CORNELL

AE S.P. no. 89-10

CORNELL AGRICULTURAL ECONOMICS STAFF PAPER

THE ROLE OF CREDIT IN AGRICULTURAL AND RURAL DEVELOPMENT

by

John R. Brake, W. I. Myers Professor

April 1989

Staff Paper 89-10

Department of Agricultural Economics
Cornell University Agricultural Experiment Station
New York State College of Agriculture and Life Sciences
A Statutory College of the State University
Cornell University, Ithaca, New York, 14853

THE ROLE OF CREDIT IN AGRICULTURAL AND RURAL DEVELOPMENT

by
John R. Brake, W. I. Myers Professor
Cornell University

Thank you for inviting me to visit with your Commission this morning. My purpose is twofold: one is to discuss the role of credit in agricultural and rural development; the second is to discuss the report of the National Commission on Agricultural Finance as it relates to the role of credit.

Interestingly, much of the discussion of the role of credit comes from the literature in the field of development finance. I've drawn many of my ideas from a study of U.S. donor programs in developing countries. The study was done by the U.S. Agency for International Development. A perspective on the role of credit comes also from thinking about the purposes for which credit is used. For example, a substantial part of the total credit extended to agriculture each year is for new entrants to purchase the agricultural assets of retiring operators. That's a continuing and important role of credit that receives minimal attention in typical role of credit discussions.

Let me start with some basic definitions. Debt is money borrowed by one person, business, or agency from another person, business, or agency with the expectation of repayment later. Technically, credit--or perhaps better understood, credibility--is what the borrower gives to the lender in return for the money received. However, we often treat debt and credit as synonymous terms; and I'll use both terms synonymously hereafter.

Credit is a means to an end--a facilitator or catalytic agent, if you will. It is not an end in itself. For example, credit is a means:

1) for acquiring resources to start a business or industry sooner than if one had to accumulate owned equity in order to acquire resources;
2) to adopt new technology;
3) to expand or grow faster than without use of credit;
4) to expand the numbers of people in resource transactions markets;
5) to provide less costly, and typically more acceptable help, than a grant to a person, group, or region;
6) to purchase goods or services from future rather than past income; and
7) for promoting socially and economically desirable goals.

Some of the goals commonly included in this category are 1) increased or more efficient production, 2) more

---

Presentation to the National Commission on Agricultural and Rural Development, Washington, DC, April 14, 1989.

desirable products or new products, 3) to move people up the economic ladder, and perhaps 4) to redistribute economic power among various classes of the population.

Credit or debt, similar to other money, is fungible. That means a dollar of debt substitutes perfectly for a dollar from any other source, such as income. Institutions which loan only for a production purpose fool themselves to think they can limit expenditures of those dollars or pesos only to production items. That debt frees other dollars that might have been spent for production to be spent instead for food or other consumption items.

The Role of Credit

Considering the economic role of credit in a business development context, economists have typically made three assumptions: 1) Credit is necessary to adopt new technology or to get started in business, 2) Credit is not economically or practically available at the moment, and 3) The provision of credit breaks the most critical constraint on farm business or rural development.

Think for a moment about those three assumptions. They underline that a potential benefit must exist. Credit becomes a means to realize that potential. If there are reasons why credit is not available to accomplish some potential benefit, can bottlenecks be removed or can new forms of credit be made available?

Let me move on to some issues and perspectives from the AID study of the success of donor credit in developing countries. The first question is whether the conditions for a successful business effort or rural development effort are met. For example, does new technology offer a potential payoff? Are relative prices of inputs and outputs favorable? (That is to say, is additional production profitable?) Are the risks and uncertainties of the new or additional output manageable? And lastly, are the necessary inputs available when needed?

One conclusion from the US experience as a donor is that, in many situations, proposed programs didn't consider the conditions for success early enough in the planning stages. Another observation was that, even where market incentives existed and some entrepreneurs were able to obtain financing, the absence of sufficient credit may have precluded widespread adjustment and mobilization of resources. For general rural development beyond financing of a few select private firms, private credit may have been inadequate and a broader approach was needed. In other instances, a government program was needed to provide funds to break the economic power of private lenders. Also, in some of the donor programs, it was found that credit and savings facilities needed development. Rural cooperatives were sometimes used to provide a secure financial base for stimulating and enhancing other essential services such as marketing.

These points underline my previous observation. The necessary condition for successful development, whether personal, business, or regional, is the potential for successful entrepreneurship--development of new products, cost advantages of new techniques, better business organization, new industry, new jobs, or new or additional services.

Next, consider whether the necessary conditions are present but lack of capital limits their achievement. That is, are private and/or existing institutions not recognizing the potential or filling the need? If, and only if that is the case, then new, additional or government credit programs may be useful to bring about realization of the potential benefits. Probably, however, in an economy such as ours, the innovation, entrepreneurship, or management expertise are more likely lacking than access to borrowed capital. As stated in the AID study, three types of business or entrepreneurs (or one might say, localities) exist: 1) those already profitable and developing, 2) those who aren't but could be, and 3) those who don't have the capacity. Efforts are needed to focus on the middle group while not destroying the vitality of those in group 1. Group 3 deserves special study of limitations to development and how to release the constraints that are holding them back.

The issue is, what is the constraint? Is it a shortage of capital or a shortage of perceived opportunities that could benefit from and repay borrowed capital?

Impacts of Alternative Credit Policies

In a PhD thesis under my supervision, Glenn Pederson, now at the University of Minnesota, examined benefits of credit use in a farm growth context. He suggested several views of limitations on farmers' production potential: 1) production opportunities are a limitation (The technology is not known by the farmer), 2) the endowment of initial resources is a limitation, 3) access to external financial resources is a limitation.

Pederson argued that the core of growth is acquisition and control of resources which earn returns over cost. He pointed out that credit may either overcome an initial unequal distribution of resources or it can bias the distribution of resource ownership even more depending upon one's assumptions about the production function.

Consider, for example, several alternative assumptions about credit benefits to a farm borrower:
1) Low income farmers will consume all credit,
2) Credit is more profitable where labor is in excess;
3) Better managers have higher return alternatives;
4) Large farms have higher return alternatives;
5) Limited resource farms face the same production opportunities as other farms; hence, their return to credit is greater than for other farm situations;
6) Small or limited resource farms have an imbalance of inputs; hence, they face more profitable opportunities from credit use because additional capital could bring the inputs back into more appropriate balance;
7) Small or limited resource farms are less knowledgeable about new technology and, therefore, obtain lower returns.

Realistically, farm firms do not perceive the same production opportunities, which is to say, returns to credit will not be the same because:
1) production opportunities are not equally known,
2) firms have different initial resource endowments,
3) lumpiness of inputs leads to discontinuities in investments (One must add 40 acres rather than one acre. A 40-acre farm finds it more difficult to add 40 acres than does a 300 acre farm),
4) there are differences in investment risk, risk bearing ability, and risk preferences among farm operators.

Finally, Pederson attempted to describe some of the costs and benefits of credit. He said benefits include:
1) the right to purchase additional assets,
2) the right to all income from such assets above the debt service costs,
4) the right to reinvest profits from credit use,
3) the right to appreciation (or depreciation) of assets purchased with credit,
4) the right to sell, lease, collateralize, or otherwise use property acquired by credit. (One has rights to sell items purchased on credit at a profit.)

In addition, he said credit might include two additional rights: 1) The right to an interest subsidy, or 2) a subsidy from nonrepayment of credit if the legal contract is not enforced. The cost of using credit, Pederson said, includes interest, increased financial risk from leverage, and risk of loss of future access to credit.

Let me quickly summarize.
1) Debt, by definition, is borrowed money which is expected to be repaid.
2) Effective use of credit depends upon the borrower being able to use the credit to advantage. Typically, this means that the borrower has the potential to earn net income through adoption of new technology, good business practices, or the like, and to be able to repay the debt--being better

off than if not having borrowed.
3) New or government sponsored credit programs tend to be most effective when the provision of credit is constrained in some way. To say it differently, if present credit institutions are not providing credit to those who can use it effectively, new credit programs that will provide the credit will be beneficial.
4) If credit is not constrained, new or additional credit programs will be neither useful nor effective.

Report of the National Commission on Agricultural Finance

No doubt national commissions are appointed in many different ways. The National Commission on Agricultural Finance was appointed, I think, somewhat uniquely. Seven members were appointed by the President. The Speaker of the House, Speaker O'Neill, appointed four, and four were to be appointed by the Senate--two each by the majority and minority leaders. Thirteen members were eventually appointed since Senator Bird, then minority leader, made no appointments.

Commission members were to serve voluntarily, and there was no provision for financing meetings or other activities of the Commission. That was later changed, when in June of 1987, the supplemental appropriation provided $100,000 for Commission activities.

Commission members brought a wealth of experience to the discussions. Among the members were three bankers, a bank executive from the Farm Credit System, an Undersecretary of Agriculture, a former acting Undersecretary of Agriculture, two former Federal Farm Credit Board members, a director of a district Farm Credit Bank, two former Farm Bureau presidents, a former Congressman, and a college professor. At least seven members had been, or are, farmers or ranchers.

Given the means of appointment, positions held, and past experiences of members, one might have expected great disagreement, heated discussions, and minority reports. That was not the case. In my estimation, the group was cohesive because it had an overriding allegiance to, and concern for, agriculture and agricultural credit. That's not to suggest a lack of discussion or conflicting viewpoints. Rather, overriding purpose and importance of our assignment took priority over our minor disagreements.

Some of the media have characterized the Commission's report as a conservative document. The President of the National Farmers' Union has sharply criticized the report, as perhaps might be expected. The difference between his view of credit and the Commission's is that we felt credit should be available to those who could use it to advantage and repay. Others apparently believe credit should be available to anyone who wants it whether they have repayment capacity or not. Frankly, I think our differences are that simple. Others, by the way, including a number of my agricultural finance colleagues, have complimented us on the straight-forwardness and honesty of the report. But, let's review some of the major points of the report.

The Commission report presents a perception of the credit system, in general, as it's now functioning. It was our assessment that credit is generally available to creditworthy farmers. There is, and will always be, a lack of credit to those who are not creditworthy. We also suggested that new institutional developments in progress, namely Farmer Mac and Aggie Mae, should add further improvement to the existing credit system. Savings do flow from investors to borrowers.

Some improvements are needed, however, in the credit delivery system. More accurate and more complete information would permit improved loan analysis. The quality of farm loan analysis in the past has left much to be desired. We believe improved loan analysis is necessary, but in general, farmers have fought it, as shown, for example, by reaction to implementation of coordinated financial statements by Farmers Home Administration. Also, perhaps, educators have not pushed it as much as they might have. And some lenders either have not understood the need for, or were too lackadaisical to implement, quality loan analysis procedures.

The Report strongly underscored the importance of competition among lenders in providing credit to America's farmers. We all agreed that more than one source of credit should be available to farmers.

The Commission believed that the market place, in general, should allocate credit. Too often, policies to give an advantage to a special group, or to change credit flows, have had poor overall results. The Commission's view was that government should be a regulator or referee of the game, if you will, rather than both referee and participant. The report also mentioned the need for consistent regulation among lenders, types of institutions, state as well as federally chartered institutions, and geographic areas of the country. Consistency has sometimes been lacking.

The Commission felt that government credit programs were sometimes misdirected--particularly when used to address income problems. Agricultural credit programs with subsidized interest rates were too often the policy response in years of low farm income or natural disaster. The Commission concluded that such policies tend to retain marginal farmers in agriculture and to direct attention away from appropriate risk management options that farm operators should be utilizing. The Commission also questioned the use of government credit programs to achieve social change. The Commission would prefer to see credit programs oriented to farm business purposes and profit opportunities. Separate programs should be designed to help distressed farmers or those in transition out of the agricultural sector.

The Commission emphasized a need for better debtor/creditor problem resolution procedures. A major crisis like the 80s forces changes in the debtor/creditor relationship. But how long are such changes warranted? At some point lenders and borrowers must return to contractual relationships that are not burdensome to either. There was agreement that more equitable, less expensive means could be developed to accomplish resolution of problems between debtors and creditors. Hopefully, improvements will be made before the next debt crisis hits.

The report also recognized that the recent financial crisis in agriculture came, in part, from too much sector debt. The report pointed to a need for means to bring outside equity into agriculture as an alternative to debt. Full ownership of all production resources may not be the most economical or effective way of getting started farming or of running a farm business. That fact is sometimes lost in government policy decisionmaking. The report also expressed concern that new techniques and ways be found to help young people enter agriculture.

NCAF Recommendations

The Commission had three recommendations. The first recognized that, with the implementation of Farmer Mac, there would be need for a standard farm loan application form. A standard form would permit loans initiated by any agricultural lender to be resold into the secondary market rather than each loan originator using unique loan application forms. That process is already underway.

Also needed, however, is agreement among educators and other farm business consultants on accounting principles and business analysis for farm businesses. The American Bankers Association had already organized a commission to consider that question. Our Commission wanted to be supportive of the effort. But more than that, if the ABA Task Force should not complete the job, we believe Congress should mount an additional effort to accomplish that end.

The Commission agreed that improved Federal crop insurance and other risk management alternatives should be made available to farmers. We supported the ongoing study of the Federal crop insurance program to make it more effective and available to farmers and ranchers throughout the country. Assuming that a more comprehensive crop insurance program will be forthcoming, the Commission argued that Congress should discontinue ad hoc disaster programs and encourage farmers to utilize the crop insurance program.

Finally, it was the position of the National Commission on Agricultural Finance that our country is missing some export opportunities for agricultural goods. Major markets are probably well served in export financing by large export banks. There is need for improvement, however, in the export financing of new products and/or new markets that are often too small to be serviced by major exporting banks. Also, export credit programs are needed for developing countries in which typical export credit arrangements can not be utilized. The Commission believed two possibilities have merit: 1) extend the authority of the National Bank for Cooperatives so that it can finance agricultural exports without restriction to only cooperative originations, and 2) devise some form of loan guarantee available to institutions providing financing for countries that otherwise are not creditworthy for typical commercial credit.

References

Pederson, Glenn and John R. Brake, "The Distribution of Financial Impacts of Alternative Agricultural Credit Policies," Research Report 424, Michigan Agr. Expt. Sta., Feb. 1982.

"Report of the National Commission on Agricultural Finance," Washington, DC, February 22, 1989.

"Small Farmer Credit Analytical Papers", A.I.D. Spring Review of Small Farmer Credit, Vol. XIX, Agency for International Development, Department of State, Washington, DC, June 1973.

<u>Other Agricultural Economics Staff Papers</u>

No. 88-21	A Bioeconomic Model of Pollution and Resource Management	J. Conrad
No. 88-22	Economics and the Risk from Low Level Radioactive Waste	J. Conrad
No. 88-23	Italian Wine in the U.S. Market, A Case Study of Cantine Riunite	A. Segre G. White
No. 88-24	Utilizing a Geographic Information System to Develop an Agricultural Land Use Database	M. Kelleher N. Bills
No. 89-1	Using Strategic Planning to Formulate Future Business Opportunities	G. White
No. 89-2	Some Thoughts for the Farm Financial Standards Task Force	E. LaDue
No. 89-3	An Overview of the 1988 Rural Household and Farm Energy Use Survey	N. Bills M. Kelleher
No. 89-4	An Overview of Dairy Policy Options	A. Novakovic
No. 89-5	Changes in Farm Size and Structure in American Agriculture in the Twentieth Century	B. Stanton
No. 89-6	Testimony Concerning the Proposed North-east Interstate Dairy Compact	B. Anderson B. Henehan A. Novakovic W. Wasserman
No. 89-7	Recent Changes in Credit Institutions Serving Agriculture	E. LaDue
No. 89-8	Change -- The Third Certainty	J. Brake
No. 89-9	Biocarbon: A Model of Energy Use, Forestation, and Climate Change	T. Drennen D. Chapman