CHAPTER SEVEN

RURAL FINANCE AND THE ROLE OF THE RURAL BANKING AND FINANCE CORPORATION

Introduction

This chapter concerns government intervention in the land use area and financial markets through the provision of concessionary loans to the rural sector and also through the ownership of a large financial institution, the Rural Banking and Finance Corporation (Rural Bank).

It is divided into five parts:

- Background
- Concessionary lending to the rural sector—the reasons for concessionary lending, concessionary lending as a form of assistance
- The Productive Development Loan Scheme which is scheduled to begin in October 1984
- The performance of the Rural Bank
- Summary and future directions

Background

a *Rural Bank*

i *History*

The Government first entered the field of mortgage finance in 1894 with the aim of providing loans at commercial interest rates and on stable terms and conditions to farmers for land development purposes. Later, advances were also made for housing. Both types of loan were provided through what eventually became known as the State Advances Department. The functions of this department were later taken over by the Mortgage Corporation, established in 1934/35, and half owned by the private sector. This however was replaced in 1936 by the State Advances Corporation (SAC). The Rural Bank was set up as a separate rural bank under the Rural Banking and Finance Corporation Act of 1974.

ii *Structure and Functions*

The board of the Rural Bank consists of a Chairman and four other directors who are appointed by the Minister of Finance. Two of the four other directors are appointed after consultation with Federated Farmers. The main functions of the Rural Bank, as set out in its Act, are to:

a make loans and provide other assistance, in its discretion, for farming purposes and other purposes in relation to primary industries and related service industries; and

b accept, in its discretion, deposits of money on such terms and conditions as the Minister of Finance specifies.

The administrative structure of the Rural Bank was formed from the rural division of the SAC, and both it and the Housing Corporation (HCNZ) have in many cases shared the same staff and other resources. In April 1984 Cabinet approved the administrative separation of the two organisations.

At 31 March 1984 the Rural Bank had assets of $2409 million. Of this $56 million represented equity in the form of reserve funds and property, while the remaining $2353 million consisted of debt, 94 percent of this owing to the Loans Account, with the other 6 percent in the form of farm vendor bonds, stock purchased earlier by the Post Office, and Rural Bank commercial stock.

iii *Relationship with Government*

The Rural Bank is a body corporate but, in practice, it has little more independence from the Government than most departments of state. Pursuant to the Rural Banking and Finance Corporation Act 1974, it is required to give effect to government policy as directed in writing (this provision is very rarely used) and to make any loan and to give any guarantee etc. that the Minister of Finance may specify. (It should be noted that under the Rural Bank Act the Minister of the Rural Bank is the Minister of Finance, while the Minister in Charge of the Rural Bank has hitherto been another Minister). The Minister of Finance's approval is also required to such things as the level of interest rates charged and the issuing of securities. Because of these controls, and because it is almost totally dependent on the Public Account for funding of mortgage advances, the Rural Bank has in practice little real commercial or operational independence of the Government.

In terms of the Public Finance Act 1977 money in the accounts of the Rural Bank is not deemed to be public money. However, the payment of money from the Public Account to the Rural Bank requires annual appropriation by Parliament. The annual level of lending by the Rural Bank is currently determined in the context of the Budget, and the Board of Directors has little influence over the outcome. The most recent trend, however, has been for the Minister in Charge of the Rural Bank to have the authority to determine, after consultation with the Board, how the total level of funding is to be apportioned between the various lending categories.

The Rural Bank does have more freedom than most departments in determining how its operating expenditure is spent. Also, it is only required to comply with a reduced number of specified Treasury Instructions. Surplus operating expenditure is treated as 'profit' and, after tax and transfers to reserves, it is returned to the Public Account. It is registered as a finance company.

Its staff is employed under the State Services Act 1962 and the State Services Commission has a level of involvement with it that is similar to the level which it has with most government departments.

iv *Funding of Lending*

Legislative provision is made for the Rural Bank to raise funds through the acceptance of deposits and through the issuing of securities. However, it is only during 1984 that it has actioned plans to raise a significant level of funds from the market. Up to now the main sources of funding of new lending have been loan repayments (principal only) and borrowings from the Loans Account which are not repaid. Table 1 shows the level of funding from these sources and of levels of overall lending in past years. It has been estimated that SAC and Rural Bank lending has increased between 1970 and 1983 by about 49 percent in real terms (AERU Discussion Paper No.82 Lincoln College refers).

TABLE 1

Rural Bank Funding and Lending Levels

Year Ended March	*Repayments ($m)*	*Loans Account drawings ($m)*	*Loan Authorisations* ($m)*	*Loans outstanding at at 31 March ($m)*
1975 ..	37	61	103	446
1976 ..	35	93	139	545
1977 ..	48	90	154	624
1978 ..	59	150	228	752
1979 ..	65	183	293	939
1980 ..	86	208	307	1,153
1981 ..	114	246	370	1,395
1982 ..	150	334	466	1,695
1983 ..	150	287	443	2,023
1984 ..	167	251	390	2,275

* Excludes authorisations under the tax option of the Livestock Incentive Scheme and includes authorisations under schemes funded by other government agencies but administered by the Rural Bank.

The Rural Bank offered its first issue of stock to the public in February 1984. The $25 million raised by this issue is being on-lent at interest rates that should enable it to 'cover costs'. The funds are being lent mainly to rural industrial activities, and have not in general been used to reduce its Loans Account drawings In May 1984 it opened its second issue of $50 million. It has yet to be finally decided whether or not the $50 million from the second issue will be used in place of Loans Account drawings to fund its regular lending activities. Pursuant to its Act, all securities issued by it are government guaranteed. Also the farming investment segment of the government securities ratio applying to insurance companies and superannuation funds can now be met by investment in securities issued by the Rural Bank.

v *Types of Lending*

Most of its lending is on a longer-term basis and only a very small amount of seasonal finance is made available. For instance, the results of a 1983 survey of farmers showed that 78 percent of Rural Bank mortgages issued were for ten years or more, 18 percent for three to ten years and only 4 percent were for less than three years (AERU Research Report No.152, Lincoln College refers).

The Rural Bank's lending can be split into two groups:

- lending under its regular lending categories (the bulk of lending falls within this group); and
- lending under special schemes.

Regular Lending Categories

Table 2 shows the activities for which the Rural Bank authorised loans in 1983/84. About 75 percent of this lending is for settlement and development.

Special Schemes

The Rural Bank has recently administered four limited period lending schemes on behalf of the Government. The Livestock Incentive Scheme (LIS) was introduced in 1976, and the Land Development Encouragement Loan Scheme (LDEL), was introduced in 1978. Together the two schemes involved total loan authorisations of $280 million, while an additional $16.6 million was authorised under the tax option of the LIS. The Sheepfarmers' Consolidated Loan Scheme, introduced in 1982, and the Development Consolidation Loan Scheme, introduced in 1981, were aimed mainly at assisting certain groups of farmers who had undertaken development programmes. These latter two schemes involved total authorisations of about $70 million.

In June of this year the Government announced the introduction of the Productive Development Loan Scheme aimed at increasing the productivity of development already completed. This scheme is further discussed later in this chapter.

The Rural Bank also administers a number of ongoing smaller assistance schemes, mainly on behalf of other departments, particularly the Ministry of Agriculture and Fisheries (MAF). These schemes generally involve suspensory loans, while others are concerned with special saving arrangements or incentives for farm vendors to offer finance to the farm purchaser. It will also, under the Rural Mortgage Guarantee scheme, protect lenders to farmers against loss of principal and some interest income. A fee is charged for this service.

b *Other Government Organisations Providing Concessionary Finance to the Rural Sector*

In addition to funding almost all of the Rural Bank's lending activities, the Government provides finance for lending to the rural sector through the Departments of Maori Affairs and Lands and Survey. At 31 March 1984, advances outstanding to the rural sector from the Rural Bank, Maori Affairs and Lands and Survey totalled about $2.6 billion. Of this, Rural Bank advances outstanding comprised about 89 percent, Maori Affairs loans, about 3 percent, and Lands and Survey, about 8 percent.

The Maori Affairs Department presently lends about $9.5 million a year, mainly for development of Maori-owned land. Most of the Department of Lands and Survey rural lending is for the purchase and further development of land that has been developed by the department. Generally, after an initial period of establishment, the loans to purchasers of Lands and Survey farms are bought by the Rural Bank.

c *Interest Rate Levels on Government Funded Lending to the Rural Sector*

For many years interest rates on all government loans to the rural sector were subsidised. However, in 1971 interest rates on certain classes of loans (involving apparently about 30–40 percent of the Rural Bank's new lending) were raised to market levels. It appears that this was due to concern over the decline in farm investment by private lenders.

The report of the 1972 Committee of Inquiry on Lending to Farmers had recommended that all government loans to farmers should be at market rates of interest to retain the balance of lending funds between non-Government and Government sources. However, since the early 1970s the gap between the interest rates on government-funded loans and market interest rates has gradually widened as market rates have steadily increased, and

TABLE 2

Rural Bank Loan Authorisations 1983/84

Type of Loan	*Number*	*Total ($m)*	*Average Loan ($)*	*Term Offered[1] (Years)*	*Interest Rate from August 1983 (%)*
Farm Settlement— ..			)		mainly 7.5 remainder 9.5
Standard and Special					
— Sheep	328	54.6	166,500)		
— Dairy	286	40.0	139,900)	10–25	
— Other	71	6.5	91,500)		
Farm Workers' Holdings	240	14.2	59,200)		
Additional Land ..	223	17.3	77,600)		
Total Settlement ..	1,148	132.6	115,500		
Development— ..					mainly 7.5 remainder 9.5
— Land Improvements	2,479	25.2	10,200)		
— Farm Buildings & Houses	2,747	67.3	24,500)	3–20	
— Extra Stock & Plant..	377	3.9	10,300)		
— Irrigation/Drainage ..	242	6.5	26,900)		
— Irrigation Interest Deferred	772	28.9	37,400)		
— Sundry	2,174	27.3	12,600)		
Total Development ..	5,962[2]	159.0	26,700		
Stock (to Landless Farmers)	1,144	33.8	29,500	5	7.5
Climatic Relief ..	1,351	26.2	19,400	5–20	7.5[6]
Refinance	82	2.4	29,300	10–20	9.5
Estate Duty	15	0.8	53,300	10–20	9.5
Purchase of Lands & Survey Loans	28	2.4	85,700	25[3]	7.5
Plant & Machinery[4] ..				3–10	11.0
Rural Industrial ..	568	30.3	53,300	5–15	11.0
Fishing				5–15	7.5 & 11.0
TOTAL	10,298	387.7[5]	37,600		
Agency Lending e.g. Irrigation Suspensory Loans	259	2.7	10,400	variable	mostly 7.5

Notes:

[1] The Rural Bank advises that the repayment term offered for each loan depends mainly on the ability of the client to repay.

[2] The numbers of authorisations for each type of development do not sum to the total as a loan to one applicant may involve loans for several different types of development.

[3] When the loan is initially advanced by Lands and Survey it is generally for a 25 year term.

[4] Almost all plant and machinery loans authorised in 1984/85 are being funded from the Rural Bank's commercial funds and will generally not be on the terms shown above.

[5] Due to rounding this column does not add to the total shown.

[6] There is provision to lend at 6 percent but this is not often used.

there have only been a few small upward adjustments in the rates on government loans. It appears that the increase in subsidisation in most cases arose not so much from specific policy decisions to increase the level of subsidisation but rather from simply not reviewing interest rates upwards.

In 1983 the Cabinet approved a new interest rate structure for the Rural Bank. This involved the Rural Bank setting a base interest rate comparable with market rates, but with the ability to give rebates of up to 5 percent (this rebate would be reduced by the equivalent of 1 percent per annum until the designated rate was reached) and also to charge rates up to 2 percent above the base rate. The new structure was to have been implemented when the Financial Services Regulations were lifted. Instead, in early August 1983, the interest rates charged by the Rural Bank were reduced to their current levels (refer Table 2). At that time the interest rates on lending by the Departments of Lands and Survey and Maori Affairs were also reduced to their current levels. The interest rate paid by the Rural Bank on its new drawings from the Loans Account was reduced at the same time from 8.5 to 8.0 percent.

d *Government Policies Concerning Rural Sector Finance Other Than the Provision of Credit*

Besides providing funds for government organisations to lend directly to the rural sector, the Government is able to influence the availability and cost of rural credit in other ways, including:

— different forms of assistance of which the most important in recent years has been the SMP scheme which has tended to reduce the credit demands of farmers and to improve their debt-servicing ability;

- the requirement that part of the government securities ratios of the Life Insurance Offices be met by investments in farming or housing. Private superannuation funds may meet part of their government securities ratio in this way;
- credit guidelines requesting trading banks to give finance for exporters the highest priority;
- Reserve Bank lending to some of the Producer Boards;
- various methods used to directly control the money supply;
- regulations controlling interest rates; and
- taxation measures.

e *The Supply of Rural Credit*

Table 3 shows the main groups lending to the farming sector and an estimate of the share of this lending held by each group of suppliers at the end of 1982/83. The Government is estimated to hold a 40.6 percent share of total lending, a 57.9 percent share of long-term lending, a 29.5 percent share of medium term lending and a 7.6 percent share of short-term lending. As can be seen, the Government dominates the area of long-term lending. The only other significant lenders in this area are the insurance companies and family lenders. Medium- and short-term lending is shown to be more widely distributed, with lenders of any significance in addition to those mentioned above being the trading banks, solicitors' trust funds, private sources, stock and station agents and finance companies.

It has been estimated that, for those private sector institutions for which data are available, agriculture's share of borrowing by the private sector declined from 22 percent in 1970 to 13 percent in 1982 (AERU Discussion Paper No.82, Lincoln College refers). This decline in the share of private sector institutional finance going to the agricultural sector appears to be due, among other things, to a tendency for the large amounts of finance offered through government institutions at concessionary interest rates to crowd out the private sector institutions.

f *Some Factors Affecting the Level of Farm Borrowing*

In general, it appears that over the last five years or so farmers' equity has been increasing as a percentage of total assets. (With stable and, in some cases falling, land prices, this trend may have reversed in the last year or

TABLE 3

Distribution of Farmers' Total Liabilities at the End of the 1982/83 Financial Year (percent)

Source	*Share of Total Lending*	*Share of Long-Term Lending*	*Share of Medium-Term Lending*	*Share of Short-Term Lending*
Rural Bank	36.27	51.47	26.78	6.72
Other Government ..	4.36	6.38	2.74	0.89
Trustee Savings Banks ..	2.90	3.81	2.34	1.12
Trading Banks	8.47	1.20	12.89	22.71
Building Societies ..	0.55	0.70	0.38	0.39
Insurance Companies ..	9.94	12.61	8.89	4.02
Stock and Station Agents ..	2.70	0.45	1.40	10.29
Trust Companies ..	2.67	1.30	4.87	3.77
Solicitors Trustee Funds ..	6.74	0.96	8.47	20.29
Family	15.49	18.05	14.18	10.20
Private Sources	5.11	0.82	12.10	8.38
Local Bodies	0.76	1.06	0.60	0.13
Finance Companies ..	2.33	0.13	2.44	8.14
Dairy Companies ..	0.46	0.21	0.57	1.11
Private Savings Banks ..	0.27	0.25	0.18	0.44
Others	0.98	0.60	1.17	1.40
TOTAL	100.00	100.00	100.00	100.00

Notes:
[1] Long term — over 10 years
Medium term — 3-10 years
Short term — under 3 years
[2] The survey included only farms of 20ha or more
Source: AERU Research Report No.152, Lincoln College

so.) The main reasons why farmers have not borrowed more appears to be low farm output price expectations and, for those willing to borrow, difficulties in generating the cash flow to service the debt. The current uncertainty in the rural property market and the taxation changes announced in the 1982 Budget are probably also responsible at present for lower levels of borrowing for investment in farmland. A recent survey of farmers (AERU Research Report No.136, Lincoln College refers) found that of those surveyed only a small percentage gave refusal by lending institutions as a reason for not borrowing more money in 1981/82. Regulations imposed in the last year restricting interest rate levels and lending growth may have altered this situation.

Concessionary Lending to the Rural Sector

a *Introduction*

At present lending to the rural sector by the Rural Bank and Departments of Lands and Survey and Maori Affairs is highly subsidised. Most of the Rural Bank's new lending to the rural sector is at an interest rate of 7.5 percent and the average rate on all loans outstanding to that sector is probably around 8.5 percent. Most new lending by Maori Affairs and Lands and Survey is also at 7.5 percent. By contrast, the average rate of interest on new mortgages, excluding those from government agencies, registered in April 1984, the latest month for which statistics are available, was 13.1 percent. The weighted average of the trading bank term loan interest rates for the six months to March 1984 was 15.3 percent.

Of the estimated $839 million of assistance received by the pastoral sector in 1983/84, $95 million is estimated to have come from concessionary lending by the Rural Bank, Lands and Survey and Maori Affairs. The value of the concession received by each loan recipient varies considerably depending on the repayment terms of the loan, the expected period over which the loan will be used, and the difference between the subsidised interest rate and the rate that would have to be paid on the open market for the same type of loan. In addition many of the smaller assistance schemes operated by the Rural Bank involve special elements, such as suspensory loans, which further vary the value of assistance received.

Several different reasons are given to justify the Government's current concessionary lending policies. The rest of this section examines some of these reasons and looks at some of the problems that arise from the current concessionary lending policies. The following discussion and conclusions apply equally to the policies of Maori Affairs and Lands and Survey as well as to the Rural Bank. Any changes to the Rural Bank's interest rate policies should be accompanied by similar changes to the policies of these two departments.

b *Concessionary Interest Rates on Lending to the Agricultural Sector*

i *To Offset the Costs Imposed on the Agricultural Sector*

Interest rate subsidies to some parts of the agricultural sector can be justified as one of many means of offsetting cost disadvantages imposed by the assistance structure elsewhere in the economy. There are, however, a number of problems with using the Government's concessionary interest rate policies as a form of assistance. These are discussed below.

— They encourage distortions in resource use through assistance disparities:

- within product groups in the agricultural sector. Not all producers within a group receive a subsidy or the same subsidy on the use of finance. This means that inefficient farmers may be encouraged to expand their activities at the expense of efficient ones, particularly as the criteria used to ration finance are often not necessarily related to the ability to use resources efficiently, e.g. preference is often given by the Rural Bank to owner/occupiers, and not to those in financially strong positions;

- between different product groups in the agricultural and forestry sector groups. The Rural Bank advises that it will lend for all types of farming. It does not, however, lend for forestry activities which also use New Zealand's land resources. Also it has traditionally lent to the pastoral industries and tends to have lending policies specifically designed to meet their needs. An example was the Livestock Incentive Scheme which was aimed only at the pastoral industries. These assistance disparities between product groups may result in a movement of resources away from more efficient product groups; and

- between applicants. The concessionary nature of Rural Bank finance results in excess demand for its funds and the need to ration funds by means of administrative criteria. Rural Bank settlement financing involves substantial transfers of funds to administratively selected applicants. The criteria for successful application may not in fact be those required for economic efficiency.

— They tend to retard adjustment to changing external market and domestic conditions because concessionary loans are generally provided to individual producers and groups of producers on the basis of need. For instance the Rural Bank, Maori Affairs and Lands and Survey do not generally lend on a concessionary basis to those in strong financial positions.

— Some lending policies, in particular special schemes such as LDEL, involve high administrative costs and increase the cost of providing assistance.

— Private sector lending institutions are discriminated against in that interest concessions are only available on credit provided through the Rural Bank, Maori Affairs, and Lands and Survey. This means that market processes can not be used to monitor the efficiency with which government agencies deliver credit. It is possible therefore that lending is being diverted from more efficient to less efficient channels. Another result of limiting the delivery of concessional credit to government agencies is the likely crowding out of private sector financial institutions from the rural credit market.

— The concessionary interest rates offered on settlement loans appear to have resulted in upward pressure on land prices. All assistance to farming (especially SMPs) will, to some extent, increase the demand for farming inputs, including land. Because the supply of land is relatively fixed, any increase in demand generally results in an increase in prices. It has been estimated that in the period from 1970 to 1982 the annual increase on a compounded basis in the farmland price index was 18.2 percent, while annual increases in the consumer price index averaged 12.9 percent. (AERU Discussion Paper No.82, Lincoln College refers.) Since 1982 farm prices overall have stabilised in real terms. It is difficult to determine the part played by the Government's concessionary lending in the recent large land price increases. However it is likely that this part is significant, given the proportion of total farm sales that the Rural Bank is involved in each year and the high level of assistance given to the recipients of its settlement loans.

The effects of rapidly increasing land prices are that:

- established farmers tend to be enriched with tax-free capital gains;
- encouragement is given to farm the land for capital gains rather than for increasing income through productivity improvements; and
- there is an increase in the level of funds needed to enable people to purchase farms (this generally means increased debt servicing without an increase in farm returns to service the debt) and a decrease in the rate of return on capital for many land-based activities.

ii *To Correct for Market Failures*

It is sometimes asserted that credit markets may fail to yield optimal levels of investment in certain areas due to attitudes towards risk and the time period over which they require activities to provide returns. In such cases, it is argued, society should intervene, for instance through concessionary lending, to correct this sub-optimal behaviour.

The two areas in the field of lending to farmers where market failure is often alleged to occur are the provision of longer-term finance (more than five years say) and lending for stock to landless farmers. It is argued that these market failures are justification for the provision of finance at concessionary rates, i.e. rates less than those the market would charge in these areas.

— *Provision of Longer Term Finance*

The large initial investment required for the purchase of a farm coupled with the low rates of return on investment in many farming activities mean that the purchase of many types of farms is an investment which can not be paid off over a short period. Hence, farm purchasers require long-term loans (as have traditionally been used), or short-term loans on a flat basis, or a high level of equity. The same also applies, though to a lesser extent, to financing many farm development activities. The problem is, however, probably not so much a failure of the capital markets, but rather an inability of many farming activities to yield high enough returns to cover market rates of interest on loans for the purchase of land or for land development. If land prices increase without any increase in income from the land then even lower interest rates are needed to sustain viability. Thus the problem is not so much non-availability of long-term loans due to a 'market failure' but that farmers are not prepared, or are not in a position, to pay high enough interest rates to ensure availability.

As noted earlier it has been estimated that the Government provides 57.9 percent of all long-term lending (more than ten years) to farms and 29.5 percent of all medium-term lending (between three and ten years). The dominance of the Government in the provision of longer-term lending does not, however, necessarily indicate market failure. It is in fact more likely that the very competitive terms offered by the Government have resulted in the crowding out of private sector institutions. Nor does the fact that there is not enough longer-term finance available at the interest rates that farmers (or other borrowers) would like imply a market failure.

Investors have in recent years preferred shorter-term securities, probably mainly due to increased uncertainty over future interest and inflation rates. Significantly higher interest rates are now required to attract investors to longer term securities and they raise the cost of finance for projects which have a low rate of return and a large initial capital input. These problems can be overcome or reduced by indexation of contracts, shorter term loans, and review clauses. However, if the benefits of intervention can be shown to outweigh the costs then intervention is justified. We are not persuaded that the case for intervention has been made. We understand that recently there has in fact been a trend towards increased provision of short term loans on a flat basis. This we consider to be a rational reaction by the market to meet the demand for longer term finance and also to accommodate the preference of the market towards shorter term securities. Financial and equity markets continue to show themselves to be quite capable of marshalling large sums for profitable long-term investment projects.

— *Lending to Landless Farmers for the Purchase of Stock*

The reluctance, for security reasons, of the private sector to lend to landless farmers at low interest rates for the purchase of stock is often given as a major reason for the Rural Bank meeting most of the borrowing needs in this area, about $34 million in 1983/84. However, this does not appear to be a case of market failure. Lending to landless farmers for the purchase of stock is actually riskier than many other types of lending. Often the stock are the only security: the value of the stock can quickly drop and the stock cannot be insured. We understand that trading banks, for instance, will lend for the purchase of stock, but at a higher than usual rate of interest to reflect the risk involved. This is a rational reaction to cover the higher risk. We conclude that allegations of market failure in this area are not convincing and that the costs of intervention through Rural Bank lending would appear to outweigh the benefits.

iii *Arguments Concerned with Settling of Young Farmers*

It is often claimed that it is in the national interest to get more young farmers onto the land, and concessionary settlement loans and/or stock loans for landless farmers are seen as a convenient way of achieving this. The benefits of settling more young farmers on farms are often not stated explicitly. However, it seems that the perceived benefits include increases in efficiency, giving young farmers the access to farm ownership that they are 'entitled' to, and a notion that society as a whole derives some benefit from a certain number of young farmers each year settling on a farm or having access to farm ownership. The same assumptions do not seem to be made, however, in respect of assistance to most other sectors of the economy where small businesses operate.

The question arises whether there are, in fact, any impediments in the financial market which prevent young farmers from getting onto the land. Certainly young farmers will generally lack equity and collateral. However, this is also the case for many other young entrepreneurs in commercial areas other than farming. It is very doubtful whether a case can in fact be made that able young farmers are prevented from obtaining capital by market failure e.g. that banks and other lending institutions only lend to those who do not 'need' money. Rather the position seems to be that the Rural Bank has such a dominant position in the settlement market (see Table 3), by virtue of its ability to lend at concessionary interest rates, that other financial institutions are effectively squeezed out. But for this fact, private sector institutions would presumably assess applicants for farm finance by the same sort of commercial criteria as they apply to applicants for finance for other purposes e.g. small businesses in other sectors.

Our conclusion is that there are no economic grounds for assisting young farmers any more than young businessmen in any other field of entrepreneurial activity. Providing concessional finance gives substantial advantages to a relatively few fortunate individuals. The preferred route is to improve the rural finance market. This requires the Rural Bank to operate at market (and not concessional) rates, thus allowing private sector institutions to compete on equal terms, to improve their performance in this area and to improve the overall efficiency of intermediation.

iv *Summary*

To summarise, we consider that policies of concessionary lending to the farming sector can only be justified on general economic grounds if they are an economically efficient means of providing assistance to the agricultural sector to offset cost disadvantages caused by structural problems elsewhere in the economy. Arguments in favour of special groups such as young farmers are essentially non-economic.

The current interest rate concessions are, however, a particularly bad way of providing assistance. They do not result in an even 'spread' of assistance across the sector. Also they place upward pressure on land prices, and may not encourage lending to be channelled through the most efficient financial institutions to the most efficient farmers.

If it is not possible to reduce significantly this form of assistance, then we consider it is important that changes are made to improve the efficiency with which the concession is delivered. For instance, the concession should be available on finance from all lenders so that the way the concession is delivered does not distort borrowers' choices between different sources of finance.

iii *Rural Bank Lending to the Fishing Sector*

The Rural Bank's lending to the fishing sector at interest rates of 7.5 and 11.0 percent is also concessionary. In general, the conclusions reached in the preceding paragraphs on the reasons for, and desirability of, lending to the farming sector also apply to its concessionary lending to the fishing sector. Moreover, where the fish catch is not limited by quotas, concessionary lending tends to increase the problem of over-fishing.

The Productive Development Loan Scheme

a *Outline of Scheme*

In June of this year the Government announced a special concessionary lending scheme, the Productive Development Loan Scheme (PDL) for introduction later this year. If it proceeds, it will be administered by the Rural Bank and is intended to maximise the productivity of development already completed. Under the scheme $150 million of loans will be authorised over a two and a half year period starting from October 1984. Authorisations under the Rural Bank's standard development lending category will be reduced by $75 million over the same period, so that the scheme will involve a net increase in Rural Bank lending of $75 million over the next four financial years.

Essentially the scheme provides that interest on loans approved under the scheme will be capitalised at 7.5 percent per annum for the first three years. The principal will be payable during the fourth to thirteenth years at the then appropriate rate of interest payable on Rural Bank loans. A similar type of arrangement applies to loans for on-farm irrigation made under the irrigation lending policy which was implemented in November 1982. The PDL scheme will cover agricultural, pastoral and horticultural propositions.

b *The Desirability of Introducing the PDL Scheme*

Given that the PDL loans would commit resources to agricultural development that might otherwise have been invested elsewhere in the economy, the scheme should be subject to the same economic analysis and rate of return criterion that applies to other government investments. However very little economic analysis has been done on the costs and benefits of the scheme. The analysis Treasury has conducted on the basis of information supplied by the Rural Bank indicates that the activity generated as a result of investments funded by the scheme could yield rates of return to the nation well below the 10 percent guideline on most plausible assumptions. The analysis is necessarily somewhat imprecise. It does, however, indicate that proceeding with the scheme would encourage some investment that would result in a use of resources inferior to alternative uses in other sectors. On this basis we consider the scheme should not be implemented.

We also do not support the scheme from the point of view of current assistance reform. The scheme was decided on in response to falling levels of farm development and concern that, in some areas, past development was not being maintained, and that this may eventually be at the expense of previous gains made under the LIS and LDEL schemes. In other words the scheme aims to increase assistance in response to lower investment and income levels in the agricultural sector. We do not consider increases in assistance levels are an appropriate response to decreases in industry investment and income in the agricultural, or in any other sector, except as part of a predetermined adjustment process. Such increases tend to impede the adaptation of resource use to changing economic circumstances. As well as this, the form of assistance provided under this scheme is undesirable in that it will be limited to certain categories of investors, to a limited range of activities, and to only specified inputs, and so will bias investment decisions within the agricultural sector.

We also question the wisdom of introducing any scheme that is aimed, in large measure, at increasing the production of traditional farm products at a time when farmers are unwilling to make investments on a normal commercial basis, and when some of the product prices are currently substantially subsidised. Finally, we add that the introduction of this scheme would hinder any plans to move the Rural Bank in the near future onto a basis that is as comparable as possible with its private sector counterparts.

c *Conclusion*

We consider the scheme should not be introduced unless it is shown that it is likely to contribute to the overall level of national welfare. Preliminary economic analysis and the other factors noted above suggest it would instead reduce national welfare. For these reasons and on account of the high level of resources involved, we consider that the scheme should not proceed.

The Performance of the Rural Bank

a *Size of Rural Bank*

At 31 March 1984 total Rural Bank assets equalled about $2.4 billion or about 40 percent of the assets of the Bank of New Zealand. In terms of total advances outstanding, the Rural Bank is the largest financial institution apart from the BNZ. Total Rural Bank advances at 31 March 1984 equalled about $2.3 billion which at that time was about one third of all trading bank advances (overdrafts and term lending), or about 80 percent of advances by the twelve largest finance companies. Further data on the Rural Bank's share of the rural finance market are given in Table 3. It should be noted, however, that due to the long term of most its lending, at present only about 7 percent of total Rural Bank advances outstanding turnover each year.

b *The Performance of the Rural Bank*

Given the size of the Rural Bank, particular attention should be paid to the efficiency with which it operates. This is not easy insofar as there are no benchmarks against which its performance can be measured. The performance of private sector counterparts cannot be used as the Rural Bank is not established on comparable terms. It receives a different level of assistance and it does not report its results on the same basis.

Competition is a very effective means of ensuring that managers are performing efficiently. The Rural Bank, however, is not subject to competition as (apart from mainly Maori Affairs and Lands and Survey) only it offers government subsidised finance to the rural sector, and hence no private sector financial institution is able to compete with the terms it offers. This lack of competition means incentives are reduced for the Rural Bank to perform as efficiently as its private sector counterparts.

Even on lending under its commercial division, the Rural Bank is able to offer more attractive terms than its counterparts due to special advantages it enjoys. It has, for example, lower fund raising costs resulting mainly from the government guarantee on its private sector borrowings and the government security ratio requirements. The more attractive terms lead to ever increasing demand for its lending. As its lending increases, it tends to crowd out private sector competitors and discourages potential new entrants to the rural finance industry. In addition, its under-pricing of finance could artificially induce the expansion of the farming industry as a whole. This would inevitably draw resources from other areas of the economy, and implies an efficiency loss through the misallocation of resources.

c *Government Owned Trading Enterprises : Some Guidelines*

The problems noted above are similar to those encountered with other government owned enterprises as discussed in Chapter 13 of Part Two of Treasury's post-election brief 'Economic Management', and referred to briefly in Chapter 2 of this volume. These problems can be eliminated or reduced, and substantial improvements made in the contribution of this government owned trading enterprise to the economy, if the enterprise were to function under similar competitive conditions to private sector counterparts. This approach involves to a greater or lesser extent, depending on the Rural Bank's current position on the particular points, the application of the following:

- determining whether any non-commercial objectives given to the enterprise can be better achieved by some other means. If these objectives are to remain with the enterprise they should be commercialised, for instance by the Government paying a subsidy to cover any extra cost involved in attaining the objective;

- removing existing advantages and disadvantages including differences in funding and capital structure, and regulatory positions. In particular, the enterprise should have a commercial capital structure including both debt and equity, should pay income and other taxes, and should have an overall cost of capital and debt/equity ratio conforming with that of private firms in the same industry and market risk class;

- setting clear measurable targets based on private sector norms of profitability so that the performance of the enterprise can be compared with the performance of similar enterprises in the private sector;

- establishing a corporate plan to translate the targets into performance criteria;

- introducing information systems so that performance can be assessed; and

- highlighting accountability so that managers have the incentive to strive to meet the targets. This could be achieved by the regular reporting of actual performance against targets to Ministers, to the Public Expenditure Committee, and to the public.

This approach implies a shift over time from the current control framework, which is primarily based on the need to control government expenditure, to one which is more flexible and sympathetic to commercial objectives, requirements and modes of operation. It would be inconsistent to expect government enterprises to behave commercially and achieve commercial rates of return while they are subject to additional restraints associated with government ownership. Accordingly, traditional input controls and limits to activity should be gradually reduced. Most would eventually be replaced by enhanced internal planning and management procedures, coupled with external monitoring based on performance.

Summary and Future Directions

In summary, our conclusions from the above discussion are:

- concessionary credit is a very undesirable way of delivering assistance because of the distortions that result in resource allocation. These adverse effects are compounded by the 'crowding-out' effect on private sector institutions, and upward pressure on land prices;
- concessionary lending involves a transfer of substantial benefit to administratively selected individuals. The cost of entry to farming is raised as applicants seek to acquire the necessary qualifications;
- there is no persuasive evidence to indicate that private sector capital markets could not meet the financial needs of the agricultural sector;
- if special measures are required to assist young farmers, then more efficient methods of assistance should be used than the present policy of providing concessionary finance. This would involve using a wide range of financial institutions and not just the Rural Bank and other government institutions;
- the Productive Development Loan Scheme would involve the investment of considerable resources, the return on which could be very low. We consider that the scheme should not be introduced;
- early attention needs to be given to increasing the commercial orientation of the Rural Bank and providing improved methods of monitoring its performance as a major financial organisation. The closer the Rural Bank's operating environment moves to that of its private sector counterparts the more incentive there will be for it to perform and the easier it will be to monitor performance; and
- the Rural Bank should, as an essential part of increasing commercial orientation, raise most, if not all, its funds on the private capital markets.

As regards future directions of the Rural Bank, we are most concerned that it becomes, increasingly, a commercial entity operating in the financial markets as far as possible under the same conditions as its private sector counterparts. This will reduce the concessionality of its lending, and thus improve the efficiency of resource allocation. It would also involve a very substantial and desirable reduction in the fiscal deficit. Further, it would impose the disciplines of the market on it, providing both an inbuilt incentive to improve performance and measures by which performance can be more readily monitored. An essential component is that the Rural Bank raises most, if not all, of its funds on the capital market. Movement in this direction would not preclude using the Rural Bank (along with private sector financial institutions) as a supplier of special rural finance schemes which the Government wishes to retain or to introduce.