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POLITICAL ECONOMY OF SUBSIDIZING AGRICULTURAL CREDIT IN DEVELOPING COUNTRIES

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POLITICAL ECONOMY OF SUBSIDIZING AGRICULTURAL CREDIT IN DEVELOPING COUNTRIES

Edward J. Kane *

This paper explains how repeated collisions of political and economic forces shape the life-cycle of programs intended to subsidize credit for agricultural development. Offering credit on below-market terms to a set of politically favored borrowers lets powerful arbitrage pressures loose in the financial marketplace. Over time, these arbitrage pressures tend to offset the gap between market rates of interest and explicit interest rates on program loans by forcing implicit interest to be paid and collected. Since the program's intended beneficiaries find it difficult to offer the market-clearing level of implicit interest, they find themselves increasingly cut off from program credit and press for regulatory change to narrow the program's major loopholes. As the network of supporting controls grows, unintended budgetary expense, loss of freedom, economic waste, and distributional inequity foster political demands for radically different policy approaches.

Development plans in many countries include regulatory schemes for controlling the volume, terms, and distribution of agricultural finance. The professed strategy is to make agricultural credit cheap enough to encourage farmers to adopt modern methods of production, and thereby to increase agricultural output for the nation as a whole. Distributionally, such policies are sometimes also justified as offsets for distorted exchange rates and product-price discrimination that favor importers and urban consumers over agricultural producers (Adams, 1971; Ray, 1981). Typically, banking institutions set up to specialize in agricultural development loans are mandated to make credit for <u>small</u> farmers and <u>remote</u> agricultural regions particularly abundant and especially cheap.

Although adherents maintain that agricultural development banks and other credit-allocation strategies to promote economic development are theoretically sound, in country after country, practical results have been greatly disappointing. The long-run consequences of development-promoting credit-allocation policies invariably run counter to their ostensible goals. The analytical framework set

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forth in this paper explains how the predictable response of economic forces to financial-market regulation makes it impossible to keep credit-allocation policies on target over long periods of time.[1/]

Agricultural Development Banks and the Problem of Finance

For government planners in a developing nation, the problem of finance centers on how to acquire sufficient funds to support the various programs targeted in development plans. Funds raised from foreign sources are called external finance; funds raised from domestic sources are called internal finance. A parallel distinction between internal and external finance relates to sources of funds used to pay for expenditures in excess of income by individual spending units within a country (i.e., by firms, households, and government agencies).

These distinctions treat finance as a matter of delivering funds to would-be deficit spenders. But funds delivery is merely one side of the finance coin; funds generation is the second side. To deliver funds to deficit spenders, development planners and financial-services firms must first gather loanable funds in some way. Apart from running down previous accumulations of wealth and making use of foreign borrowing or government tax receipts, this involves tapping into funds accumulated by spending units that voluntarily or involuntarily run an expenditure surplus.

Inasmuch as an agricultural development bank can extract funds from international donors and the local government, it seldom competes simultaneously for domestic deposits. But ignoring private funding leaves a financially incomplete institution that can not survive without continuing subsidies from an external source. Most agricultural development banks function like philanthropic institu-

[1/]Analytically, the explanation offered by von Pischke (1980) closely resembles the slightly more general dialectical theory presented here. Research on rural financial markets by Gonzalez-Vega (1981), Ladman and Tinnermeier (1981), and Vogel (1981) also fits comfortably into the dialectical approach.

tions. They don't truly "finance" their own operations by borrowing loanable funds for their own account at market interest rates and seeking energetically at least a breakeven rate of repayment. They are organized to receive funds from domestic or foreign "donors" and to lend them out on subsidized terms to designated beneficiaries (von Pischke, 1980).

In principle, an agricultural development bank acts as a retail distributor for the domestic government or international donor that supplies it with loanable funds. Although the funding source tends in the short run to assess the quality of an agricultural bank's performance strictly by bureaucratic criteria, in the long run it wants the institution to earn a net profit. These conflicts in performance criteria put agricultural banks and their employees through a repeating two-stage life-cycle.

Initially, the institution and its employees are judged not by the institution's bottom line, but by how quickly they can lend out the funds the sponsor delivers to the bank and how well they appear to exclude applicants other than intended beneficiaries from receiving loans. Compared to a profit-oriented institution, too little emphasis is placed on project evaluation, credit-screening procedures, and contractual safeguards (such as collateral) that affect the probability that loan funds are actually paid back on schedule. Emphasizing borrowers' repayment capacity would impact immediately and unfavorably on the institution's initial goals, while improvement in payback experience is not visible to the sponsoring agency or government until a much later date.

After three or four years, the economic costs of these bureaucratically "successful" lending priorities come to outweigh their ongoing political benefits. As repayment problems mount, the institution comes under fire and its original managers either jump ship or are pushed overboard. In this stage, strengthening the institution's balance sheet becomes the dominant objective. Operating costs are cut and lending officers concentrate on borrower repayment capacity. But this emphasis on the financial viability of the bank's loan portfolio tends increasingly to exclude from access to program funds the beneficiaries originally targeted by the funds source. Eventually, bureaucratic pressures to serve this group renew the cycle.

In establishing guidelines to be followed by loan officers at agricultural development banks, assessment of borrowers' repayment capacity is only one of several problems facing bank sponsors. Their most fundamental difficulties flow from the fungibility of credit. A fungible good is one that can freely replace — or be replaced by — other goods of a similar nature or kind. Fungibility refers to the ease with which perfectly equivalent substitute arrangements can be established. Fungibility is an essential property of loan funds that resists erasure by program restrictions and government regulations (von Pischke and Adams, 1980). It is nearly impossible without full borrower cooperation to ascertain — either before or after the fact —the true purpose of a proposed loan. Just because loans are made to persons who are farmowners or farm operators or are secured by agricultural land, equipment, or crops does not prevent the proceeds from being expended in unauthorized pursuits. Even making loan funds payable in kind or in special currencies that are redeemable only for agricultural inputs (as in the use of fertilizer, seed, or pesticide "credit stamps") cannot guarantee that the purchase of the designated products was the marginal expenditure ultimately financed by the additional liquidity provided by the loan. The ostensible restriction can be neutralized as long as the goods or stamps can find their way through intermediate trades in grey or black markets into the hands of others. Credit stamps or in-kind loans have their highest value to individuals who would have purchased the targeted products even without access to program credit.

Government and Financial Markets

Financial markets may be defined as the set of institutional arrangements by which a nation's citizens exchange current funds or commitments against future funds or commitments. When they are allowed to operate without government subsidies, financial-services firms are arbitrageurs by nature. They borrow funds to lend them out again at a profit. Precise institutional arrangements differ in form from nation to nation, but in almost every society self-regenerating financial intermediaries offer a similar set of economic benefits to those who supply funds to them: fiduciary pooling of individual accumulations of wealth, formal schemes for sharing risk, individualized payment and safekeeping services, and detailed record-keeping.[2/]

In every country and in every era, governing authorities almost always impose special restrictions on financial-services firms. Politicians (even dictators) calculate a policy's effects predominantly in the short run and in terms of its impact on the chances of staying in office (Downs, 1957). They are attracted to economic policies whose short-run balance of costs and benefits is favorable, especially policies whose long-run costs are disguised and widely spread across the population. Government interference in the workings of financial markets looms as a quick and administratively convenient way for politicians either to penalize or to reward specific segments of the population. The explicit marginal costs of such interference are extremely low in the short run. These costs are low because, whether or not a particular government interferes with credit-allocation decisions, it is already active in establishing the credibility of private financial contracts.

Financial markets can be no better than the quality of the contracts they feature. Participants depend on a system of legal sanctions to make financial

[2/]Ray (1981, pp. 5-8) nicely summarizes the economic explanation of how and why financial intermediaries typically combine these particular functions.

contracts enforceable. The trick in any contract is to establish a set of incentives that makes it highly likely that both sides will perform. Whether a commitment is unconditional or contingent on stipulations designated in the contract, the market value of the associated instrument depends in essential ways on the particular system of laws that governs its enforceability. Since final performance typically turns out to be more painful _ex post_ for one side of the contract than the other, the penalties that may be imposed on a defaulting party closely affect the probability of contract compliance. For example, the most important difference between finance-company and loan-sharking operations is the extent to which extralegal penalties for default (especially violence to persons and property) may be threatened and exacted.

Even in the freest real-world society, the government must inevitably serve as referee in civil disputes. Costs incurred in serving this function make the government a contingent partner in collecting damages suffered by either side of any unfulfilled financial contract. As a partner, it is natural for the government to look for ways to safeguard its interests. Precisely because transactions in financial markets require governmental rule-making and careful documentation, governments must always monitor these markets to some degree. It is natural for lawyers (though less natural for economists) to suppose that merely by stepping up the degree of monitoring a government can readily mandate who receives credit and on what terms. To the legal mind, interference in financial markets looks like an easy opportunity to redistribute benefits from financial intermediation in politically advantageous ways.

Although a country's financial markets and institutions are shaped importantly by its inherited legal system and cultural traditions, contemporary _changes_ in arrangements for delivering financial services express the interplay of recognizable political and economic forces. This paper uses a conceptual framework developed in Kane (1977 and 1981) to interpret the interaction of political and economic elements in the evolution of programs for subsidizing credit for agricultural development. Although the presentation focuses on contemporary problems of channeling credit to agriculture in developing countries, the scheme is potentially useful in explaining financial change in any country and in any era.

Political Economy of the Regulatory Dialectic

Political economy is the name by which the study of economics was known before twentieth-century academic specialization led economists and political scientists to adopt a less holistic vision of economic and political processes. Taking an old-fashioned perspective, this paper maintains that the dynamic interaction of these processes is the driving force in institutional change.

The paramount explanatory concept in the paper is the regulatory dialectic. The philosophical word dialectic represents a careful way to characterize the dynamic workings of a process that operates more or less like a playground seesaw. A dialectical process is one whose outcomes are governed over time by two forces poised always in direct opposition to each other. As the respective forces gain and lose momentum, they push outcomes first one way and then the other. However, because both sides' gains in momentum are inherently self-cancelling, neither side can ever permanently dictate the result.

In the regulatory dialectic, the opposing forces differ in the manner in which power is amassed and in the precise real-world arenas where they are expressed. On the political side, power is accumulated by coalition building and is expressed in legislative activity or government decrees. On the economic side, power is gained by accumulating wealth and is exercised by purchasing or borrowing financial and productive resources and employing them efficiently.

In regulated markets, economic and political forces offer a lagged response to every action taken by the other side. The sequence of mutual action and reaction may be likened to the progression of alternating moves in a chess game or to the unfolding of successive tennis shots in a sustained volley. At each step along the way, opposing players develop advantages for their side intended to meet and overcome disadvantages previously imposed on them by their opponents.

My analysis depicts the flow of events in a regulated market as a three-stage process, driven by alternating acts of political and economic arbitrage. The individual stages — which deliberately parallel Hegel's famous triad: thesis, antithesis, and synthesis — are conceived as acts of regulation, avoidance, and re-regulation. Although Hegelian processes are essentially seamless, in analyzing the role of subsidized credit in strategies for national development, it is convenient to start each sequence with an exogenous political effort to intervene in a particular set of markets.

Although lags are visible both between the regulation stage and the avoidance stage and between avoidance and re-regulation, in most countries the <u>re-regulation lag</u> tends to be considerably longer than the <u>avoidance lag</u>. I attribute this to differences in the structure of incentives for timely action facing managers of regulatee firms as against those facing employees of regulatory agencies. In particular, traditions of bureaucratic procrastination and of gradually phasing in (or "grandfathering") the impact of important changes in operative regulations simultaneously reduce the risk of avoidance activity to regulatees and retard the pace of regulatory realignment.

From the point of view of a regulatee, regulation may be characterized either as a tax-like forcible taking of potential income (Posner, 1971) or as a type of "negative innovation" which destroys selected economic opportunities. Holding other things equal, regulation increases the cost of doing business. Just as waves of positive innovations account in Schumpeterian theory for growth and fluctuations in economic activity, the regulatory dialectic can explain the nesting of long, intermediate, and short cycles in specific regulated industries.

In any society, self-interest leads individuals to strive to accumulate both economic wealth and political clout. Once accumulated, individuals will express their economic and political power advantageously and will respond to others' efforts to exercise power against them. In modern mixed economies, political power and economic power collide almost perpetually in a dual process or arbitrage. Powerful political coalitions press for changes in taxes and regulations intended to alter in their favor market determinations of how income and wealth are to be distributed among the population. Similarly, economically powerful persons seek to avoid the tax and regulatory burdens that political efforts to redistribute wealth propose to lay on them. The conflict may be described as the rule of legal force *versus* the law of one price.

Why Regulate? Differential Political Opportunities Establish the Dimensions of Regulatory Conflict

Political power resides in being able to mobilize what we may call an "effective political majority" to place legal restraints on persons or firms with whom one deals. What matters is controlling a majority of votes in the forum where a crucial policy decision is actually made. Such a forum need not be an open one. In the United States, the relevant forum for legislative decisions sometimes reduces to a ten-person House-Senate Conference Committee which, in reconciling differences in legislation previously passed by the two houses, can fix the final form of a new law. In regulatory matters, the relevant forum may reduce to the governing board of a particular agency, to their top staff advisors, or to a pivotal group of military officers. Particularly in the self-appointed oligarchies that dot the landscape of the developing world, the crucial forum may not even be a governmental institution.

Even in a democratic society, an effective majority seldom needs to command a numerical majority of the voting population. When the government actively interferes in the marketplace, the numerical majority invariably becomes an exploited political minority. Unlike parties whose interest in government regulatory action is direct and immediate (e.g., providers of regulated goods and services and employees of regulatory agencies), the average citizen has a small stake in the typical regulatory action. The net benefits an individual has at stake in a proposed regulatory change closely conditions his or her willingness to study the pros and cons of an issue and to spend his or her own resources to support lobbying efforts seeking to influence the outcome.

In contemporary democracies, the ostensible purpose of a given regulation is seldom the purpose that actuates the coalition that pushed it into law. The true purpose of real-world systems of economic regulation is seldom to promote greater economic efficiency in the long run. Lobbying activity seeks primarily to employ government power to redistribute current income and wealth from politically weak to politically powerful sectors. Coalitions form to persuade elected politicians to set up and to oversee for their benefit detailed systems of economic regulation (Stigler, 1971). Legislative processes help politicians to disguise and to legitimize beggar-my-neighbor political activity by special interests. If coalition members were to throw their weight around openly, they would alert the numerical majority of the need to protect themselves from the coalition. By delegating the detailed operations of regulatory schemes to a semi-autonomous financial agency, elected officials erect still another layer of cosmetic shielding. Regulatory bureaus insulate sponsoring coalitions and their agent politician from being blamed for the unpopular long-run consequences of specific regulatory decisions.

As political institutions, agricultural development banks are unusual in that the wealth being allocated -- and sometimes even the ostensible purposes of the allocation system — come in large part from outside the nation. International development assistance agencies such as the World Bank disturb the workings of the domestic regulatory dialectic by making external funds available to finance farm loans. Negotiations over the shape of the credit-allocation program between domestic politicians and international donors add another dimension of political activity.

Whatever ostensible purposes the domestic sponsors of an externally funded agricultural development bank may profess, an additional intention is to serve politically powerful domestic groups, including almost inevitably wealthy landowners. Unlike regulations that have been demanded by an effective domestic majority, regulations adopted to please an external donor may well be deliberately sabotaged both in the design and execution stages by domestic politicians. In response to the funding opportunity, an effective domestic majority develops to shape a system of regulations that, appearances aside, is meant to frustrate some or all of the goals of the external donor. The problem is to accomplish this subtly, without alienating officials of the donor agency enough to cause them to reduce greatly their planned contribution of foreign exchange.

Subterfuge in political purpose tends also to promote subterfuge and corruption in bank operations. No matter how many formal bureaucratic safeguards are established to earmark funds for agricultural purposes or for small farmers in particular, career incentives within the bank and opportunities for personal enrichment invariably predispose loan officers toward allowing funds to flow into uses that are only apparently agricultural and to wealthy persons whose connections with farm operations may in many cases be relatively tenuous.

Processes of Economic Circumvention

Establishing a preferential explicit borrowing rate for specific classes of agricultural borrowers represents a political attempt to violate the tendency toward price equalization that economists call the "law of one price." Unlike governmental laws which depend on a system of external policing and penalties for enforcement, the law of one price derives its force from individuals' pursuit or their own self-interest.

Borrowing at a below-market interest rate enriches the borrower by an incremental "wedge" equal to the product of the interest-rate differential and the amount borrowed. The more one actually borrows, the greater is the wealth transfer that takes place. Hence, even eligible borrowers want to obtain program funds for unauthorized uses. Additional demands for funds come from lenders and ineligible borrowers and trace to arbitrage profits that they can earn once they find ways to circumvent the credit-allocation program.

Ineligible borrowers recognize that they can gain wealth either by misrepresenting or transforming the status of their loan request. Ineligible borrowers are willing to incur substantial amounts of implicit interest, either to achieve eligibility or to persuade loan institutions (perhaps by bribing loan officers) to overlook their ineligibility. Similarly, lending institutions can improve their balance sheets by relabeling or recollateralizing what would otherwise be ineligible contracts to divert program funds to unintended uses. These reactions illustrate the so-called "balloon principle," which describes how an attempt to squeeze one side of a balloon (or credit market) creates excess pressure that is displaced into the unregulated part.

Credit-allocation programs try to force lenders to act against their economic self-interest. Rather than put funds to the most profitable use, institutions are supposed to lend funds to targeted beneficiaries. But the more profits a lender forgoes, the greater the economic pressure it feels to allocate current funds flows away from the targeted population.

Lender Circumvention Techniques: Lawful Avoidance vs. Illegal Evasion

Arbitrage pressures summarized in the law of one price explain why preferential loan schemes require continual and close bureaucratic supervision of lending-institution screening procedures. As long as a wedge of excess value can be found in program loans, a fringe of unsatisfied borrowers exists. The harder that unsatisfied borrowers compete for program funds, the more the intended loan subsidy tends to be converted into elements of implicit interest and lender cost.

This is because the eagerness of unsatisfied borrowers allows lenders to extract additional value in the form either of bribes to loan officers (which lead to unlawful evasions of program provisions) or of lawful nonpecuniary institutional compensation to the institution. Nonpecuniary compensation is collected by tightening unregulated features of the loan contract such as the degree of credit risk or promises of profitable ancillary business. Either form of compensation may be usefully conceived as implicit interest paid by the borrower, the imposition of which tends to squeeze marginal borrowers out of the loan market.

Given enough time, competitive financial markets inevitably transform preferential loan rates into a system in which market clearing occurs primarily through variations in implicit interest. In the long run, competition among borrowers and lenders requires that the sum of explicit and implicit interest a borrower pays for program funds rises to the market rate of interest. However, implicit interest often diverts economic resources from their best use. The degree of waste embodied in a particular market-clearing interest combination varies principally with the amount of political energy channeled into the program. Potential ways of conveying implicit interest are so diverse that further governmental restrictions can stop them only by compromising increasingly higher forms of economic and personal freedoms.

Borrower Circumvention Techniques

In credit-allocation programs channeled through agricultural development banks, circumvention becomes a cooperative game played by lenders and borrowers at the expense of the external sponsors and the intended beneficiaries of the program. Every technique for lender avoidance has a counterpart technique in the sphere of borrower avoidance.

Even without lender connivance, borrowers find it easy to misrepresent both the purpose of their loan requests <u>ex ante</u> and the effect that loan accommodation has <u>ex post</u> on their economic activities. Taking account of all relevant costs, every borrower wants to raise funds as cheaply as possible. But costs of repackaging the documentation supporting a loan request to conform to the requirements of a credit-allocation program are typically a minor element in funds costs. Because loan funds are fungible, the purposes for which a borrower can <u>demonstrate</u> a need for funds include any expenditures he or she plans to make during the time interval covered by the loan. Merely by relabeling various features of a proposed loan contract, a borrower can substitute cheap program loans for market sources of finance, with little or no effect on the allocation of his or her resources to agricultural pursuits. Von Pischke (1980, pp. 95-96) describes several such creative devices for borrower avoidance.

It is hard for borrowers skilled or lucky enough to obtain program funds to refrain from using them to arbitrage financial and nonagricultural investment opportunities. No matter how cheaply funds have been borrowed, an optimizing borrower must put them to the most advantageous use he or she has available. In this way, loans made for agricultural purposes may end up supporting consumption or real-estate purchases.

Finally, we must recognize that borrowers should be willing to offer favors and kickbacks to program personnel in exchange for access to subsidized funds. Patterns of corruption in government subsidy programs are considered extensively in Sanchez and Waters (1971).

Intended and Unintended Effects of Interest-Rate Subsidization

Over time, the wedge between market rates of interest and the explicit loan rate mandated in a program of subsidized agricultural credit tends to be filled in completely by methods of extracting implicit interest. However, the forms that implicit interest takes and its distribution between program personnel and their employers differ importantly from one institutional setting to another. Unsatisfied borrowers will learn to bid in the currencies that elicit the delivery of loan funds. When career incentives constrain loan officers to promote the development bank's economic welfare, they will look to borrowers with good collateral, strong balance sheets, and solid business prospects. However, loan officers who can safely enrich themselves through loan administration must be expected to do so. Hence, the better an agricultural development bank's systems of incentive payment and information auditing and the more severe the penalties that a given society imposes on corrupt behavior, the more likely it is that corrupt allocational criteria will give way to lawful forms of implicit interest. But greater limitations on increases in compensation and career opportunities in government than in private business may make it systematically harder to prevent loan officials in a public enterprise from being corrupted.

Although subsidized loan programs may achieve a good portion of their intended distribution effects in the short run, they impose a series of unintended costs that tend to increase the longer the program stays in operation. First, they tend to require a growing diversion of resources to monitoring program procedures. Second, they tend to deprive a program's intended beneficiaries (who are often less able or willing to offer implicit interest) from access to program funds. Third, they tend to produce a more corrupt society in general and a more corrupt bureaucracy in particular.

Finally, feeding politically at a donor's trough tends to weaken financial institutions economically and, in particular, to suppress their natural propensity for savings mobilization and portfolio diversification. The diversion of a nation's loan business towards a subsidized agricultural development bank impedes the natural development of efficiently diversified and financially <u>complete</u> financial intermediaries, particularly in the agricultural regions the development bank is supposed to favor. The "one price" to which the regulatorily constrained arbitrage process moves contains wasteful elements of implicit interest that worsen opportunity sets for borrowers and lenders alike. The result is that a socially suboptimal amount of risk-bearing takes place and domestic savings (especially rural savings) are mobilized less effectively than they should be. In the long run, this <u>reduces</u> rather than increases the maximum achievable rate of national economic growth.[3/]

<u>Emergence of Re-regulation</u>

Just as regulation calls forth regulatee avoidance, circumvention activity generates political pressure for re-regulation. This third stage in the original process becomes simultaneously the first stage in a fresh cycle of regulation and avoidance.

[3/] For developing countries, Bauman (1981) describes the forms and institutions in which rural households typically save and emphasizes the need to mobilize rather than to <u>squelch</u> domestic savings.

Re-regulation occurs because external donors and domestic proponents of subsidies for agricultural credit become aware that poor repayment experience and unintended flows of implicit interest serve increasingly to frustrate the purposes of the credit program. The threatened loss of foreign exchange increases domestic proponents' ability to require politicians to tighten reporting requirements in all stages of the credit-granting process and to expand efforts to monitor borrowers' subsequent use of loan funds. It also leads to demands for stiffer penalties on parties guilty of fraud, misrepresentation, corruption, or even nonrepayment of loan funds. In the process, the agricultural bank is likely to be restaffed, reorganized, and even renamed.

What makes re-regulation necessary is the unpredictability of the precise timing and details of avoidance schemes. Avoidance is inherently a creative and reactive activity. Regulatees pursue avenues of "loophole productivity" that would not have remained open if they had been foreseen at the outset by sponsors of the operative regulations.

Moreover, the effectiveness of restrictions on the flow of farm credit is further undermined by differences between regulator and regulatee ability to adapt to changes in opportunity sets caused by exogenous economic forces such as changes in inflation rates and farm technology. To satisfy political restraints, government organizations are often suboptimally organized from an economic point of view. To please regional interests, agencies may be excessively decentralized. This makes it hard to transmit head-office priorities effectively to personnel in field offices, especially -- as in efforts to assure program compliance and prompt repayment — where the benefits accrue to the head office and negotiation costs fall almost completely on branch-office personnel. To ensure head-office control, loan officers may have to complete thick bundles of forms to document eligibility at the expense of timely disbursement of loan funds. In addition, regulatees usually have better-motivated employees and easier access to information about the consequences of change. Finally, agency response to change usually has to clear a maze of internal and external red tape. For all these reasons, private borrowers and lenders should be able to adapt their avoidance activity more quickly and efficiently to exogenous shocks than government agencies can adjust pre-exisitng patterns of regulation.

Over time, trying to close program loopholes tends to transform what may initially have been a simple and narrowly targeted system of regulations into a complex and wide-ranging network of government interference. But expansion in the control network cannot go on forever. Eventually, the social cost of monitoring and enforcing program provisions begins to exceed the value to the recipient government of the external subsidy and the program's domestic potential benefits. The rising budgetary expense, social inconvenience, economic waste, and distributional inequity associated with a growing network of controls feed political demands for new approaches, both in recipient countries and in the boardrooms of donor agencies.

Policy Implications

Every attempt to use political power to rechannel financial resources kicks off a cycle of economic adjustment and political counteradjustment. Particularly in financial markets where avoidance costs are negligible in the long run, market reactions tend to neutralize political power. Regulatees short-circuit regulatory intentions by finding and exploiting loopholes and by the simpler expedient of disobeying the law. Regulatory avoidance and evasion absorb productive resources by raising the cost of performing regulatory activities and requiring government agencies to undertake costlier patterns of enforcement.

Far from promoting financial development in agricultural regions, political schemes that hold down explicit interest rates and focus predominantly on the character of loan recipients and the proposed uses of loan proceeds simultaneously inhibit the growth of efficient techniques for diversifying risk and impede the development of self-regenerating financial institutions. To increase the flow of rural finance permanently and reliably, international donors and governments in developing countries must endeavor to work with, rather than against, financial-market forces. They must emphasize schemes that improve opportunities for risk-bearing and that develop both sides of lending-institution balance sheets. Above all, they must avoid interfering with incentives for financial intermediaries to diversify risks, to maintain viable rates of loan repayment, and to reach out to absorb rural savings into the financial flow.

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