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***WORKING PAPERS  
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**EFFECTS OF THE RURAL CREDIT SUBSIDY ON  
ECONOMIC GROWTH AND WELFARE OF  
BRAZILIAN REGIONS**

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# EFFECTS OF THE RURAL CREDIT SUBSIDY ON ECONOMIC GROWTH AND WELFARE OF BRAZILIAN REGIONS

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## ABSTRACT

The objective of this paper is to evaluate the impact of government spending with the Interest Rates Equalization (IRE) policy on the economic growth of Brazilian regions. Additionally, it aims to measure the opportunity cost of the subsidy in relation to an alternative application in the transportation sector. The model, database, and software from the General Equilibrium Analysis Project of the Brazilian Economy (PAEG) are applied to the simulations. The result shows that the IRE policy provides economic growth in the Midwestern, Northeastern and Southern regions above the cost of the policy. Besides, in the Northern and Southeastern regions, there is a decrease in the GDP. For Brazil, the policy is cost-effective and offers a 34% rate of return. Furthermore, all regions benefit in terms of welfare. For the country, in terms of GDP or welfare, spending on the IRE has negative alternative rate of return when applied to the transportation sector. The IRE policy is efficient and contributes to reduce regional disparities.

Keywords: Subsidies, economic growth, Brazilian regions, PAEG.

## 1. INTRODUCTION

State intervention is a controversial and complex subject and divides the economic theory into opposing currents. However, despite all the criticisms on intervention, some believe that policymakers may envision positive results in terms of economic and welfare growth with the application of subsidies. In this sense, one may question the impact of subsidies applied to the Brazilian agriculture through the interest rate equalization policy.

In Brazil, Interest Rate Equalization policy of Rural Credit (IRE)<sup>1</sup> is an important subsidy to agriculture, which has contributed, firstly, to a higher demand for agricultural inputs, and, secondly, to expand production. Formally, the IRE is an action intended to cover the differential rate between the cost of fund raising by financial institutions, plus administrative costs and tax, and the charges levied on farmers borrowing credit (MINISTRY OF FINANCE, 2003). With the IRE, the federal government wants to expand the

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<sup>1</sup> Established by the Brazilian Federal Government Law no. 8427 of 1992.

participation of private banks in financing the rural sector as a form of expanding credit application without burdening the Treasury (GONÇALVES NETO, 1997, p.161).

According to Castro and Teixeira (2004), the IRE policy subsidizes about 30% of the total funds invested in agriculture through rural credit. However, credit is concentrated only in some regions. According to Bittencourt (2003), the regional distribution of rural credit in Brazil is not homogeneous, since it is closer to the participation of Gross Agriculture Production Value (VBP) in each region than to the number of farms. In 2009, the Northeastern region had the highest number of farms, but only 11% of rural credit resources were allocated to the Northeastern and Northern regions (BCB, 2010). Thus, it should be noted that any analysis that takes into account the effects of various types of rural finance in Brazil should be conducted regionally.

Providing rural credit at lower interest rates than those prevailing in the market is an agricultural subsidy. This subject is very controversial, insofar as the theory postulates that the agricultural subsidies lead to allocative and distributive inefficiency, as well as to social costs. However, concomitantly, the most developed countries, especially the U.S. and the EU countries insist on maintaining this type of grant. Two questions arise: are the social benefits the real reason for the subsidies? Or does the subsidy exist because the policy promotes economic growth greater than its cost? Perhaps the legislators favor subsidies because they realize that the economic growth and social benefits outweigh the distortions caused by this type of intervention. Considering that Brazilian agriculture is subsidized through the IRE policy, what are the effects of this subsidy on economic growth and welfare in the country's regions?

Regarding the effects of rural credit subsidy on the Brazilian economy, Castro and Teixeira (2004) estimated the impact of the IRE policy on GDP growth using the input-output matrix. These authors concluded that the benefits to the economy in terms of economic growth are higher than the cost to government with the policy. However, the effects measured took into account only the backward linkages of the agricultural sector, i.e., the demand. The effects of subsidy on economic growth is that it generates growth by increasing input demand (backward linkages), and also by increasing product supply into the economy (forward linkages). Thus, the total effect of rural credit on economic growth is evaluated using a general equilibrium analysis.

One has to consider that, besides the direct cost, an opportunity cost is associated with this policy, since the resources could be applied in another sector, probably able to generate greater benefits for the economy as a whole through forward and/or backward linkages.

However, the need to protect the agricultural sector is evident because of its dependence on external factors, such as the weather, and because of rural poverty and income concentration, a result from past Government policies.

The transport sector has a strong interdependence with the agricultural sector given the significant share of its cost to the farmers' production structure. According to Stülp and Plá (1992), the transportation sector strongly affects the efficiency of various other sectors in the economy. According to Castro (2002), the expansion and improvement of transport services generate significant externalities and multiplier effects on the economy, introducing positive discontinuities in the growth potential of several sectors. Also according to this author, in agriculture, the significant dependence on random internal and external factors, such as equipment availability, weather, input and output prices, makes this sector more vulnerable to the transportation service.

If the resources spent on the IRE were applied to the transportation sector, besides benefiting the agricultural sector by reducing costs to the producer, other economic activities would also be favored. Is the IRE for the rural credit the most efficient way to subsidize? The question is how high the opportunity cost is related with the IRE.

Accordingly, the purpose of this study is to determine the efficiency of rural credit spending in relation to its ability to generate economic growth and welfare in the five Brazilian regions and to determine the direct and alternative costs of this policy. This paper innovates in that it analyses the effects of the IRE at the regional level rather than looking at the country as a whole. Besides, despite studies that use partial equilibrium approaches and input-output matrices, this study uses an Applied General Equilibrium Model, specifically the model from the General Equilibrium Analysis Project of the Brazilian Economy (PAEG), which presents an unprecedented contribution to model the regions of Brazil and the relationship of these regions with the rest of the world. Another important contribution of this study is that it proposes to measure the opportunity cost of subsidized agricultural credit, not evaluated in other studies.

The analysis is performed by two analytical scenarios. The PAEG model is used to estimate the effect of the rural credit subsidy via interest rate equalization on the economic growth and welfare of the five regions. Applying the same analytical tools, the opportunity cost of the expenditure with IRE applied to the transportation industry is also measured.

This paper is divided into four sections, with this introduction being the first. The second section includes the theoretical framework, where the effects of subsidies within a context of general equilibrium are briefly studied. The PAEG model, data source and

analytical scenarios are also introduced in this section. In the third section, the results are discussed, and in the fourth, the main conclusions are presented.

## **2. METHODOLOGY**

According to Jensen et al. (2010), general equilibrium models are more appropriate for measuring the effects of trade and interventionist policies, since they are able to capture the total effect (direct and indirect) the policy provides. An adaptation of the model by Harberger (1962) is used for the theoretical framework to illustrate the effects of subsidies on agricultural production within a context of general equilibrium. PAEG is the model applied since it is capable of representing the economies of large regions and partner countries, analyzing trade flows and trade protection, as well the implementation of changes in policy variables in the regions. The following subsections describe the theoretical and analytical approach and present the data source and proposed scenarios.

### **2.1. Production subsidies and allocative and distributive distortions**

The model by Harberger (1962) provides the theoretical basis for this study. It has the following simplifying assumptions, which are: the existence of only two goods, two factors of production supplied in a fixed amount, the markets are competitive, and in the absence of interventions, resources are allocated so that the economy is Pareto efficient. It is further assumed that all the subsidy policy spending will be equal to the income transfer from one sector to another, so that the total expenditure with agricultural and industrial products remains constant. Thus, the theoretical model used in this study has two sectors, Agriculture (A) and Industry (I), and two factors of production, capital (K) and Labor (L), which initially are in equilibrium.

State intervention is considered to be justified when in the presence of externalities in the case of public goods; in extreme cases, income transfer may be considered when market failures occur. The high interest rate of the Brazilian economy sets up a market failure, i.e., in Brazil, the basic interest rate (“Selic”) is not defined by the market, but rather by the Monetary Policy Committee (COPOM) from the Central Bank (CB), and aims to meet inflation control objectives. Since the “Plano Real”, the basic interest rate of the economy is maintained by the Central Bank at high levels to control inflation, and, therefore, it is not determined in the monetary market. Very high interest rates represent a market failure because they encourage financial applications but discourage productive investments. Thus, some sectors facing this market failure need to be encouraged by sector policies, since they

would be unfeasible at the high interest rates fixed for the entire economy, which is the case of agriculture. Thus, the government implements a subsidy policy for the agricultural sector through a program of rural credit with interest rates below that prevailing in the market.

Targeted subsidies for agricultural production increase the net return of capital in agriculture relative to the industry, thus increasing the demand for capital in agriculture. In other words, they reduce the marginal cost of capital in agriculture relative to industry. Thus, with no restrictions on capital mobility, it moves from industry to agriculture due to increased attractiveness brought about by higher returns. This subsidized capital movement in agriculture lasts until the return is equal in the two sectors. The basic effect of a subsidy policy on a given sector is to raise the income for the capital owners in the subsidized sector. The reduction in the cost of capital in agriculture, due to the credit subsidy, alters the relationship between capital and labor. Because of the greater amount of capital, agricultural production increases, while industrial production decreases, since capital is relatively more expensive for this sector. Considering that the agricultural product price is lower after the incorporation of agricultural subsidies, an increase will occur in consumption by workers and capital owners. In the manufacturing sector, workers will respond negatively to higher prices; however, agricultural capital owners will increase their industrial consumption once their income increases more than proportionally to increase in industrial prices. Thus, it seems that subsidy increases the real income of capitalists who invest in agriculture, since they consume more of both goods, agricultural and industrial products.

The change in relative prices provides a new balance; however, it is not Pareto efficient. The decrease in efficiency represents the welfare loss or the social cost that subsidies bring for transferring resources from one sector to another; in this case, from the manufacturing sector to agriculture. However, as industrial prices increase and agricultural prices fall, the real income of the economy can vary significantly, depending on the weight of each sector in the economy. The difference between the current product (after the subsidy) and the product at the initial equilibrium may be evidence of change in real income, that is, of change in GDP through subsidies to the agricultural sector.

## **2.2. The PAEG Model**

The PAEG model is static, multiregional, and multi-sectorial. It is built to analyze the Brazilian economy regionally. It represents the production and distribution of goods and services in the global economy, where each region is represented by a structure of final demand and optimizing agents, maximizing their welfare subject to a budget constraint. The investment and production in the public sector are fixed. The productive sectors combine

intermediate inputs and primary production factors to minimize costs, given the technology. The database includes bilateral trade flows between countries and regions as well as transportation costs, import tariffs and export subsidies or taxes. Table 1 describes the data set represented in the model.

Table 1: Database Contents

Index	Description
i, j	Sectors and goods
r, s	Countries and regions
f ∈ m	Production factors with free mobility within a given region: skilled labor, unskilled labor and capital
f ∈ s	Fixed factors of production: land and other natural resources

Source: Gurgel *et al.*(2009).

The operation of the PAEG model can be demonstrated by macroeconomic accounting identities, represented by the social accounting matrix. Equation (1) shows that domestic production ( $vom_{ir}$ ) is distributed among exports ( $vxmd_{irs}$ ), international transport services ( $vst_{ir}$ ), intermediate demand ( $vdfm_{ijr}$ ), private consumption ( $vdpm_{ir}$ ), investment ( $vdim_{ir}$ ) and government consumption ( $vdgm_{ir}$ ). Equation (2) denotes that imported goods, represented by  $vim_{ir}$  are distributed among intermediate consumption ( $vifm_{ijr}$ ), private consumption ( $vipm_{ir}$ ) and government consumption ( $vigm_{ir}$ ).

$$vom_{ir} = \sum_s vxmd_{irs} + vst_{ir} + \sum_j vdfm_{ijr} + vdpm_{ir} + vdgm_{ir} + vdim_{ir} \quad (1)$$

$$vim_{ir} = \sum_j vifm_{ijr} + vipm_{ir} + vigm_{ir} \quad (2)$$

In the production of good j ( $Y_{ir}$ ), intermediate inputs (domestic and imported) and mobile and specific production factors ( $vfm_{fir}$ ,  $f \in m$ ) are used. The production factor service income is distributed to the representative agent. Equilibrium in factor markets is given by an identity that relates the amount of the factor services payment with their income, as in equation (3).

$$\sum_i vfm_{fir} = evom_{fr} \quad (3)$$

The balance between supply and demand requires exports to be equal to imports (equation 4).

$$vxm_{ir} = \sum_s vxmd_{irs} \quad (4)$$



where  $vxm_{ir}$  represents exports of good  $i$  by region  $r$  and  $vxmd_{irs}$ , imports of same good by trading partners.

Similarly, the aggregate supply of transport services  $j$  is equal to the value of transportation services in exports (equation 5).

$$vt_j = \sum_r vst_{jr} \quad (5)$$

The balance between supply and demand in the market of transport services makes the supply of such services equal to the sum of bilateral flows of purchased transport services in imports of goods, as in (6).

$$vt_j = \sum_r vtwr_{jirs} \quad (6)$$

Government income ( $vgm_r$ ) is the sum of taxes and transfers. Thus, government budget constraint can be represented by equation (7).

$$vgm_r = \sum_i R_{ir}^Y + R_r^E + R_r^G + \sum_i R_{ir}^M + R_r^{HH} + vb_r \quad (7)$$

where  $R_{ir}^Y$ ,  $R_r^E$ ,  $R_r^G$ ,  $R_{ir}^M$  are indirect taxes on production and exports, consumption, government demand and imports, respectively.  $R_r^{HH}$  stands for indirect taxes for the representative agent, and  $vb_r$  are transfers from abroad.

The budget constraint of the representative agent relates income from production factors  $evom_{fr}$ , minus the tax payments  $R_r^{HH}$ , with consumer spending  $vpm_r$  and private investment  $vlm_r$  (equation 8).

$$\sum_f evom_{fr} - R_r^{HH} = vpm_r + vlm_r \quad (8)$$

Thus, based on the equations presented, two conditions are considered: supply equal to demand in equilibrium, and balance of income, i.e., net income equal to net expenditure. In PAEG, as in GTAP, the economy is considered to operate in perfect competition and, thus, classical assumptions are valid: Constant returns of scale, production cost equal to the value of production, and, thus, economic profit equal zero. These conditions apply to each of the productive sectors and activities, according to equations (9) to (14).

$$Y_{ir}: \sum_f vfm_{fir} + \sum_j (vlfm_{jir} + vtfm_{jir}) + R_{ir}^Y = vom_{ir} \quad (9)$$

$$M_{ir}: \sum_s (vxmd_{irs} + \sum_f vtwr_{jirs}) + R_{ir}^M = vlm_{ir} \quad (10)$$

$$C_r: \sum_i vdpm_{ir} + vipm_{ir} + R_r^C = vpm_r \quad (11)$$

$$I_r: \sum_i vdlm_{ir} = vlm_r \quad (12)$$

$$FT_{fr}: evom_{fr} = \sum_i vfm_{fir} \quad f \in s; e \quad (13)$$

$$YT_j: \sum_r vst_{jr} = vt_j = \sum_{irs} vtwr_{jirs} \quad (14)$$

The expressions presented above show the economic identities of the model. However, they do not describe the behavior of the economic agents, as completely described by Rutherford (2005).

The closure in the PAEG model considers that the total supply of each primary factor is fixed; however, these factors are mobile among sectors within a region. Among Brazilian regions, free mobility for capital and labor is assumed. It must be noted that among countries such mobility does not occur. The land factor is specific to the agricultural sectors, while natural resources are specific to certain sectors (for extraction of mineral resources and energy). Unemployment is not considered in the model; thus, factor prices are flexible. On the demand side, investment and capital flows are fixed, as well as the results of the balance of payments. Thus, changes in real exchange rate must occur to accommodate changes in the trade flow after the shocks. Government consumption will change with changes in goods prices, and revenue from taxes will be subject to changes in activity level and consumption.

The PAEG is based on the Global Trade Analysis Project (GTAP) model and database (Hertel, 1997; GTAP, 2001). However, it adopts the basic structure of the model GTAP in GAMS (Rutherford; Paltsev, 2000; Rutherford, 2005) that uses the syntax of Modeling Programming System for General Equilibrium (MPSGE), and the development of a nonlinear complementarity problem in GAMS.

The PAEG data base is compatible with the GTAP data base 7.0. However, in the case of the PAEG, instead of considering the country as a whole, it considers the five major regions of Brazil with compatible data for the year 2004. Thus, the data for Brazil obtained from an aggregation of the GTAP data base 7.0 must be replaced by the data obtained from the Brazilian regions' input-output matrix. In this replacement, the data for trade flows between Brazil and other regions of the world are kept intact. The first step is to disaggregate GTAP data and the data from the Brazilian regional matrices in the regions and sectors of interest to the research. Subsequently, both data are fed into a single file and the data from the Brazilian regional matrices are rescheduled, so that the Brazilian GDP, obtained by the sum of regional GDP from inter regional input-output matrices, is consistent in magnitude with the Brazil's GDP in the GTAP database. Data for Brazilian imports are distributed among regions, using the regional matrices to define the relative share of imports from each region in total Brazilian imports.

This same procedure is used to distribute the Brazilian exports regionally as these data come from the GTAP database for the entire country. However, the accounts of supply and demand for the Brazilian regional matrices lose balance, since the original data on exports

and imports have been replaced by data from Brazil in the GTAP database. In order to restore the balance, the sectorial investment and capital flow values are adjusted in the Brazilian regions. This procedure avoids the inconvenience of changing the input-output coefficients in the sectors in disequilibrium. Finally, the elasticities for Brazil contained in the GTAP database are allocated to the Brazilian regions, and the data for Brazil are removed, leaving only the data of the regional Brazilian matrices and those of the other GTAP regions.

In preparing the PAEG database for the Brazilian regions, the 1995 interregional input-output matrix, obtained by Parré (2000), is broken down into five geographical regions. The inter-regional matrix, however, has been updated for the year 2004, and the agricultural sector was disaggregated into eight sectors. International data in the PAEG data base comes from the GTAP 7.0 database that reflects the economic environment for the year 2004 and includes information to the international and domestic trade<sup>2</sup>. Table 2 presents the sectors and regional composition of PAEG.

Table 2: Aggregation across regions and industries for PAEG

Regions	Activities
1- Brazil-Northern region (NOR)	1- Rice (pdr)
2- Brazil-Northeastern region (NDE)	2- Corn and other cereal grains (gro)
3- Brazil-Mid-Western region (COE)	3- Soybean and other oilseeds (osd)
4- Brazil-Southeastern region (SDE)	4- Sugarcane, beet sugar., ind. sugar (c_b)
5- Brazil-Southern region (SUL)	5- Meat and live animals (oap)
6- Rest of Mercosul (MER)	6- Milk and milk products (rmk)
7- United States (USA)	7- Other agricultural products (agr)
8- Rest of Nafta (NAF)	8- Food - Other food, beverages and tobacco (foo)
9- Rest of America (ROA)	
10- European Union 25 (EUR)	9- Textiles (tex)
11- China (CHN)	
12 – Rest of world (ROW)	10- Clothing and footwear (wap)
	11- Wood and furniture (lum)
	12 - Paper, cellulose and ind. Graphics (ppp)
	13 – Chemicals, ind. rubber and plastics (crp)
	14 -Manufactured: non-metallic minerals, metallurgical, mining, and other ind. (man)
	15 - SIUP and com.(siu)
	16 – Construction (cns)
	17 – Trade (trd)
	18 – Transport (otp)
	19 - Services and public administration (ser)

Source: Pereira *et al.* (2009).

<sup>2</sup> For more details on the GTAP 7.0 data base, see Narayanan and Walmsley (2008).

The expenditure data on the Interest Rate Equalization (IRE) policy and the total rural credit were obtained from the Federal Budget Secretariat (SOF) (2010) and from the Rural Credit Statistical Yearbook (BCB, 2004), respectively. IRE data in the above publication are aggregated at the country level, but disaggregated between family and commercial agriculture. However, the total rural credit data are broken down into regions and activities, family and commercial farms. To separate government expenditure with IRE from the total subsidies paid to agriculture, proportional distribution of total rural credit to the regions was considered. Despite the fact that actual data for the IRE is not available in every activity and region, this procedure is believed to have allowed good proxies, since, according to Bittencourt (2003), IRE supplies approximately 70% of the credit directed to family farms and around 30% of those directed to commercial agriculture. Therefore, it is considered a reasonable approximation to assume the expenditure with IRE and the amount of credit provided based on their distribution according to the total rural credit. The volume of rural credit provided by the IRE to Brazil as a whole was calculated based on the work of Bittencourt (2003) and Castro (2004)<sup>3</sup>.

### **2.3. Analytical Scenarios**

This paper simulates two analytical scenarios to meet two distinct goals: to estimate the effect of government expenditure with the IRE on the economies of the five Brazilian regions and to measure the opportunity cost of this subsidy. However, it is worth noting that in these two scenarios it is considered that primary factors (labor and capital) to have perfect mobility among Brazilian regions.

To measure the effect of the IRE policy on regional economies, it is necessary first to eliminate all government expenditure with the policy in the form of subsidy and, second, to eliminate the entire amount of credit generated by the subsidy. Thus, the shock consists in eliminating the entire portion corresponding to the IRE from the total subsidy (rto) allocated to the agricultural sector. At the same time, the expenditure with intermediate input purchase by the agricultural sector is eliminated by taking out the volume of credit provided by the subsidy. This second part of the shock is done by a homogeneous shock on the intermediate consumption taxes (rtfd and rtfi) of those sectors where agriculture is directly interconnected. The goal of this simulation is to eliminate any effect provided by the credit supplied by the IRE subsidy. This is done to compare with the initial equilibrium in which the policy is in

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<sup>3</sup> For more details, see Cardoso (2011).

place. The increase in intermediate input tax decreases the agriculture intermediate input purchase by a value equivalent to the subsidized credit supplied by the IRE subsidy.

Some drawbacks from the shock on the intermediate consumption tax are worthy noting, though: a) The tax increase causes changes in relative prices and thus agriculture faces higher prices for intermediate consumption in relation to industry and services; b ) it is not possible to specify the shock for each agricultural sector input consumption reduction. Thus, expenditure reduction of intermediate inputs to agriculture is simulated in each region, using the same amount of resources made available by the IRE, and c) change in government tax revenues due to increase in tax rates and indirectly via changes in economic activity. However, given the limitations to simulate straight reduction in the purchase of intermediate inputs in a general equilibrium model, the proposed simulation, despite these drawbacks, is believed to be a reasonable alternative representation for the effects of the IRE policy.

The second scenario measures the effects on economic growth from the alternative use of the resource spent by the government with the IRE. Accordingly, it is considered that the IRE subsidy is transferred from the agricultural sector to the transportation sector. The objective of this simulation is to determine the opportunity cost of the IRE subsidy in terms of changes in GDP and welfare on the regions.

### **3. RESULTS**

The rural credit IRE policy provides higher credit than government expenditure, since the subsidy is limited to the payment of the differential between market interest rates and the rates paid by farmers. Thus, to evaluate the efficiency of the IRE policy in terms of its capacity to generate GDP growth to the Brazilian regions, it is simulated the elimination of the subsidy and the subsidized credit, since this policy is already in place. The results are described as if the signs were opposite. To evaluate the opportunity cost of the IRE subsidy, the effects of expenditure with the IRE transfer to the transportation sector on regional GDP were measured. In a second step, the effect of IRE policy on the welfare of economic agents was evaluated in the five regions, as well as the opportunity cost for the welfare.

Table 3 shows the GDP change results in the five major Brazilian regions and in Brazil as a whole (2), in monetary terms, compared to government spending with the IRE policy. Additionally, results are shown for changes in GDP of subsidy expenditure transfer to the transportation sector (3). Overall, perceptible changes are found in the regions GDP. Table 3 also shows that the IRE policy promotes an increase in GDP in the Northeastern, Midwestern, and Southern regions and in Brazil as a whole. By contrast, contrary to

expectations, it promotes a decrease in GDP in the Northern and Southeastern regions. The effect of simulating subsidy transfer to the transportation sector on GDP to measure the opportunity cost showed positive results for the Northern and Southeastern regions and negative results for the others.

Table 3: Effects of the IRE expenditure and credit provided by this policy on GDP, and impacts of this subsidy transfer to the transportation sector on GDP, 2004.

<i><b>Brazilian regions</b></i>	<i><b>IRE<sup>1</sup> expenditure (R\$ billion) (1)</b></i>	<i><b>Rural credit supplied by IRE (R\$ billion) (2)</b></i>	<i><b>(Scenario 1) Effect of IRE and credit on GDP (R\$ billion) (3)</b></i>	<i><b>Multiplier (3/1)</b></i>	<i><b>(Scenario 2) Effect of IRE subsidy to the transport sector on GDP (R\$ billion)</b></i>
NORTH	0.05	0.23	-0.64	-12.88	0.62
NORTHEAST	0.10	0.45	0.97	9.66	-0.90
MIDWEST	0.15	0.87	1.43	9.51	-1.17
SOUTHEAST	0.22	1.19	-1.47	-6.69	0.92
SOUTH	0.41	2.04	0.97	2.36	-0.28
<b>BRAZIL</b>	0.93	4.78	1.24	1.34	-0.81

Note: <sup>1</sup> IRE –Interest Rate Equalization.

The Midwest is a region in which agricultural subsidies provide the largest gain in GDP. In 2004, R\$0.15 billion were spent with interest rate equalization, providing R\$ 0.87 billion for rural credit, allowing an increase in GDP of around R\$ 1.43 billion. Therefore, the multiplier effect on GDP is 9.51 times the amount spent with the IRE. That is, for every R\$ 1.00 spent on equalization, there is an increase by R\$ 9.51 in the Midwest GDP.

These results confirm the importance of those subsidies to the Midwestern region, marked by significant competitiveness of its agricultural products. This region is also a major generator of foreign currency, due to its capacity to export agricultural commodities, explaining the high rate of return for the IRE subsidy. Besides, the substantial rate of return from the IRE expenditure is associated with the commercial standard of the agricultural sector in the Midwest. That is, since the majority of the farmers are part of the Commercial Agriculture, equalization spending is lower, since commercial producers pay higher interest rates compared with family farmers, with the IRE costing less to the government. Low IRE spending, combined with the effect enhanced by a highly dynamic production, promotes a substantial rate of return in terms of GDP increase.

Regarding the alternative rate of return of the IRE in the Midwest, it is found that granting the equivalent IRE subsidy to the transportation sector from agriculture promotes a decrease of R\$ 1.17 billion in the region GDP. Thus, by transferring the IRE subsidy to the transportation sector, this region would no longer earn R\$ 1.43 billion but would still lose R\$ 1.17 billion in GDP. Therefore, the rural credit IRE subsidy has no alternative rate of return in the Midwest, since the region gains the most by subsidizing interest rates for rural credit. This result also indicates that, although the logistics sector is the major bottleneck in the region, the subsidy granted to the rural credit in agriculture is much more cost-effective.

In the Northeast, the increase in GDP by the IRE policy is R\$ 0.97 billion, compared to a subsidy expense of R\$ 0.1 billion. Thus, the multiplier effect on GDP is 9.66 times the amount spent with the IRE policy, or, in other words, for every R\$ 1.00 spent, there is a GDP gain of R\$ 9.66 in the region. The rural credit subsidy is also associated with a significant rate of return in the Northeast, a region that, despite the dynamism of some of its economic activities in recent years, still shows strong traces of subsistence agriculture. The economic growth observed by government spending with the IRE can boost this economy and reduce social problems, since PRONAF<sup>4</sup> is the credit modality that benefits the most from the IRE policy in the Northeastern region.

The IRE subsidy in the Northeast has no alternative rate of return in relation to its application to the transportation sector. By subsidizing rural credit, instead of granting the subsidy to the transportation sector, this region will not lose R\$ 0.9 billion, but still earns R\$ 0.97 billion in GDP. The Northeastern region gains the most with the IRE policy.

In the South, the multiplier effect on the IRE subsidy, in terms of generating economic growth, is more modest, compared to the Midwest and Northeast. This region received the largest amount of equalization funds in 2004, equivalent to R\$ 0.41 billion, obtaining a gain in GDP of about R\$ 0.97 billion, which provides a multiplier effect of 2.36 times the expenditure with the IRE. Thus, every R\$ 1.00 spent on interest rates equalization generates an increase of R\$ 2.36 in the Southern region GDP. Although the gains in economic growth in the South and in the Northeast were of the same magnitude, the IRE policy costs more in the South, and the subsidy is more cost-effective in the Northeast.

Regarding the opportunity cost in the South, subsidy transfer to the transportation sector causes a reduction in GDP of R\$ 0.28 billion. Thus, the IRE policy is not associated with alternative rate of return in the region, either. The gain of this economy (in GDP) in

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<sup>4</sup> PRONAF -National Program of Family Farming.

maintaining the current policy, rather than the alternative, is R\$ 1.2 billion, once it stops losing R\$ 0.28 billion and still earns R\$ 0.97 billion.

The North and the Southeast are among the regions that do not benefit in terms of economic growth from the current IRE policy, with the latter being the most penalized.

The Southeastern region presents a GDP reduction of R\$ 1.47 billion, while spending R\$ 0.22 billion in equalization. Thus, the multiplier effect on GDP is negative, that is, every R\$ 1.00 spent on IRE policy promotes a reduction of R\$ 6.69 in economic activity in that region. The Southeastern region, in relative terms, has a comparative advantage in industrial production. The subsidy to agricultural production represents a stimulus to this sector, which provides a disincentive to the industrial activity. This implies that the IRE distorts production, shifting production factors from the industrial sector to the agricultural sector in the region and in other regions where this sector has the greatest comparative advantages. However, in this region, the economic activity gain in the agricultural sector is proportionally smaller than the loss of activity in the industrial sector, promoting a reduction in GDP.

The IRE policy in the Southeast is associated with opportunity cost. If the subsidy was transferred to the transportation sector, the region would not lose R\$ 1.47 billion and would still earn R\$ 0.92 billion in GDP. Therefore, an opportunity cost of R\$ 2.4 billion is estimated. This result is much more associated with the elimination of distortions caused by subsidies to agriculture in the region rather than to their imposition on the transportation sector<sup>5</sup>. The elimination of agricultural IRE promotes the redistribution of production factors, stimulating industrial production in the Southeast. The same analysis can be extended to the North.

The Northern region also has a comparative advantage in manufacturing production, as a result of the Manaus Free Zone. The IRE policy provided a negative multiplier effect on GDP of greater magnitude (12.88) in this region, since very little was spent with the policy in this region (R\$ 0.05 billion) but the negative effect on GDP was of great magnitude (R\$ 0.64 billion). Thus, it appears that every R\$ 1.00 spent on equalization causes a decrease of R\$ 12.88 in the region GDP.

In the North, as well as in the Southeast, IRE policy presents an opportunity cost. If the subsidy is transferred to the transportation sector, the region's economy would cease to

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<sup>5</sup> In the simulation in which only the subsidy and subsidized credit are eliminated without granting subsidy to the transportation sector, the Southeastern region shows gain in GDP of around R \$ 1.47 billion. By transferring the subsidy to the transportation sector, the gain in GDP is much smaller, R \$ 0.92 billion.



lose R\$ 0.64 billion in GDP and still earn R\$ 0.62 billion. Therefore, the opportunity cost for the IRE policy is R\$ 1.26 billion.

For Brazil, the aggregate result shows economic growth gains of around R\$ 1.2 billion, compared to an IRE expenditure of R\$ 0.93 billion. Thus, the multiplier effect on GDP is 1.34 times what it is spent on equalization, or, in other words, each R\$ 1.00 spent on IRE promotes an increase of R\$ 1.34 in GDP. That is, the rate of return of the IRE subsidy in terms of promoting GDP growth is 34.0%. It is clear that, for the country, the effects of IRE policy are positive, in terms of promoting economic growth. Moreover, the spending with the policy has zero opportunity cost. Thus, in terms of economic activity, rural credit IRE expenditure offers the highest gain when applied to agriculture. A positive effect of spending on IRE on Brazilian economic growth was also observed by Castro and Teixeira (2004).

The key to understanding regional results is the possibility of mobility allowed by the model for the production factors labor and capital. One must remember that the movement of factors is an alternative to trade in goods and services. By the assumption of free factors mobility, allocation should occur in the same direction of the trade based on comparative advantage. That is, regions relatively more abundant in a productive factor are potential exporters of goods intensive in that factor and tend to see movement of this factor to other regions<sup>6</sup>. To support the discussion presented, the results for the mobility of capital (K) and labor (L) are shown in Figure 1, which presents the percentage change in the capital rate of return and wages paid in each region by IRE policy.

According to Figure 1, the Midwestern, Northeastern and Southern regions show increases in the return to capital and wages paid. In contrast, the Southeastern region show a reduction in both factors, and the Northern region, despite having experienced an increase in wages paid, show a more important reduction in the return to capital.

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<sup>6</sup> This factor movement does not occur as freely as represented by the model; thus, this interpretation must be met with caution.

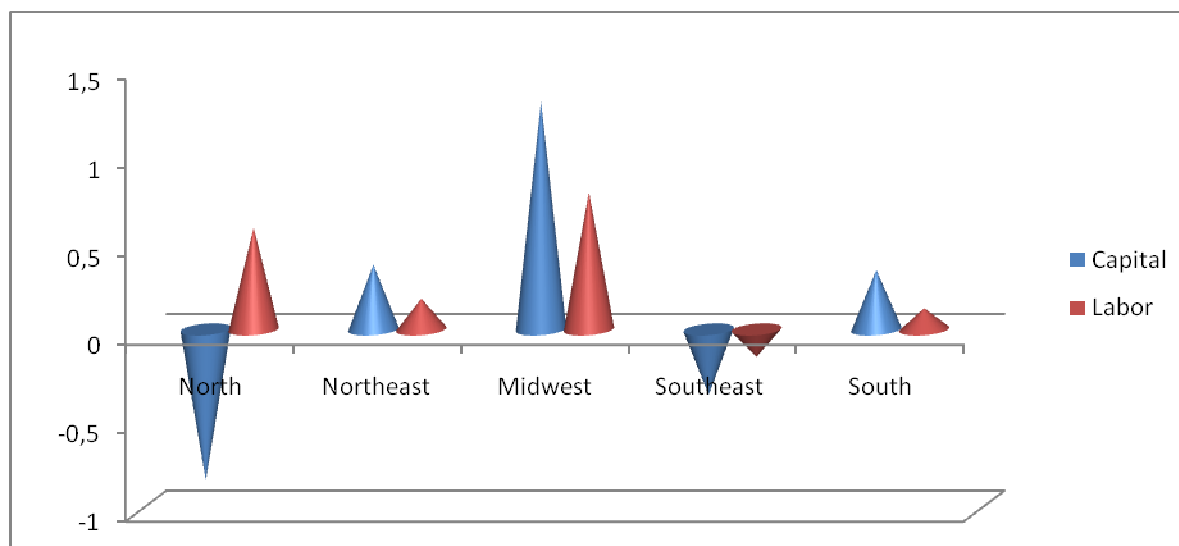


Figure 1: Percentage change in the capital rate of return and wages paid in the regions of Brazil as a result of IRE subsidy.

The subsidies distort sectorial production, i.e., regions where the manufacturing and services sectors have greater comparative advantage (North and Southeast), the disincentive (relative) caused by the stimulus (relative) to agriculture will lead the production factors to migrate to regions with comparative advantage patterns favoring the agricultural sector (Midwest, Northeast and South). These regions will absorb the migrant factors, particularly in agriculture, a more competitive sector.

It was concluded that the IRE policy promotes economic growth in the regions whose productive pattern favors agriculture (the Midwest, Northeast and South), while in regions relatively more competitive in the manufacturing sector, (the North and Southeast), subsidy distorts production and does not present the same results. Thus, government spending with equalizations is cost-effective (in terms of economic growth) in the Midwest, Northeast and South, while providing no return on economic growth in the North and Southeast.

The results for the effect of the IRE on the regions' GDP, ultimately, suggest that policies play an important role in reducing economic inequalities since they transfer resources from the richest region, namely the Southeast, to disadvantaged region in terms of GDP, such as the Northeast. This may be a regional policy goal which has been met with success, since by redistributing productive factors can raise the economically disadvantaged regions to higher levels of economic growth and development. However, it is worthy noting that the Northern region, which can be considered economically poor, is penalized by the policy.

Another analysis concerns the effect of IRE policy on regional welfare. As subsidies interfere with the income of the economy, it exerts a direct impact on consumption, and therefore, in the welfare of agents. The changes in welfare resulting from variations in the utility of agents, measured in terms of increased income, are measured by equivalent variation. Figure 2 shows the welfare gains, measured by equivalent variation, in response to government spending on IRE policy (scenario 1). Also, Figure 2 shows the effects on welfare of a transfer of funds to transport activities (scenario 2) to define the opportunity cost.

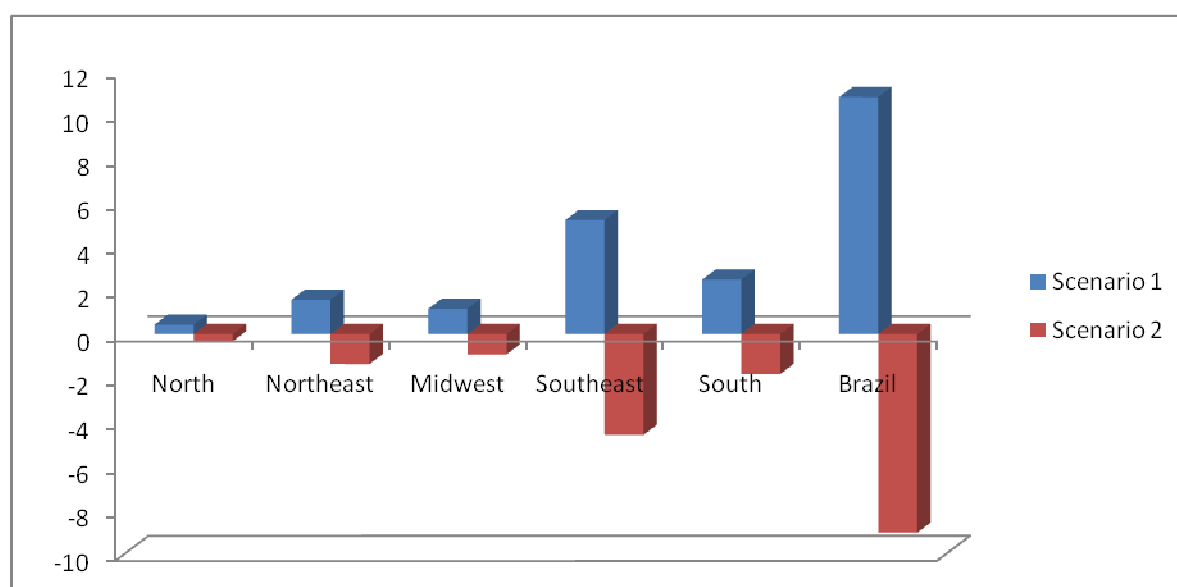


Figure 2: Comparison between changes in welfare in response to IRE policy (scenario 1) and to an alternative policy of subsidy transfer to the transportation sector (scenario 2), 2004 (in R\$ billion).

The results indicate that government subsidy via IRE policy brings welfare gains to all regions (scenario 1). Welfare is higher in the presence of the IRE because subsidies on agricultural products encourage consumption by reducing the price thereof. For Brazil, in 2004, earnings of R\$ 10.8 billion were estimated in terms of welfare; among regions, the southeast was the one whose welfare increased the most, surpassing the amount of R\$ 5.18 billion, followed by the South, with a gain of R\$ 2.48 billion.

This effect is interesting because even though the South has received the greatest amount of subsidy and the Midwest's GDP has increased the most, the Southeast has presented the largest gain in utility. The equivalent variation is measured by the change in utility multiplied by the per capita regional income, i.e., by the size of the economy at the initial equilibrium. Thus, since the Southeast has more than 50% of national income, even a

small variation in per capita utility generates a great effect on the equivalent variation. It can be concluded that, in terms of welfare, the policy is cost-effective in all the regions. Finally, Figure 2 also shows that, in terms of welfare, there is no opportunity cost associated to government spending with IRE policy in the Brazilian regions, and thus, in the country as a whole. While the rural credit interest rates equalization policy promotes gain in welfare in all regions, the transfer of resource spent on this policy to the transportation sector (scenario 2) promotes a significant loss of welfare.

It must be pointed out that the efficiency of IRE policy, in terms of economic growth or welfare, is mainly related to the mechanism of subsidizing rural credit interest rate, which provides a lot more credit than the amount the government spends on the policy. Also, the importance of strong agricultural inter-sectorial linkages should be taken into account, as it certainly contributes to policy efficiency.

#### **4. CONCLUSION**

This study aimed to contribute to the debate on state intervention in the economy. Specifically, it aimed to measure the effects of the Rural Credit Interest Rates Equalization (IRE), implemented by the Federal Government, on economic growth and welfare of the Brazilian regions. Additionally, it aimed to measure the opportunity cost of this subsidy relative to an alternative application to the transportation sector. The model, database and software from the PAEG package were applied.

The results suggest that regional issues in the intervention analysis deserve attention. The subsidy to the rural credit promotes higher economic growth than the cost of policy in the Midwestern, Southern and Northeastern regions. However, it leads to a decline in economic activity in the Northern and Southeastern regions. For Brazil as a whole, every R\$ 1.00 spent on IRE policy provides a GDP growth of 1.34 times the amount spent with the policy; that is, the rate of return of the IRE subsidy is 34%. In relation to welfare, the IRE policy promotes welfare gain in all the regions of Brazil, being the aggregate gain to Brazil of R\$ 10.8 billion. Thus, the gain in economic growth and welfare exceeds the monetary cost of the policy.

The IRE policy has zero opportunity cost in terms of economic growth in the Midwestern, Southern, and Northern regions. However, for the latter two, the IRE policy is associated with opportunity cost. In terms of welfare, however, spending on IRE policy shows zero opportunity cost in all regions. In general, for Brazil, there is no opportunity cost associated with the IRE policy expenditure, by granting the equivalent IRE subsidy to the

transport sector, in terms of economic growth, or even of welfare. Thus, the country is at its best opportunity gain subsidizing the rural credit interest rate.

Thus, the IRE policy proves to be effective, since it promotes economic benefits that outweigh its cost. This result allows two conclusions: the first suggests that some policies, i.e., governmental intervention in the economy, can generate higher gains in economic growth and welfare than the cost of the policy; the second finding suggests that the emphasis of policy-makers in maintaining agricultural subsidies for agricultural production in developed countries may be linked to social and economic rationality.

In regional terms, the policy contributes to a reduction in economic disparities, since it allows regions, such as the Northeast and Midwest, to achieve income growth, while the richer Southeastern region presents decrease in income growth. Thus, despite the fact that some regions did not benefit in terms of economic growth, the IRE policy must be maintained, especially if the goal is to reduce economic disparities among regions.

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