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Last Published: Wed, May 24 2017. 11 52 AM IST

The hazards of farm loan waivers

Research provides evidence that a blanket farm loan waiver scheme is detrimental to the development of credit markets

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A well-designed farm loan waiver programme could enhance the overall well-being of the households by improving their productive investments. Photo: Hindustan Times

The Bharatiya Janata Party (BJP) won the 2017 state elections in Uttar Pradesh with a thumping majority and once again, the state government has a debt-waiver package ready to be implemented. The BJP's electoral manifesto had committed to write off loans of small and marginal farmers, which would approximately cost the government Rs37,000 crore, according to initial reports. Intervention in the credit market through household debt relief has been a fiscal policy adopted by many governments both at the Central and state level for many years.

The support for debt-waiver programmes comes from the theoretical argument that a high level of outstanding debt reduces the incentive for the debtor to exert effort to repay. In such a situation, a policy of debt forgiveness could induce the optimal level of effort from the debtor and maximize repayment. However, repeated debt-waiver programmes might alter the expectations of debtors about enforcement of future credit contracts. This, in turn, could adversely affect the level of effort. For instance, consider the case of debt-waiver programmes in the context of agricultural credit markets wherein farmers obtain loans against collateral, land in most cases, which are freed once the loans are repaid. If farmers expect governments to intervene and free their collateral from banks, in case of default, they are likely to reduce productive investments and spend more on consumption.

Past empirical research analysing the 2008 nationwide Agricultural Debt Waiver and Debt Relief Scheme (ADWDRS) found that it led to a delay in loan repayment, increase in defaults, and no significant productivity gains. In spite of the evidence against the effectiveness of the ADWDRS programme, many states continue to announce their own state-level debt-waiver schemes. It is possible that state-level debt-waiver schemes could address state-specific indebtedness problems that a generic national-level programme like ADWDRS could miss.

Uttar Pradesh farm loan waiver scheme

The Uttar Pradesh Rin Mafi Yojana (UPRMY) is one such programme that was announced immediately after the ADWDRS programme in November 2011. We evaluate UPRMY to understand how repeated debt-waiver programmes affect people's consumption and investment decisions by changing their expectations about future waivers. Under the UPRMY, a total of Rs1,720.42 crore was disbursed to 730,000 farmers from 74 districts over 2012-2015 (*Table 1*). Repayment rates fell dramatically after this announcement: the average repayment rate fell from 25%-50% in 2010-11 (pre-announcement) to 10%-25% in 2011-12

We collected primary data in 2015, from 5,270 individuals in 770 households across six districts of Uttar Pradesh—Auraiya, Agra, Firozabad, Kanpur Dehat, Sitapur, and Lakhimpur. In each district, a household is eligible for loan waiver under UPRMY if it had taken an agricultural loan of up to Rs50,000 from the Uttar Pradesh Gramin Vikas Bank and repaid at least 10% of the borrowed amount on or before the official programme announcement date.

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Our analysis captures the differences in the consumption and investment decisions between eligible and not eligible households in districts that received the waiver vis-à-vis the differences between potentially eligible and not eligible households in districts that did not receive the waiver.

We find that households which qualified for the waiver spent approximately Rs8,000 more on consumption per year than households that did not qualify for the waiver. Of greater concern is that qualifying households also spent significantly more on social events such as weddings, family occasions, and so on, even when there was no significant difference in farm productivity between qualifying and non-qualifying households.

Given that households in the same district face similar agricultural shocks, no improvement in farm productivity for households qualifying for loan waiver indicates a failure of the programme to achieve its desired goals.

Implications for design of loan waiver programmes

Our research provides evidence that a blanket waiver scheme is detrimental to the development of credit markets. Repeated debt-waiver programmes distort households' incentive structures, away from productive investments and towards unproductive consumption and wilful defaults. These wilful defaults, in turn, are likely to disrupt the functioning of the entire credit system. It is important to note, however, that our findings do not speak against debt-waiver programmes altogether. Rather, they warn against implementation of loan-waiver programmes based on simplistic eligibility rules that do not account for the actual needs of the farmers and the agricultural shocks they have faced.

A well-designed loan-waiver programme could enhance the overall well-being of the households by improving their productive investments, as opposed to distorting their loan utilization and repayment patterns. One possibility is to formulate eligibility rules that depend on historical loan-utilization, investment, and repayment patterns. Another option is to explore alternative policy interventions like agricultural insurance. The desired intervention could then be the one, which nudges households into investing more now and increase long-term productivity.

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First Published: Tue, May 23 2017. 11 36 PM IST

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