Farming Damage

A spate of recent farm loan waivers by India's states, says **Adit Jain**, threatens the country's fiscal health, and is ineffective, to boot

In 2008, when the Government of India announced a Rs 60,000 crore farm loan waiver, the decision horrified economists and the financial markets. The waiver, amounting to 1.3 per cent of GDP, would cripple national finances and damage the credit culture. The moral hazard of penalising prudent borrowers would be systemic and enduring. However, its proponents argued that it would free farmers 'from the suffocating clutches of endemic debt' and, in the process, also provide a quick consumption stimulus to the economy.

Subsequent events proved both assumptions awry and the folly of the decision was absorbed in a hard and painful way. Nevertheless, a lesson was learnt and federal Governments have since avoided a repeat. However, it would seem that it is now the turn of state Governments to blunder. In the last few months, Uttar Pradesh, Maharashtra, Karnataka and Punjab announced waivers of agricultural loans in their states to the tune of Rs 80,000 crore. Fortunately, the Union Finance Minister declared in no uncertain terms that the federal Government would provide no support to states that choose to go down the debt waiver route.

Loan waivers do nothing about the underlying problems that create indebtedness in the first place

The 2008 waiver did not reduce farmer indebtedness

Farm loan waivers do not work because they fail to tackle the underlying problem that creates indebtedness in the first place. In 2003, there were 89.4 million 'farmer households' (defined as a family with at least one member that qualifies as a farmer) in India. Of these, 43.4 million, or 48.6 per cent, were in debt. In 2013, this ratio increased to 51.9 per cent (see table). However, the problem is not so much the number or proportion of households in debt but the magnitude of the debt-servicing burden on an individual household. Here the picture is actually alarming. In 2003, an average farmer household had an outstanding debt of Rs 12,585. By 2013, this jumped to Rs 47,000, an increase of 14 per cent per annum. During the same period their income, which determines their debt-servicing ability, grew by only 11.8 per cent pa from Rs 25,380 pa to Rs 77,112 pa. As a result, the debt-to-income ratio of farmer households surged from 50 per cent to 61 per cent over the ten-year period. This is despite the massive bailout of 2008, suggesting that the waiver had no lasting impact on reducing structural indebtedness.

	Rural HH	Agri HH	HH in debt	Indebtedness
2003	147.9	89.4	43.4	48.5%
2013	156.1	90.2	46.8	51.9%

Source: Indebtedness of Farmer Households, NSS 59th Round, 2003; Situation of Agricultural Households in India, NSS 70th Round, 2013. Household figures in millions; indebtedness in %.

The consumption jab turned out to be a myth too

The second of benefit of the waiver – that it would provide a consumption boost – also failed to occur. A study by the World Bank revealed that there was no positive impact on household consumption after the bailout. In fact, it went to the extent of disproving all the other benefits that loan waiver proponents had claimed – that there would be an improvement in productivity as farmer balance sheets were now deleveraged; that there would be an increase in agricultural wages and employment; and that the future flow of bank credit would not be negatively impacted by the moral hazard created by the waiver. The paper argued that no wage benefits could be attributed to the waiver nor was there a noticeable increase in new investment or productivity. On the contrary, banks re-allocated fresh credit away from districts with a high exposure to the bailout fearing degeneration in their

credit culture. Sure enough, loan repayment in the high-exposure districts fell in the months following the waiver even in borrower accounts that had previously been in good standing.

Why should it be any different this time?

Theoretically, you could argue that since the World Bank study was based on an empirical analysis, its findings would apply only to the specific environment in which it was undertaken. Future farm loan waivers may not suffer the same fate – 'whilst it didn't work in 2008, it could in 2017'. In actual fact, this premise is irresponsible and glosses over some compelling counter-arguments.

The most obvious one is that waivers do not address the fundamental malady behind indebtedness i.e. low productivity; fickle incomes due to monsoon dependence; un-remunerative prices caused by unfavourable regulations; and the high incidence of informal lending by loan sharks. Unless these are addressed, loan waivers will remain futile. As recently as 2016, farmers across many crop categories saw a net decline in revenues despite bumper crops from a good monsoon. Higher volumes had the effect of driving down prices. In some crops there were export restrictions while imports were free, resulting in an even sharper price collapse. If this is the state of affairs after two straight years of good rains, things will be near hopeless should the monsoons fail. Offering a loan waiver might be

Rather than boosting consumption, these hand-outs may actually inhibit it

politically tempting but the fact is, next year farmers will be right back to where they started.

Secondly, loan waivers by definition apply only to institutional loans whereas the real stress for indebted farmers stems from loan sharks. Moneylenders, landlords and other informal sources of credit typically levy interest rates that are 200-300 per cent higher than the 6-15 per cent rates charged by banks . Moreover, they are known to resort to bullying and harassment to obtain repayment such as community shaming, intimidation and even physical violence. According to statistics, 40 per cent of all farmer loans were from non-institutional sources in 2013, only marginally lower than 42 per cent in 2003 (see table). Farmer suicides are inevitably concentrated amongst these borrowers and it is important to recognise that bank loan waivers do not fix this.

What is worse is that small and marginal farmers are the ones most dependent on non-institutional credit and therefore, the least benefited by waivers. They borrow 44 per cent of their loans from informal sources (see chart). Large farmers get 75 per cent of their loans from institutional sources and corner the majority of the waiver benefit. One could therefore argue that bailouts naively end up exacerbating the gap between rich and poor farmers .

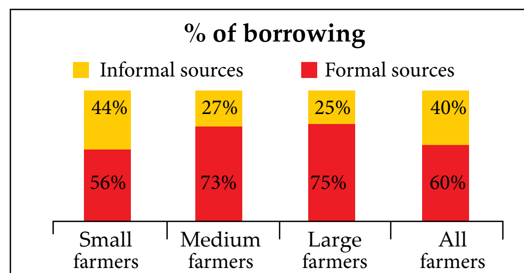
The consumption impact will actually be negative

Since farmers have a high marginal propensity to consume it could be argued that they will spend most of the new found 'wealth', the result of loan write-offs. This logic is flawed on two counts. Firstly, behavioural economics suggests that households have a very different reaction to 'income earned' versus 'expenditure avoided'. They may spend a high proportion of the former but are likely to spend a far lower proportion of the latter, since it is notional income with a psychologically different connotation. Some analysts have estimated the propensity to consume to be as low as 25 per cent for notional income , against 80-95 per cent for actual income.

The second flaw in the stimulus argument is simply that there will actually be no stimulus at all! In fact, there will be a net negative impact on consumption. To see why this is so, it is necessary to comprehend the macroeconomic principle at work. A loan waiver is nothing more than a transfer of liabilities from the household balance sheet to the Government's balance sheet, since it is the latter that now pledges to repay banks. Since the public sector balance sheet has no 'stored wealth'

	Year	Institutional	Non-institutional
% of loan amount	2003	58%	42%
	2013	60%	40%
% of households	2003	47%	53%
	2013	51%	49%

Source: Indebtedness of Farmer Households, NSS 59th Round, 2003; Situation of Agricultural Households in India, NSS 70th Round, 2013.



Source: Economic Survey, Volume 2, August 2017, IMA analysis

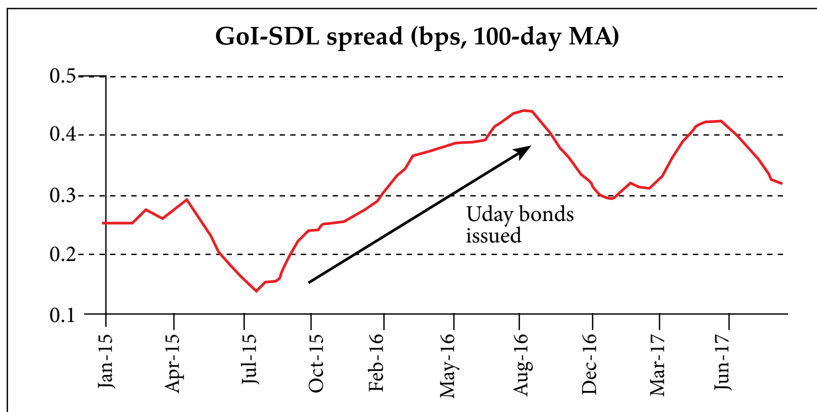
to pay out from, it has only two choices – expand its fiscal deficit by the waiver amount or reduce expenditure/increase taxes thereby reducing aggregate consumption. In the case of state Governments, those that are below the 3 per cent of GDP deficit limit specified under fiscal responsibility recommendations of the 14th Finance Commission (FFC) can afford to borrow more while the others have no option but to cut expenditure to make fiscal space. The Economic Survey 2016-17 offers some calculations for both categories.

If all states were to waive the full extent of outstanding small and medium farmer loans from the formal sector, the figure could be as high as Rs 2.2-2.7 trillion. Assuming that states below the FFC threshold deficit choose to expand their balance sheet to accommodate the waiver, they would generate additional spending of around Rs 63.5 billion pa in the form of debt servicing expenditure. On the other hand, states that have no fiscal leeway will have to cut back on expenditure to the tune of Rs 1.9 trillion. Taking into account the increased consumption by deleveraged farmer households, 25 per cent of the waiver amount or Rs 550 billion, the economy will witness a net reduction in aggregate consumption to the tune of Rs 1.3 trillion.

A small positive that may come out this exercise is an improvement in bank balance sheets, which might support credit growth

Higher borrowing costs and credit reallocation

Additionally, there are second round effects of such a strategy – most obviously the fact that private borrowings will be crowded out if state Governments were to raise an additional Rs 1.9 trillion. The experience with Uday bonds shows what happens when a large volume of state development loans (SDLs) are issued in a short span of time. Spreads between SDLs and Government of India securities widened by almost 30 bps over a few months (see chart). SDL issuances to finance loan waivers will widen spreads further and raise the cost of borrowings for states. Unlike Uday bonds that had the implicit blessing of the federal Government, 'waiver bonds' are unlikely to carry any such assurances. The fiscal implications of high cost borrowings pose grave risks at a time when state balance sheets are already stretched .



Source: CCIL, IMA analysis. Spread plotted as the difference between CCIL's All Sovereign Bond Index and SDL Index.

Arguably, one positive outcome of a loan waiver would be an improvement in bank balance sheets to the extent that non performing farm loans are removed from their books. This may lead to some increase in fresh lending. However, given past experience, it is more than likely that such lending would be directed away from populations that received the bailout since such borrowers now present a higher credit risk due to the moral hazard phenomenon. Small and medium farmers will therefore find it harder to access formal sector credit in future and will be driven further into the clutches of local money-lenders.

Bailouts simply don't work

In the ultimate analysis, while one could draw fine lines between assumptions and question the calculations, the fundamental argument is hard to refute. Loan waivers do not address the real problem plaguing farmer economics. At best, it has the effect of a painkiller administered to a patient with a chronic illness – the effectiveness of the analgesic is temporary and reduces over time while the underlying disease remains untreated, eventually killing the patient. Waivers impose a heavy growth and fiscal burden upon the economy and by denying future credit to bailout recipients, hurt the interests of the very population they were created to serve. If the right mix of policies to improve farmer profitability are implemented bailouts will not be necessary; if they are not, bailouts will not be effective. Either way, it is time policy makers realise that bailouts simply don't work. ■

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