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# Support for farmers in developing and emerging countries
## Making a case for the right subsidies in the agricultural sector

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**Agriculture is subsidised around the world. However, how successful subsidies are depends on how they are structured – also in terms of development financing.**

### Why subsidies?

Financial aid for farms is a common instrument used in agricultural policy. In Germany, there are agricultural investment aid programmes (Agrarinvestitionsförderprogramme – AFP) and programmes for investment aid for individual farms (Einzelbetriebliche Investitionsförderung – EIF). Key enterprises like sugar refineries receive direct financial support. At EU level too, most subsidies flow into the Common Agricultural Policy. European farms today still generate an average of 20 % of their operating income from subsidies, largely independently of their production output[1]. Funding is also increasingly being channelled to environmentally friendly farms.

Subsidies are legitimate – to strengthen and develop sectors that serve the public interest. Farm subsidies often aim to safeguard food production, jobs and income in rural areas. They are also designed to contribute to nature conservation and environmental protection. Intervening in market mechanisms is considered acceptable because it is assumed that market forces alone are not adequate to achieve these goals.

In Africa, the 2008 food price crisis served as the impetus for governments to invest more in national food security. Since then, there has been a clearly evident renaissance of farm subsidy programmes and initiatives to regulate food imports. Discussions about subsidies seeking to provide food security have also taken on particular relevance since the crisis.

The documented impacts of farm subsidies, however, have so far been sobering. A current analysis of ten national African farm subsidy programmes shows that the costs of input subsidy programmes far exceed the benefits[2].

Experts agree that the most important element is the "how". This means that subsidies in developing and emerging countries can only achieve the desired impacts under certain conditions.

### Under which conditions?

Subsidies have to pursue a clearly defined political, economic and environmental financing and development goal – a basic principle e.g. that applies to EU farm subsidies[3].

Another condition is that the decision about which instrument can most effectively achieve the set financing and development goals must be made on the basis of economic and political cost-benefit analyses.

Subsidies may also not serve individual institutions because this would

[1] **OECD (2014)**: "Agricultural policy monitoring and evaluation 2014" http://dx.doi.org/10.1787/agr_pol-2014-9-en)

[2] **Jayne, T.S. and S. Rashid (2013)**: "Input subsidy programs in Sub-Saharan Africa: a synthesis of recent evidence", Agricultural Economics, Vol. 44, pp. 547-562.

[3] **CABFIN (World Bank, BMZ, GIZ, FAO, IFAD and UNCDF) (2011):** "Subsidies as an Instrument in Agricultural Finance: A Review".

give them a competitive advantage. Last but not least, subsidies may only be used for a limited time period[4].

A distinction needs to be made here between direct and indirect subsidies.

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Experience with subsidies in agricultural financing in developing and emerging countries shows that the most important element is the "how". Subsidies can only achieve the desired effects under certain conditions.

### Direct subsidies

Subsidies for operating costs, for example, fertilisers or seed programmes, or subsidies for energy costs are direct subsidies. Direct subsidies also include the one-off provision of pump systems when switching operations to irrigation, compensation payments for changing from conventional to organic farming, funding for business consultancy services for start-ups in the agricultural value chain or grants for efficient biogas installations. The goal of direct subsidies – unlike indirect subsidies in the agricultural sector – is unambiguous in most cases.

### Indirect subsidies

Indirect subsidies in the agricultural sector include tax concessions, input and product price supports and the establishment of financial sector institutions (e.g. banks, micro financing institutions, training centres, credit offices) to improve access to financial services for farms. Interest subsidies are also considered indirect subsidies.

### Interest subsidies

Interest subsidies are often justified by the fact that farmers in developing and emerging countries cannot afford loans at standard market terms and conditions – if a bank is even ready to grant loans to them. Interest-subsidised loans thus aim to lower interest payments and incentivise banks to increase the number of loans they grant to the agricultural sector over the long run. However, it has seldom been possible to achieve both goals at the same time.

Even if the farmer benefits from lower interest payments in the short term, many evaluations of agricultural credit programmes show that not only is little use made of them, but that they have often even caused damage[5]. KfW Development Bank's experience with subsidised agricultural credit programmes also shows: on average, only half of the loans granted under these programmes have been repaid. Apart from the lack of expertise among the partner banks, this was not least due to the fact that decisions made by the partner banks about whether to grant loans were also politically influenced.

In some cases, the poor track record for repayments continues long after these kinds of subsidy programmes end. This has weakened finance systems over the long term. These correlations are still cited today as one reason why commercial banks are reluctant when it comes to financing agriculture.[6]

### The right subsidies

There is no doubt that loans from the financial sector are needed to finance agricultural investments in addition to the farmers' own financial resources. If the degree of agricultural investment does not meet the expectations of policymakers, the reasons should be identified – this applies to both developing and emerging countries as well as countries with well-developed finance systems.

Countries with well-developed finance systems usually do not lack financing products for investments. If too little is invested, this is often the result of an unwillingness to invest. There is then less demand for investment loans. Interest subsidies have proven an effective way to increase companies' willingness to invest. In OECD countries, for instance, low-interest loans are successfully used to stimulate investment. KfW also uses these kinds of loans for climate protection and building modernisation[7].

In Germany, the Landwirtschaftliche Rentenbank in particular grants low-interest loans for the agricultural sector – in parallel to the implementation by AFP and EIF. Loans from KfW and the Landwirtschaftliche Rentenbank are not granted directly, but indirectly through banks and savings banks to

In countries with poorly developed finance systems, there is usually a willingness to invest but a lack of suitable investment financing available[8]. Loan requests from farmers can often

**Coffee picker in Kenya**

not be processed because banks in these countries do not have suitable financing products and capabilities to assess risks. Under these circumstances, interest subsidies are hardly

[4] **CABFIN (World Bank, BMZ, GIZ, FAO, IFAD and UNCDF) (2011):** "Subsidies as an Instrument in Agricultural Finance: A Review".

[5] **Adams, D. W. and J.D. von Pischke (1984)**: "Undermining Rural Development with Cheap Credit", Boulder, Colorado: Westview.
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[6] **Maurer, K. (2014)**: "Where is the Risk? Is Agricultural Banking really more difficult than other Sectors?", in Köhn (2014), pp. 139-165.

[7] **ZSW (2013)** "Evaluierung der inländischen KfW-Programme zur Förderung Erneuerbarer Energien im Jahr 2012", expert opinion commissioned by KfW Group, Stuttgart.
**IWU (2014)** "Monitoring der KfW-Programme 'Energieeffizient Sanieren' und 'Energieeffizient Bauen' 2012", expert opinion commissioned by KfW Group, Bremen.
**Prognos (2014)** "Evaluation des KfW-Programms 'Altersgerecht Umbauen', expert opinion commissioned by KfW Group, Basel.

[8] **Dalberg (2012)** "Catalyzing Smallholder Agricultural Finance"
http://dalberg.com/documents/Catalyzing_Smallholder_Ag_Finance.pdf

conducive to creating the range of financing products needed.

### Strengthening finance systems

The finance systems first need to be expanded in developing and emerging countries. The primary goal pursued with subsidies in these countries is creating access to suitable financial services for agricultural companies, i.e. developing the banks' capabilities to assess agricultural risks and adapt financial products to the needs of agricultural companies and farmers, thus expanding the range of investment financing.

Working on behalf of the German federal government, it is KfW Development Bank's job to build the capacity and infrastructure at institutions such as banks, micro financing institutions, insurance companies, central banks as well as financial, agricultural and other relevant ministries in developing and emerging countries. This is the only way to establish on the market financial services that are priorities in investment policy.

Subsidies from the financial sector do not, however, provide this support through interest subsidies, but through "institution building". Even though this model does not assure lower financing costs for farmers on a permanent basis, it has still shown lasting success.

Once effective financial institutions have been set up and demand for loans from the agricultural sector is still low, targeted interest subsidies can be used to stimulate investments.

### Promotion of alternative financing models

The development of the finance system will not, however, be immediately successful. Banks and micro financing institutions need time to develop farmers as a new customer group.

Until the financial system is able to provide suitable financing for farmers across-the-board, companies in the agricultural value chain and agricultural cooperatives can take on this role to some extent. Companies that work with small farmers on the basis of supply agreements (e.g. processing companies) or agricultural cooperatives that provide financing to their members are suited to this task.

### Interest subsidies outside of the financial sector

Developing the finance system over the long term and providing targeted investment support for innovative farms are not mutually exclusive. If policymakers are convinced that the standard market interest rates for investment loans in the agricultural sector are too high, the interest rate can be lowered for farmers without directly involving the financial sector in these kinds of aid programmes. For example, by giving grants to farmers if the investment is financed through a loan.

Well-functioning financial institutions must exist, however, to be able to provide loans. Otherwise, farmers have no other choice but to finance their investments with their own usually extremely limited resources or to rely on alternative sources of financing.

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**Photos**

p. 1, 2: KfW photo archive / photothek.net

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