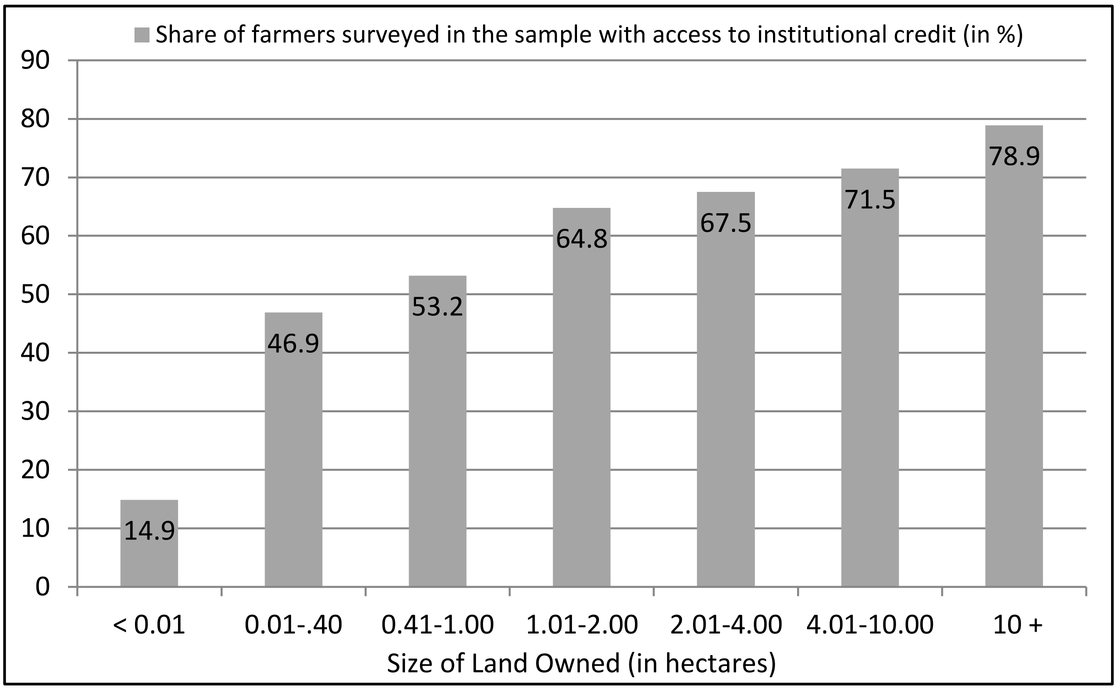
hectares of landholding size) will not come from loan waiver programmes. This is because only 15% of smallest farmers have access to institutional credit (formal credit)as illustrated in the figure, and loan waiver schemes typically cater to farmers who have availed formal loans.

Figure 1: Farmers with access to institutional credit (in %)



Source: National Sample Survey Office's 2013 situation assessment survey of farm households, Government of India.

Once a loan waiver is announced, banks usually stop giving loans to farmers qualifying for the waiver during the next loan cycle (Kanz, 2016, and Giné and Kanz, 2018).[4] The banks lose on the interest payment, and at times it is not clear within what time frame any state government is going to pay back the principal amount, leading to credit rationing. Then there are moral hazard issues, where more productive farmers who can pay-off their loans deliberately default. Rath (2008) points out those farmers who had already repaid their loans before the announcement of loan waivers felt cheated and therefore were reluctant to repay fresh loans. Some farmers believe that such write-offs will occur from time to time, and therefore are unenthusiastic about repayment. Kanz (2016) shows that beneficiary farmers appear less concerned about the reputational effects of defaulting on their loans.

[4] Through the Agricultural Debt Waiver and Debt Relief Scheme, 2008, the United Progressive Alliance government announced a $8.5 billion loan waiver package for 30 million small and marginal farmers. Both these papers examined the effects of the 2008-loan waiver scheme. The amount of loans waived was equivalent to 0.5% of India’s GDP in 2016-17.

Evidence suggests that small farmers quite often use the money saved from loan waivers for consumption purposes instead of using it as an investment to augment farm productivity. Globally, India has the second largest amount of arable land (next only to the United States) but ranks lower when it comes to agricultural productivity. For example, in potato farming, the productivity in India is less than half of that in the United States, Germany, or the Netherlands. In the case of rice, it is less than half of that in the United States or Egypt. And for wheat, it is less than half of that in the United Kingdom or Egypt.

Analysing the loan waiver program announced by Uttar Pradesh government in 2011, Chakraborti and Gupta (2017) find that eligible households in districts that received loan waivers had higher consumption expenditure, by approximately $113 per year, compared to the non-eligible households. What is of greater concern is that eligible households also tend to spend significantly more on non-productive purposes, such as social and family gathering events including weddings. This study points out that within the same district households who received loan waivers had no significant productivity difference when compared with the households who were not eligible. Households expected governments to intervene so that credit institutions would not seize their collateral in case of default. The expectation that they can avoid any penalty for non-repayment of a loan is likely to affect household decisions regarding the utilization of loans. As a result of the moral hazard issue, state-owned as well as private commercial banks, fearing that it might become too costly for banks to operate branches in remote rural areas, are reluctant to extend credit to a large number of small farmers. Bottom line, small farmers lose out both in term of access to formal loans and agricultural output as debt forgiveness is likely to disincentivize farmers from using loans for productive investment.

Yet political parties use farm loan waivers as a strategy for winning elections. As has been seen time and time again, “farmers first” provides political mileage. With more than 55% of Indians earning their livelihood through the agricultural sector, it comes as no surprise that political parties like to place their bets on farmers’ cause.

The real gainers from loan waiver programmes

The big and mid-size farmers (with more than 2 hectares of landholding size) are the ones who gain from farm loan waivers. Giné and Kanz (2018) show that loan waivers during the current loan cycle prompt banks to reduce credit outlay for small and marginal farmers during the next loan cycle—farmers below the 2 hectares cut-off experience an 8 percentage point reduction in formal lending after a bailout. The implication of this finding is that farmers with more than 2 hectares of land receive more credit after the bailout which is made available to them at the cost of small farmers qualified for loan waivers. The benefit to larger farmers is simply the total formal credit increase multiplied by the interest rate differential between formal and informal sectors. This amounts to $75.4 million per year.

Tripathi (2017) calculated the average interest rate on formal credit as 11.67%, while the rate in informal credit reached 25.20%. These interest rates represent the weighted average of diverse sources of credit, including banks and government (formal) as well as moneylenders, shopkeepers, friends, family, and landlords (informal). Kanz (2016) indicates that farmers are able to substitute 75% of the formal credit gap with informal sources of debt. If this were to come from costly money lenders the extra interest expense would be significant. Kanz (2016) does suggest that the credit gap is mostly filled with loans from friends and relatives. However, in reality, with a credit rationing, small farmers increasingly rely on costly informal credit. For the farmers relying on costly informal loans, they invest 15% less on agricultural inputs in comparison to the farmers who do not face credit rationing (Kanz, 2016). Costly informal loans reduce their purchasing power and to an extent reduce farm productivity, thereby cutting the income of the smallest and most marginal farmers by 13.5%. In sum, loan waivers mostly help richer and bigger farmers, leaving smaller farmers worse-off in the future.

A tale of two states

We studied responses to farmer distress in Andhra Pradesh and Rajasthan (Banik, 2018a, 2018b). In 2016, Andhra Pradesh announced a loan-waiver, costing the state exchequer $3.38 billion. In terms of benefit-cost ratio, our work for Andhra Pradesh shows that waiving formal loans for landholders with less than two hectares would cost $3.50 billion. The benefits will be slightly lower at $3.47 billion. Giving out a rupee to achieve just 14 cents of benefit is a poor deal (Banik, 2018a). For Rajasthan, our analysis shows that waiving formal loans for landholders with less than two hectares would cost $1.65 billion. The benefits will be slightly lower at $1.34 billion. Like in the case of Andhra Pradesh, for Rajasthan giving out a rupee to achieve just 11 cents of benefit is also a poor deal (Banik, 2018b). Most egregiously, spending thousands of crores on less effective policy leaves less for much more effective ones.

If not the farm loan waivers, what else to do to increase farm incomes?

Loan waivers are not the solution to farm crisis. During the year following loan waivers, small farmers lose out on three counts: lower access to formal loan, falling agricultural revenue because of higher informal loan cost, and a falling agricultural productivity. This has a wider implication on income distribution. 83% of the farmers in India who qualify for loan waivers are marginal and small farmers. The median annual income of these farmers is around $290, which is barely two months' minimum wage in Mumbai—the commercial capital of India. A low farm income exacerbates an already rising income inequality in India.

What interventions, then, could be more helpful in increasing farm income in India? After all, the current Government wants to double farm income by 2022-2023 over the base year of 2015–2016.[5] During 2015–2016, per-capita farm income was $1,693 per annum (in current price). To double farm income by 2022–2023 will require agriculture output to grow at 10.4% annually. However, at present, the agriculture output is growing at around 3% annually (NITI Aayog, 2017). At this pace, it will take 25 years to double farmers' income. To boost an increase in farmers' income, we recommend several different interventions.

1. Building cold storage and warehouses: India is one of the largest producers of many agricultural perishables and yet nearly 20% of India's fresh produce is wasted because of lack of adequate cold storage facilities. Reducing waste of perishable fruits, vegetables, and milk that command higher market prices than staple crops will augment farm income. Most small farmers do not risk growing perishable crops. Because of the lack of storage facilities, small and marginal farmers seldom venture to grow high-valued crops. Only 22.2% of marginal farmers (with less than one hectare of landholding size) and 23.6% of small farmers (between one and two hectares of landholding size) grow high-value crops. Small and marginal farmers are likely to gain from shifting to high-value crops, after which the likelihood of a farmer being poor will be 3 – 7% lower (Banik, 2018a).

   We studied how building cold storage and warehouses will help farmers in Andhra Pradesh and Rajasthan. The National Centre for Cold Chain Development (NCCD) has estimated Rajasthan's total requirement for storing milk, fruits, and vegetables at 74,889 metric tonnes. Providing pack houses and trucks would cost $843 million. The benefits in terms of the reduced wastage in milk, fruits, and vegetables are worth more than 15-times that figure. Similarly, for Andhra Pradesh, the current total storage requirement for storing milk, fruits, and vegetables stands at 744,650 metric tonnes. The total number of pack houses and specialized trucks required are 4,382 and 1,312, respectively. About 90% of the storage requirement already exists within the state, but the remaining infrastructure needs are not filled yet. To fill this gap requires a one-off investment of $378.3 million. The benefits in terms of the reduced wastage in milk, fruits, and vegetables for Andhra Pradesh, are worth more than 9-times that figure. It is worthwhile to build more cold storage and warehouse facilities.

2. Linking domestic market with international market: The present Government has increased budgetary allocation for agriculture sector, up from $17.04 billion (between 2009 and 2014) to $ 30 billion (between 2014 and 2019).[6]This has led to an increase in food and livestock production. For instance, pulse production has increased on average by 10.5% annually. Production of fish, milk, and egg has increased by 26%, 24%, and 25%, respectively. Although India allowed

[5]Fiscal year 2022-2023, will mark the 75th anniversary of Indian Independence Act 1947.
[6]In India, typically, sector specific planned budgetary outlay happens for a period of 5 years.

exports of livestock, the typical farm sector outputs such as rice, wheat, and other dietary items are only restrictively allowed. India also has higher import duties, in comparison to the ASEAN level, when it comes to agricultural products. In short, trade in agriculture items is restricted to tame domestic price, enable food security, and ensure the livelihood of Indian farmers. However, a restricted agriculture market and lack of adequate storage facilities often lead to crop output getting wasted. Food grain production in India touched an all-time high of 280 million tonnes during 2017-2018, and there is a need to follow a liberal trade policy and put in place necessary infrastructures to facilitate exports. For instance, a necessary condition for exports is to have testing facilities that provide sanitary and phytosanitary certification. Unfortunately, the numbers of such testing facilities are limited (Haq, 2018). Likewise, agriculture tariffs should be brought down to allow imports at the time of shortage.

3. Other supply-side interventions: Building rural infrastructures such as village electrification and canals will help. The fact that irrigation coverage on small landholding size is less than 40% means crop failures in bad rainfall years. Likewise, a reform in the APMC Act is required. In a supply chain examination study involving trade in potatoes, it was found that middlemen can charge a commission of up to a staggering 70% (Singh, 2017). For example, during June 2017 in the Azadpur and Ghazipur markets of Delhi, the middlemen were selling a common variety of potatoes at 7–9 cents per kilogram. If these rates were being offered to farmers they should have realized between $3.5 and $5 for a 50-kilogram sack. However, in reality, the maximum price the farmers were offered was $1.4 for a 50-kilogram sack. Hence, most often farmers do not know the actual market prices of the commodities and it is the middlemen who siphon-off most of the profits. The lack of reforms in the APMC Act prevents small farmers to sell directly to supermarkets, exporters, and agro-processors (thereby, enhancing their income).

4. Financial literacy: Financial literacy is also important. Lack of financial awareness has affected the growth and deepening of agriculture finance markets.[7] National Centre for Financial Education (NCFE) conducted India's first-ever national benchmark survey of Financial Literacy and Financial Inclusion in 2015 which captured a broad array of information from 76,762 respondents. The survey highlighted that the farmers are not aware of basic financial products. For example, less than 1.67% of the farmers are aware of crop insurance products. The corresponding numbers for cattle/livestock insurance and agricultural futures are 0.66% and 0.38%, respectively. Banerjee et al., (2017) find evidence about the existence of a positive relationship between financial awareness and financial

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[7] Agricultural finance refers to financial services ranging from short, medium, and long-term loans, to leasing, to crop and livestock insurance, covering the entire agricultural value chain - input supply, production and distribution, wholesaling, processing and marketing.

inclusion. Thus, more financially literate households have better awareness of the existence of the financial products and are, therefore, more likely to own advanced financial products such as insurance and capital market products. Even introduction of e-mandis—an online market where farmers can bypass the middlemen and sell directly to the retailers—are helping them a little. Evidence from Rajasthan suggests that because of the introduction of an e-market, farmers witnessed a price premium of 13%. However, at present, e-mandis are catering to only 7% of all Indian farmers and handles only around 2% of the total value of the coutry's agricultural output.

In conclusion, waivers of farm loans may help any political party win an election once. For them to win an election twice, however, it is important to undertake these aforementioned policy measures that will make a real difference to the life of poor farmers.

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