Decentralization of Agricultural Services

Decentralization of Rural Financial Services
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by

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for the

Food and Agriculture Organization of the United Nations, FAO

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Table of Contents

1 Summary ................................................................. 1
2 Introduction............................................................... 1
3 Characteristics of rural financial markets......................... 2
  3.1 Nature of rural financial services............................... 2
  3.2 Effective demand .................................................. 3
  3.3 Supply of rural financial services .............................. 4
4 Past failures and new vision of rural finance ..................... 6
5 Conceptual framework for decentralization ....................... 7
  5.1 Main approaches to decentralization ......................... 7
  5.2 Principles of service provision .................................. 8
6 Policy implications ..................................................... 9
  6.1 Assessing decentralization options ............................ 9
    6.1.1 Deconcentration and devolution .......................... 9
    6.1.2 Privatization of government owned agricultural banks ....... 10
    6.1.3 Liberalizing the formal financial market .................. 10
    6.1.4 Fostering rural microfinance institutions .................. 10
  6.2 Government roles and responsibilities ....................... 11
7 Readers' notes ........................................................ 13
  7.1 Easypol links ........................................................ 13
8 References and further reading .................................... 13
Module metadata ................................................................ 134
1 SUMMARY

This module first examines the characteristics of rural financial services, including demand and supply factors in rural financial markets. It draws attention to past failures of centralized and directed rural credit services, and the emergence of a new broader vision of rural financial services, based on liberal economics and decentralization policies. The conceptual framework for reform of rural financial services is discussed, and important principles of decentralization reiterated.

Policy implications, in terms of options for decentralization, and the roles and responsibilities of the government are next examined. Various options which might be considered under deconcentration, devolution, and diversification of ownership of financial institutions, through privatization and other means, are reviewed. The importance of providing an enabling environment, including the legislative and regulatory framework, and facilitating growth and development of new financial institutions are also discussed.

2 INTRODUCTION

Objectives

This module focuses on the decentralization of rural financial services, within the ambit of sub-sector service delivery\(^1\). It draws examines the economic reasons for government interventions in rural credit and finance, including misconceptions which shaped credit policies in the past. Attention is drawn to the paradigm shift in rural financial services, including the wider role these could play in meeting livelihood needs and strategies of rural people, rather than focusing narrowly on credit provision for crop production or simply as a means of compensating for economic distortions.

Options for decentralization of financial service, through reforming existing government financial institutions, and diversifying ownership of these institutions are also examined. As with many other types of agricultural services, the message here is that there can be no single prescription as to what constitutes the most appropriate form of decentralization. The importance of government support in policy setting, and provision of a legislative and regulatory framework is also highlighted. Issues discussed have applicability in a range of other training contexts, including those on rural development strategies, local and regional development, and in poverty reduction strategies.

Target audience

This module is intended for a wide audience, ranging from policy analysts and decision makers, to development practitioners, training institutions, and media. It is of particular relevance to senior and mid level officials and professional officers in ministries of

\(^1\) An overview of the main issues relating to policy decisions on whether and how to decentralize agricultural services is given in the EASYPol Module 013: Decentralization and Agricultural Development: Decentralization of Agricultural Services.
agriculture, livestock, forestry, rural development, and cooperatives, including line departments and training institutes/units. It should also be of particular interest to senior executives of parastatals, financial institutions, and NGOs/CBOs. Suitably adapted, it may also be used as a reader in undergraduate courses in development.

**Required background**

No specific technical background, beyond reasonable language skills, is required for this module. However, it is anticipated that individuals with a degree in economics, and agricultural or rural development related areas, and those with several years of experience in agricultural policy analysis or development planning and implementation, at a mid to senior level position, should have little difficulty in grasping the module’s content.

To find relevant materials in these areas, the reader can follow this links included in the text to other EASYPol modules or references².

### 3 CHARACTERISTICS OF RURAL FINANCIAL MARKETS

#### 3.1 Nature of rural financial services

Broadly speaking, financial services, through loans and savings, allow uneven income and expenditure streams to be smoothed out over time. Credit provision is a private good as it is excludable and rivalrous, in common with some agricultural services like provision farm inputs. However, it differs from other agricultural services in one respect: a loan involves an exchange of access to resources now for an undertaking to repay at some future date. In effect, a property right in current consumption is exchanged for a property right in future consumption. From the lender’s point of view this involves certain risks, namely, that the borrower may be unable to repay (the use made of the funds is less productive than anticipated, due perhaps to unfavourable weather or lower market prices³), or is unwilling to repay (opportunistic behaviour due to asymmetric information).

Overall, the lending activity entails⁴:

- Exchange of consumption today for consumption in a latter period
- Protection against default risk.

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² EASYPol hyperlinks are shown in blue, as follows:
- training paths are shown in underlined bold;
- other EASYPol modules or complementary EASYPol materials are in bold underlined italics;
- links to the glossary are in bold; and
- external links are in italics

³ It is important to appreciate that the borrower also faces a variety of risks in a credit transaction.

⁴ Hoff and Stiglitz (1993).
• Information acquisition regarding characteristics of loan applicants (the screening problem).
• Measures to ensure that borrowers take those actions that make repayment more likely (the incentives problem).
• Actions to increase the likelihood of repayment by borrowers who are able to do so (the enforcement problem).

The risk of non-repayment means that the private sector is usually unwilling to provide credit unless collateral\(^5\) is available or the lender has particular ties to the borrower. The high transaction costs associated with imperfect information (search, monitoring and enforcement) and risks increase the costs of credit transactions and lower the effective demand. For credit providers, the transaction costs of servicing rural areas compared to urban areas are higher, due to the dispersed nature of rural populations.

In principle, the government should be a more willing lender than the private sector as it is less risk-averse and has greater powers of coercion and hence ability to obtain repayment. However, it is generally disadvantaged relative to the private sector in terms of local knowledge and loyalty from borrowers, leaving it exposed to an adverse selection\(^6\) problem and unwillingness by borrowers to repay loans.

In most developing countries, rural populations are inherently more difficult to provide with financial services than urban populations. Small loan sizes, low literacy rates, and lack of documented credit histories are amongst some of the factors making rural populations difficult to service. The dependence on agricultural activities, which are often subject to climatic risks and fluctuations in agricultural prices render rural loans more risky than that for urban activities. Consequently, many commercial banks prefer the less challenging task of lending to industrial and service sectors, and to urban rather than rural people.

### 3.2 Effective demand

Many of the problems relating to rural financial services stem from a misunderstanding of the nature of the effective demand for these services. One important misconception was that farmers and other rural dwellers mainly needed credit for agricultural production purposes. The second was that the majority of poor farmers were too poor to pay for credit, that is there was a need for credit but little effective demand.

In fact, credit for non-agricultural purposes may be as important as agricultural loans. For many rural dwellers the most important reason for demanding credit is as a consumption loan to meet living costs in the months before the next harvest, not to purchase inputs to raise agricultural productivity. There is also mounting evidence that

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5 Collateral is an asset(s) offered by a borrower as security for loan repayment that will be surrendered to the lender in the case of loan default.

6 Adverse selection was a term first used in the insurance industry to describe the phenomenon that as the premium for a policy rises there is a tendency for the best risks (those least likely to make a claim) to no longer find the policy worthwhile. This leaves the company exposed to the adverse effect of poorer risks, a higher probability of claims, and the potential need to raise the price of the policy again.
poor households are both willing and able to service loans if they borrow for their own perceived needs and are adequately screened and monitored.

The above misconceptions have shaped agricultural credit policies over much of the 1960s and 1970s, based on the following premises:

- It was the function of the central government (normally of the Ministry of Agriculture, or those acting on delegated authority to government-owned financial institutions) to decide:
  - what farmers should do with credit
  - what the cost of credit to rural borrowers should be
  - who should actually benefit from the loans
  - what the total amount of agricultural credit should be.

- It was the central government function to provide:
  - savings mobilization mechanisms in rural areas
  - lending facilities on a subsidized basis.

- That responding to farmers’ demand for credit for other purposes than agricultural production was not a government priority.

### 3.3 Supply of rural financial services

In most developing countries there are typically two types of suppliers or financial intermediaries. The ‘formal’ sector consists of bank and non-bank financial institutions that provide intermediation services between depositors (or the government) and borrowers and, as they fall under the banking law, are regulated and supervised. In the past these typically charged relatively low rates of interest that were usually subsidized by the government. The flow of funds in a typical centralized and directed agricultural credit system is shown in Figure 2. In many cases little attention was paid to voluntary savings mobilization in rural areas as small farmers, being poor, were considered to have a low propensity to save.

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8 Hoff and Stiglitz (1993).
The ‘informal’ sector typically comprises private individuals – professional moneylenders, traders, commission agents, landlords, friends and relatives – who lend money generally out of their own equity and are not regulated or supervised by the national monetary authorities. One of the major differences between these two types of suppliers is the mechanisms used for dealing with the screening, incentives and monitoring problems with the informal sector relying much more heavily than the formal sector on their intimate knowledge of their clients to overcome these problems.

Informal financial markets have always existed in rural areas, but were ignored by government policy for a very long time. They have been excluded from playing a role on two grounds. First, that the operators in informal financial markets do not share the same commitment as government to promoting agricultural production. Second, they would charge exorbitant interest rates which, allegedly, agricultural producers could not afford to pay. In many countries and for almost 30 years, governments hindered the spontaneous development of informal financial intermediaries by occupying, through subsidized operations, the market space that informal operators could have exploited and developed. This is sometimes known as the ‘crowding out effect’ of government agricultural credit policy.

Overall, various factors of a physical, social or institutional nature can affect the supply of agricultural finance, including:

- The high financial transaction costs of attending dispersed and small farm households.
- Seasonality and importance of opportune timing of farm operations, the heterogeneity of farmers’ borrowing needs, and duration of loans.
- Dependence on sustainable natural resources management and the relative low profitability of on-farm investments.

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8 FAO/GTZ (1998a).
• Weather and other production and marketing risks, which require appropriate risk management techniques, both for producers and financial intermediaries.
• Limited availability of conventional bank collateral that farm households can offer, and the related problems of using less conventional substitutes.
• The reality that farm households often have emergency needs and their repayment capacity is highly dependent on consumption and social security contingencies.
• The lack of financial skills of staff of rural financial institutions and also of farmer clients.

4 PAST FAILURES AND NEW VISION OF RURAL FINANCE

For many years, government interventions in credit markets have taken the form of directed allocations of loans, subsidized interest rates and state ownership of rural banks. In some countries, the government required banks to lend an increasing percentage of their portfolios to farmers. In others, major segments of the rural financial system were attached to crop production. Elsewhere, subsidized credit was used to compensate farmers for other economic distortions, such as food price controls and over-valued exchange rates.

The experience with the above interventions had generally been dismal. Besides limited success in relation to production and social objectives, such interventions posed an unsustainable fiscal burden. Availability of formal credit to agriculture had, in real terms, declined in many regions of the world in recent years. With few exceptions, the consequences of centralized and directed approach to agricultural credit provision were catastrophic, including liquidation of agricultural credit banks across the world. It became clear that governments could not afford to:

• Continue to subsidize low interest lending rates
• Make good poor loan recovery
• Compensate for very high operating costs and overheads.

This situation has prompted the elaboration of alternative credit policies based on liberal economics and decentralization principles. These policies focused on:

• Adopting market-determined interest rates (as a rationing device for credit and incentive for mobilizing rural savings);
• Supporting development of financial markets and increasing competition among financial services providers (to improve efficiency and reduce lending costs); and
• Facilitating better access of rural households to financial services and institutions (improved contact between lenders and clients and reduction of transaction costs).

Recognition of the limitations of past approaches has led to a new vision of rural finance amongst development practitioners that encompasses its service role in helping meet the livelihood needs and strategies of rural households. This includes catering for
consumption smoothing, off-farm income generation, education of family members, human capital enhancement, and insurance against future cash flow requirements, besides meeting current production needs.

In addition, opportunities for: a) reallocation of financial resources from those that save to those that invest; and b) reallocation of costs of lumpy investments over time (from future or past incomes) were also recognised. The paradigm shift in rural agricultural service provision underscores the key role that decentralization would need to play, as countries seek new and innovative means of improving the economic and social roles of financial services to the rural population.

5 CONCEPTUAL FRAMEWORK FOR DECENTRALIZATION

5.1 Main approaches to decentralization

In line with the paradigm shift in rural finance above, major objectives of decentralization of rural financial services would be to:

- Bring about closer links between service providers and beneficiaries.
- Respond to the demand for a variety of financial services by the rural people.
- Improve the transparency and accountability of financial institutions dealing with rural people.
- Reduce the high costs and risks of financial transactions in rural areas.

Two main approaches to decentralization of rural financial services can be distinguished:

- One approach involves a drastic reform or restructuring of government-owned financial institutions operating in rural areas, by shifting power away from the centre and changing responsibility and accountability systems through a combination of deconcentration and devolution measures. This will require a major review of existing institutions, the prospects for reorganization, and scope for efficiency improvements and/or cost reductions.

- The other approach aims at diversifying the ownership of the financial institutions operating in rural areas. This objective can be achieved in three major ways:
  - Changing the capital structure of government-owned agricultural development banks by selling a controlling interest to the private sector.
  - Encouraging the development of private banks and by eliminating subsidies and liquidating, restructuring or reducing the scope of operations of banks retained in the public sector.
  - Promoting and regulating the emergence of new types of grassroots-based rural financial intermediaries.
The various ways of diversifying ownership can of course be implemented at the same time. When many service providers operate in capital markets, a multiplicity of service delivery channels, and redistribution of the power and influence associated with the control of financial flows, is created. Competition and a variety of policies, new financial technologies, and products are thus introduced.

5.2 Principles of service provision

The above approaches bring out the broad questions concerning service delivery, as to who should pay, produce, and regulate. In deciding what type of decentralization would suit a particular country situation, the principles of subsidiarity, jurisdictional spillover, and specialization should also be brought to bear. The application of these principles in addressing the above questions, would be helpful in identifying and assessing potential roles of government, private sector, and community organizations in various aspects of service provision.

For instance, if community organizations can undertake savings and credit transactions at the village level effectively, there is little justification for a branch of the agricultural bank at village level. Provision of township or district level on-lending facilities, with technical support to village institutions periodically, may be more appropriate.

Assume now that greater competence with respect to financial procedures on credit and saving operations rest with ministry of finance and other monetary authorities, while ministry of agriculture staff have the skills relating to crop and livestock production advice. There would be little logic in assigning agricultural staff the task of regulating and supervising local credit and saving activities. Similarly, the task of drawing up lending plans for promoting crop production targets may not be consistent with the specialized ‘domain’ of operations of rural financial institutions. The principles of subsidiarity and specialization would apply in these two examples, respectively.

Disaggregating service provision functions and understanding the strengths and weaknesses of existing and potential service providers in relation to specific roles is thus an important analytical step. This should provide a rational basis for designing the reforms needed for the evolution of a system of rural financial services and that is also accessible to most rural households, relevant to their livelihood needs, and also sustainable. In so doing, the reasons for government intervention, explicit or implicit, would also need to be re-examined.

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9 Refer to the EASYPol Module 013: Decentralization and Agricultural Development: Decentralization of Agricultural Services.

10 As discussed in the module 012: Decentralized Development in Agriculture, An Overview.

11 Refer to the EASYPol Module 013: [see footnote 9 above for link] for further discussion on the main reasons for government intervention in service provision.
6 POLICY IMPLICATIONS

6.1 Assessing decentralization options

Two main sets of options for reforming rural financial services were outlined above, namely: reforming and restructuring existing government financial institutions, through deconcentration or devolution; and diversifying the ownership of rural financial institutions. In practice, informal financial institutions generally already exist in one form or another in many developing countries, hence the latter set of options would include giving official recognition to, and harnessing the potential of, such institutions in provision of savings and credit services.

There can however be no single prescription as to what forms of decentralization or their variants should be adopted. All have their advantages and disadvantages, and any one or a combination of options may be applicable, depending on circumstances. A review of a number of options, based on recent country experiences, is given below as a general guide. Four sets of options are presented, with the first based on restructuring existing government institutions, whilst the remaining incur diversification of ownership.

6.1.1 Deconcentration and devolution

This involves transferring the responsibility to operate as profit centres to local branches and sub-branches that are capable of expanding their outreach on a viable and sustainable basis. Full autonomy is granted to front-line managers to decide how best to achieve the objective. This approach has been successfully tested in Indonesia, where it turned a non-performing agricultural development bank, Bank Rakyat Indonesia (BRI), into a viable and very dynamic provider of rural financial services (see Box 1).

Box 1 - Decentralization of the Bank Rakyat Indonesia (BRI)

The success of the bank was built on:

- Strict adherence to principles of viability, self reliance, sustainability and broadening of outreach
- Incentives to staff and clients which reward adherence to those principles
- Turning the 4000 sub-branches into profit centres
- Effective supervision of each profit centre

Following the reforms, rural savings were mobilized and the funds collected lent out within the rural areas. Whilst the government no longer contributed to the bank’s resources or subsidized the cost of the decentralized units or branches, the bank’s capital was still fully controlled by the central government.

The apparently successful reform process was however made possible by the favourable environment that had been established in that country, in terms of macroeconomic stability, a differentiated financial infrastructure, prudent deregulation and liberalization of the domestic market and of foreign trade. A significant transfer of power had also taken place, with local managers responding to local market signals and not to central government directives. Failure to satisfy local clients would affect profits, with negative
effects on the local sub-branch manager's remuneration and career prospects. Because of the independence of decision making accorded to branch and sub-branch managements, the reform of the BRI has resulted in a substantial devolution of responsibilities and resources. This involved new tasks at all levels and was not simply a deconcentration of functions and offices.

6.1.2 Privatization of government owned agricultural banks
A number of governments have tried to privatize government-owned agricultural banks. In practice, there have been many difficulties due to the problem of capital valuation and to the poor expectations of profit from future operations. Short of outright fraud, government banks are in financial trouble for two main reasons:

- Excessive operating costs (overstaffing, unprofitable branches, low staff productivity, wrong personnel policies, inadequate spread between active and passive interest rates, etc.)
- The poor quality of their portfolio (high loan delinquencies).

Excessive operating costs can eventually be corrected by new management, provided labour legislation does not impose too much rigidity, but the poor quality of the loan portfolio may often be difficult to remedy in the short- to medium-term. Thus governments are unlikely to find a buyer for take-over unless they clear the portfolio of bad loans. In some cases, the bulk of bad loans are held by bankrupt government enterprises. However, buying out delinquent debtors is a poor solution, because it does not establish an encouraging environment for making new loans. Transferring non-performing assets to a separate company responsible for recovering them has also been tried, but it did not always ensure the financial recovery of the original lender.

6.1.3 Liberalizing the formal financial market
This involves the liquidation of non-viable government banks, coupled with allowing the entry of foreign capital and the encouragement of local private groups to form joint ventures with foreign banking groups. In practice, private investors, particularly foreign capital, tend to be cautious given past experiences with nationalization and political interference with staffing and lending policy. Thus, in the short term, this option may not be a solution for rural areas because private enterprises usually invest in commercial banking in urban areas before expanding to rural areas. However, one important effect in rural areas would be to improve lending to enterprises involved in crop purchasing, equipment supply and input trading. Part of the finance made available to input suppliers and traders is likely to be passed on to farmers in the form of suppliers’ credit. But the overall contribution to rural credit availability may be limited.

6.1.4 Fostering rural microfinance institutions
This aims at expansion of the role of MFIs in the voluntary or mutualistic sector as rural financial intermediaries. This is the most far-reaching objective of decentralization of rural financial services: it mobilizes the potential of informal rural financial markets and rationalizes their operations. The operators in the informal market include all those
intermediaries who are not subject to the regulations and supervision of the monetary authorities, such as money lenders, rotating savings and credit associations, informal savings groups, informal safe-deposit providers, village level savings and loans associations.

The common feature of mutual or cooperative financial institutions is that their members own them. Members’ savings are mobilized and people appointed and controlled by members oversee the use of these savings. The cooperative nature of these institutions improves the chances that loans respond to the borrowers’ requirements. Moreover, the loans are made to borrowers who are well known to the institution and whose creditworthiness most members of the institution can easily assess. In this case, loan delinquency tends to be limited, since the social pressure to repay results from lending the members’ own hard-earned savings.

Safeguarding one’s own money is a much stronger incentive for repayment than a generic sense of duty or interest in becoming eligible for an additional loan. The social pressure for loan repayment in classical group-lending schemes of agricultural development banks, where it was the government’s (or the donors’) external funds rather than the members’ own money that was loaned, in general has not worked. Experience suggests, however, that even with own funds the group liability mechanism tends to weaken whenever the local financial institution becomes too large or a large share of loan resources is obtained from outside sources.

6.2 **Government roles and responsibilities**

The above service reforms will take time both to plan and implement. Whichever options and decentralization pathways are selected, a sustained period of government involvement is essential. Government roles should however be a largely supportive and facilitative one. Of critical importance here is the provision of an enabling environment for rural financial markets to function. This includes designing and following through the necessary policy, regulatory and legal provisions, and addressing market failures, such as monopolistic practices, where they occur. The following specific aspects merit special attention:

a) **Availability of appropriate legislations** An enabling environment is possible only when there is the appropriate legislation that would:

- Protect private savings
- Ensure transparency of banking institutions
- Prevent unlawful or imprudent practices
- Encourage the introduction of new financial products
- Protect financial intermediaries from undue interference with their autonomous decision making processes and management of their affairs.
b) *Existence of a regulatory framework* This is essential in order to:

- Provide adequate security as well as incentives to both lenders and depositors
- Ensure stability and sustainability of the financial system
- Encourage competition in financial markets.

c) *Responsibilities for regulation* Both formal and informal financial institutions such as MFIs are subject to the regulatory framework, although the nature and extent of rules and controls can differ:

- Formal institutions require licensing and are required to operate in accordance with regulations of national monetary authorities; they are subject to inspection by the Central Bank or similar regulatory bodies.
- Rules and controls are also necessary for informal institutions. These generally lie outside the area of competence of ministries of agriculture. Rules need to be established centrally by the monetary authorities. However, controls can either be centralized, or delegated to apex bodies of MFIs and/or commercial banks that are supporting or promoting the operations of the MFIs.

d) *Support of new financial institutions* Support to new financial institutions should be to assist primarily with capacity building aimed at increasing the staff and managerial skills of the new institutions. Assistance may be justified on the grounds that institutional development and diversification of service providers are public goods that could help to deal with financial market failures. They should not help fill gaps in operating income or interfere with interest rates and the free play of market forces. Support activities eligible for subsidies would include:

- Initial assistance to groups wishing to start a savings and loans association (spontaneous groups’ animation, market studies, defining by-laws, registration procedures)
- Experimentation/adoption and training in new financial methodologies, technologies and products, and better banking practices for financial officers of emerging institutions
- Initial assistance in keeping adequate accounts and drafting balance sheet and income statements
- Initial free assistance in routine inspection and audit of accounts.

Governments may also support the piloting and start-up of innovative credit guarantee approaches for banks. However, banks ought to assume a good share of the risk in order to ensure that they assess their clients effectively. Sustainability requires financial institutions, irrespective of their size and nature, to respect sound banking practices. It is up to the market to determine to what extent financial institutions are sufficiently creditworthy in accessing loan funds from higher level financial intermediaries.
7 READERS' NOTES

7.1 Easypol links
This is one of several modules in the training path Decentralization and Agricultural Development. It follows the Thematic Overview, EASYPol Module 013: Decentralization and Agricultural Development: Decentralization of Agricultural Services and is accompanied by modules on decentralization of other agricultural services, namely:


Other training paths which have close technical linkages to the present one include:

- Analysis and monitoring of socio-economic impacts of policies
- Investment planning for rural development

8 REFERENCES AND FURTHER READING


APED series No. 7, Rome, Italy.


Excerpts of the “Online Sourcebook on Decentralization and Local Development” (Collaborative effort by FAO, GTZ, SDC, UNDP and the World Bank) either electronic versions or as hard copies may also be provided. This sourcebook is hosted by Ciesin - the Center for International Earth Science Information Network, at Columbia University), (http://www.ciesin.org/decentralization/Entryway/english_contents.html).
Module metadata

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<td>This module focuses on the decentralization of rural financial services, within the ambit of sub-sector service delivery. Although not intended for a specialist economist audience, it draws attention to and questions the economic reasons for government interventions in rural credit and finance, including misconceptions which shaped credit policies in the past. Attention is drawn to the paradigm shift in rural financial services, including the wider role these could play in meeting livelihood needs and strategies of rural people, rather than focusing narrowly on credit provision for crop production or simply as a means of compensating for economic distortions. Options for decentralization of financial service, through reforming existing government financial institutions, and diversifying ownership of these institutions are also examined. As with many other types of agricultural services, the message here is that there can be no single prescription as to what constitutes the most appropriate form of decentralization. The importance of government support in policy setting, and provision of a legislative and regulatory framework is also highlighted. Issues discussed have applicability in a range of other training contexts, including those on rural development strategies, local and regional development, and in poverty reduction strategies.</td>
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8. Topic covered by the module

- Agriculture in the macroeconomic context
- Agricultural and sub-sectoral policies
- Agro-industry and food chain policies
- Environment and sustainability
- Institutional and organizational development
- Investment planning and policies
- Poverty and food security
- Regional integration and international trade
- Rural Development

9. Subtopics covered by the module

- Decentralization and agricultural development

10. Training path

Decentralization and agricultural development

11. Keywords