CENTRE FOR MICRO-FINANCE & AJIT FOUNDATION, JAIPUR

First Prof VS Vyas Memorial Lecture
16th February 2019

Bleeding Hearts and Thinking Minds: Beyond Loan Waivers

YV Reddy[1]

Honourable Shri Bulaki Das Kallaji, Professor Vikram Vyas, Professor Sriram, Ms. Aparna Sahay, family members of Professor Vyas, distinguished scholars and friends,

I am grateful to the Centre for Micro-Finance and Ajit Foundation for bestowing upon me the honour of delivering the first Professor V.S. Vyas Memorial Lecture. My lecture today is in memory of a respected friend, a scholar, a gentleman to the core, and above all, a fine human being. He had a subdued but eloquent presence. He left an indelible impression on people with his humility and gentle persuasion. He carried his intellectual stature lightly on his shoulders. The positions held by him and his contributions to

[1] Dr. Reddy acknowledges the benefit of discussions with Professor Sriram, Mr. Senthil and Ms. Usha Thorat. He is grateful to Professor A. Vaidyanathan for his valuable advice on an earlier draft.

the down-trodden are too well-known to be recalled here. Yet, he did not allow his heart to dominate his thought. His heart determined his priorities, but his mind determined the line of action. I have selected the subject today keeping in view his interests, inclinations and contributions.

For my part, I had the privilege of sharing concerns on matters relating to agriculture and banking with Professor Vyas. For instance, he kindly agreed to my request in 2004 to chair an advisory committee on flow of credit to agriculture and related activities from the banking system. The RBI accepted the recommendations and action taken was put in the public domain.

There are several reasons for choosing the subject for this lecture. First, the life-time and immense work done on the subject by Professor Vyas. Second, my practical experience dealing with the issue of agricultural credit and loan waivers. Third, the recent spate of announcements of debt waivers by States. Fourth, the discussions about alternate mechanisms implemented by State Governments such as Telengana, Orissa and Kerala. Fifth, the latest Union Budget's announcement of programme of transfers to farmers on a national wide basis, with fiscal implications of a recurring nature in significant magnitudes. Sixth, a race among major political parties, States and Union, to move in the direction of more reliefs and large transfers on a recurring basis (for example, Universal Basic Income). I believe that cumulatively these have the potential to seriously undermine fiscal stability and growth of country. We should, therefore, pause, think and proceed on a new path. Ideally, a national consensus is needed on such a new path with participation of Union and States.

Let me start with the case for and against loan waivers.

The case for Loan Waivers

Loans are contracts between the institution that is providing the loan and the borrower. Under normal circumstances, this loan with interest is to be serviced either through repayment; or through a mutually agreed settlement mechanism. Normally, if a borrower is in distress, the borrower needs to make a case for relief and on the basis of the veracity of the claims and the agreeable haircuts the lender could potentially settle with the borrower. In case this process does not happen, lender or the borrower is termed as a defaulter, with consequences to both lender and borrower. Loan waiver is a third party unilateral intervention in private debt contract. Two contracting parties readily agree to this third party intervention because both the parties to the contract gain as the cost is borne by the tax payer.

There is a plausible explanation for the occurrence of loan waiver in lieu of individual account settlement in the case of Agriculture. At the individual account level, most of them might be small accounts and not material enough to merit the attention of individuals for restructuring. It does not attract the attention of the senior management within respective commercial banks to guide their staff at the field who might have limited powers for renegotiation. Therefore, where there are a large number of accounts under stress, the problem gets externalized and, sometimes, politicised.

The case being made in favour of loan waiver is that it is necessary for the government to intervene because the economic activity will be adversely affected if the flow of credit for the crop of season is interrupted in order to go through the process of case by case negotiated settlement.

Why this approach to agriculture?

The risks in agriculture are different from the risks in other sectors warranting such waiver. Loans to farmers do not have limited liability option. Farming, more often than not, is not a business option. The personal wealth of the farmer is at stake. One very important reason or justification for waiver is repeated droughts and floods leading to crop failure.

The case against Loan Waivers:

The case against loan waivers can be summed up as follows:

First, there is a third party intervention in a contract between the borrower and the lender, and that is done by the Government at the cost of tax payer who is not a privy to the commercial transaction, unless the problem is on account of a natural calamity.

Second, the waiver provides an omnibus relief to defaulters and punishes the people who have repaid.

Third, it is a centralized panacea for a localized problem that varies significantly from farm to farm, block to block, district to district and state to state.

Fourth, repeated waivers create a moral hazard and have the danger of shutting out formal credit completely.

Fifth, it benefits only the borrowers from the formal sector and not the larger population, particularly those who are vulnerable and are indebted to the informal sector.

Sixth, it usually involves a substantial outflow from the exchequer disproportionate to material benefit to the farmer.

Seventh, the loan waivers follow the electoral cycles rather than the distress cycles.

Eighth, it does not assure that the defaulting farmer will get a loan for the next cycle.

What has been the experience with such waivers?

Experience with Loan Waiver

In 1990, Finance Minister Madhu Dandavate in his budget speech said, and I quote extracts: *"I consider the debt relief measure as a positive step which will enable our farmers, artisans and weavers to increase their productivity. It is at the same time necessary to ensure that there is no erosion of the credibility of the banking system..... The scheme should contribute to better agricultural recoveries and better identification of willful defaulters, who do not deserve any sympathy...... The Government would also like to make it clear that the Scheme will not be extended nor will it be repeated."*

In fact, the scheme has been repeatedly repeated.

In 2004 the Expert Committee on Rural Credit chaired by Professor Vyas said, and I pick up some extracts:

"The central and state governments should desist from giving blank remissions in loans and/or interest and the grant of relief to borrowers".

Going further, the committee said:

The central government may wish to consider, after consultations with important political parties, appropriate additional provisions in the People's Representation Act to deter political parties from including loan remission or waiver or similar schemes in their election manifestos. The Election Commission may also want to consider incorporating such conditions in the model code of conduct for elections. State governments may consider adding provisions to make a call for not paying bank dues a cognisable offence punishable by imprisonment of up to three months.....

"Grant of relief to borrowers by banks should be disassociated from state declarations of annawari. Banks should assess crop failures on their own in their areas and take appropriate action on conversion/rescheduling through a collective decision.

General remissions should be entirely stopped. If state governments wish to help only the non-wilful defaulters, they may do so by providing funds limited to a certain percentage of loans outstanding to all banks, including RRBs and commercial banks, to enable them to grant remission in interest and/or principal in clearly specified deserving cases."

Of course, the Committee was not alone in advocating this approach; and no Government took the advice seriously.

In fact, the Government of India announced a loan Waiver nationwide for small and marginal farmers in the budget speech of 2008. The amount involved is Rs.60,000 crores. Reason given in favour of loan waivers is the threat to social order that Prime Minister Manmohan Singh invoked in his discussions with me on the subject in 2008. I am giving below the extracts from my book "Advice and Dissent":

"I opposed the proposal made in February 2008 to write off loans to farmers amounting to Rs.60,000 crores. I argued my case before the finance minister, and at one stage before the prime minister accompanied by the finance minister. Economic logic including preservation of credit culture was in favour of RBI's position. During the discussions, references were made to precedents of periodic write-offs in the past, urban-rural divide in growth, social unrest and farmers' suicides. The arguments advanced were on the following lines. Fifty per cent of the population dependent on agriculture has to be content with 15 per cent of GDP. Worse, their per capita incomes were growing at about two per cent, while for the rest it was a multiple of that. This was a threat to social order unless immediate concern was demonstrated. Loan waiver was the best fit for this." (page 381).

My position on the subject was "I believe that as governor, I could advance arguments from the point of view of money and credit, but I had no legitimacy to question the judgement of the government on social order." (page 382).

In brief, we cannot ignore the political reality but equally we cannot afford the adverse impact of farm loan waiver.

Cost to national exchequer

Debt waiver has fiscal implications to the Union and State Governments. This is clear from the opening remarks of Dr Urjit R Patel, Governor of the Reserve Bank of India, at the Seminar on "Agricultural Debt Waiver - Efficacy and Limitations", Mumbai, 31 August 2017.

"The first major nationwide farm loan waiver was undertaken in 1990 and the cost to the national exchequer was around ₹ 10,000 crores, which works out to ₹ 50,557 crores at current prices using the GDP deflator. The second major waiver was under the agricultural debt waiver and debt relief scheme (ADWD) of 2008 amounting to ₹ 52,000 crores (0.9 per cent of GDP) or ₹ 81,264 crores at current prices using the GDP deflator. Unlike the 1990 scheme that aimed at providing blanket relief to all farmers up to a certain loan amount, the 2008 scheme waived debt for certain classes of cultivators. In 2014, Andhra Pradesh and Telangana announced farm loan waiver of₹ 24,000 crores and ₹ 17,000 crores, respectively. Beginning with Tamil Nadu in 2016, domino effects have spread in 2017 to several states and the total cost of loan waivers announced amounts to around ₹ 1,30,000 crores (0.8 per cent of GDP)".

The RBI governor further highlighted that bank loan waivers are typically borne by the respective state governments, and hence, there is no impact on the bottom-line of banks. Banks only provide a temporary write-off, but the eventual liability is on the state government. The most indebted states -Uttar Pradesh, Madhya Pradesh, Maharashtra, Karnataka, and Punjab had taken farm loan write-offs to the tune of Rs1,08,000 cr.

An Assessment:

It is very clear that farm loan waivers are undertaken by Government from time to time. They are taken unilaterally by Central Government or by State Governments with no coherent assessment or assumption of responsibilities. The decisions are made on an adhoc basis and piece-meal fashion. There is an element of arbitrariness. Significant fiscal costs are incurred. The distress which is the basis of loan waiver is not defined, but based on a sweeping generalisation.

It is also not very clear as to how much of the waiver benefits the farmers and now much of it is relevant to banking system that has extended the loans.

Further, through the loan waivers, beneficiary's net-worth goes up. To that extent their capacity to discharge their loan obligations to informal sectors including money lenders increases, since there is no corresponding waiver by them.

Surveys have shown that credit to farmers is generally availed by the influential farmers. They often use the money borrowed at low interest rates for on-lending at market rates or use the funds for other businesses. Small and marginal farmers for most part are not the major borrowers.

C&AG report in 2013 has brought out the real facts on ground to indicate that most of the monetary benefits from the loan waiver went to ineligible big farmers while the small, marginal and landless (tenant) farmers received little relief.

Yet, debt waiver may, in certain situation, become inevitable. But then there has to be an independent apolitical body to make the determination to ensure process integrity and the funds should flow from a non lapsable corpus shared by the Union and the State Governments. Farmer has to become co-payee to the risk mitigation and risk insurance. This is not the case now.

In brief, it is difficult to find economic justification for loan waivers in the present form of such magnitudes, except on grounds of preserving social order or political compulsions. In other words, these loan waivers demonstrate the hearts bleeding for the millions of "distressed farmers". Recently, some more schemes are emanating out of such bleeding hearts.

Other Bleeding heart schemes:

The Rythu Bandhu scheme launched by the Telangana government very recently provides financial support to all the farmers to the extent of Rs.4000 per hectare per season.

This is an omnibus support for agriculture to improve the viability of agricultural operation, with a significant recurring fiscal commitment but of unclear magnitude.

The loan waiver is undoubtedly of questionable benefit. However, there is scope for improvement of such schemes to take care of the distress of affected farmers (I will explain this a little later). In contrast, the alternative of transfers has a potential for self-perpetuation.

Following the Rythu Bandhu scheme, the union government has also announced a scheme that provides income support to farmers who have less than 2 hectares of land. This support to the extent of Rs.6,000 per holding will be given in three tranches – at the time of sowing, for the standing crop and at the time of harvesting, thereby increasing the cash flows for the agri-households and de-stressing the situation, irrespective of a crisis. It is not clear how the Union Government will implement a scheme when the administrative machinery is with State Governments. The land records are with State Governments and domain knowledge is with State Governments. The Union Government may also face some risks in future. First, some of the States may argue that the scheme does not make a distinction between the poorer States with distressed agriculture and others where agriculture is relatively more viable. Secondly, some of the States may argue that the better-off States are in a position to take care of the distress of the farmers whereas there are other States that have greater fiscal constraints to take care of their vulnerable agricultural sector.

The instrumentality used by the Telangana Government and the Union Government is in the nature of adding to the viability of agriculture. But it is important to note that the Rythu Bandhu and PM Kisan have no links with loans or default or a defined distress. These are not akin to universal basic income because they are not universal but linked to asset ownership. The Universal Basic Income is a proposal that has equal, if not more, complex challenges, especially for Union Government.

However, there is one thing common between these, and loan waivers, namely, a bleeding heart, that is a transfer from exchequer.

When we think about it, more we spend liberally on relief, less of resources we have to invest in solving the problem unless the relief proposed is a substitute.

Transfers in lieu of Subsidies:

There has been an argument that transfers are preferable to subsidies and that fiscal costs are not significantly different. Two questions arise, namely, what are the chances that we will end up with both transfers and subsidies? It is anybody's guess. Second, how much of subsidies attributed to agriculture really benefit the farmers?

The major subsidies relate to food subsidy, fertiliser subsidy, irrigation (water subsidy), power subsidy and interest subsidy. This is supplemented by loan waiver. It will be useful to assess the aggregate of subsidies and also the impact of the subsidies on viability. Firstly, the food subsidy is not entirely on account of the operations in relation to minimum support price. The subsidy bill contains a significant interest cost of the Food Corporation of India because the Government does not promptly pay to the FCI for its purchase operations. In a way, this expenditure is in the nature of Ways and Means Advance to the Government and not a subsidy to the farmers.

Secondly, the fertiliser subsidy helps the farmers, but some of the reports from World bank have indicated that a significant element of the subsidy is really in favour of domestic fertiliser industry which is not internationally competitive.

Thirdly, irrigation and water subsidy is not quantifiable. Despite several recommendations for installing water meters, this has not been done.

Fourthly, with regard to subsidies on account of power sector it is well known that a significant part of the subsidy is attributable to the land losses and other inefficiencies.

Finally, the interest rate subsidy is most relevant to the issue of loan waiver and credit markets in general.

In brief, therefore, there should be an objective analysis of the subsidies attributable to the farmer and the possible implications of the withdrawal of the subsidies, before embarking on transfers.

Risk Fund: An Alternative to Loan Waivers

It may be recalled that Vyas Committee recommended an Agri Risk Fund more than ten years ago. The relevant extract reads as follows:

"Restructuring of loans affords temporary relief to farmers; however, long term remedies to deal with impairment of farmers' repaying capacity caused by recurrent external adversities such as droughts and floods are also needed. The Committee, therefore, recommends setting up of an Agri-Risk Fund with equal contribution from Central and state governments and participating banks. It feels that such a fund would moderate the risk of lender banks as they could take recourse to the fund in the event of a genuine default; it would also assuage some of the farmer hardships.

I understand that Swaminathan Commission had also suggested an Agriculture Risk Fund aimed at providing relief to farmers in the aftermath of successive natural calamities.

Genuine farm distress must certainly be addressed and alleviated and it is the Government's responsibility to do so. But there is the need to make the process targeted, premeasured and credible. The process integrity of farm loan waiver would provide confidence to the genuine beneficiaries, general public, creditors of both Union and State Governments.

A credible process and determination through apolitical mechanism is required to support small and marginal farmers in distress instead of an across the board general waiver.

Further such credible process would be effectual only if supplementary measures are also taken to avert farmers from slipping back into an agonizing state of indebtedness. It is also essential to nudge the farmer to partially de-risk himself.

New Approach to future of Agriculture

There are two fundamental problems faced by the farmers, namely commercial viability and unbearable risks. Addressing these problems may require reconsideration of the instruments, incentives and institutions of public policy in a comprehensive manner.

The current approach clearly concentrates on the immediate problems of the crisis and is paying less attention to the future role of agriculture in the Indian economy. The new approach should take a view of agriculture in the economy as a whole, in future. In the long term, the share of agriculture in GDP will be coming down. Therefore, the resources that flow to this sector cannot have an increasing trend. At the same time, the number of people depending on agriculture is already very large. The obvious solution is to enable people to move out of agriculture. In brief, in the long run, the solution for the agrarian distress does not lie in agriculture alone.

It is also inevitable that the demand for agricultural products, as a proportion of aggregate demand, will be coming down. There will, therefore, be a secular tendency towards excess supply. Therefore, emphasis may have to be more on productivity increases than expansion in output.

There is scope for increasing the productivity since our current levels are very low. An important constraint felt by the farmer relates to the risks associated with agriculture. The de-risking of agriculture is as important as increasing productivity. The de-risking may relate to water, power, quality of inputs and volatility in price.

In regard to credit, the supply has to be enhanced and risk has to be priced properly. In other words, institutions and incentives in regard to credit require a thorough review.

Relief measures should be so designed that they are incentive compatible and do not assume permanent character.

I am aware that I am only illustrating some aspects of policy which have proven to be ineffective.

The policy approach to agriculture, both for relief and solution, should to be well thought out and has to be futuristic.

Conclusion: **Towards a New Approach**

Friends,

I started with a description of loan waivers by Centre and States. That led us to other schemes which are meant for giving immediate relief.

We then realised that immediate relief is not a solution and, in fact, excess relief or ill designed relief may jeopardise the solution to the problem. The problem warrants several actions outside the agricultural sector along with comprehensive reforms in agriculture.

The contours of a reform in Agriculture have been very well articulated by Professor Vyas in December 2014 in his valedictory lecture to the annual conference of Indian Economic Association titled "Economic Reforms in Agriculture". I had forwarded the lecture to Professor Arvind Panagariya, Vice Chairman, NITI Aayog. In my forwarding letter to him, I wrote about Professor Vyas' lecture. "I believe that this is the best paper I have come across, listing out the agenda of items for Reforms. There is only one area that is missing, viz., removing uncertainties in regard to supply of power and water to the farmers, and also, uncertainties in regard to the quality of fertilisers and pesticides."

I am forwarding this to you since I think it will be useful for you while crafting the strategy for reform of agriculture, encompassing both Union and the States."

I recall it now and reiterate its contemporary relevance. It is pertinent to note that Professor Vyas particularly mentioned the role of the States and the importance of agreements by the States for effectuating reform.

In regard to loan waivers, it is very clear that the case for such waivers as being practiced is weak and yet cannot be wished away. What is possible is improvement in the process to depolitcise such waivers. For this purpose, a Risk Fund has been suggested. An important ingredient of the proposal is the joint efforts of Centre and States in addressing this problem.

Of late there has been a disturbing competition to design schemes which are in the nature of simple transfers to farmers. This is being done by some State Governments, by the Union Government and major political parties. These schemes and proposals involve large expenditures of a recurring nature. There are genuine concerns about their potential for irreversible fiscal deterioration and for conflicts between the Centre and the States. The 15th Finance Commission has to necessarily make estimates about the committed expenditures of the Union and the States. I hope the Finance Commission will take this issue on board.

Finally, we should accept that our approach to agricultural sector and agrarian crisis so far has been less than successful. The current approach has to be replaced with a new and better approach. We should not rush into costly adhoc reliefs or solutions. The new approach should ideally be set out by a National Commission on Future of Agriculture in Indian Economy. This should no doubt include immediate reliefs. Further, we should recognise that agriculture is a nationwide problem, but it expresses itself differently in different parts of the country, requiring localized suitable measures. Hence, a national consensus involving both Union and States has to be built around a new approach.

I will take leave of you, by recording that interacting with Professor Vyas has been an education for me.

The new approach should be built around ending the dependence of farmers on Government for their survival because genuine farmers cherish their freedom.

Thank you.