When Is Smallholder Credit Necessary?

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[This article strongly questions the frequently asserted "need" of small farmers for access to low-interest credit to enable them to adopt technological improvements. In many cases credit may be unnecessary, in others it may be useless, and in most circumstances low interest rates do more harm than good.]

Credit as a Need

One reason for the importance frequently attached to small farm credit as a vehicle for rural development in Africa is the belief that the lack of small farmer access to credit constitutes a critical constraint to the adoption of improved inputs and modern technologies which can lead to increased incomes and enhance rural welfare. This belief, which may be called "the small farmer credit need-creed", is articulated in development plans such as those evolved in Kenya.

If farmers are to adopt improved farming methods such as the use of improved livestock, better seeds and pesticides etc., they will require credit, especially short term credit, to help them purchase these inputs. (emphasis added) [1970-74 plan]

Eric Clayton adds that:

In Kenya, loan funds are needed by the farmer for such things as the purchase of fencing wire, improved livestock, cash crop planting material, water tanks,

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sprays, the installation of water supplies and buildings. It is needed too for payment of hired labor to undertake bench terracing and cash crop planting and to finance the 'waiting' or zero-income period before cash crops come into bearing. (emphasis added)

The "need-cred" is also expressed by economists such as the World Bank's Uma Lele, who wrote:

Modernizing agriculture requires large infusions of credit to finance use of purchased inputs such as fertilizer, improved seeds, insecticides, additional labour, etc... Because savings in traditional agriculture tend to be relatively small at initial stages of development, increased demand for working and fixed capital must largely come from increased supply of credit... Small farmers have meager internal resources and, therefore, are most in need of production credit. (emphasis added)

Statements of this need-cred are frequently based on a number of assumptions which may not always be valid when applied to a specific rural situation. The first is the pre-development blank page. Before the development planner or aid mission arrived on the scene there would appear to have been no stocks or flows worth bothering about or large enough to allow those managing them any realistic alternatives. But it seems unrealistic to assume that most smallholder economies today have remained at a subsistence level. Relative to this picture of stagnant traditional agriculture it is also assumed that the requisite inputs for change, or at least their financial analogues, are massive and indivisible. But field trials on farms and on experimental stations in Western Kenya have demonstrated that local maize yields can be increased from 8.8 bags to 21.8 bags per acre simply by good husbandry, without fertilizer and without improved seeds. (Good husbandry is defined as early planting, recommended planting density and clean weeding until tassel time.) The possibility that change may occur gradually, and that it could involve a succession of small increments—as would be consistent with the high degree of risk aversion frequently ascribed to peasant cultivators—is dismissed by need-creders. Also disregarded is the possibility that development may actually enable cultivators to save, indeed that it would give them an incentive to save, and that these savings could often be sufficient to finance further growth through on-farm reinvestment by the savers themselves.

Despite the great leaps in farm output that are projected in many project appraisal documents, it frequently appears that the project designers do not expect the financial priorities of participating farmers to alter significantly within the planning horizon. The
provision of savings facilities, for example, is rarely part of rural development projects which include credit schemes. The old, and presumably hand-to-mouth patterns of resource allocation at the farm level are evidently expected to persist in spite of the multitude of changes to be introduced and induced by the project, so the farmer will remain with insufficient cash to meet the financial requirements of the changes envisaged. On this assumption schemes and public sector institutions are established which, for a variety of reasons, often provide credit at less than its accounting cost and at less than its opportunity cost to the economy.

The Need-Creed and Capital Market Considerations

The need-creed reflects the widespread belief that small farmers are "poor," and therefore suitable receptacles for subsidies of many types including subsidized credit. Indeed, it would appear that most institutional attempts to provide small farmers with credit in Africa are subsidized. Evidence rests in: a) the financial statements of specialized farm credit institutions, whose position is weak and unprofitable (unless earnings from large scale agricultural lending or from mainstream commercial activities are available to offset the losses incurred on small scale loans), implying that credit is provided below its accounting cost; b) the provision of capital to agricultural lenders on soft terms, including an interest rate below going rates; or c) agricultural interest rates which are below those charged to borrowers for commercial and industrial activities.

Systems of agricultural finance in LDCs which are heavily subsidized generally fail to serve very many of the rural population. They also usually fail to attract private domestic resources, including potential deposits from the liquidity generated and held by the rural sector. Specialized agricultural banks in LDCs are often not financially or administratively strong enough to compete for local funds in the market place, or to attract and develop the expertise in operation and management which is required for the solicitation of deposits from those with funds to place. The causes of this institutional immaturity are frequently related to the requirement that interest rates be kept low on the assumption that smallholder agriculture is not capable of, or should not be subjected to paying the full costs of the funds it borrows. Interest charges, and thus the earnings of agricultural lenders, are consequently limited, and the high costs of lending to small farmers therefore lead to losses. Hence the inability to generate independently or attract the funds required for dynamic institutional development or even to halt capital impairment.

The spread between the going deposit rate of interest necessary to attract local savings and the permitted agricultural lending rate
is too small to cover the overheads of the lender; so private local deposits, for which the going deposit rate must be paid, are not even solicited. Treasuries and foreign donors prop up the exercise with soft money and other subsidies. With this support, agricultural credit institutions may not be stimulated to go to the local money market or, more importantly, to the rural areas in search of funds for relending. These institutions are frequently isolated from local capital markets and from the rural economies they were designed to serve. They remain capital-city or enclave-economy entities, and public-sector appendages, not dynamic links between rural people and the financial sector. Such lenders must exercise severe credit rationing, because low lending rates stimulate excess demand for their loans, and because supply is held down by their inability to attract funds from domestic markets or to generate their own resources in the form of retained earnings. Credit severely rationed usually means credit for the few. The difference between private and social costs which such credit programs are ostensibly designed to rectify are frequently exacerbated by these schemes' performance.

The tendency of subsidized agricultural credit programs to serve rural elites rather than poor farmers has been explored by Dale Adams and others, using data from Brazil and other Latin American countries. These data suggest that low lending rates and consequent difficulties in attracting funds force lenders to use more stringent credit rationing than would otherwise be required. Rationing is frequently accomplished by lenders' making a few large loans rather than many small loans, given the economics of loan administration. Thus small farmers are rationed out of the market. The large farmers receiving credit at subsidized rates, sometimes even below the prevailing rate of inflation, are able to expand their asset portfolios and diversify out of agriculture. This observation negates any equity justification for the provision of subsidized credit to agriculture, since it tends to flow to a select group of large farmers.

The lack of formal credit institutions capable of intermediation in rural areas (because low lending rates make it difficult if not impossible for them to venture into these markets without incurring losses) means that rural savings in the form of cash cannot easily or conveniently be converted into interest-bearing financial assets, and that rural savings potential remains untapped and unstimulated. The lack of deposit facilities in rural areas results in low levels of rural deposits, reinforcing the belief that rural people are indeed "poor", unable to save, and deserving of subsidized credit for developmental purposes. In fact, however, a larger number of farmers can save than can borrow from institutional sources. In even the most highly developed financial systems, the total number of deposits lodged with financial institutions exceeds the total number of loans made by these institutions.
An alternative approach, based on lending and deposit rates determined without direct government regulation by supply and demand in the market, has been attempted in several non-African developing countries with surprising results. Financial services meaningful to rural people will grow independently to the extent that it is profitable to serve rural markets. It is profitable to serve rural markets only when the price is right, and "low" interest rates are virtually never the right price. The fact is that the rural economy includes the bulk of the population, and a substantial portion of value added. This makes it virtually impossible for governments in Africa, usually having only a narrow range of tax and other revenue sources, to provide subsidies sufficient to spread non-profitable rural credit very widely.

Situational Approaches to the Role of Credit

There are no doubt cases in which the development process faces bottlenecks in the form of indivisibilities in the required investments, i.e., items which must be financed on a large scale or not at all, and for which there is no good (smaller) alternative. But this is not usual; and it would be useful to place credit in its proper context as simply one form of capital, or one alternative financial resource. As such, credit could be replaced by other types or sources of capital should these alternatives yield higher returns to the farmer or the economy. In fact, institutional credit may not be required at all, and "needs" might be adequately met by moneylending in the local informal market—especially friendship and kinship loans.

A more qualified and perhaps oblique approach to credit in agricultural development is made by John Mellor:

There is a common tendency to give excessive emphasis to credit as a means of solving the problems of the lowest income farmers and too little attention to the credit needs of the middle and higher income farmers. In a traditional agriculture, credit needs lie largely with the lowest income farmer, and their needs are largely for consumption credit. With modernization, the credit needs of the medium and high income farmers increase rapidly and their credit needs are largely for production credit. (emphasis added)

Credit is not homogenous. The uses to which it is put, controlled to some extent by lenders, are numerous. The terms on which and the channels through which credit is issued vary widely. Likewise, the rural community is not homogenous; and patterns of credit use or credit use potential could be expected to vary with the size and nature of the asset structure and economic flows managed by differ-
ent individuals or firms. Financial priorities are not uniform or constant. "Needs" are more subtle and complex than is suggested by bald expressions of the need-creed.

However, Mellor's classification of productive and consumptive needs would appear to break down in theory and in practice. The distinction between production and consumption credit may be challenged by these FAO observations on the nature of the peasant farm and its decision-making dynamics:

It is only at later stages of agricultural development that the productive element in agricultural credit gradually increases. As long as agriculture is not a business but a way of life, cost price is a sheer fiction, household and farm expenditure an inextricable knot, and it will be impossible to draw a clear borderline between credit for consumptive and credit for productive purposes.

Accounting theory also suggests that distinctions between production and consumption credit are less than watertight. Credit is essentially fungible: each shilling in a farmer's pocket or in a bank account is like every other shilling in his pocket or account. When an additional shilling is added, its identity by source is essentially lost. An input supplied on credit here may free funds which the borrower would otherwise have used for the purchase of that input to be used for a little consumption or investment there. The purpose for which credit is given is not necessarily the same use of funds, or the only use of funds, which is in fact expanded as a result of the increase in resources made available to the borrower. Doubtless many who talk about farm development to their bank managers use their loan proceeds for investment in taxis, shops or school fees, or even colossal binges. Even when loans are given in kind, as when disbursements are made by the lender directly to suppliers against their invoices, loan diversion is not infrequent: suppliers and borrowers may conspire to submit fictitious claims, or borrowers may resell the credit goods to obtain cash for the things they really "need."

An element of circumspection in approaching the role of farm credit in rural development is found in the 1973 ILO study of employment in Kenya.

It is frequently argued that a shortage of working capital or seasonal credit is a serious hindrance to the adoption of new technologies and farming practices that require either purchased inputs or hired labor. The three types of cases in which such a shortage is most likely to be restricting agricultural development are:
a) cases in which the farmer, lacking purchased inputs, is unable to generate domestic savings...

b) cases in which the purchased input or development item is available only in a relatively large indivisible quantity...

c) cases in which there is a long period between investment and the beginning of a cash flow from the investment...

This statement provides a constraint-orientated strategy for credit deployment which goes well beyond the vague concept of the need for credit. The need-creed contains the implicit assumption that farmers or the rural capital market are not able to supply funds for the purposes which "need" credit. The view expressed in the ILO report challenges this assumption, properly implying that the real world contains a graded range of relevancies and irrelevancies: farmers may not always require credit when the specified conditions are present. For example: what is meant by domestic savings? Some Kenyan smallholders who do not save any of their farm income seem able to develop their farms from the proceeds of remittances from urban wage earners within their extended families. This may imply "extended firms" as well, given the classificatory problems of splitting the peasant economy into firms and households.

The discussion of savings in peasant agriculture is easily confused by the non-monetized nature of a portion of the farm-firm's productive activity. Some observers may restrict their definition of savings to cash surpluses, which is consistent with the conventions of modern finance and credit: i.e., principal amounts are expressed in monetary terms, loans are repayable in cash, etc. Rural capital formation involves non-cash elements, however. In Murang'a District in Kenya the writer found examples of substantial increases in cattle herds coupled with virtually no cash investment in the enterprise. Non-cash assets may be available for liquidation when farmers require cash for innovations: acquisitions of grade cattle may be financed by the sale of native stock; or trees may be sold in situ or converted into charcoal when cash is required. In Malawi the state-owned supplier of agricultural inputs offers a discount to cash purchasers of lorry load lots of fertilizer, and delivers the fertilizer to the point designated by the buyer--an important consideration given the state of the infrastructure in Malawi. Small farmers (10 acres is a large farm in Malawi), without access to credit for inputs or for farm development, have in many instances grouped together on their own initiative for the purchase of a lorry load for delivery to their village, overcoming problems of indivisibility through joint action.

To return to the consideration of alternative approaches to the role of credit, it should be noted that some observers are openly
skeptical of the need-creed. In Arthur Mosher's classic manifesto, credit is included among the "accelerators" of agricultural development rather than the "essential" conditions for change (accelerators will speed productivity growth but are not indispensable to it).

We must keep in mind that the purpose of production credit is to enable farmers to purchase productive equipment and supplies. Credit is therefore less important to agricultural development than is the ready availability of such supplies and equipment at convenient nearby markets. But where effective and profitable production supplies and equipment are available nearby, and where farmers have facilities for learning how to use them, production credit can accelerate the adoption of improved practices.

It is of course possible that credit could be a critical constraint if all of the essentials were operative and available to farmers. Rarely, however, would the development process appear to be this neat. The need-creed school generally appears not to acknowledge the difference between essentials and accelerators.

Judith Heyer, an observer of Kenyan agriculture since before independence, also suggests that credit, especially subsidized credit to smallholders, should be used very cautiously in rural development schemes.

It is generally assumed that it is necessary to extend credits to small scale farmers to enable them to purchase modern inputs and to raise productivity. Only if it can be shown that farmers are critically short of finance, and that there are profitable investment opportunities open to them (and these two situations do not usually occur together in Kenya's small scale farming areas), should a credit scheme be incorporated in a pilot program.

This observation stresses the interplay of factors internal and external to the farm in the determination of the usefulness of farm credit. David H. Penny uses data he gathered in Indonesia to illustrate that farmers' willingness and ability to use credit productively for farm development is a function of their "economic-mindedness," which may be translated roughly as commercial outlook. Landed farmers who were not economic minded and who used credit were likely to end up as indebted tenants in several of Penny's Indonesian villages.

It is not capital or credit they lack, but the motivation to use resources for development. Until governments realize this point, and act accordingly, money will continue to be
lent to farmers without a corresponding increase in production.

More generally, Penny concludes that:

A government credit program will be profitable to the government itself, and to the economy as a whole, only if:

1) there is unexploited productive potential in the farming areas where the loans are to be made;

2) the farmer-borrowers and the lenders know what the economic opportunities in each locality are;

3) the farmers are willing to borrow and to use the loans productively, and

4) steps are also taken to raise the propensity to save.

A less extreme but equally critical case is put by E. B. Rice in his summary of the Spring Review of Small Farmer Credit (sponsored by A.I.D.):

With respect to the role of credit, the conclusions are that credit is necessary in the long term process of capital formation on small farms, but that an infusion of new public credit is not always needed and the conditions under which these funds can successfully affect small farmer productivity are more restrictive than commonly supposed. If technologies and markets are not set to reward small farm adopters for taking risks and investing in borrowed funds, credit from whatever source will be wasted... Small farmers... are seen to respond to suitable incentives, and to invest in new technologies. Here the source of funds is not only institutional credit but also on-farm savings and informal money lenders, especially for investments that don't include any large, lumpy expenditures. In fact these other sources are often adequate to finance the initial period of technological change. If small farmers are not adopting an allegedly improved technology for basic food crops, the explanation usually does not involve the lack of credit.