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AGRICULTURAL CREDIT, POLITICAL PATRONAGE AND POLITICAL ECONOMY

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Prefatory note

This paper was written to be included in a volume of essays stemming from the Colloquium on Rural Finance held in Washington on 1-3 September 1981 and sponsored by the Economic Development Institute of the World Bank, the United States Agency for International Development and the Ohio State University.

The papers presented at the Colloquium, drawing upon the very rich body of empirical work done by those connected with the Ohio State group over the years, reinforced a growing conviction among many in the donor community by showing convincingly that subsidized agricultural credit programs do not reach the rural poor but rather instead tend to benefit the rural wealthy. This essay is an effort to address the patterns of political economy that underlie these program failures and to raise some ideas as to what might be done to improve attempts to raise agricultural productivity and at the same time reach the rural poor.

Agricultural Credit, Political Patronage and Political Economy*

The evidence is now overwhelming that subsidized agricultural credit programs over the past two "development decades" have not been very effective either in getting credit to the small farmer or in promoting equity. Indeed, the effects of these programs often have been perverse, in that they have tended to further concentrate income away from small farmers and the rural poor.

A growing body of literature shows that there is a very strong connection between low interest rates in agricultural credit programs and this concentration (see, e.g., the essays by Adams and Tommy, Gonzalez-Vega, Ray and Vogel in this volume).

This is not a new finding. Many of the country case studies done for the AID Spring Review of Small Farmer Credit in 1972-73 (AID, 1973) revealed the same pattern (summarized in Donald, 1976: Ch. 8), and there is evidence that goes back much further (e.g., Robert, 1979--a study of South India in the early decades of this century).

There are several reasons why subsidized credit programs benefit the bigger farmers. One is the obvious bureaucratic one: it costs more on a relative basis to administer small loans than large ones. Accordingly, it makes good bureaucratic sense to make bigger loans in order to hold down on these costs.

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Secondly, there are transaction costs for a loan, in the form of transportation costs that the borrower must lay out to get to the lender's place of business, opportunity cost in the form of work foregone during these visits, bribes and the like. Naturally, for small borrowers these costs will loom much larger as a proportion of total loan cost than for large-scale borrowers (see the essay by Ladman in this volume) and so the latter are more likely to be willing to incur the costs and get the loans.

Bureaucratic convenience and transaction costs are not enough to attentuate demand sufficiently, however, and further rationing is needed. It takes place in the process pointed out by Kane in his essay (see also Ladman and Tinnermeier, 1981; Singh, 1981). What happens is very simply that governments attempt this further rationing by regulation rather than allow the market to ration by price, but the market circumvents these regulations by adding what Kane calls "implicit interest" in the form of bribes, kickbacks, corruption and political pressure, which will tend to push the interest rates back up to their natural level. And since the wealthier farmers are more able to pay this "implicit interest," they will get most of the loan money.

If subsidized interest rates mean agricultural loans going to the rich, then it should follow that the remedy would be to raise those rates to market level and thereby cut off the differential access enjoyed by the wealthy. In addition to the theoretical argument that such a strategy would work, there is empirical evidence as well, for instance from an experiment in rural finance in Bangladesh showing that small farmers will in fact pay higher interest rates--up to 30 percent and more (G. Adams, 1980). The case for raising interest rates, in a word, is such a good one that one must wonder why governments do not in fact raise them. Yet subsidized credit programs do continue and so do their unfortunate results.

A number of observers feel that politics is the main reason for the persistence of these programs. The large borrowers who benefit most from credit programs want to protect that benefit, and at the same time politicians and bureaucrats want the power and the fruits of corruption that these programs put into their hands. The result is that the programs become politicized and the economic environment, in the phrase of one analyst, becomes "multiply distorted" (see Ray's paper for this volume; also Kane's and Von Pischke's papers). The problem, then, becomes one of restoring the marketplace, or in Ray's words of "foster[ing] the emergence of a financial market solution to the resource allocation problem and not to try to substitute government controls and regulations for a properly functioning financial sector."

Both large borrowers and the politicians/bureaucrats are seen as blameworthy in this view, for the former are willing to corrupt and the latter are more than ready to be corrupted. It is the politicians who are most to blame, though, for in a sense the borrowers are merely doing what is necessary to get their loan money, and the administrators are just taking advantage of a chance to flesh out their meager salaries, while politicians are building careers on the patronage power that a politicized credit program gives them. Through steering loans in this direction or that, politicians are able to protect and enlarge their constituencies, assemble the necessary support to aspire to higher office, and so on.

Credit programs, in this view, must accordingly be "depoliticized." The vested rural interests who are using their influence and the government officials who are selling that influence must somehow be neutralized and things must be put on the kind of unbiased footing that the market would provide.

The fact is, however, that things of substance that are in scarce supply cannot be "depoliticized" or "removed from the political arena." Any attempt to do so is in the end an attempt to substitute one political solution for another, to change the rules.[1] If interest rates are raised to market levels, the new rules will mean that some will gain (presumably savers and erstwhile non-borrowers) while others will lose (large borrowers/big farmers). That interest rates do not get raised and that these consequences do not ensue is due in part to the self-seeking behavior of officials and large borrowers, to be sure, but it is due more fundamentally to the nature itself of the political economy of low income countries, and it is to this topic that we now turn.

When agricultural credit programs consistently benefit the rural wealthy rather than the intended target populations and when programs run into viability problems, we tend to view them as failures. But it would make more sense to employ Griffin's approach:

> Rather than assume that governments attempt to maximize social or national welfare but fail to do so, it might

> be more fruitful to assume that governments have quite different objectives and generally succeed in achieving them. Rather than criticizing governments for failing to attain what they did not set out to attain, or offering advice on how to attain a non-goal, it would be instructive if more time were devoted to analyzing what governments actually do and why (Griffin, 1974: 172).

The best way to test out this perspective would be to ask what are the needs of governments and of the various strata of the rural population, then see how agricultural credit policies might answer those needs.

The primary need of a low income country's government (or more accurately of the politicians running it) is to stay in power.[2] This, of course, is a truism, but like so many truisms it is often lost sight of in explanations of why people do what they do. The major requirement in meeting that need is for stability, and stability in turn is most easily obtained by maintaining the support of those groups who could disrupt it. In the cities, where coups d'etat generally take place, maintaining support means dealing with the military, the industrial sector, workers, the student/ intellectual establishment, urban consumers and the bureaucracy itself (that is, in its lower and more populated echelons--the higher level bureaucrats are generally part of the decision-making political leadership of the country). A few of these groups (most often industrial workers and lower level government servants, who even if organized tend to have little real strength) are relatively easily coerced into acceptably docile behavior, but most of them cannot be dealt with in such cavalier fashion. The military must be given large and increasing budgets, industry its subsidy, import and tax concessions, the students and intellectuals some ideological sops,[3] and urban consumers cheap food.

Coups d'etat do not often take place in the countryside, but insurrections do and they can be just as dangerous to the regime in power (moreso, in fact, for there is always the possibility of coming back after a coup with a countercoup, whereas successful insurrections tend to be rather more permanent). Understandably, then, governments want to protect their rural flanks. At the same time the larger rural landholders want to retain the position of wealth, status and power that they presently enjoy. Thus an exchange relationship is worked out, in which governments protect property rights (though they may feel constrained from time to time to issue meaningless decrees on land reform in order to please urban intellectuals the rural poor and foreign donors) and dispense patronage to the rural wealthy; in return the recipients support the government and use their resources to maintain order in the countryside. That is, they employ their tenancy and sharecropping arrangements, labor-hiring relationships, moneylending operations (with the customary embellishments, such as threats to foreclose and enforcers for collections) to keep things under control. In those relatively rare instances when this sort of control begins to break down, the government sends in its police to restore order, but precisely because outbreaks are relatively rare, only a small constabulary is needed. As for the lower strata in the countryside, they generally do not have exchange linkages with the central government, because for the most part they present little threat to it and have little to offer it.

This picture, of course, is a general one and is not universal in all its particulars. Governments are not monolithic, and all policy making officials do not behave in concert. Some officials may be geniunely interested in land reform, in rural projects targeted on the poor, and so on. Nor is there in all cases necessarily a conscious connivance between officials and the recipients of their largesse. Rather, some policies succeed in keeping things relatively stable, and these policies tend to be continued over time. Thus while there is certainly considerable cynicism and hypocrisy behind agricultural credit policies ostensibly intended for small farmers but in fact benefiting big farmers, there is also a good deal of what might be called "convergence"--low interest policies just seem to be good for everyone that matters--at least in the short run, but then the short run is the time frame that those in positions of power and wealth tend to be most worried about. Long run costs of these policies may be high, it is true. As von Pischke et al. observe:

> It may...be argued that the costs of lagging specialized farm credit institution performance are higher, from almost any perspective except political expediency, than those associated with the performance of most development activities undertaken by government (von Pischke et al., 1981a: 20).

The problem is that from the viewpoint of many LDC governments political expediency is the most important perspective.

As Ray points out in his essay in this volume, it will not be easy for governments to liberalize and rationalize rural financial policies. To do so will entail "substantial political risks" and "a painful but necessary transition" in his words. If the only pain involved in imposing higher interest rates were to be borne by the economically poor and politically weak, we could rest assured that many governments would be able to find the courage to set things right. But as is all too clear, it would be the rural rich and powerful who would have to make the sacrifices, and few governments would be willing to undermine their main support base in the countryside.

Subsidized credit programs, in sum, tend to succeed all too well at keeping governments in power through political patronage and at maintaining (and even enhancing) the position of rural elites. These programs do so because they are part of a dynamic political economy that serves the interest of both these groups in continuing a status quo which does not include much possibility for either equitable allocation of credit or optimal economic growth.

It should be clear from the analysis thus far that rural finance institutions do not stand outside their economic and political environment but instead are deeply embedded within it. It follows that they cannot be changed without regard for their milieu as though they were somehow autonomous from it. Accordingly, it does little good for well-intentioned foreign donors to lecture governments on the need to raise interest rates as if they could do so in a policy vacuum. Specifically, a government cannot just raise interest rates to market levels; those interest rates represent a subsidy that (whether originally designed for the purpose or not) buys the support of a very powerful constituency. If a government decides to raise interest rates and thereby remove the subsidy, then it must also decide to do one of two other things concomitantly. Either it must somehow compensate that constituency for the loss of the subsidy, or it must compensate itself for the loss of that constituency's political support by building up other bases of support.[4] In other words, if it is going to remove interest rate subsidies, a government has three policy choices:

(1) provide some other form of patronage to big farmers;

(2) build up some other support group (e.g., small farmers, landless workers, etc.); or

(3) suffer the potential loss of all support from the countryside. In view of the risky position almost all regimes perceive themselves to be in, the third option is not going to be taken if there is any possible way to avoid it, and to all but the most courageous governments even the second course is seen to be fraught with unacceptable hazard.[5] This second option is seen as full of risk, despite widespread belief (among many officials in LDC governments as well as among foreign observers) that something has to be done for the other rural constituencies in the fairly near future in order to prevent what amounts to the third option from occurring in the only slightly more distant future. But again, it is the immediate future that governments are most worried about, with the result that intermediate and longer run needs tend to be put off indefinitely.

Against this backdrop, the task of the donor community is twofold. First, donors should help LDC governments devise strategies that will allow them to remove interest rate subsidies without at the same time alienating the rurally dominant classes. Second, donors should work at including in these strategies equity-enhancing components that would, even if slowly, improve the position of the rural poor. The point, in sum, is to try to pursue both options (1) and (2) at the same time.

What might some of those other strategies be that would allow governments to cease subsidizing agricultural credit yet still nurture their big farmer constituencies? Deregulating foodgrain prices or increasing grain procurement prices to be paid by government stockpiling agencies might be an answer, for such policies would benefit the larger farmers who grow more surplus grain, besides having the salubrious effect of encouraging them to grow more grain anyhow. But "getting prices right" (see Brown (1978) for more detail on price distortions) would also have other less desirable effects, particularly from the government's point of view, because like credit subsidies, low price policies are there for good reason. Urban consumers tend to react to high food prices by rioting, and most LDC governments (or any governments for that matter, e.g., Poland) are no more eager for urban food riots than for rural insurrections.[6]

Another strategy might be to reverse previous investment patterns that have favored the city over the countryside and industry over agriculture (Lipton, 1977: esp. ch. 14). Having the most (and generally the best) land, big farmers would presumably benefit the most from such investment policies and thereby be compensated for the loss of their subsidized interest. But here again, the policies to be displaced are there for a practical reason. The urban industrial constituency has its needs too, and if import substitution development strategies are to be followed in pursuing economic growth as so many less developed nations wish, that sector will have to be subsidized by the countryside. Of course, government may decide it does not want to follow such a tack any longer, but such a decision is much more complex than simply raising investment rates in the agricultural sector. And even if industrial growth policies are abandoned or slowed down, the urban sector cannot by itself support the countryside over the long run, for there is just too much of the latter in most LDCs. Agriculture, in sum, will have to support its own investments in the end; the sort of experimental or pilot project activities that can be undertaken with external aid are by their nature relatively short-term efforts and cannot (except perhaps in a few small and strategic countries on which aid can be lavished) substitute for mobilizing resources within the agricultural sector itself.

A third approach might be to change import controls, overvalued exchange rates and so on, in order to compensate the larger farmers for the loss of subsidized credit. Most LDCs have restrictions of one sort or another on importing consumer goods, and surplus farmers would welcome the chance to purchase these high-status items, particularly durable goods like automobiles or jeeps, electronic items and the like.[7] Again, however, the currency exchange and import regulations currently in effect have their constituency--in this case the industrialists and importers who have licenses to acquire the scarce foreign exchange to bring foreign goods into the country--and this constituency will feel itself aggrieved if policies are liberalized.

Perhaps a solution could be devised whereby the bias in government investment patterns would be turned to some extent away from urban industry and toward agriculture, say in the form of providing the capital cost of small scale irrigation projects, prices for agricultural commodities could be increased slightly, currency and import restrictions could be eased somewhat, interest rates for agricultural credit could be raised and the subsidy that had gone to agricultural credit could now go to providing cheap food for the urban lower and middle classes. There would still be losers (e.g., urban manufacturing entrepreneurs who would face reduced subsidies and more competition from increased imported goods), but there would be even more winners if all these strategies could be implemented simultaneously.[8] The point is, though, that a large number of major adjustments would have to be made in a number of key sectors in an LDC economy that its government sees as very fragile. Even in a large country like India with its long record of stability such a multifaceted strategy would be seen as very daring, and in a country where much of the government's thinking centers on whether it will still be in control six months or a year hence, the risks would seem impossibly great. Changing a large number of major policies simultaneously, in short, may be a bit like the "big push" strategy of development: a fine idea but just too much to be undertaken all at once.

To sum up: one-shot, "quick-fix" solutions like raising interest rates will just move problems from one sector to another, and universalistic strategies to do everything at once are impossibly ambitious. What we find is that policy planners in the less developed countries face much the same constraints of political economy as they do in the developed countries. A large number of special interest groups representing powerful constituencies greatly constrain the ground for maneuver, particularly for policy planners seeking to help those who are not represented by those groups. But these limitations do not mean that the cause is hopeless or that political leaders (or donors) should stop trying to improve a society's institutional arrangements.[9]

In the context of the less developed countries three suggestions might be offered. First, if governments cannot be weaned away from subsidizing interest rates, then perhaps they could be convinced to put the low-interest money into long term loans for agricultural investment, as several students of agricultural credit problems have suggested (e.g., Singh, 1981; von Pischke in his paper for this volume). Loans could be directed into areas where they would be more likely to increase both production and employment in agriculture as opposed to short term loans that too often do neither. There is certainly scope for considerable change here, as is apparent from World Bank (1975:82) data on institutional agricultural lending in 28 less developed countries showing an average of 69 percent of loans going for less than two years and only seven percent on average for more than five years. If farmers are given more longer term loans and can be directed to investing the money in tubewells, land terracing, complex drainage systems for reclamation of salinized land and so on, then the loans would promote growth and at least some measure of equity (by providing more employment with their labor-demanding investments) while at the same time doing something for the big farmer constituency.

Second, donors should think of agricultural credit more in connection with longer term strategies for institution building, especially at the local level.[10] In particular there should be more focus on weaving agricultural credit policies and programs into participatory institutions that include those outside the local elite strata -- small farmers, tenants and the landless, for it is only through having a real voice in local institutions that the poor will come to have some control over their own lives and futures.

If donors are successful in convincing LDC governments to raise interest rates up to or near to market level and consequently all strata have a more or less equal chance to avail themselves of institutional credit, then it would be fruitful to administer loans through local institutions in which the non-dominant classes have some role, such as village councils, cooperatives and the like. Initially these non-dominant groups may well have little voice in running the institutions, but as time goes on their access to credit, to the outside market place and the economic advancement stemming from both these things can combine synergistically with the increasing knowledge of political linkages outside the villages that comes from participation in the institution itself to give the poor a real place in the system. This may seem a naively optimistic scenario, and to be sure there is considerable evidence indicating that such institutions are difficult to build and are subject to all the risks of elite takeover that those in the development field know about all too well. But there is also evidence, from South Asia (Blair, 1981) and elsewhere as well

(Korten, 1980 and 1981), indicating that participatory development institutions at local level can bring a significant measure of improvement to groups that have not been part of the traditionally dominant strata. Even in a country with developmental prospects as slim as those of Bangladesh would appear to be, there is good reason to think that the outlook for such longer-term strategies, especially if combined with credit programs, is a good one (Korten, 1980; Chen, 1981).

If donors are unsuccessful in eliminating subsidized interest rates but can induce LDC governments to modify credit programs toward longer loan periods and more capital investment as in our first suggestion, a focus on participatory institution building still makes sense. The poor will not benefit as directly and immediately as would be the case if the subsidy were abolished, but they would find more employment and economic security as a result of the capital investments in agriculture resulting from the loan program. In turn this improved economic position will give the poor a more secure base from which to participate in local institutions. In sum, the combination of participatory institution building with a long-term agricultural investment and employment generating approach could be a powerful engine for rural development.

The third suggestion is that donor agencies spend more effort at understanding and becoming sensitive to the realities of the political economy of developing countries. Just like the developed countries, so too LDC governments in formulating public policy face a melange of classes, interest groups and constituencies, some of them more powerful and some less so. There is no guarantee that public policies in the rural development field which take these realities into account will be successful in achieving both growth and equity goals, but it should by now be clear that strategies that fail to confront and deal with such factors stand little chance of success. The very mixed record of subsidized agricultural credit programs to date offers ample evidence of this truth.

In the donor community methods of economic analysis have been developed and honed to a high degree of sophistication, but at the same time there has been little interest in either the political aspects of development or (save for an occasional denunciation of political interference) in the area of political economy, where the two concerns come together. In part, of course, this reluctance reflects the sensitivity of host country governments to political issues and to even the appearance of foreign political interference with the domestic matters of an LDC. But it also relects an unwillingness on the part of economic advisors on the donor side to sully the abstract elegance of their economic models with the reality of political economy, as well as what amounts to a fear that to deal with political matters is somehow to compromise the integrity of one's model and one's development project--in a word, to "sell out.

And finally, this reluctance to enter the thicket of political economy covers an uneasy awareness that dealing with the realities of the development process in most LDCs is an inelegant and messy business where choices always seem too constrained from the start and programs can never be implemented as planned without getting compromised, sometimes beyond recognition. In trying to modify the big-farmer bias of agricultural credit programs, for example, one may find that it is impossible to substitute other benefits like higher prices or more capital investment funds for low interest rates because big farmers have already secured these benefits in addition to low interest rates. Or one may find that virtually any program targeted on the rural poor invariably loses over half its impact to corruption. Patterns like this can be discouraging.

In this connection it is worth reflecting that similar problems are present in the public policy process in the advanced countries as well: powerful special interest lobbies block needed changes, and few if any policies in the economic sphere ever work out just as planned. Yet such difficulties and uncertainties do not mean that there is no point or purpose in trying to improve our policies and systems. On the contrary, the pervasiveness of problems mean that there is all the more need to do so. Furthermore, planners and advisors in the developed countries can do a better job if they are sensitive to political realities and weave those realities into the recommendations that they advocate.

So too in the LDCs, advisors will do a better job if they display more sensitivity to the political economy of host countries. To do so is not necessarily to interfere excessively in the domestic political arena, nor is it the case that exposing economic development plans to political reality means compromising them beyond recognition. Instead, as I have endeavored to show in this essay, to do these things offers a significantly greater chance for successful programs than we have enjoyed so far.

It is an old revolutionary saw that one cannot make an omelet without breaking eggs. Perhaps we could change the metaphor to observe that just knowing the proper proportions of economic ingredients is not enough to cook an omelet; one must also understand how much heat is required and how to apply the cooking oil of political economy in order to keep the omelet from sticking to the pan.

FOOTNOTES

[1]For an analysis at a more general level on the impossibility of depoliticization strategies, see Schaffer (1980 and 1981).

[2]The analysis that follows in general terms is traced out in more detail elsewhere for Bangladesh (Blair, 1978) and India (Blair, 1980). For a somewhat similar analysis of the African situation, see Bates (1981).

[3]Usually leftist in nature (as in empty promises of socialist redistributive politicies) but sometimes very conservative (as with groups in India demanding cow protection, or communities in Islamic countries demanding prohibition) or even racist (e.g., demands for job quotas excluding ethnic Chinese in Southeast Asian countries, etc.).

[4]It could be argued that a government would only be partly alienating its big farmer support base by removing the credit subsidy, for there are other forms of patronage that could be continued, but the argument still holds, given the precarious hold on power that most LDC governments see themselves having, and some compensatory action would be deemed necessary for that.

[5]The fact that governments are reluctant to trade in the big farmer constituency for a chance to build one on landless workers, tenant farmers or the laike that could replace it, of course does not prevent regimes from pretending to reach out to lower strata with various populist propaganda ploys. The history of failed land reform efforts in the last decade or two is ample testimony to the appeal of this strategem.

[6]Particularly in the smaller states of Africa, discontent over food prices has been an especially sensitive area of concern (Bates, 1981: Ch. 2). In other countries, the situation is the reverse: big farmers already have both credit subsidies and high food prices, so the question of trading off one benefit for another does not arise.

[7]One hopes that policies would not e changed to favor big farmers so much that they would be able to import heavy labor-saving machinery like tractors at subsidized prices, thereby using the subsidy to displace agricultural laborers, as happened in Pakistan in the mid-1960s. See Gotsch (1972 and 1973).

[8]Vogel (1981) develops some of these relationships.

[9]For a response to the line of argument that political realities prevent any meaningful improvements at all, in the context of irrigation programs (which have many similarities to credit programs so far as subsidies, equity and political economy are concerned) see Bottrall (1981:esp. 246-247).

[10]For a general analysis of the role of participation in the development process see Cohen and Uphoff (1980).

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