

## Farm loan waivers and state finances

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### Abstract

Food security and the welfare of farmers is considered as the utmost priority of the state. The number of farmer suicides increasing at one hand and the protests and demonstrations of farmers on the other reflect the deep rooted agrarian crisis persistent in the Indian economy. The human tragedy and socio-economic crisis precipitated by farmer suicides in several regions require immediate attention of the state with appropriate intervention mechanisms. Responding to the situation, the state governments of Uttar Pradesh, Maharashtra and recently Punjab have announced loan waivers for the small and marginal farmers. Madhya Pradesh has resisted to join the bandwagon and has instead offered an alternative of providing fresh credit at zero interest for the next cycle. While State has a moral responsibility of responding to the situation, whether farm loan waivers is the the most appropriate instrument remains a persistent question. Empirical evidence reveals that farm loan waivers though provide a short term relief to the farmers but they have never been able to provide the intended relief. Infact, Debt relief does not improve the investment or productivity of beneficiary households, but leads to a strong and persistent shift of borrowing away from formal sector lenders. Starting its use from 1990s, when the government first used farm waiver, it has always been observed that every after loan waiver, a spike in non institutional credit was observed that loan waivers doesn't only lead to burden on the financial health of the state but also to lead to the moral hazard problem which ultimately hurts the farmer in the long run.

**Keywords:** loan waivers, economy, mechanisms, evidence, financial, health

### Introduction

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### Burdening the already burdened States

Fiscal consolidation has been adopted as a commitment by the centre with the adoption of Fiscal responsibility and budgetary management act, 2003. Similar goal has been adopted by the various states at different point of time with the adoption of Fiscal Responsibility Legislation (FRL). Till 2015-16, the impressive fiscal performance were accompanied by other favorable exogenous factors, such as, acceleration of GDP growth, increased transfers from centre, increased CSS expenditure, decline in interest payments among others. However, recently there is a trend reversal for these favorable factors. The recent report of the Reserve bank, *State Finances: A study of Budgets 2016-17*, reveals a deteriorating stance for the state finances. The primary deficit of the states is 2 % of GDP as compared to 0.7% in case of the centre. This poses serious threats to the debt sustainability for the states. Pay commission recommendations, slowing growth, rising payments from UDAY bonds are posing fiscal challenges in front of the states. This along with the newly announced debt waivers substantially add to already mounting fiscal challenges which is critical for the macro stability and the investor confidence. The ineffectiveness of the waivers in the long run and the added fiscal burden questions the effectiveness of the government response.

### The moral hazard problem of debt waivers

Limited access to formal credit has been widely recognized as an important underlying cause of persistent poverty. Economic theory suggests two channels through which financial distress at the household level may affect investment,

productivity and the aggregate economy. First, 'poverty trap' models (Banerjee and Newman 1993, Banerjee 2000, Mookherjee and Ray 2003) argue that household income net of debt service may be insufficient to cover investments in human or physical capital, causing indebted households to remain in low-productivity equilibrium. Second, theories of debt overhang and riskshifting (Jensen and Meckling 1976, Myers 1977) emphasize that indebtedness affects both the level and risk-profile of investment. If a household's debt burden is sufficiently high that the proceeds of any profitable investment go largely towards debt service, the household may pass up profitable investment opportunities. Similarly, heavily indebted households may undertake excessively risky investments, since much of the downside-risk is borne by debt holders. Both channels would imply improvements in investment and productivity as a result of debt relief.

Building on theories of debt overhang and risk-shifting bailout proponents argue that extreme levels of household debt distort investment and production decisions, so that debt relief holds the promise of improving productivity. This view is challenged by critics of large-scale debt relief programs, who argue that debt relief has the potential to generate substantial moral hazard problems, likely to limit the financial access of marginal borrowers in the long run. While both views can appeal to a foundation in economic theory, there is surprisingly little evidence on how indebtedness and debt relief affects access to credit and economic decisions at the household level.

There is, however, much concern that such efficiency effects of debt relief may be outweighed by moral hazard problems and behavioral responses arising from the prospect of future bailouts. Opponents of debt relief warn that unconditional bailouts may do lasting damage to the culture of prudent borrowing, in fact making banks more reluctant to lend to marginal borrowers in the long run. Indeed, debt relief has often served electoral interests.

It has been found, first, that debt relief leads to only a moderate improvement in the overall level of household debt among beneficiary households. This result is consistent with evidence from the literature on personal bankruptcy, which shows that households typically accumulate new debt very quickly after a settlement. However, it is also shown that debt relief leads to a significant and persistent shift in the composition of household debt away from formal sector borrowing.

The potentially far-reaching macroeconomic implications of extreme household indebtedness have motivated a range of large-scale debt relief initiatives. Some recent examples include a US\$ 2.1 billion bailout program for farmers in Thailand in 2010, and the rescheduling of US\$ 5 billion of agricultural household debt in Brazil since 2001. While the benefit of debt relief programs to individual households is substantial, their merit as a tool to promote financial inclusion, investment and productivity remains highly controversial.

### **Indian scenario**

Agricultural Debt Waiver and Debt Relief (ADWDR) Scheme (2008) was the first large-scale debt relief programme implemented by the government after 1990, when it had introduced the Agricultural and Rural Debt Relief (ARDR)

Scheme.

Soon after the announcement of the loan waiver scheme, peasant organisations pointed out two major problems in its provisions. First, the scheme was likely to exclude a huge section of farmers in the dry regions of India, as the average size of land holding in these areas is above 5 acres per household. Secondly, the scheme ignored the needs of farmers who borrowed from the informal sector, and of agricultural labourers whose loans are not considered as crop loans. The government refused to address the second problem but tried to partially address the first by creating the provision of "dry and unirrigated districts."

Agricultural and rural debt relief scheme of 1990-91 for small borrowers had left a serious scar on the credit delivery arrangements precisely for such small borrowers and borrowers in the agricultural sector. Banks violated priority sector lending majorly due to unhealthy socio-political environment created against the discipline of loan repayments. After the declaration in March 1990, there was a decline in the availability of agricultural loans from cooperative credit societies and commercial banks.

It was observed that, Amongst scheduled commercial banks, the number of small borrowal accounts with credit limits of Rs 25,000 or less had attained a peak of 62.55 million in March 1992, but by March 2001, these had dwindled to one-half at 37.25 million; the percentage share of these small borrowal accounts in aggregate bank credit had dropped from the peak of 25.4 per cent to 7 per cent during the period. A similar decline had occurred in direct finance for agriculture, with the number of loan accounts declining from 27.34 million in March 1992 to a low of 19.56 million in March 2001 and their share in aggregate bank credit receding from a peak of about 15 per cent to 8 per cent. The neglect of agriculture by the formal financial institutions has thrown the cultivator households further into the clutches of moneylenders and other non-institutional agencies. For the first time after four decades (1951-1991), the share of institutional credit for cultivator households slipped from 66.3 per cent in 1991 to 61.1 per cent in 2002 as per the decennial all-India debt and investment survey (AIDIS).

The obverse was the steep rise in the share of non-institutional agencies in cultivators' debt from 30.6 per cent in 1991 to 38.9 per cent in 2002 or that of moneylenders from 17.5 per cent to 26.8 per cent. It should be noted that, the dependence on non institutional agencies is observed to be high amongst low landholding classes; it is as high as 47 to 77 per cent amongst farmers owning below one hectare of land and 42 per cent for the 1 to 2 hectare category.

The reasons for fall in institutional credit and rise in non institutional credit can be attributed to many factors. The governments were not in a position to compensate the credit societies or banks for the write-off at one go: it took a number of years. Therefore, those individuals or societies, which had still over dues, could not have access to fresh loans. Those cultivators, who had already repaid their loans before the announcement, felt cheated and therefore, were reluctant to repay their fresh loans. Those who had benefited realized that such a write-off will occur from time to time and therefore, were unenthusiastic about repayment (moral hazard problem) Besides, there were either droughts, floods or cyclones leading

to failure of repayment.

When banks waived or settled loans, their loss was to be reimbursed by the government. The program waived more than Rs 650 bn (US\$14.4 bn) of overdue agricultural debt issued by commercial and cooperative banks between 1997 and 2007. The volume of the program corresponded to approximately 1.6% of India's GDP and covered more than 36 million households across the country (Government of India 2008).

If we try to measure the positive impacts, we observe that there was a significant increase in the number of livestock and number of sprinkler and drip sets which would imply an increase in income and livestock.

All meaningful studies on the agricultural crisis tell us that farmers' indebtedness is only a symptom; there are deeper issues in the twin dimensions of the crisis – an agrarian crisis and an agricultural development crisis. The agricultural development crisis has manifested itself in reduced overall agricultural growth accompanied by declining productivity and profitability of farm operations. Superimposed on this weak agricultural base has been the increasing marginalisation of landholdings. Land degradation, Water scarcity, climate change, dependence on monsoon and depletion of water resources further add to the problem. Volatility of prices in crops and shifts in consumers' demand patterns as seen in case of chilly production in Andhra Pradesh this year also contribute to the financial losses in addition to the crop losses. Lack of insurance and other employment opportunities to fall back in case of a loss push the farmer to take extreme steps.

Though, adequate evaluation of the government's debt waiver scheme is limited by the scarcity of disaggregated data. However, Kanz (2011) attempted to study the scheme with the help of data collected from a survey of 2,897 beneficiaries in Gujarat. He found that "debt relief does not improve the investment or productivity of beneficiary households, but leads to a strong and persistent shift of borrowing away from formal sector lenders". He argued that debt relief has major "reputational consequences" and encourages default with respect to future loans. Therefore, It is important for our government, political parties and the intellectuals to realise that what we are doing in order to help the people is in reality axing at the base of the people's effort to stand on their own feet. Other commentators have similar views. Rath (2008) noted that while debt waiver would "bring some relief to many farmers," the "long-term consequence" of the scheme would be "a gradual demise [driven by moral hazard] of the people's own institutions like the cooperative credit societies and self-help groups". The debt waiver scheme "will go down in history as damaging the interests of the very small and marginal farmers that it has mainly sought to serve", and that a socio-political environment that nurtures expectations of a loan waiver is not conducive for building a healthy financial system, particularly in rural areas where borrowers have weak bargaining power and bank officials are known to be reluctant to end at the smallest sign of a poor recovery.

Several other experts and institutions have also tried to critically assess the scheme in terms of concept and possible impact. The following were the broad inferences: 'Default' has been the basis of reward, thereby disincentivizing good borrowers. The eligibility criteria pre-suppose 'one size fits

all' farmers irrespective of the diversities of the country in terms of yield, terrains, etc. It tried to cure the symptom, rather than the disease. As an instrument of relief, ADWDRS is likely to have short-term effect, rather than long-term impact. The waiver has not invariably led to issue of fresh loans, which could have been gainfully used for reforms/revival of the sector, meeting emerging infrastructural needs and for long-term asset creation. Similar lessons can be drawn from Andhra Pradesh and Telangana loan waivers in 2014, therefore, requiring the states to distribute resources amongst immediate relief and long term relief measures.

### **What can be done**

It is necessary to help farmers suffering due to bad weather, poor quality seeds or a fall in the price of the farm product in the market. Farmers adversely affected by unfavorable weather and without crop insurance should be helped by writing off loans taken for the second or third sowing and the interest on the original loan and in case of crop failure in consecutive years, by a thorough waiver of the initial loans. The RBI, NABARD and the government should have institutional arrangements for this. There can be many ways of preventing and fighting these very sad cases of suicides, but it is a mistake to think that writing off loans at one go can be a single step solution. It will, of course, not lead to a decline in the number of cases of suicides. On the other hand, it would lead to a gradual demise of the people's own institutions like the cooperative credit societies and self-help groups. The only agencies left in the field will be the village moneylenders and their institutional brethren – the microfinance institutions.

In such a situation, what is required is a concerted strategy of strengthening the rural credit structure; increasing the number of rural bank branches, augmenting their staff strength and establishing a sound relationship banking in rural areas, should constitute key elements of this strategy. Even as banks are encouraged to increase their rural commitments, an essential aspect of the incentive structure for them should be an assured recovery process for their loans. A sociopolitical environment that allows for nurturing expectations of loan waivers and laxity in loan repayments is certainly not conducive for promoting and strengthening a healthy financial system. The loan waiver policy which comes out as a knee jerk reaction is thus antithetical to the very essence of promoting a healthy and strong financial system. It is also antithetical to the policy of financial sector reforms which the present government propagates day-in and day-out. Instead, the loan waiver policy smacks of micro management while what is essential is a systemic approach to institution building as well as ensuring the enforcement of societal goals in credit delivery through well set-out policy guidelines.

This does not imply that the state should not intervene to control such unfortunate events. It just argues for state to divert from populist measures such as waivers to more effective policy measures such as insurance, water management, agriculture extension services. Use of Digital technology and platforms like NAM should be used to minimize the losses due to market volatility and change in consumer preferences.

The states must be encouraged to adhere to the fiscal norms and adherence must be incentivized. The 13<sup>th</sup> finance

commission had a weight of 17 percent for states' own fiscal performance in allocating resources. There may be considerable merit in going back to such important incentive mechanism. Given the limited resources, a well balanced distribution into immediate and long term relief would go a long way in solving the agrarian crisis at hand.

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