Credit in Rural India: A Case Study

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Abstract

This paper presents a case study of credit transactions in Palanpur, a north Indian village. Drawing on detailed informtion from all borrowers and lenders in the village, we examine a number of issues related to the functioning of rural credit markets. These include the segmentation of the credit market, the achievements and failure of public lending institutions, the role of interest-free lending, the lending strategies of village moneylenders, social inequalities in access to credit, and the politics of rural credit, among others. An attempt is also made to relate these findings to those of other studies of credit in rural India.

Keywords: India, Palanpur, rural credit markets.
JEL Nos.: G2, O16, Q14, D23

CREDIT IN RURAL INDIA: A CASE STUDY

> Money, says the proverb, makes money. When you have got a little, it is often easy to get more. The great difficulty is to get that little.
>
> Adam Smith, The Wealth of Nations, I.ix.

Introduction and Background

On 9 January 1987, during one of our sojourns in Palanpur, a village of western Uttar Pradesh, we received the visit of a man called Mahavir. The first half of January is a time of slack labour demand, and Mahavir, a landless labourer, had been unable to find work for several days. He told us that he had spent the whole morning trying to find someone who would lend him one rupee (about two UK pence at the prevailing exchange rate), so that he could at least feed his two children in the evening.

Mahavir is a well-known resident of Palanpur, who is in no danger of leaving the village, and, poor as he is, he would have had no difficulty in repaying a one-rupee loan later in the season. But no-one agreed to lend him a rupee. He commented, "garib aadmee ko koi naheen deta", "no-one lends to a poor man". Eventually, he was able to obtain one kilogramme of wheat (worth two rupees) from one of the village moneylenders, repayable with an interest of 50 per cent in kind after the harvest -- four months from then.

At that time, the local branch of Prathma Bank (a state-run rural bank) was implementing the "Integrated Rural Development Programme", a scheme of subsidised credit intended for households below the poverty line. Loans of several thousand rupees could be obtained under this programme, at a nominal interest rate of 12 per cent per year. The scheduled castes, of which Mahavir is a member, were one of the main target groups, and had to repay only two-thirds of the principal according to the programme's official guidelines. We asked Mahavir why he had not applied for a loan from Prathma Bank, but he dismissed this fanciful idea. To start with, he did not have the resources to bribe the headman, the village development officer and the bank manager. Besides, he was afraid of being cheated. "These people", he said, referring to the bank managers, "they tell you something and write something else".

We begin with this anecdote because it illustrates a number of interesting aspects of credit transactions in Palanpur, including the chaotic state of the village "credit market", the special difficulties of assetless households in obtaining credit at reasonable rates, the limited practice of reciprocal interest-free credit, the continuing role of the traditional system of seasonal loans in kind, and the failure of public lending institutions to meet the credit needs of disadvantaged households. In this paper, we investigate these and other features of credit in Palanpur. Given the paucity of reliable evidence on credit in rural India (partly due to the sensitive nature of the required information), a detailed case study may be a useful addition to the available empirical material. An attempt will also be made to compare our findings with those of similar studies elsewhere in India.

Two of us (Jean Drèze and Naresh Sharma) spent one year in Palanpur, from October 1983 to October 1984, and revisited the village on many occasions since then.[1] Credit-related data were collected in mid-1984, and, unless stated otherwise, all the data presented in this paper refer to that point of time. The term "survey year" refers to 1983-4. From time to time, we shall also draw on three earlier surveys of Palanpur. The first two of these surveys were carried out in 1957-8 and 1962-3 respectively by the Agricultural Economics Research Centre of Delhi University. The third survey was conducted in 1974-5 by Christopher Bliss and Nicholas Stern (see Bliss and Stern, 1982).

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[1]. Our field work in 1983-4 was carried out in collaboration with Mr. S.S. Tyagi (Jr.) of the Agricultural Economics Research Centre, University of Delhi; we are very grateful to him for this most rewarding association.

The Village

Palanpur is situated in Moradabad district, 13 kilometres away from a small town called Chandausi.[2] In 1983-4, the village had 143 households and 960 individuals. Hindus and Muslims represented 87.5 and 12.5 per cent of the village population, respectively.

The main economic activities in Palanpur are (in order of importance) agriculture and wage employment outside the village. The latter consists partly of casual labour in Chandausi as well as in Moradabad (a larger city one hour away by train), and partly of permanent or semi-permanent employment in sectors such as the railways, spinning industries, bakeries, sugar factories and steel-polish workshops. Compared with agriculture, permanent jobs outside the village tend to involve relatively high and stable earnings.

Agriculture is organised around two major seasons: rabi (November-May), when wheat is the main crop, and kharif (from June-November), when a variety of crops are grown including sorghum, millet, maize and pulses. Sugarcane, a ten-month crop, is also quite important. Palanpur households own about 2,600 bighas of land, almost all of which is irrigated.[3] In 1983-4, the size of the largest landholding had 99 bighas (a little over 15 acres), which is not very large, and it cannot be said that the agricultural economy of Palanpur is dominated by a few landowners. One fifth of all households are landless, but their occupations are quite diversified, so that landless agricultural labourers only represent a small part of the village population (a characteristic feature of rural Uttar Pradesh). However, many households engage in agricultural labour on a part-time basis.

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[2]. The reader is referred to Bliss and Stern (1982) for a detailed account of the economy of Palanpur. Analyses based on the 1983-4 survey have been presented in Drèze and Mukherjee (1989), Drèze (1990a, 1990b), Sharma and Drèze (1990), Lanjouw and Stern (1989, 1991), Lanjouw (1992, 1994), Sharma (1992), Kynch (1994); see also Lanjouw and Stern (forthcoming).

[3]. The bigha is the local unit of measurement for land area, which will be used throughout this paper. There are 6.4 bighas in one acre.

The caste composition of the village population is as follows. The two largest castes, in numerical terms, are Thakurs and Muraos (with 217 members each in 1983-4). Thakurs, who belong to the Kshatriya varna, occupy the highest position in the local caste hierarchy (there are no Brahmins in Palanpur). In economic terms, however, their dominant position has been increasingly challenged in recent years by the Muraos, a caste of cultivators from the Sudra varna who have experienced considerable upward mobility during the "Green Revolution" period. At the bottom of the caste hierarchy (if we exclude three sweeper households) are the Jatabs, a "scheduled caste". Jatabs are mostly casual labourers and marginal farmers, and they suffer from even higher levels of poverty and illiteracy than other sections of the Palanpur population. The other Hindu castes (e.g. Dhimars, Gadarias, Passis) are relatively small in numerical terms. Muslims in Palanpur are divided into two endogamous groups with distinct traditional occupations, Telis (oil-pressers) and Dhobis (washermen). Muslims, like Jatabs, represent a highly disadvantaged section of the society. Further details about the demographic and social composition of the village are given in Table 1.

For purposes of interpretation of some of the figures given in this paper, the reader may find it convenient to think of Palanpur as a village of about 1,000 persons with average per-capita income of about Rs 1,000 per year in 1983-4, where prices were rising at about 10 per cent per year in the early 1980s. Unless stated otherwise, all interest-rate figures are expressed in money terms.

The data

Something should be said about the quality of our credit data. Information on credit tends to be quite sensitive and is often difficult to collect, especially through brief ad hoc surveys. In this case, however, the collection of credit data was part of a broader village survey, and by the time we started collecting these data we had been able to establish quite a good rapport with most Palanpur households. We had also acquired a good knowledge of the circumstances of

Table 1
PALANPUR: BASIC DEMOGRAPHIC AND SOCIO-ECONOMIC CHARACTERISTICS (1983-4)

Caste	Number of households[a]	Traditional occupation	Main current occupations[b]	Male/female literacy rate (age 5+) (percentage)	Land owned per capita (bighas)	Percentage of households with at least one regular job	Per-capita income in 1983-4 (Rs/year)
Thakur	30 (217)	warriors	CT, RJ	44/ 8	3.5	43	1,119
Murao	27 (217)	cultivators	CT	34/ 1	5.0	22	1,265
Dhimar	13 (74)	water-carriers	CT, RJ	17/ 0	0.9	77	1,026
Gadaria	12 (83)	shepherds	CT, RJ	20/10	2.4	42	1,112
Dhobi	4 (27)	washermen	CT, RJ, CL	9/ 0	0.8	0	922
Teli	16 (92)	oil-pressers	CT, RJ, CL	24/ 3	1.1	25	784
Passi	15 (85)	mat-makers	CT, RJ	31/ 0	1.7	47	1,202
Jatab	19 (118)	leather workers	CT, CL	4/ 0	1.8	5	436
Other	7 (47)	miscellaneous	RJ, SE	39/41	0.4	29	1,023
ALL CASTES	143 (960)	miscellaneous	CT, RJ, CL	28/ 6	2.7	34	1,025

[a] Number of individuals in brackets.

[b] CT = cultivation; CL = casual labour; SE = self-employment; RJ = "regular job" (i.e. wage employment with monthly salary and some security of employment)

Note: Castes are arranged in a roughly decreasing order of social status, following Bliss and Stern (1982), with Thakurs at the top and Jatabs (Palanpur's main "scheduled caste") at the bottom. Dhobis and Telis are Muslims and therefore do not, strictly speaking, constitute distinct "castes". In economic terms, Telis and Jatabs are the most deprived castes.

each household, making it more difficult for respondents to conceal or misrepresent their debts and loans. Further, we resorted to extensive cross-checking between lenders and borrowers to reduce gaps and inaccuracies.

Our experience is that most respondents disclosed their debts without reluctance, but tended to be less eager to reveal the loans they might have given. If p is the probability of a loan being concealed by the borrower, and q the probability of a loan being concealed by the lender, the overall proportion of unrecorded loans is simply p.q (assuming that the probabilities of non-reporting by borrower and by lender are independent). In our judgment, 0.2 and 0.4 are plausible values for p and q respectively, leading to an overall proportion of unrecorded loans below 10 per cent.[4] The proportion may be somewhat higher for small, interest-free loans within the village, which can be easily overlooked by respondents.

This assessment, however, ignores one particular type of credit, which has not been systematically recorded. This is what one might call "implicit credit". The term refers to the fact that an economic transaction sometimes includes the effective provision of credit, without it being necessarily recognised as such by the parties involved. For instance, an affluent landlord sometimes agrees to pay for non-labour costs during the agricultural season, and to recover the tenant's share of these costs (usually one half) after the harvest. A landlord may, indeed, benefit from being able to attract the more productive tenants by offering this concession from the standard terms of sharecropping contracts, which specify that input costs should be shared equally as and when they are disbursed. Similarly, during the survey year we were able to observe how one particular pumping-set owner succeeded in capturing a large share of the market for irrigation services by

[4]. In principle, p and q can be estimated from the available data (by examining the proportions of loans that have been reported by the lender only, by the borrower only, and by both). We have not attempted to do this, because the computerized version of the data incorporates consistency checks and corrections that invalidate this simple procedure.

allowing his customers to postpone the payment of pumping-set hiring charges until after the harvest. Contracts of this kind involve some implicit credit, usually interest-free, but since the provision of credit occurs without any explicit act of loan-taking, these implicit credit transactions were often omitted by our respondents. This being the case, implicit credit will receive little attention in this paper.

In addition to collecting quantitative information, we engaged in extensive discussions with borrowers and lenders. Discussions with moneylenders were particularly informative. Out of six regular moneylenders residing in Palanpur, four can be said to have been quite cooperative in informal discussions (the other two were completely non-cooperative). This paper draws both on the quantitative data and on the discussion material.

1. **Credit Transactions in Palanpur**

Indebtedness in Palanpur is quite high in relation to the level of income. As Table 2 indicates, outstanding household debts add up to Rs 429,863.[5] With loans outstanding from village lenders amounting to Rs 32,000, Palanpur has a net debt of a little below Rs 400,000. This represents just under 40 per cent of the total annual income of the village (roughly one million rupees in 1983-4).

Most households (85 per cent to be precise) are involved in credit transactions, as borrowers or lenders or both. Interestingly, as many as 38 households in this small village of 143 households can be counted as "lenders", in the sense that they had at least one loan outstanding at the time of interview; 20 of them charged interest on some or all of their outstanding loans. It is also noteworthy that 23 households simultaneously borrow and lend (a majority of

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[5]. As stated in the introduction, the data presented in this paper relate to mid-1984 (unless stated otherwise). Statements made in the present tense should be understood to refer to that period.

Table 2

BASIC FEATURES OF VILLAGE DEBT (1984)

Total debts outstanding (Rs)	429,863
Net village debt as a proportion of annual village income (%)	40
Distribution of outstanding debts by source (%):	
Public lending institutions	79
Private sources within Palanpur	7
Private sources outside Palanpur	14
Number of households in different credit-status categories at the time of the 1984 survey[a]	
borrowing only	84 (59)
lending only	15 (10)
borrowing <u>and</u> lending	23 (16)
neither borrowing nor lending	21 (15)

[a] Percentage distribution in brackets. "Borrowing" means that the concerned household owed money to some other household or institution at the time of the 1984 survey; "lending" means that some outstanding loan was due to the concerned household at that time. Palanpur had 143 households in 1983-4.

them have a negative net credit balance). Both from the point of view of total debt outstanding, and from the point of view of the number of households involved, credit transactions are a highly significant aspect of Palanpur's economy.

The details of credit transactions in a village such as Palanpur offer quite a complex picture. To illustrate, Table 3 presents information on debts outstanding at different interest rates in mid-1984. It can be seen that interest rates range from 0 to 300 per cent per year, with more than 25 different interest rates being reported.[6] It would be hard to deviate further from the textbook "law of one price".[7] And it should be remembered that the interest rate is only one of the relevant components of a credit contract -- others may include the repayment schedule, the provision of collateral, the choice between cash and kind, the specification of simple or compound interest, the treatment of default and other contingencies, and so on. An important step towards making sense of this confusing variety of contracts is to make broad distinctions between different sources of credit.

Credit sources: Public and private

One basic feature of credit in Palanpur is the prominent role played by public lending institutions, which account for nearly 80 per cent of total debt outstanding (Table 2). The main features of different types of public lending institutions will be discussed in the next section.

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[6]. Much as in Palanpur, Bailey (1964) finds that interest rates vary between 0 and 250 per cent per year within a single village of Orissa. He adds: "Nevertheless it is clear that all these different kinds of loan are kept in separate compartments, and governed by different conventions of behaviour" (p.113). That observation, too, applies in Palanpur, as will be seen further on.

[7]. Of course, this "law" is hard to take seriously when it comes to credit, given that the usual arbitrage mechanisms cannot be expected to work smoothly in this case.

Table 3

VILLAGE DEBT BY RATE OF INTEREST (1984)

Reported rate of interest (% per year)	Amount due by Palanpur households at the state rate of interest (Rs) To public institutions	To private lenders	Total
0	0	23,926	23,926
9	28,169	0	28,169
11	2,255	0	2,255
12	286,195	0	286,195
13	2,847	0	2,847
15	324	0	324
16	1,769	0	1,769
17	1,159	0	1,159
18	1,000	0	1,000
19	0	300	300
20	0	4,000	4,000
24	0	300	300
25	0	1,250	1,250
30	0	4,490	4,490
36	0	16,764	16,764
37	0	1,400	1,400
40	0	7,701	7,701
42	0	2,229	2,229
60	0	10,081	10,081
120	0	520	520
180	0	598	598
240	0	2,857	2,857
300	0	78	78
25% in kind[a]	9,450	0	9,450
50% in kind[b]	0	5,695	5,695
usufruct mortgage[c]	0	1,660	1,660
unknown	6,439	6,407	12,846
TOTAL	**339,607**	**90,256**	**429,863**

[a] Wheat loans obtainable at the beginning of the rabi season, and to be repaid after the rabi harvest with 25% interest in kind.

[b] Wheat loans obtainable at any time before the rabi harvest, and to be repaid after the rabi harvest with 50% interest in kind.

[c] In lieu of charging interest, the lender cultivates a plot of land belonging to the borrower until the loan is repaid.

The data on debts outstanding in Table 2 suggest that private credit plays a relatively minor role in the village economy. This conclusion, however, needs to be qualified in at least three ways. First, the rate of turnover of debts is much lower for public institutions than for private lending (with some institutional loans remaining unrepaid for several decades). Outstanding institutional debt reflects many years of accumulated borrowing and sluggish repayment, whereas private credit, being typically more expensive (and more energetically administered), tends to be more swiftly repaid. Hence, the share of private sources in new borrowings over a specific period is much larger than their share in debt outstanding. For instance, during the 1983 calendar year, private sources supplied as much as one half of the total amount borrowed by Palanpur households (see Table 4). Second, a majority of households in Palanpur do have some debt to private lenders. Even though the sums involved are often small in comparison with institutional debts, these private debts are a matter of concern for many households. Third, private credit is quite unevenly distributed between different groups of households, and for some of them it represents a large proportion of total liabilities. In particular, many poor households, being at a disadvantage in terms of access to institutional credit, have no alternative than to borrow from private sources on comparatively exacting terms. In that sense, too, private credit is of considerable social significance despite its relatively small volume in terms of outstanding debts.

Private credit: Interest-free and interest-bearing

Within the broad category of private credit, one important distinction is that between interest-free and interest-bearing credit. Indeed, the economics of these two types of credit are quite different. The main source of interest-free credit consists of various personal contacts: important examples include committed friends, obligated neighbours, helpful relatives, regular employers, and accommodating landlords. For convenience, we shall refer to this category of lenders as "allies and patrons", although the precise nature of the personal relationships that bind the respective parties of these interest-free transactions will

Table 4

BORROWINGS BY SOURCE

Source	Amount borrowed by Palanpur households during calendar year 1983[a]		
	Cash (Rs)	Wheat (kgs)	Total[b] (Rs)
Public lending institutions	18,221 (43)	7,000 (71)	27,671 (49)
Private sources within Palanpur	8,253 (19)	2,361 (24)	11,440 (20)
Private sources outside Palanpur	16,255 (38)	450 (5)	16,863 (30)
TOTAL	**42,729 (100)**	**9,811 (100)**	**55,974 (100)**

[a] Percentage distribution in brackets.

[b] Wheat has been valued at Rs 1.35 per kg, the post-harvest price in 1983-4.

call for further investigation in due course.[8]

The complete identification of "interest-free credit" with "credit from allies and patrons" is somewhat defective, for two reasons. First, in some cases credit is obtained on concessional, but not interest-free, terms from a person who can be plausibly described as an ally or a patron. For instance, a considerate landlord may grant a low-interest loan to his or her tenant, without going so far as to waive all interest payments. Second, interest-free credit is sometimes obtainable from a person who cannot be described in such terms. This applies, in particular, to a good portion of the "implicit credit" mentioned in the introductory section. The owner of a pumping-set, for instance, may allow his customers to pay the hiring charges at harvest time in order to attract greater demand for his services, and this may happen even in the absence of a personal relationship that would make it appropriate to describe him as their "ally or patron". A detailed treatment of interest-free credit would have to take these complications into account, and the categories of "interest-free credit" and "credit from allies and patrons" might have to be correspondingly distinguished and disaggregated. For our purposes, however, little will be lost by conflating these two categories.

Private credit: Internal and external

Private sources of credit can be divided (as in Tables 2 and 4) into sources internal and external to the village. Internal sources (mainly consisting of moneylenders residing in the village) account for a relatively small share of outstanding debt: one third of total outstanding debt from private sources, representing only 7 per cent of outstanding debt from all sources.

External sources of interest-bearing private credit overwhelmingly consist of urban traders and goldsmiths who lend money to villagers against large

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[8]. Interest-free credit is often assumed to come from "friends and relatives", but this term is rather misleading, since the relationship between lender and borrower often involves neither friendship nor kinship.

collaterals, at rates lower than those typically charged by village moneylenders.[9] Thus, there is practically no inter-village (interest-bearing) lending within the area surrounding Palanpur, with one important exception which is discussed below. One explanation for the absence of inter-village lending is that village moneylenders have a comparative advantage in lending to residents of their own village, about whom they have a good deal of information, and with whom they often have a long-term relationship of some kind. In fact, as will be seen later on, village moneylenders in Palanpur usually lend without collateral. An outsider who would try to do the same would expose herself to serious problems of asymmetric information. Demanding a large collateral (like urban moneylenders) would reduce the risks involved, but the rate of interest would have to be correspondingly lowered, and the lender may find it more profitable to lend without collateral in her own village. Further, in the case of collateral-based lending, village moneylenders may not be able to compete with urban traders and goldsmiths, who tend to have better access to subsidised institutional credit.

The only important case of interest-bearing inter-village lending in Palanpur concerns the activities of Vishnu Dutt, a rich Brahmin landowner from an adjacent village (Ari Khera). Vishnu Dutt comes quite close to the stereotype of the greedy and heartless moneylender who takes advantage of helpless and gullible borrowers. He owns some land in Palanpur, and has close connections with the elite of the village. Unlike Palanpur moneylenders, he usually demands land as collateral, and insists on written contracts enforceable in court. When he is not repaid on time, he does not hesitate to confiscate the collateral. More than once, he has been able to augment his already large landholding in this calculated way.[10]

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[9] As will be seen further on, in the case of interest-free credit the distinction between external and internal sources largely boils down to a distinction between "relatives" and other kinds of "allies and patrons".

[10]. Note that, when land is used as a collateral, village moneylenders do have some advantages over urban-based lenders (e.g. in terms of ability to assess the value of the land, take possession in the event of default, and make good use of confiscated property). The actual confiscation of land, however, requires special coercive powers;

Interest-bearing credit within the village comes primarily from six individuals, most of them prosperous farmers, who can be described as "regular moneylenders" (bearing in mind that even for these six persons money-lending is only a secondary activity and a supplementary source of income). But it is important to remember that, aside from these regular moneylenders, quite a few other individuals are prepared to give the odd loan if the circumstances are advantageous. In mid-1984, 14 individuals other than the six regular moneylenders were found to have issued interest-bearing loans, with their oustanding loans adding to Rs 7,159 (compared with Rs 19,383 for the six regular moneylenders). These individuals will be referred to as "occasional lenders", and the term "village lenders" will be understood to include both these occasional lenders as well as the six regular moneylenders.

Summary

To summarise, credit sources can be usefully divided into four broad categories: (1) public lending institutions, (2) allies and patrons, (3) urban moneylenders, and (4) village lenders (both regular and occasional). This leaves a small residual category which will be referred to as "other sources". We shall include Vishnu Dutt in this residual category, so that "village lenders" refers to Palanpur-based lenders specifically. To avoid double-counting, interest-free loans from persons who also happen to be village lenders will be counted as coming from "allies and patrons", rather than from "village lenders".

Table 5 presents a comparative picture of the different credit sources, while Table 6 reexamines the diversity of interest rates in the light of these broad distinctions. In contrast with the confusing picture that presented itself earlier (see Table 3), a coherent structure of interest rates already begins to emerge.

As Table 6 indicates, there is a clear ranking of major credit sources in

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we will return to the role of violence and coercion in money-lending.

Table 5: SYNOPTIC LIST OF MAIN CREDIT SOURCES

Credit source	Percentage distribution of debts outstanding, 1984	Percentage distribution of amount borrowed in calendar year 1983	Typical range of interest rates (%/year)	Collateral requirements	Eligibility conditions	Remarks
Allies and patrons	5	9	0	None	Special relationship with the lender	Credit transactions are embedded in broader social or personal relations
Public institutions	79	49	9 to 18	None	Depend on the scheme; may include owning land, or being below the "poverty line"	Bureaucratic rationing, biased in favour of privileged and better-educated farmers
Urban money-lenders	6	13	30 to 36	Gold or silver	None, as long as collateral is provided	No rationing, except that urban moneylenders are reluctant to deal with scheduled-caste clients
Village lenders	6	17	36 to 60	Usually none	Depend on the lender	Rationing based on the lender's assessment of the credit-worthiness of different borrowers, and related considerations
Other sources[a]	4	12	-	-	-	-

[a] Residual category: mainly Vishnu Dutt (see text) and two Provident Funds.

Table 6

STRUCTURE OF INTEREST RATES (1984), DISTINGUISHING BETWEEN FOUR BROAD SOURCES OF CREDIT

Source	Interest rate (per year)	Amount due by Palanpur households (Rs)	Remarks
ALLIES AND PATRONS	0%	23,926	
PUBLIC INSTITUTIONS	9 to 18%	323,718	Cash loans.
	25% in kind[a]	9,450	Kind loans (Seed Store).
URBAN MONEYLENDERS	30%	4,490	Gold collateral.
	36%	15,670	Silver collateral.
	other	5,800	
VILLAGE LENDERS	below 37%	2,644	Concessional loans, or loans issued many years earlier (when interest rates were lower).
	37%	1,300	Traditional adhanni system no longer in use.
	40-42%	5,030	Previous "standard", applicable until 1983 or so.
	50% in kind[a]	5,087	Traditional system for loans in kind (deora), still in use.
	60%	4,581	Current "standard" for cash loans.
	above 60%	3,653	Gambling loans only.
	"usufruct mortgage"[a]	1,660	Only one moneylender (Nisar) practices this.
RESIDUAL[b]	(miscel- laneous)	22,854	
ALL SOURCES		429,863	

[a] See text for details.

[b] This includes the "other sources" category of Table 5, and also a few outstanding loans (with a combined value of Rs 6,926) for which no information on interest rate was available.

terms of interest rate levels. Allies and patrons charge the lowest interest rates (by definition), followed by public lending institutions, urban moneylenders, and village lenders, in that order. It is tempting to speculate that some kind of rationing device applies to the cheaper credit sources, and that borrowers generally take loans from the cheapest available source, with village moneylenders acting as a "last resort". It should be borne in mind, however, that the observed ranking need not apply to the overall attractiveness of different credit sources, taking into account not only the interest rate but also other relevant features of a credit contract. For instance, an interest-free loan from one's father-in-law may appear to be very "cheap" in conventional accounting terms, but it may also entail a serious loss of prestige. Similarly, the danger of being cheated by a bank manager, or the need to pawn the family silver in order to obtain a loan from an urban moneylender, can substantially lower the perceived advantages of credit from these sources. The precise mode of operation of different sources of credit requires further discussion.

2. Public Institutions

2.1. Profile of Public Lending Institutions

Institutional credit in Palanpur comes from four sources: a "cooperative society" (the Farmers' Service Society), the attached Seed Store, and two rural banks.[11] Table 7 summarises their respective aims and activities. While these different institutions have a number of important features in common, they also differ significantly in their mode of operation; we begin by considering each of them separately.

[11]. In addition, a number of Palanpur farmers receive advances on sugarcane sales from a local government-owned sugar mill, for purchases of fertilizer and seeds. Except for a few large farmers, these advances are small; they will be ignored throughout this paper.

Table 7

INSTITUTIONAL CREDIT IN PALANPUR (1984)

Source	Total amount due by Palanpur households (Rs)	Remarks[a]
Farmers' Service Society (FSS)	228,648	Government-assisted "cooperative" aiming to promote agricultural investment and new inputs by lending to its share-holders (recruited among land-owning cultivators).
Seed Store	16,147[b]	An appendix of the FSS. Gives small loans of wheat at the time of wheat sowing, mainly to small and marginal farmers.
Land Development Bank	24,738	Government-owned rural bank; gives large cash loans for agricultural investment (e.g. purchase of diesel engine), mainly to well-off farmers.
Prathma Bank	70,074	Government-owned rural bank, mainly geared to the promotion of agriculture and related activities; in 1985, Prathma Bank started acting as the local implementing agency for the Integrated Rural Development Programme, a credit-based anti-poverty programme.
All sources	339,607	

[a] See text for details.

[b] Including some outstanding cash loans, probably given for fertilizer purchases.

Note: Both the Farmers' Service Society and the Seed Store have their headquarters in Palanpur itself (although they serve the surrounding villages as well). The Land Development Bank and Prathma Bank have branches a few kms away from Palanpur.

The Farmers' Service Society

The Farmers' Service Society (hereafter FSS), which is based in Palanpur but also serves about 20 nearby villages, has the formal status of a "government-assisted cooperative". As will be seen shortly, however, there is nothing cooperative in the way it actually functions. Although farmers do have to buy "shares" in the society in order to be eligible for loans, the management of the FSS is completely outside their control. The manager of the cooperative and his assistant are all urban-based employees appointed by the government.

The official aim of the FSS is to promote agriculture by providing subsidised loans to land-owning farmers. In principle, the amount of money which a particular farmer is entitled to borrow from the FSS depends on a range of variables such as number of shares held, ownership of land and other property, normal annual income (a certain fraction of which must be agricultural income), value of agricultural production, etc. Loans are short-term (except those issued for purchase of improved bullock-carts or diesel engines), and they should not exceed the actual cost of the operation for which they are sought. They are repayable after one year, with an interest charge varying from 12 to 18 per cent in money terms. Simple interest is charged on longer-term loans, and the total interest due is never supposed to exceed the value of the principal. The official terms and conditions of FSS credit are, thus, quite favourable to the borrower.

That, at any rate, is the theory. The practice of FSS credit is quite different, as will be seen in the next section.

The Seed Store

The Seed Store is a semi-autonomous appendix of the Farmers' Service Society. Its main activity is to lend wheat at the beginning of the rabi season (around the first week of November), repayable with an interest charge of 25 per cent in kind after the wheat harvest (in May or June). Wheat issued by the Seed

Store is supposed to be sown, but there is a widely-shared view in Palanpur that this wheat is not worth sowing, and in practice most of it is simply consumed. With few exceptions, borrowers are allowed to borrow only one or two bags of 100 kg in a particular year. As with the FSS, only landowners are eligible, on the grounds that wheat borrowed from the Seed Store is meant to be sown. However, 5 among the 30 individuals who borrowed wheat from the Seed Store in November 1983 were in fact landless.

Although the Seed Store operates under the umbrella of the Farmers' Service Society, and is partly managed by the same staff, the actual performance of the two organisations differs in some important ways. Specifically, the Seed Store's credit operations appear to be less susceptible to corruption, low repayment and regressive distribution. This important contrast will be examined in greater detail further in this section.

Rural Banks

Two state-owned rural banks have clients in Palanpur: the Land Development Bank and Prathma Bank. Both of them operate throughout the district, and have a local branch based a few kilometres away from Palanpur.

The Land Development Bank specialises in large loans for major investments in agricultural capital. In mid-1984, the Land Development Bank had only 8 loans outstanding in Palanpur. The amounts initially borrowed ranged from Rs 3,700 to Rs 7,800 - large amounts by the standards of other credit institutions. Most of these loans had been given to relatively well-off farmers for the purchase of irrigation equipment. Interest rates on these loans were of the order of 10-12 per cent in money terms.

Prathma Bank was created in 1975, but did not start operating in the Palanpur area until shortly before the survey year. Its original purpose was to supply cheap credit to small farmers and the landless. In order to be eligible for a loan, a borrower should not own more than a certain amount of land or earn more than a certain level of income. In practice, however, eligibility conditions are not strictly applied, as the local manager of Prathma Bank himself readily admitted when we interviewed him. Nominal interest rates vary slightly between different types of loans, with an average of about 12 per cent per year. Since 1984, Prathma Bank has been the implementing agency for the Integrated Rural Development Programme, one of India's main "anti-poverty programmes" in the 1980s.

Achievements and Shortcomings of Public Lending Institutions

The record of public lending institutions in Palanpur is mixed. On the positive side, institutional credit has probably played an important role in facilitating the improvement of irrigation facilities and the transformation of agricultural practices that have taken place in the last few decades.[12] Having said this, institutional credit also suffers from several major shortcomings. These include: (1) endemic corruption, leading to a drastic reduction of the benefits of subsidised credit (especially for disadvantaged borrowers), (2) low recovery rates, threatening the sustainability of the rural banking system, and (3) bureaucratic procedures, with an overall bias in favour of privileged households. It is fair to say that these broad characteristics of institutional credit have been widely observed elsewhere in rural India.[13] Each of them deserves closer examination.

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[12]. A large majority of institutional loans outstanding in 1984 had been officially taken, and actually used, for agricultural investment and related productive purposes. It should be noted, however, that the arguments for subsidising capital accumulation in agriculture are stronger for some types of investment than for others. While the improvement of irrigation facilities in Palanpur has had widespread benefits, the social value of more recent investments in labour-displacing technology such as threshers and tractors is less obvious.

[13]. See the literature cited in section 6.

2.2. Corruption

Corruption is a central feature of institutional credit in Palanpur. It is impossible to understand the performance of public lending institutions without examining this issue.

We shall illustrate the problem of corruption in public lending institutions in the form of a case study of the Farmers' Service Society. The motivation for concentrating on the FSS is partly that it appears to represent the most acute case of this malady, and partly that we have particularly detailed information on the functioning of this institution: our living quarters in 1983-4 were adjacent to the FSS office, and this privileged observation post gave us ample opportunity to familiarise ourselves with the accounting tricks and other fraudulent practices of the society's employees. Another good reason for focusing on the Farmers' Service Society is that it accounted for more than two thirds of total outstanding debts to public lending institutions in 1984 (see Table 7).

As was mentioned earlier, the management of the Farmers' Service Society is entirely in the hands of urban-based employees appointed by the government. These employees are alienated from the village society, and look on most of its members as potential targets of extortion.[14] The key actor is the manager, who has the effective power to sanction loans, and to override official eligibility conditions if necessary. While eloquent pleading or the intermediation of a well-placed ally

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[14]. Only a few residents of Palanpur and the surrounding villages have more "clout" than the FSS manager and his aides. This privileged group mainly consists of powerful landlords and goondas (henchmen, often engaged in a variety of illicit income-earning activities such as the selling of liquor) who sometimes resort to armed violence, or to the threat of armed violence, in order to assert their authority. The fraudulent operations of the FSS are essentially based on a tacit alliance between the FSS employees and this local clique: the powerful landlords and goondas do not interfere with the extortions carried out by the Farmers' Service Society, and, in return, the FSS employees give them a preferential treatment in their lending operations. Conflicts between members of the two groups, however, do erupt from time to time.

sometimes suffice to persuade him to sanction a loan, the payment of a bribe is a more common procedure.

The most important occasion for corruption in the Farmers' Service Society, however, is not the allocation of credit but the process of accounting and recovery, which is based on an arrangement locally known as laut badal or "transfer entry". This arrangement was initially evolved under official auspices with the objective of providing insolvent borrowers with an opportunity to escape the status of "defaulter" by rolling over loans. However, as discussed below, laut badal soon degenerated into a system of institutionalised fraud. This system, which is not specific to Palanpur, works roughly as follows.

Consider a farmer who has borrowed a sum of Rs 1,000 at a particular date. Twelve months later, when repayment is due along with an interest charge of (say) Rs 150, it may well happen that he or she is unable or reluctant to repay. In that case the manager states that, if the client is willing to pay the interest charge of Rs 150 as well as a so-called "collection charge" of Rs 100 (calculated as 10 per cent of the amount due), the problem can be dealt with by writing the loan as repaid and entering a new loan of Rs 1,000 in the books. If, as often happens, the farmer cannot even pay Rs 250, this problem can itself be dealt with by entering a new loan of Rs 1,250 rather than Rs 1,000. This enables the manager to balance his books and pocket the "collection charge" of Rs 100. Under this system, borrowers pay interest charges at a compound rate of up to 25 per cent per year.[15]

The "transfer entry" system has very different implications for the different parties involved. The manager and his acolytes make a fortune, by collecting a sum representing up to 10 per cent of the society's assets every year. Prudent and resourceful borrowers who make sure to clear their debt within one year are able

[15]. In fact, the interest rate can be even higher (up to 35 per cent), if the borrower is required, at the time of "transfer entry", to simultaneously buy further "shares" in the cooperative so as to be eligible to a new loan larger than the initial loan.

to take advantage of the relatively favourable terms under which FSS credit is officially issued. But those who opt for repeated transfer entry (because they are unable to repay, or fail to understand the full implications of the system, or yield to the temptation of postponing repayment) often find, after a few years, that their debt has grown at a surprisingly high rate and is in danger of becoming altogether unmanageable.

At that point, the borrower faces a harsh dilemma between several possible strategies. One strategy is to make an all-out effort to clear the debt before it is too late, if necessary by selling land or by making enormous sacrifices of current consumption. Another strategy is to let the debt grow, in the hope that it will eventually be cancelled, and that in the meantime it will be possible to resist pressures to repay without facing punitive action such as the confiscation of property. A third strategy is to migrate from the village and default. Examples of adoption of each of these strategies can be found in the recent history of FSS credit in Palanpur.

The adverse effects of transfer entry are compounded by a number of less systematic, but nevertheless common, additional violations of the official rules, e.g. issuing fake loans under real names or understating repayments in the account ledgers. Many borrowers have little understanding of the complicated accounting procedures of the FSS, cannot make sense of the receipts they are given at the end of the year, and have to retreat as soon as the manager answers their deferential enquiries with a loud request to leave him alone. For them, dealing with the FSS is a risky affair.

It should be stressed that corrupt practices are not applied neutrally to different classes of borrowers. Poverty, illiteracy and low social status all reduce the bargaining power of a borrower, and enhance his or her vulnerability to fraudulent procedures. An illiterate Jatab labourer, for instance, is far more likely to be the victim of various forms of "creative accounting" than an affluent Thakur farmer. Even the payment of bribes is more frequently demanded from the poor than from the rich, according to most of our respondents.

This point, and the general effects of repeated "transfer entry", can be illustrated with reference to the FSS's history of lending to members of the Jatab caste, the most disadvantaged social group in Palanpur. Table 8, which provides details of all the outstanding debts of Jatab borrowers to the FSS in 1984, gives an idea of their exceptional vulnerability to fraud, and of the difficulties they experience in repaying their debts. Years of transfer entry and dishonest accounting have transformed their tiny initial dues into back-breaking liabilities.[16]

Table 8 also presents some tentative estimates of the interest rates effectively paid (in money terms) by Jatab households on FSS debts. Each of these estimates represents a lower bound on the effective interest rate paid by the relevant borrower, in the sense of the lowest effective interest rate compatible with the information reported.[17] Despite the conservative nature of the calculations, the estimated interest rates effectively paid by Jatab borrowers are exorbitant. In contrast with the officially-applicable simple interest rate of 12 to 18 per cent corresponding to the official rule (combined with the stipulation that total interest charges should never exceed the amount of the principal), Jatab borrowers are found to pay effective interest at a compound rate of 21 to 78 per cent per year.

The discriminatory mode of operation of the Farmers' Service Society helps to explain the lack of resistance of the rural population to the systematic extortions perpetrated by its employees. Even though the "transfer entry" system is common knowledge in Palanpur and the surrounding villages, it has been applied for many years without organised protest on the part of its victims. This lack of challenge may have something to do with the general limitations of political organisation and collective action in this area, discussed elsewhere (Drèze and Gazdar, 1996).

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[16]. One Jatab household sold its entire landholding (25 bighas, which is above the average landholding size in Palanpur) after the survey year to repay FSS debts.

[17]. It is possible that some respondents exaggerated their repayment record. Even if we ignore repayments, however, the basic conclusions remain applicable.

Table 8

THE FARMERS' SERVICE SOCIETY (FSS) AND THE SCHEDULED CASTES: DETAILS OF OUTSTANDING DEBTS OF JATAB BORROWERS IN 1984

Name of debtor	Details of FSS loan(s)[a]	Effective (nominal) interest rate[b] (percent per year) Simple	Compound
Danni	Borrowed Rs 50 in 1960. Repaid many instalments (including Rs 800 during the last 2 years). Current balance: Rs 3,523.	372 %	21 %
Lila Dhar	Borrowed Rs 50 around 1960. Repaid many instalments (including Rs 300 last year). Current balance: Rs 983.	109 %	15 %
Gangu and Sompal	Borrowed Rs 140 about 20 years ago. Rs 1,900 were repaid about 10 years later, but no receipt was given. In 1983-4, they sold property and cleared their debt by paying another Rs 5,500.	259 %	32 %
Mangli	Borrowed 100 kgs of wheat about 8 years ago ago (approx. value Rs 130 at that time). Repaid at least 3 instalments (Rs 600 total). Current balance: Rs 2,143.	251 %	46 %
Naubat	Borrowed one bag of fertilizer 5-6 years ago (approx. value Rs 120 at that time). Repaid at least 4 instalments (Rs 850 total). Current balance: Rs 2,943.	510 %	78 %
Chander	Sold land to repay one FSS debt. Inherited another debt from his father about 15 years ago. Current balance: Rs 2,669.	n/a	n/a
Lochan	Outstanding debt of Rs 8,000. Details not available.	n/a	n/a

[a] The information on amount outstanding (and, in some cases, on amount borrowed) is based on the official FSS records; other details were reported by the concerned debtors.

[b] Lowest value compatible with the information reported in the preceding column. The increase of consumer prices between 1960-61 and 1983-4 corresponds to an average inflation rate of about 8% per year (based on the CPI for Agricultural Labourers, Uttar Pradesh).

Note: All the borrowers are poor labourers or marginal farmers belonging to the Jatab caste, and all are illiterate. The average per-capita income of Jatabs in 1983-4 was Rs 436.

But it also reflects the divided interests of different sections of the rural population: while disadvantaged borrowers have been the main victims of corruption, the more influential ones have often been able to take advantage of the relatively favourable lending terms on the basis of which the Farmers' Service Society officially operates.

2.3. **Repayment**

Low recovery rates are an endemic problem in India's rural banking system. So far as we can tell from the available data, public lending institutions in Palanpur are no exception to this general patten.

As far as the Farmers' Service Society is concerned, the transfer entry system makes the recovery record look very good, with most loans being fully recovered within a year. It is more appropriate, however, to consider rolled-over loans as overdue. In that case, the recovery rate is poor: each year, a majority of loans are rolled over, instead of being recovered within the stipulated repayment period of 12 months. Further, in 1983-4 a large number of debts to the FSS had become so large (due to repeated transfer entry) that the borrowers saw no means of repaying them in the foreseeable future.

We have no precise information on recovery rates in rural banks, but discussions with bank managers indicate that poor recovery is also a problem for these institutions. In 1987, the manager of the Nagalia branch of Prathma Bank told us that he was considering discontinuing all lending in Palanpur, due to particularly low recovery rates. The Seed Store has a much better recovery record, as will be discussed further in this section.

The problem of low recovery in India's rural banking system is often attributed to the reluctance of borrowers to repay. Accordingly, a commonly-proposed solution is to improve repayment incentives. It is certainly the case that, if official interest charges were actually applied, many borrowers would have little short-term incentive to repay, since better financial returns could typically be obtained from alternative investments (e.g. in agriculture, or repayment of private lenders) than from repayment of institutional debt. But this reasoning ignores the fact that the official rules are often not fairly applied, and that incompetent or corrupt management can be as important in generating large overdues as any possible reluctance to repay on the part of borrowers.

The Farmers' Service Society provides a good illustration of this point. Low recovery of FSS loans has little to do with the fact that borrowers are unwilling to repay. In fact, a majority of borrowers have repaid substantial amounts on several occasions after taking a loan, and many of them are anxious to clear their entire debt in order to avoid the trap of spiralling indebtedness through "transfer entry".[18] Direct examination of the "debt histories" recorded in our credit survey strongly suggests that, according to the official accounting procedures, a large proportion of currently-outstanding loans ought to be considered as fully repaid.

Low recovery of FSS loans, in other words, is not a simple question of low repayment. It is also a symptom of the fact that the fraudulent practices of the Farmers' Service Society make it very hard for some borrowers to repay their debts without enormous sacrifices. A related point is that the employees of the Farmers' Service Society have little incentive to enforce the recovery of loans. On the contrary, their interest is to take full advantage of the "transfer entry" system by rolling-over as many loans as possible.[19] Poor managerial incentives to recover outstanding debts may be just as important in explaining low recovery rates in

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[18]. Until recently, few Palanpur villagers with debts to the FSS placed their hope in a possible cancellation of debts. The general belief was that "sarkaar paisa naheen chorti", "the government never gives up its claims". This may have changed since 1990, when large-scale cancellation of institutional debts took place in Palanpur as in the rest of India.

[19]. The following remark appears in the margin of one of the questionnaires used in the mid-1984 credit survey: "He [the borrower] wants to repay the full amount, but says that the FSS staff object".

rural banking as inadequate incentives to repay for the borrowers.

2.4. Distribution

Assessing the distribution of institutional credit is not an easy task. A standard procedure is to look at the distribution of outstanding debts from institutional sources between different sections of the population. This procedure, however, is not very satisfactory, since repayment rates and accounting practices could be very different for the different groups. An alternative method, which will be followed here, is to look directly at the distribution of credit issued during a particular period.

The contrast between the two methods can be briefly illustrated as follows. Data on debts outstanding indicate that 37 per cent of Jatab households were indebted to the Farmers' Service Society in 1984, compared with 40 per cent for all households taken together. The average amount outstanding was also very similar for both groups (about Rs 4,000 per household). This might be interpreted as indicating that Jatabs have more or less the same share of FSS credit, in per-capita terms, as other households. However, a detailed examination of the history of FSS lending leads to a completely different conclusion, as we saw earlier: the outstanding debts of Jatab households overwhelmingly reflect the accumulated effects of many years of corrupt accounting practices, and the special difficulties experienced by these households in clearing their debts. If we consider loans issued by the FSS in calendar years 1983 and 1984, we find that none of them went to Jatab borrowers. By that time, Jatabs had probably selected themselves out of a credit system which they had learnt to fear

Another difficulty in assessing the distribution of institutional credit is that past loans can affect current levels of income and related measures of economic status. The fact that households with high incomes in 1983-4 account for a disproportionate share of loans issued during (say) the previous five years could, in principle, reflect either a regressive distribution of loans or the fact that institutional credit has succeeded in boosting the incomes of the recipients. This difficulty is not a serious one when loans are small (as in the case of the Seed Store), and therefore unlikely to have a major impact on incomes. But with large loans such as those issued for agricultural investment by the Land Development Bank, the problem is less easily dismissed.

In Table 9, this problem is dealt with, in the case of rural banks, by looking at loans issued to different per-capita income groups both before and after the survey year (using information collected from the banks in 1986 and 1987). Corresponding information for the Farmers' Service Society is not available, and the possibility that loans taken from that source in 1983 or 1984 had some positive effect on the incomes of the borrowers in that year has to be borne in mind.[20] Even then, Table 9 strongly suggests that the allocation of credit from public institutions other than the Seed Store is regressive (i.e. richer households have a disproportionate share of institutional loans). Credit from the Seed Store, on the other hand, is quite evenly distributed between different per-capita income classes. This pattern is consistent with informal observation. Taking loan <u>size</u> into account would, in all likelihood, reinforce these findings, since large institutional loans are typically taken by richer households.

An alternative way of dealing with the difficulty posed by a possible relationship between borrowing and income is to relate the allocation of credit to indicators of economic status that are not likely to be significantly influenced by short-term borrowing opportunities. Caste and land ownership are two good examples, and the corresponding evidence on the distribution of institutional credit is also shown in Table 9. Here again, we find some evidence of a bias against disadvantaged groups, except for Seed Store loans. For instance, while Jatab households have an above-average propensity to borrow from the Seed Store, they did not obtain a single loan from other institutional sources during the

[20]. Four of these seven loans were issued (and actually used) for the purchase of fertilizer, and two for the purchase of an improved bullock-cart; one was issued for fertilizer purchase but actually used to pay for marriage expenses.

Table 9: Distribution of Institutional Loans

	Proportion of households which borrowed from the Seed Store in 1983 (%)	Proportion of households which borrowed from the FSS in 1983 or 1984 (%)	Proportion of households which ever obtained loans from rural banks[a] (%)	
			up to and including 1984	from 1984 to 1986
Per-capita income groups				
Poorest quintile	23	0	10	3
Second quintile	25	0	7	0
Third quintile	21	4	25	7
Fourth quintile	14	4	32	14
Richest quintile	21	18	32	25
Caste groups				
Thakur	13	3	27	13
Murao	26	11	19	11
Muslim	20	0	15	10
Jatab	26	0	0	5
Other	21	6	19	8
Landholding size group (bighas)				
Landless	19	4	15	4
0.1- 5	16	5	16	11
5 - 15	14	3	20	9
15 - 30	33	0	25	8
30 - 50	33	20	27	20
50+	0	9	27	18
All households	21	5	21	10

[a] Excluding the Integrated Rural Development Programme (discussed separately). Only one IRDP loan was issued before the end of 1984.

Note: The sole criteria used in chosing reference periods for different credit sources are relevance and data availbility.

reference periods.

The question remains as to whether poor households are unable or unwilling to borrow substantial amounts from other institutional sources. It would be pointless to seek a general answer to this question. We have met several poor individuals who emphatically stated that they would never dare to borrow from a public lending institution (for fear of being cheated or of not being able to repay); we also know others who have made repeated but unsuccessful attempts to persuade a bank manager to give them a loan. The point is that, in both cases, (1) there is a failure of public provision of credit services to poor borrowers, and (2) the root of the problem lies in the discriminatory practices of the public lending institutions.

2.5. The Integrated Rural Development Programme[21]

In connection with the distributional issues examined in the preceding section, we should comment briefly on the implementation of the Integrated Rural Development Programme (hereafter IRDP) in Palanpur, even though IRDP loans started being issued only after the end of the survey year. Indeed, the major distinguishing characteristic of IRDP, compared with other credit schemes, is that loans are supposedly "targeted" to poor households (defined as households earning an income below a pre-specified poverty line). One might therefore expect that the adverse distributional biases discussed earlier for other sources of institutional credit would be reversed in the case of IRDP. The evidence, however, does not support this hypothesis.

The characteristics of IRDP beneficiaries are summarised in Table 10. Note that the information on household characteristics presented in that table pertains to 1983-4, the year immediately preceding the issue of IRDP loans in 1985 (a few

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[21]. This section is based on Drèze (1990b), where a more detailed discussion of the Integrated Rural Development Programme can be found.

Table 10

AVERAGE CHARACTERISTICS OF IRDP BENEFICIARIES, COMPARED WITH OTHER HOUSEHOLDS

	Land owned[a] (bighas)	Land cultivated[a] (bighas)	Number of adult males	Household income, 1983-4[a] (Rs/year)	Proportion of housholds below the poverty line, 1983-4[b] (%)
Average for IRDP households	**15.1 (2.0)**	**17.5 (2.3)**	**2.0**	**7,214 (965)**	**43 (33)**
Average for all (2.7) Palanpur households	**18.1 (2.8)**	**18.5**	**2.0 (1,025)**	**6,883 (34)**	**40**

[a] Per-capita figures in brackets.

[b] Based on a poverty line of Rs 140 per capita per year at 1960-1 prices; in brackets, the proportion of <u>individuals</u> below the poverty line.

Note: The information in the first row pertains to 21 households which received IRDP loans in 1985 and (in a few cases) 1986.

loans were also issued in 1986). Thus, this information provides the right basis for assessing whether the scheme has reached the "intended" beneficiaries.

Table 10 suggests that IRDP has failed in its objective of targeting loans to poor households. The average characteristics of beneficiary households (in terms of amount of land owned, size of operational holding, number of adult males and per-capita income) are quite close to the corresponding averages for the village as a whole.[22] Further examination of the distribution of these characteristics also suggest that, if anything, there is a bias against the poorest households in the allocation of IRDP households. For instance, (1) <u>none</u> of the beneficiaries are landless, except a shop-keeper who happened to be in the top decile of the per-capita income scale in 1983-4; (2) <u>all</u> the beneficiary households have at least one adult male.[23] Also of interest is the fact that the list of IRDP beneficiaries does not include a single female beneficiary.[24] We also note in passing that IRDP beneficiaries include the headman of the village as well as the deputy headman, both of whom are prosperous farmers.

The manager of Prathma Bank readily admitted that IRDP loans were sanctioned with little attention to the official requirement that they should be given to poor households. As far as he was concerned, it was extremely hard to ascertain whether the applicants were genuinely below the "poverty line". Besides, as a bank manager he had little interest in dealing with poor borrowers, whom he considered to be particularly prone to default.

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[22]. Interestingly, the average household income of IRDP beneficiaries is more than <u>twice</u> as high as the eligibility cut-off of Rs 3,500 (in spite of 1983-4 being a year of poor harvests and depressed incomes in Palanpur).

[23]. On the vulnerability of households without adult males in Palanpur, see Lanjouw and Stern (1991) and Drèze (1990a). Palanpur has 6 households without adult males, and 18 households without a physically fit adult male, none of which are included in the list of IRDP beneficiaries except for the relatively affluent shop-keeper mentioned in the text.

[24] This may have changed later on, after the introduction of a 30 per cent quota for women.

In conclusion, if we recall that the targeting of credit to vulnerable groups is the main distinguishing feature of IRDP, it is hard to be cheerful about the implementation of this programme in Palanpur.[25] In spite of its claim to the special status of "anti-poverty programme", IRDP functions more or less like any other form of institutional credit.

2.6. **Contrasts in Institutional Lending**

Much of our discussion so far has concentrated on the Farmers' Service Society, which accounted for two-thirds of institutional debts outstanding in 1984. The record of this particular institution is poor by any standard, with the transfer entry system playing a major part in this failure. It is quite possible that rural banks, on the whole, function somewhat better than the Farmers' Service Society. The "cooperative" sector in Uttar Pradesh is notorious for endemic corruption, and the institutional arrangements involved in a "government-assisted cooperative" certainly provide little protection against unscrupulous managers. The managers of Prathma Bank and the Land Development Bank seem to be more accountable to higher echelons of the banking bureaucracy, and this may explain why we have not found evidence of anything like the transfer entry system in the functioning of these institutions. Having said this, Palanpur residents were able to cite many instances of corruption on the part of rural bank managers, and objective evidence of fraud is also not hard to find.[26] Similarly, the problems of low recovery and

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[25]. The other distinguishing feature of IRDP is that loans are "tied" to the acquisition of specific productive assets. This procedure, which is implicitly based on the dubious assumption that bank managers know better than their clients where the latter's economic interests lie, is itself seriously flawed. See Drèze (1990b) for further discussion, and also Seabright (1989a, 1989b).

[26]. For instance, when we visited one of the local Prathma Bank offices (in Jargaon), and examined the bank records, we found that many of the borrowers from Palanpur did not meet the official eligibility conditions. When we pointed this out to the manager, he replied with an embarrassed smile, "you mean that there is something black at the bottom?". Later we discovered that a number of these loans had actually been taken by Mahinder Singh, a petty gangster from Chandora (one of the neighbouring villages), in the name of Palanpur gamblers who owed him money.

regressive distribution are not confined to the FSS, as we saw earlier. On the whole, the operational similarities between the Farmers' Service Society and the rural banks are more striking than the differences.

The contrast between the Farmers' Service Society and the Seed Store is more interesting. In comparison with the FSS, the system of seasonal loans in kind operated by the Seed Store works relatively well. We have already noted one aspect of this contrast: unlike the Farmers' Service Society (or, for that matter, the rural banks), the Seed Store lends more to the poor than to the rich. Another distinguishing feature of the Seed Store is that it has a good recovery rate: a large majority of farmers repay their debts at harvest time, as agreed.[27] Finally, there is no evidence of large-scale corruption in the operations of the Seed Store, even though borrowers often complain of receiving under-weight wheat bags and other mild forms of managerial deception.

A number of related explanations can be advanced for this contrast. First, the administrative and accounting procedures of the Seed Store are simple and widely understood. In fact, the Seed Store's system of wheat loans to be repaid with 25 per cent interest in kind after the harvest can be seen as an institutionalised version of the traditional system of deora loans in kind practiced by village lenders (see section 5.2). Further, the reliance of borrowing and repayment operations on physical quantities of wheat, rather than on paper money and written entries in account books, makes all transactions clearly visible. This transparency is in sharp contrast with the secretive accounting of the Farmers' Service Society.

Second, all wheat loans given by the Seed Store in a particular year are issued within a short period of time (just before the beginning of the rabi season), and they are also recovered over a short period (just after the wheat harvest). As

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[27]. Discussions with Seed Store employees indicate that the recovery rate on kind loans is high in other villages too.

a result, issue and repayment are to some extent collective processes, with much less scope for harassing individual borrowers than exists in the case of FSS loans. The collective nature of the recovery exercise, together with the conformist instincts of Palanpur villagers, also make it less likely that a farmer will take the bold step of refusing to repay.[28]

Third, the link between harvest and repayment strengthens the chances of timely recovery. At harvest time, when there is grain in abundance, it is not very difficult to persuade a farmer to part with a small proportion of her or his stocks in order to get rid of a potentially threatening debt. And it is hard for a farmer, at that time, to claim that he or she is unable to pay. Just as private moneylenders seem to find it comparatively easy to recover seasonal <u>deora</u> loans in kind, if necessary by meeting their borrowers on the threshing ground (see section 5), the operations of the Seed Store take successful advantage of this link between harvest and repayment.[29]

Fourth, as was discussed earlier, loans from the Seed Store are small, and take the form of low-quality wheat. This procedure helps to ensure a relatively progressive distribution of credit through self-selection.

Fifth, the employees of the Seed Store have an incentive to recover the loans, since wheat repaid at the end of one year provides the basis for new loans in the following year. In the absence of adequate recovery, the lending operations of the Seed Store are bound to shrink, and the employees may eventually lose their job.

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[28]. For formal analyses of "peer monitoring" in credit markets, see Stiglitz (1990), Armendáriz de Aghion (1994) and Besley and Coate (1995).

[29]. In this connection, it is worth mentioning that the sugar mill mentioned in footnote 11 also has a relatively good repayment record. Here again, there is a link between harvest and repayment, in so far as the mill recovers its advances through deductions from payments for sugarcane deliveries. The system is helped by the fact that clients have an incentive to maintain a good rapport with the government-owned mill, which usually pays a higher price for sugarcane than the private mills.

In short, there are useful lessons to be learnt from the relatively successful performance of the Seed Store. Among these lessons are the usefulness of a "self-selection" device, the importance of transparent procedures, the advantage of linking recovery with the harvest, and the relevance of managerial incentives. At the same time, it must be remembered that the Seed Store serves a rather limited purpose of short-term consumption stabilisation. Its mode of operation may not be so easy to emulate when it comes to the more ambitious aim of supporting productive investment.

3. **Allies and Patrons**

3.1. **Introduction**

Before commenting on interest-free credit, we should reiterate that the extent of underreporting is likely to be somewhat higher than average for this particular type of credit.[30] Although we feel confident that the overall level of underreporting in the credit data presented in this paper is quite low (due to careful data collection and extensive cross-checking), some substantial underreporting of interest-free loans cannot be ruled out. Small amounts borrowed for short periods from friends, patrons or neighbours can be easily overlooked by respondents in a credit survey. The larger interest-free loans tend to be taken from relatives outside the village, which precludes cross-checking, and are sometimes regarded as a private matter, not to be lightly disclosed. The resulting estimates of the importance of interest-free credit must be, if anything, on the low side.

Even then, the available data indicate that interest-free credit plays a significant role in Palanpur's economy. In 1984, interest-free debts outstanding amounted to nearly Rs 24,000, or about 6 per cent of total debt outstanding and

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[30]. Following the terminology introduced in section 1, the terms "interest-free credit" and "credit from allies and patrons" will be used interchangeably.

27 per cent of outstanding debt to all private creditors (see Table 11). The share of interest-free credit in debts outstanding is almost as large as that of credit from village lenders or urban moneylenders.

Interest-free loans can reflect a variety of motives on the part of the lender. In a majority of cases, the reported purpose (as stated by the lender) is to "help a friend or relative", but this response is not very informative. In some cases, an interest-free loan is simply an unrequited favour made by the lender to the borrower, possibly due to genuine concern or to a sense of social obligation (the latter is likely to be particularly important for loans given to relatives). In other cases, the loan is embedded in a broader relationship of "balanced reciprocity" between the borrower and the lender, involving careful mental accounting of what the partners do for each other and a strong expectation that every gift or favour will be returned at some stage. A third possibility is that the lender sees the loan as a way of gaining the sympathy or loyalty of the borrower. For instance, a village shop-keeper or doctor may occasionally give an interest-free loan in the hope of winning a regular customer; similarly, a farmer who hires a great deal of labour may find it in his or her interest to enter into a patronage relation, involving occasional interest-free loans, with a particularly skilled labourer.

Turning to the motives of the borrowers, an interest-free loan is likely to be more readily obtainable if the borrower's need for cash is seen as compelling, urgent and legitimate; this suggests that the "purpose" of interest-free borrowing would often be related to some kind of unforeseen distress. The information presented in Table 12 broadly supports this hypothesis: nearly half of outstanding interest-free debts are accounted for by medical expenses and other crisis-related needs, not including expenditure on social functions such as marriage ceremonies and death rites (the obligations associated with these social functions do, in fact, often cause unforeseen financial distress). While a significant proportion (25 per cent) of loans have been classified as taken for "productive" purposes, it should be noted that even within that category distress can remain an important factor (e.g. when the purpose is to quickly replace draught animals that have been lost

Table 11

INTEREST-FREE CREDIT FROM "ALLIES AND PATRONS"

Source	Total debts outstanding in 1984[a] (Rs)	Average debt size (Rs)	Total amount borrowed in calendar year 1983[a] (Rs)
Outsiders:			
relatives	17,250 (15)	1,150	2,950 (5)
others	3,180 (5)	636	200 (1)
TOTAL OUTSIDERS	**20,430 (20)**	**1,022**	**3,150 (6)**
Palanpur residents:			
regular moneylenders[b]			
same caste	400 (3)	133	150 (1)
other caste	1,675 (10)	168	950 (4)
others			
same caste	221 (3)	74	171 (2)
other caste	1,200 (6)	200	400 (1)
TOTAL PALANPUR	**3,496 (22)**	**159**	**1,671 (8)**
GRAND TOTAL	**23,926 (42)**	**570**	**4,821 (14)**

[a] Number of loans in brackets.

[b] This group consists of six individuals who regularly issue interest-bearing loans (see section 5 for details).

Table 12

DISTRIBUTION OF INTEREST-FREE DEBTS TO ALLIES AND PATRONS, BY REPORTED PURPOSE (1984)

Purpose reported by the borrower	Amount outstanding[a] (Rs)	
Coping with a crisis	4,500	(31)
Medical expenses	2,350	(16)
Marriage ceremonies, death rites and related occasions	2,430	(17)
Construction of house	1,700	(12)
Productive purpose	3,700	(25)
TOTAL	**14,680**	**(100)**

[a] Percentage distribution in brackets (excluding the "unspecified purpose" category).

Note: Only debts for which a specific purpose could be identified are included in this table.

at a critical time). The importance of unforeseen distress as a motive for interest-free borrowing contrasts with the predominance of productive investment as a motive for borrowing from institutional sources.

As far as the sources of interest-free credit are concerned, the most interesting observation emerging from Table 11 is that the bulk of interest-free credit comes from relatives outside the village. Within the village, there is a certain amount of interest-free lending by regular moneylenders.[31] But interest-free loans from Palanpur residents other than regular moneylenders are few and far between (for instance, only three such loans were issued in 1983).

The large share of interest-free lending coming from relatives outside the village sharply contrasts with the almost total absence of interest-free lending between relatives <u>within</u> Palanpur. Given the practice of strict caste endogamy, a loan from a relative living in the village would appear in Table 11 under one of the two "same caste" categories, although not all loans in these two categories can be assumed to come from relatives. Thus, loans from relatives within the village account <u>at most</u> for a paltry sum of Rs 621 outstanding, and for three loans issued in 1983. This contrast is worth pursuing.

3.2. **<u>Interest-free Credit from Relatives</u>**

The virtual absence of interest-free loans from relatives within the village tells us something quite important about the relationship between close relatives who live in "separate" households (<u>nyare</u>). If it were the case that a strong sense of solidarity often existed between such relatives, one would have expected this solidarity to be visible inter alia in a certain amount of interest-free lending.[32] In

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[31]. As explained in section 1, interest-free loans from persons who also happen to be village lenders are counted as coming from "allies and patrons".

[32]. One qualification is that close relative typically have other means of practising solidarity than interest-free lending (including joint living arrangements). On its own,

fact, there is no evidence of such lending, suggesting little economic solidarity between relatives belonging to different households. Direct observation lends some support to this view. For instance, relations between separated brothers in Palanpur are often (though not always) quite strained.[33]

The fact that interest-free credit from relatives living <u>outside</u> the village is quite important is also consistent with what we know of family relations in this region.[34] In Palanpur, as in many other parts of north India, there is strict adherence to the rule of patrilocality and village exogamy, with a bride joining her husband's village at the time of marriage and literally "belonging" to his family thereafter. Wife-givers tend to be considered as "inferior" to wife-takers, and goods rarely flow from the latter to the former. For instance, a man who happens to visit his married daughter in her husband's village rarely accepts a meal, and if he does he often insists on paying for it. By contrast, goods do flow from wife-givers to wife-takers, most conspicuously in the form of dowry but often also after the marriage ceremonies.

Interest-free credit transactions in Palanpur can be seen to fit into this general pattern. Given the strongly patrilineal and patrilocal kinship structure prevailing in the area, a man's relatives outside the village consist first and foremost of his wife's family, his married daughters and their in-laws, and his sisters and their in-laws. A majority of interest-free loans from relatives have been

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however, this consideration is unlikely to explain the virtual non-existence of interest-free lending among relatives within Palanpur.

[33]. In Palanpur, as in much of north India, a sharp dichotomy exists between "separate" and "joint" living arrangements (see Drèze, 1990a). Within the village, a group of people can either live "together in the same household" (<u>sajhe</u>), in which case the norm is that they should pool all their resources, or they can live "separately" (<u>nyare</u>), in which case solidarity gives way to strict independence. Intermediate arrangements are rare.

[34]. On family relations in north India, see Altekar (1956), Karve (1965), Shah (1973), Kapadia (1966), Miller (1981), Dyson and Moore (1983), Uberoi (1993), Agarwal (1994), among others. There are, of course, important variations between different castes and religious communities in this respect.

taken from the first of these three groups, and this agrees with the notion that goods normally flow from wife-givers to wife-takers. Borrowing from one's married daughter or her in-laws, or even from one's sister or her in-laws, would be quite contrary to dominant social norms. It is comparatively easy to obtain a loan from one's father-in-law (or brother-in-law), especially if the latter feels that agreeing to such a request would be of help to his own daughter (or sister).

This is not to say that borrowing from in-laws is altogether unproblematic. Even in this form, borrowing involves some loss of prestige, and lack of timely repayment can easily lead to considerable resentment from the lender. Reluctance to take the risk of spoiling good family relations is a motive that was often given by our respondents for <u>not</u> borrowing from relatives.

The importance of interest-free lending between affinal relatives highlights the insurance role of marriage alliances in a risky environment.[35] The convention that support can be obtained from one's in-laws in times of adversity can be seen as a form of social insurance, and village exogamy reduces the problems of covariate risks that would interfere with this insurance system if most marriages took place within the same village. This is not to say, of course, that the insurance role of marriage alliances "explains" the practice of village exogamy.[36] This insurance role, however, may have contributed to the resilience of traditional marriage practices in north India.

3.3. <u>Interest-free Credit within the Village</u>

As Table 11 indicates, a large share of interest-free credit within the village

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[35]. For an interesting empirical analysis of this question with reference to south India, see Rosenzweig (1988).

[36]. It should also be mentioned that while the practices of patrilocality and village exogamy enhance security for <u>men</u>, they create some important forms of insecurity and vulnerability for women, especially widows. For further discussion of this issue, see Drèze (1990a) and the literature cited there.

comes from regular moneylenders. About half of that is accounted for by advances on cultivation expenses made by moneylenders to their tenants. Most of the remaining interest-free loans by village moneylenders have been given by Mohan, a somewhat unusual moneylender whose lending practices will be examined in section 5.

Interest-free credit from village residents other than regular moneylenders mostly consists of small, short-term loans between friends or individuals who have some other kind of personal bond. No strong patterns emerge as far as the distribution of borrowers and lenders by caste, occupation, income or land ownership is concerned. One noteworthy observation, however, is the practical absence of interest-free lending among members of the Jatab caste. In 1984, only one of them had an outstanding interest-free debt, and none of them reported giving any interest-free loans. It is interesting that the most deprived and vulnerable social group in Palanpur is also the group within which solidarity in the form of interest-free lending appears to be most restricted.

On the whole, the most prominent feature of interest-free lending within the village is perhaps its low overall incidence (see Table 11). One possible explanation for the limited reach of interest-free credit within the village is that short-term income fluctuations are highly correlated across households. Covariate risks (arising, for instance, from common exposure to agro-climatic uncertainties) reduce the scope for reciprocal interest-free lending, since periods of economic hardship for one household are also likely to be periods of hardship for other households.[37] This argument is consistent with the fact that active systems of reciprocal interest-free credit have been observed in some Indian villages where different households face frequent but largely <u>independent</u> fluctuations in income, such as coastal fishing villages (see section 6). In Palanpur, by contrast, there is less scope for this type of mutual insurance. Even in Palanpur, however, there is

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[37]. On covariate risk as a constraint on the development of credit arrangements in Indian village economies, see Binswanger and Rosenzweig (1986a, 1986b); also Walker and Ryan (1990) and P. Dasgupta (1993).

a good deal of idiosyncratic risk, and the potential gains from mutual insurance must be far from negligible.

Note also that, according to many respondents, reciprocal interest-free credit used to be quite common in Palanpur, and has sharply declined over the last thirty years or so. This too suggests that covariate risk alone is not an adequate explanation for the limited practice of interest-free credit in Palanpur today, especially since income fluctuations for different households are probably less correlated than they used to be, due to the diversification of economic activities and cropping patterns. Another line of explanation is that mutual solidarity has declined over this period precisely because the economic circumstances of different households have become less similar. While economic diversification reduces the problem of covariate risk, it may also lead to a reduced sense of solidarity among households who used to share common circumstances. This interpretation is consistent with local perceptions of the decline of interest-free credit in Palanpur, which is often linked to a general decline of solidarity and mutual assistance in the village.

It is also possible that the main basis of interest-free credit in earlier days was not reciprocity but patronage, e.g. in the form of interest-free loans by the larger employers or landlords to their labourers and tenants. The decline of interest-free credit in Palanpur could then be interpreted in the context of the broader decline of patronage relations, widely observed in rural India. Generally, it is possible to think of interest-free credit as a non-market transaction par excellence, and to interpret the decline of interest-free credit in Palanpur as one manifestation of the displacement of personalised relations by market transactions. The decline of reciprocal credit and patronage relations fits in that broader perspective.

4. Urban Moneylenders

Urban moneylenders are usually affluent traders or goldsmiths, often members of the Banya caste (whose traditional occupation is commerce). Since Chandausi is the nearest town, and since the terms on which loans can be obtained are not likely to be less exacting in other towns, Palanpur villagers rarely go beyond Chandausi when they need a loan (although those who work in Moradabad sometimes borrow from moneylenders residing there). For specificity, and since they represent by far the most important group of urban moneylenders for Palanpur, the discussion of this section concentrates on Chandausi-based goldsmiths.[38]

For these goldsmiths, money-lending is an absorbing business. Due to legal restrictions (aimed, officially at least, at the protection of borrowers), the acquisition of a licence is a precondition of lending activities.[39] Even with a licence, goldsmiths are reluctant to lend to members of the scheduled castes, who -- in their view -- tend to be backed by the government in the event of litigation. Leaving this restriction aside, however, they are willing to lend to anyone who brings the required collateral.

A suitable collateral is, indeed, the essential condition for obtaining a loan from a Chandausi goldsmith. The standard collateral is jewelry -- either gold or silver. The value of the collateral is never less than the amount of the loan, and often it is much larger (e.g. twice as large in many cases). This may seem surprising since, with stable relative prices, a borrower is better off selling the collateral and buying it back later on (if possible) rather than taking a loan which has a lower value than the collateral. There are, however, at least two reasons why this argument does not apply. First, relative prices are not stable, and taking a loan ensures that risks arising from the uncertain future value of the collateral

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[38]. The factual basis of this section comes partly from our own survey in Palanpur, and partly from detailed information supplied by Shri Madan Lal, a Chandausi-based trader and close friend of one of the field investigators. We are grateful to Shri Madan Lal for his kind cooperation.

[39] The Uttar Pradesh Regulation of Money-lending Act 1976 provides for compulsory registration of moneylenders (section 10), maintenance of liquid assets (section 11), and ceilings on interest rates (section 12).

are shifted to the lender. Second, and more importantly perhaps, the particular items of jewelry that can be offered as collateral almost invariably have a special value in the eyes of the borrower. Often, for instance, they have belonged to the wife of the borrower ever since her marriage. This means that the cost of adequately "replacing" these items by purchasing jewelry would be much higher than their own market value. Hence, pawning may remain preferable to selling even when the value of the loan is lower than the market value of the collateral.[40]

One has to invoke similar arguments to explain why interest charges are lower for gold collaterals (typically 2.5% per month) than for silver collaterals (typically 3% per month). Again, with stable relative prices and fungible collaterals, it would be hard to make sense of this observation without invoking some rather convoluted economic model. In practice, however, collaterals of different kinds are not perfectly fungible, and this leaves scope for their carrying different interest rates. For instance, if a goldsmith is more confident about the future price of gold than about the future price of silver, he or she may demand a higher interest rate from borrowers who offer a silver collateral than from those who offer a gold collateral.[41]

Goldsmiths keep careful written records of loans and repayments. Among the terms of a loan agreement is a date at which the loan is expected to be fully repaid (usually a couple of years). If the loan is not repaid by that date, the

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[40]. A similar reasoning may explain why, in general, pawned goods consist of durable possessions that have personal value (e.g. land or household furniture) rather than of commodities for which everyone has a very similar reservation price, e.g. grain. Indeed, if borrower and lender have the same reservation price for the collateral, the system breaks down: if the value of the loan is lower than that of the collateral, the borrower is better off selling the collateral and buying it back later (assuming stable relative prices); if it is larger, the borrower has an incentive to default, and the lender is likely to refuse the loan.

[41]. Ability to produce a gold collateral may also be taken by the lender as a signal that the borrower is relatively wealthy and more likely to repay. Note, however, that goldsmiths may not be particularly concerned about repayment, given that the value of the collateral is usually well above the amount due (and remains above it throughout the agreed period of the loan).

lender reminds the borrower in writing that unless the loan is repaid without delay the collateral will be appropriated.[42] If the borrower does not respond, this threat is put into effect.

Urban moneylenders accounted for 6 per cent of all debts outstanding in 1984, and about a third of debts outstanding from private sources (Table 5). This is not very large, but credit from urban moneylenders has a special significance in so far as it is the only important credit source for which no borrower faces any rationing (as long as he or she possesses the required collateral).[43] Hence, the cost of credit from this source may be regarded as an upper bound on the marginal cost of credit for collateral-owning households in Palanpur. However, the cost of credit from urban moneylenders is not easy to assess, since one has to take into account not only the interest payments of 2.5 to 3 per cent per month, but also the risk and consequences of losing the collateral.

5. **Village Lenders**

Let us now turn to the fourth major source of credit identified earlier -- interest-bearing credit within Palanpur. For clarity, this section concentrates primarily on the lending activities of the six "regular moneylenders" mentioned in section 1, who account for more than two thirds of all interest-bearing debts owed to Palanpur residents.[44] Unless stated otherwise, the term "moneylender"

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[42]. It may be asked why a lender should bother to send a reminder to his client, and why he should accept repayments beyond the agreed date. According to Madan Lal, lenders do this to avoid getting involved in quarrels that could damage their reputation. The written reminder may also have some evidential value in the event of litigation (written reminders are, in fact, a legal requirement).

[43]. An important qualification, as we saw earlier, is that urban moneylenders are reluctant to lend to members of the scheduled castes.

[44]. Note that all interest-bearing loans issued by Palanpur residents (whether regular moneylenders or occasional lenders) have been given to other Palanpur residents; there is no case of inter-village, interest-bearing lending involving a Palanpur resident as the lender.

will be understood in this section to refer to these six individuals. Interest-bearing lending by occasional lenders will be briefly examined in section 5.3.

5.1. **The "Skill" of Money-lending**

In the literature on credit in rural India, there has been much debate around the question of whether moneylenders have much "monopoly power". Interestingly, this debate has not included much discussion of where this monopoly power, if real, might come from. One common idea, which is consistent with the stress on asymmetric information in recent analyses of rural credit, is that moneylenders have privileged information about the characteristics of local borrowers. This statement makes some sense if the comparison is between village moneylenders and, say public lending institutions or urban-based lenders, but it is much less persuasive as an explanation of why money-lending activities are taken up by particular individuals in the village and not others. Moneylenders in Palanpur, for instance, have no obvious informational advantage over other potential lenders. Further, the pool of potential lenders seems to be quite large, judging from the fact many individuals in the village lend on an occasional basis, and have enough resources to lend more. What, then, is so special about those who have become moneylenders?

Characteristics of Moneylenders

Two of Palanpur's six moneylenders, Dumber and Ram Prakash, lend exclusively to gamblers. There is an active gambling circle in Palanpur (sustained by the regular cash earnings of those who have relatively well-paid jobs outside the village), and in certain circumstances gamblers are prepared to pay extremely high rates of interest (e.g. 20% per week) to obtain a small sum of cash without delay. For those who are able to recover their loans from this rowdy crowd, and who are prepared to overlook the resentment of the village community, lending to gamblers can be an attractive investment. Dumber and Ram Prakash, both gamblers themselves, have firmly seized this opportunity. This is obviously a rather special segment of the village credit market, and we shall ignore it in the remainder of this paper, except for occasional remarks.

This leaves us with four moneylenders; their characteristics are described in Table 13. The information presented in this table suggests -- and this is corroborated by an examination of other economic characteristics of moneylenders and their households -- that, in terms of endowments or income, moneylenders occupy an advantaged but by no means exceptional position in the village society. Each of the four regular moneylenders included in Table 13 can be fairly described as a prosperous farmer or landowner. They are all above (usually well above) the median of the village distribution in terms of per-capita land ownership, per-capita income and per-capita wealth. But only two out of four are in the top decile of the per-capita land ownership scale, and only one is in the top decile of the 1983-4 per-capita income scale. The ranks of these moneylenders in the per-capita income scale were probably lower than usual in 1983-4, because cultivation is their main source of income and this was a year of poor harvests. Indeed, they do rank considerably higher in the scale of per-capita wealth (each of the three moneylenders for which the relevant data are available is in the top decile of that scale). Even the wealthiest moneylender, however, only comes fourth in the scale of per-capita wealth. While moneylenders are certainly among the better-off households in Palanpur, quite a few other households are in the same league.

Further, it should be noted that the amounts due to these moneylenders are not particularly large (see Table 14). Their average credit outstanding is only Rs 4,232, or about 30 per cent of the average annual income of households in the top quintile of the household income scale. Many households in Palanpur would be able, if needed, to save comparable sums of money: some of them, in fact, save much larger sums for their daughters' weddings, or for productive investment. The possession of exceptional economic endowments or cash resources is not the distinguishing characteristic of moneylenders.

Table 13: REGULAR MONEYLENDERS IN PALANPUR

	Gulabo	Harpal	Mohan	Nisar
Personal characteristics				
Sex	F	M	M	M
Age	55	65	55	51
Caste	Thakur	Thakur	Murao	Dhobi (Muslim)
Education	Nil	Nil	Nil	Nil
Household characteristics				
Size	9	5	8	11
Number of fit adult males	2	1	2	3
Main occupations	Culti-vation	None (landlord)	Culti-vation	Culti-vation
Land owned per capita[a] (bighas)	6.9 (2)	11.4 (1)	11.3 (1)	1.6 (5)
Land cult. per capita (big.)	6.0	2.8	10.4	4.2
Rank in the per-capita income scale, 1983-4[b] (1 = top decile, 10 = poorest decile)	4 (6,417 + 3,361)	4 (4,705 + 1,232)	1 (15,888 + 1,706)	3 (14,366 + 878)
Estimated rank in the scale of per-capita wealth (richest hh = 1, poorest = 143)	11	6	4	n/a
Remarks	Largest lender in the village. Widow, head of a joint-family household. Born in Palanpur. Relative of village headman.	Old widower. Lives with deceased son's family, mainly from land rent. Ex-headman. Brother of current headman.	Childless man, living with nephew and family. Often lends at "low" interest rates, or even interest-free.	Recently migrated to Palanpur. Lends mainly to Jatabs. Sometimes demands land collateral on cash loans.

[a] In brackets, the household's rank in the per-capita land ownership scale (1=top decile, 10=bottom).

[b] In brackets, our estimate of household income in 1983-4 (Rs/year), written as the sum of (1) non-interest income (first figure), and (2) a rough estimate of income from moneylending (second figure) based on the data presented in Table 14.

Note: This table omits the two lenders who specialise in gambling-related lending (see text).

Table 14

OUTSTANDING LOANS OF FOUR REGULAR MONEYLENDERS (1984)

Name	Total value of loans outstanding (Rs)				Total number of borrowers
	Interest-free loans	Loans in kind	Interest-bearing cash loans[a]	All loans	
Gulabo	300	361	6,363 (50%)	7,024	22
Harpal	0	203	3,058 (37%)	3,261	9
Mohan	484	2,795	1,144 (27%)	4,423	19
Nisar[b]	366	1,053	800 (n/a)[c]	2,219	10
TOTAL	1,150	4,412	11,365 (44%)	16,927	60

[a] In brackets, the average (annual) interest rate charged on interest-bearing cash loans. It should be borne in mind that differences in these interest rates between lenders reflect partly different lending strategies, and partly also differences in the dates at which loans were issued (with more recent loans typically bearing higher rates of interest, as explained in the text).

[b] Although Nisar was interviewed shortly after the harvest, by which time all his loans in kind (except one) had been repaid, this table describes his credit position prior to the harvest.

[c] Instead of charging interest on this loan, Nisar has obtained the right to cultivate a plot of land belonging to the borrower until the loan is repaid (this is the system referred to in the text as "usufruct mortgage").

Note: This table includes interest-free loans (counted elsewhere as coming from "allies and patrons").

The demographic characteristics of moneylenders are of some interest (see Table 13). The fact that all of them are aged above 50, for instance, may not be an accident. Indeed, recovery tends to be easier when the lender has a higher social status than the borrower. A young man (not to mention a young woman) could easily experience difficulties in this respect.[45] A similar consideration applies to caste. Two of the four moneylenders (Gulabo and Harpal) are Thakurs, and their joint clientele spans the whole spectrum of castes. Mohan is a Murao, a caste ritually inferior to both Thakurs and Dhimars, and his clientele does not include anyone from these two castes. Nisar is a Muslim, and almost all his loans are to poor Jatabs (there are only two exceptions, and in both cases Nisar took the unusual step of demanding a collateral). Overall, moneylenders do seem to have a tendency to avoid lending to persons who have a higher social status than their own.

Given the importance of authority and social status for successful recovery, one might also expect all moneylenders to be men. In fact, Palanpur's leading moneylender is a woman, Gulabo. However, the combination of favourable factors that has enabled her to become a successful moneylender is rather exceptional. First, she is a Thakur (by far the "highest" caste in the village). This gives her some ascendancy over people of other castes, in spite of being a woman. Second, she commands the respect due to a woman in her mid-fifties who has two adult sons (the eldest son is an active partner in her money-lending business). Third, Gulabo is a close relative of the headman. Fourth, she is a widow, and has a more autonomous and assertive lifestyle than most women under conjugal control. Fifth, and perhaps most importantly, unlike most other women in the village Gulabo was born in Palanpur itself.[46] This means that she has much

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[45]. One of the two moneylenders who specialise in gambling-related loans is in his mid-thirties. But his clients themselves tend to belong to an even younger age group, confirming the age-hierarchy pattern observed here.

[46]. Gulabo has no brothers, and whilst she did leave the village at the time of her marriage, she returned to Palanpur after her father's death, when she inherited his land.

greater freedom than other Thakur women (who normally have a very restricted lifestyle) to circulate within the village, interact with other persons, and, if necessary, seek the support of male relatives from her own family; it also means that she has a good knowledge of the character and circumstances of many of her potential clients.[47]

Considering education next, it is interesting that moneylenders are not well-educated (see Table 13). In fact, they are all illiterate, and none of them has ever gone to school. While three of the four moneylenders considered here have literate sons, it is also quite plausible that illiteracy does not stand in the way of successful money-lending, since credit contracts within Palanpur are never written and since villagers often have an outstanding ability (most evident in the case of shop-keepers) to keep mental records of complicated accounts.[48]

On the whole, moneylenders emerge as rather unremarkable people as far as socio-economic characteristics of the type presented in Table 13 are concerned. While they are all above 50 and illiterate (not a particularly exacting qualification), their characteristics in terms of caste, gender, endowments and even income are quite diverse and do not set them apart from other prosperous households in any obvious way. So far, there seems to be no important barrier to the profession.

The enforcement problem

At this point it is worth recalling that, with the kinds of interest rates that prevail in Palanpur, and in the absence of lending risks, small amounts of money

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[47]. This last reason for Gulabo's privileged position among Palanpur women illustrates the connection between patrilocal exogamy and female dependence in north India. For further discussion of this issue, see Drèze (1990a) with reference to Palanpur, and Kishor (1993) with reference to north India as a whole.

[48]. The absence of written contracts is unlikely to be a consequence of moneylenders being illiterate. Witnesses are an effective substitute, used even by moneylenders who have literate sons. Also, most borrowers are illiterate and are usually reluctant to sign written documents.

invested in money-lending would yield phenomenally high returns in a short time. For instance, Rs 1,000 lent at an interest rate of 50 per cent per year in real terms (this roughly corresponds to the current "standard" for cash loans) would yield almost Rs 60,000 after 10 years. Thus, in the absence of lending risk, one would expect wealthy households to rush to offer a loan as soon as some demand arises (bearing in mind that money-lending is a free-entry activity). In fact, no such eagerness to lend can be observed, and the business of money-lending remains by and large confined to particular individuals.

This observation, together with the finding that moneylenders have no exceptional economic attributes, points to the hypothesis that money-lending is potentially a risky business, and that the distinguishing characteristic of moneylenders is precisely their ability to handle the risks involved. The most important of these risks, of course, is the risk of default; indeed, even small probabilities of default can dramatically reduce the returns to money-lending.[49]

It is quite difficult to assess how high the risk of default really is in Palanpur, especially since we did not systematically collect information on defaulted loans (the focus of the credit questionnaire was on <u>outstanding</u> debts). A number of cases of default, however, were mentioned and discussed during the interviews; Table 15 summarises the available information. Incomplete as it is, this information strongly suggests that default does occur from time to time, and that it is perceived as a real danger by potential moneylenders. The testimonies of occasional lenders are particularly instructive in this respect. Several of them clearly explained that they had, at one stage, ventured to lend money on a regular basis, and that they had given up after failing to recover their loans.

The fact that money-lending is a risky activity is one reason why

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[49]. If r is the (real) interest rate, and p the probability of default, then the expected return on an unsecured loan is $[r - p(1+r)]$. To illustrate, if r is 30 per cent and p is 0.2, then the actual return is as low as 4 per cent. For an early discussion of default risk and interest rate determination in developing economies, see Bottomley (1975).

Table 15

INFORMAL EVIDENCE ON DEFAULT

Name of the lender	Default-related information (based on interview with the lender, independent testimonies and direct observation)
1. Regular moneylenders	
Gulabo	There is very little evidence of any default on Gulabo's loans. However, Gulabo once complained of default on a loan of Rs 1,000 given to Swaroop (a heavily-indebted Dhimar known for occasional default).
Harpal	Evidence on Harpal's ability to avoid default is mixed. Some villagers claim that he rarely fails to recover a loan. But Harpal himself complains of poor recovery and of the "dishonesty" of many borrowers. He reports default from Jagdish, the village barber, on a loan of grain (worth Rs 232) given in the early 1970s; he has lost hope of recovering the money and considers that he has been cheated. Harpal no longer lends to Jatabs; he argues that they "cheat" a lot, i.e. often fail to repay. He also seems to have serious problems recovering his money from some of his debtor-tenants. It is possible that Harpal's ability to enforce recovery has diminished in recent years: he is growing old, his health is weak, and there are no other adult males in his household. Asked whether moneylending is a profitable activity, Harpal replies "dandewale ko faida hai", i.e. "it is profitable for those who enforce their authority with the stick".
Mohan	Mohan gave no direct information, but independent sources strongly suggest that he occasionally fails to recover a loan (eg. we heard that Chander Pal, a Jatab labourer, borrowed 50 kgs of bajra from Mohan around 1980 and didn't repay).
Nisar	Nisar, who has the reputation of being a tough moneylender, boasts that "nobody can cheat me", and independent testimonies lend credibility to this claim. Nisar's understanding with many of his borrowers is that, if they fail to repay, he will demand the right to cultivate their land for a certain period; a threat which he has often put into effect, and which has enabled him to discipline some quite "disreputable" borrowers. In 1983-4, Nisar recovered all his deora loans (most of them were to Jatabs), except a small loan to Lochan, who died in December 1983; but Nisar claims that he will recover that one too, or else cultivate Lochan's land. Nisar recalls only one instance of default: a few years ago, he allegedly lent Rs 2,500 to Lila Dhar, a Jatab, who never repaid anything. Nisar preferred to give up rather than get into a serious fight with Lila Dhar because, he says, Jatabs are "protected by the government."

2. Occasional lenders

Rajinder	Reports having given three loans at 20% per week to gamblers, and that not a single paisa was repaid.
Roomi Singh	Says that "it can happen that a loan given on deora is not repaid", and gives the following examples of deora loans (to Jatab borrowers) which he never recovered: (1) 75 kgs of wheat to Danni, about 18 years ago; (2) 24 kgs of wheat to Chander Pal, 10 years ago; (3) 48 kgs of wheat to Baboo, about 20 years ago. He has no hope of recovering them.
Ram Singh	Mentions an unrecovered loan of Rs 500 to Naubat (Jatab) about 20 years ago, at 24% interest; nothing was repaid.
Gopal Singh	This household used to be deeply involved in moneylending (perhaps when Gopal's father was still alive), but has given up -- possibly because Gopal himself is unable to enforce recovery.
Raghubir	Reports three interest-free loans to Dhimar and Jatab labourers, none of which were recovered.
Bed Ram	Gave Rs 1,140 worth of wheat to Kadde Lal, a Jatab of Akroli, around 1980. Kadde Lal promised to pay the next day, but so far he has not paid. Bed Ram also gave 3 quintals of wheat to Jhargad of Bhoori, who died. He does not expect repayment.
Ram Avtar	Lalji (his father) used to lend occasionally, but he stopped after being "cheated" (partly by Jatabs) and losing Rs 10,000.
Triloki	Reports default on two deora loans given 7-8 years ago to Jagdish (the village barber) and Mangli (a Jatab). "I can't afford to get into a quarrel with Mangli because the law is against me". Triloki says he was "inexperienced" at the time, and made the mistake of lending for consumption. The four deora loans he gave this year are for seeds.
Prem Shankar	Gave Rs 600 at 2% per month to Ram Swaroop, a Passi railway employee. Prem Shankar recovered Rs 400, but then Ram Swaroop died, and Prem Shankar has little hope of recovering the balance from Ram Swaroop's widow.
Nasir	Reports giving three deora loans in 1983, none of which had been repaid by the time of the interview (July 1984).

Note: This table includes all regular or occasional lenders who reported some useful information on the question of default. The term deora refers to the traditional system of seasonal loans in kind (see section 5.2).

moneylenders are exclusively recruited among the rich (who are usually less risk-averse). As was discussed earlier, however, wealth alone is not a satisfactory predictor of involvement in money-lending. We would like to suggest that the crucial "skill of money-lending", which enables particular individuals to deal successfully with the risk of default, is the ability to enforce repayment.

Enforcement procedures

This suggestion immediately raises the further question as to why some people are able to enforce repayment while others are more vulnerable to default. One possibility that comes to mind is that successful recovery may depend on the willingness and ability of the lender to use physical force, or to threaten borrowers with the use of physical force. However, we have not heard of any case of a Palanpur moneylender beating up a recalcitrant borrower. And the mere threat of violence is not likely to be very effective unless it is actually carried out from time to time.[50]

The statement that the use or threat of physical violence on the part of moneylenders is rare in Palanpur has to be qualified, and the qualifications are themselves quite instructive. We can, in fact, report two cases where physical violence does appear to play an important role in enforcing repayment. The first case concerns Vishnu Dutt, the Brahmin moneylender who lives in an adjacent village but owns some land in Palanpur, where he sometimes lends (see section 1). Vishnu Dutt is known for his ruthlessness, and is even said to have committed at least one murder. Any borrower who dared to resist his pressures to repay would be exposing himself or herself to serious physical harm. The second case relates to Dumber, one of the two Palanpur moneylenders who specialise in

[50]. In theory, it is possible for the threat of physical violence to succeed in preventing default without ever being actually implemented (as Kolm [1973:266] has argued in a different context, the best policy may indeed be to "hang tax evaders with probability zero"). But this possibility is hard to square with the observation that default does occur quite regularly in Palanpur.

gambling-related lending. Dumber is the local henchman of Mahinder Singh, a petty gangster who -- like Vishnu Dutt -- lives in an adjacent village although he partly "operates" in Palanpur, where he is widely feared. Dumber's dealings with Palanpur gamblers are really a joint venture with Mahinder Singh; unlike other moneylenders in Palanpur, they do resort to physical force from time to time.

Both cases involve the use of violence (or of the threat of violence) by an "outsider". It is indeed quite plausible that the use or threat of violence is far more frequently invoked by an outsider than by a resident moneylender, for several reasons. First, outsiders have fewer opportunities than village moneylenders to put pressure on borrowers through non-violent means (based on social norms, peer pressure, reputation effects, etc.). Second, being less familiar with the village community, outsiders are less well placed to avoid the need for physical pressure by making sound prior judgements about the reliability of different borrowers. Third, outsiders have greater freedom to use "anti-social" practices such as harassing a borrower, in so far as they are less dependent on preserving their good reputation and the good will of the village community.

Let us now return to the issue of why some people are better than others at enforcing repayment. Willingness to use violence, we have argued, does not appear to provide an explanation. Ability to obtain a collateral from the borrower is also unlikely to be the clue, since there is no obvious reason why this ability should vary strongly between different individuals; in any case, collaterals are a rare feature of credit contracts within the village (see section 5.2). Similarly, while "interlinkage" may help to reduce the risk of default, there is no reason why a small group of lenders should have the monopoly of interlinked credit contracts; besides, interlinked contracts are rare in Palanpur (Sharma and Drèze, 1990). Surprising as it may seem, few credit contracts in Palanpur are backed either by the threat of violence, or by a collateral, or by interlinkage. Nor is it common for the borrower to be in a position of acute economic dependence on the lender (although this can certainly happen), or for any kind of clearly identifiable, tangible sanction to be commonly applied to recalcitrant borrowers.[51] In that sense, the majority of loans are completely "unsecured", and moneylenders ultimately have to rely on informal persuasion to enforce repayment.

This feature of credit contracts makes it particularly difficult to explain why some individuals appear to have a special ability to enforce repayment. However, we can mention several relevant considerations. First, Palanpur moneylenders strike the observer by their authoritative personalities: they are all individuals whom one would hesitate to antagonise or confront, and who are able to muster influential support from third parties in the event of an argument. Their authority partly derives from characteristics such as age, gender, caste and wealth, discussed earlier; it also relates to other factors such as personal history, family background, bargaining skills, etc. Second, some members of the village have a special ability to make life difficult for a recalcitrant debtor, deriving from the role they play in the economy and society and to the connections they have with other influential members of the village. The fact that both Harpal and Gulabo, for instance, are close relatives of the village headman may not be accidental. Third, ability to judge a borrower, and the incentives that he has to repay (given his concern for reputation, his relationship with the lender, the lender's position in society, etc.), must be a major asset in avoiding default on unsecured loans.[52] It seems to be a combination of attributes and abilities of this type (authority, influence, shrewdness, etc.) that enables particular individuals to become successful

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[51]. Note in particular that only a small proportion (15 per cent) of Palanpur households borrow from a single source (and in half of these cases, the single source is a public lending institution rather than a private lender). Interestingly, it is more frequent for a lender to have a single debtor -- half Palanpur's 38 lenders are in that situation.

[52]. The importance of screening devices is well recognised in the literature on rural credit in developing countries; for a good review, see Hoff and Stiglitz (1990). Note that analyses of informal screening mechanisms based on the lender's considered judgement, reputation effects, and related factors appear to be more relevant to Palanpur than those involving more sophisticated screening mechanisms such as indirect screening through choice of interest rate, formal collection of information on borrowers, or peer monitoring.

moneylenders.

The preceding discussion has a bearing on the debate between those who stress monopoly power as a cause of high interest rates in rural India, and those who see high default rates as the root of the problem. This dichotomy is somewhat misleading, in so far as monopoly power (such as it is) may precisely arise from the fact that some potential lenders are better able than others to protect themselves from the risk of default in a particular setting. In that sense, the risk of default and local monopoly power are better seen as two sides of the same coin.

5.2. Terms of contracts

Palanpur lenders give loans both in kind and in cash. The modalities applying to these two types of credit contracts are quite different, and it will be useful to consider them separately.

Kind loans

Most kind loans are based on a traditional system called deora (from der, meaning "one and a half"), which has existed in this area for a long time. Under this system, wheat lent at any time before the rabi harvest is repayable at the time of the harvest (in April-May) with an interest of 50 per cent in kind. Usually, deora wheat is borrowed around October, just before the wheat sowing season, but we have encountered instances of deora loans being taken as early as August and as late as February. Deora loans are unsecured (we have not encountered any exception to this rule). They are usually quite small, with the amount of wheat borrowed rarely exceeding 300 kgs. If a loan is not repaid after the wheat harvest, interest and principal are counted as a new deora loan, as in compound-interest accounting. However, the available evidence suggests that most deora loans are repaid without delay after the wheat harvest.

Deora loans are typically taken by relatively poor households for consumption purposes. These households tend to come from the disadvantaged castes (with a particularly high proportion of Jatabs), to own little land, and to have low per-capita incomes; see Table 16 for some relevant information. Borrowers not belonging to these groups have usually resorted to deora loans on account of special circumstances causing temporary distress. For instance, of the three Thakurs who took deora loans in 1983, one had been ill for several months and the other two needed extra resources for wedding expenses.

It is worth noting, however, that only two landless households took deora loans in 1983. Both of them are landless labourers, who borrowed from one of their regular employers. It is plausible that landless households generally have restricted access to deora credit, since the system is effectively based on using the borrower's future harvest as a quasi-collateral. In principle, landless agricultural labourers could attempt to offer their future harvest wages as a quasi-collateral, and this is what the two landless labourers in question seem to have done. But future wages are likely to be less persuasive as a quasi-collateral than a future harvest, since a landless labourer may not be in the village at the time of the next harvest, or may not be able to work (e.g. due to sickness).

The involvement of Jatabs in deora borrowing is particularly high (13 out of 19 Jatab households borrowed wheat on deora in 1983). This observation is particularly interesting in view of the very low involvement of Jatabs in other forms of private credit. As was mentioned earlier, interest-free borrowing is rare among Jatabs, and urban moneylenders are reluctant to deal with them as with other scheduled castes. It will also be seen further in this section that Jatabs do not have a single cash loan outstanding with village lenders. For them, deora loans are the only significant source of private credit.

Nisar, the Muslim moneylender, is a specialist of deora loans to Jatab households. In 1983, he gave 9 deora loans to Jatab borrowers, and none to members of other castes. Interestingly, Nisar smoothly recovered all his deora

Table 16

CHARACTERISTICS OF *DEORA* BORROWERS, COMPARED WITH OTHER HOUSEHOLDS

	Households which took *deora* loans in calendar year 1983	Other households
Per-capita land ownership (bighas)	1.9	2.9
Proportion reporting casual labour as a major occupation (%)	63	38
Proportion below the poverty line (%) [a]	63	38
Proportion belonging to the Jatab caste (%)	54	5

[a] Based on a poverty line of Rs 140 per capita per year at 1960-1 prices.

loans after the wheat harvest in May 1984, with the possible exception of a small loan of 50 kgs of wheat given to someone who died shortly before the repayment date (see Table 15 for details). This is particularly impressive in view of the fact that the wheat harvest was poor. Nisar's claim that nobody can cheat him (see Table 15) does seem to have some basis.

The real cost of deora loans depends inter alia on the date of issue and on price changes over the loan period. In general, the real monthly interest rate on deora loans, say r, can be calculated as

$$r \equiv [(1.5).(1-d)/(1+i) - 1]/t,$$

where d is the percentage decline in the price of wheat over the loan period (remember that deora loans are repaid at harvest time, when the price of wheat tends to be relatively low), i is the percentage change in the overall price level and t is the duration of the loan in months.[53] The corresponding formula for the real interest rate (say r') on a cash loan bearing a simple interest of q per cent per month is

$$r' \equiv [(1+q.t)/(1+i) - 1]/t.$$

Around the time of the 1983-4 survey, standard values of q and t were 0.05 and 6, respectively. This implies that deora loans are "cheaper" than cash loans if and only if $(1.5).(1-d) < 1.3$, i.e. the decline in wheat prices over the six-month period preceding the wheat harvest is greater than 13 per cent. This condition is likely to be satisfied in most years (in 1983-4 itself, wheat prices declined by about 25 per cent during the relevant period). Thus, deora loans seem to be somewhat

[53] This formula assumes that monthly interest charges cumulate on a "simple" (rather than compound) basis, as is the case with cash loans.

cheaper than cash loans.[54] This is consistent with the fact that deora loans appear to be less risky than cash loans from the lender's point of view.

Indeed, a distinctive feature of deora loans is that lenders seem to find them comparatively easy to recover, as our earlier comments on Nisar's loans illustrate.[55] We have already discussed, in section 2.6, how recovery rates for seasonal kind loans from the Seed Store are higher than for cash loans from the Farmers' Service Society. It is probably for similar reasons that default appears to be less frequent on deora loans than on cash loans, judging from the experience of 1983-4. In particular, the possibility of meeting a borrower on the threshing ground gives lenders some protection against default. Even then, default does occur from time to time, as the testimonies presented in Table 15 indicate.

Before concluding on kind loans, we note that the deora system has a long history in Palanpur, and that even the precise terms of deora loans have remained unchanged over an extended period. The system already existed in its present form in 1957-8, at the time of the first survey of the village. We might add that very similar systems of seasonal loans in kind have existed elsewhere in India for a long time. For instance, deora is mentioned in William Crooke's 19th-century glossary of north Indian peasant life (Crooke, 1989: 166), where it is described in the same terms as those applying in Palanpur today. There is also much historical evidence of the existence of the deora system, or some local equivalent, in many other parts of north India in the nineteenth century.[56]

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[54]. Uncertainty considerations could either reinforce or qualify this conclusion, depending especially on whether wheat prices are more uncertain than other prices, and on the weight of wheat in the price index.

[55]. The fact that seasonal loans in kind tend to have good recovery rates has also been observed in a number of other studies (see section 6).

[56] See e.g. Pouchepadass (1983) on Bihar, Whitcombe (1972: 164) and Appendix I of the Famine Commission report of 1880 (p.194) on Uttar Pradesh, and Brennan et al (1984: 10) on Bengal.

Cash loans

Like kind loans, cash loans from village lenders are usually small, short-term and unsecured, and they bear high interest rates. There are, however, some important differences in the terms of cash loans compared with those of kind loans (other than the choice of numeraire).

First, in the case of cash loans interest is simple rather than compound, i.e. unpaid interest is not added to the principal to form the basis of future interest calculations. This contrasts with the system of compound interest outlined earlier for deora loans.

Second, cash loans can, in principle, be taken and repaid at any time. The same interest rate applies throughout the year. Interest rates are stated in monthly terms, e.g. the traditional "adhanni" system (from adha, one half, and anna, one sixteenth of a rupee) implies interest payments of one half anna per rupee of principal per month.

Third, the interest rates applying on cash loans are much less "standardised" than is the case with deora loans. While a recognised "norm" usually exists in a particular year (e.g. the standard interest rate on cash loans was 5% per month in 1983-4), the norm does change over time, and even at a particular time some variation can be observed around the prevailing norm. The deviations from the norm may reflect particular features of the loan (e.g. the provision of collateral may lead to some reduction of interest rate), as well as inter-personal variations in contractual terms (e.g. a tenant is sometimes able to obtain a loan on concessional terms from her or his landlord).

The last point, and the particular issue of inter-personal variations in contractual terms, deserve elaboration. Before proceeding, it is useful to recall the important role played by village-level norms in the specification of contractual terms for the exchange of production factors, especially those (e.g. land and labour) that are mostly traded within the village. In the case of casual agricultural labour, for instance, a "standard" daily wage is found to apply at a particular time (6 rupees per day in late 1983), and daily-wage labour contracts rarely deviate from this standard, despite substantial and observable differences of productivity between labourers. Similarly, all sharecropping contracts follow accepted norms (e.g. concerning input and output shares), leaving little scope for bargaining between individual tenants and landlords, despite known variations in land quality, farming skills, etc. Thus, many important contracts are "standardised", despite relevant differences in personal characteristics, and to a large extent this applies to credit contracts as well.[57]

We have already noted this feature in the case of kind loans: the deora system defines impersonal contractual terms that apply irrespective of the identity of the borrower or lender. In the case of cash loans, however, the situation is a little more complicated.

Table 17 indicates the distribution of outstanding interest-bearing cash loans from Palanpur moneylenders by date of issue, interest rate and identity of the lender.[58] It can be seen (from the last column) that cash loans outstanding in 1984 carried quite a wide range of interest rates, from 1.5 to 5% per month. However, a large part of this variation arises from differences in dates of issue, with more recent loans carrying higher interest rates. This pattern arises because (1) the (nominal) interest rate applying to a particular loan is fixed once and for all at the

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[57]. For further discussion, see Drèze and Mukherjee (1989) and Sharma and Drèze (1990). As noted there, the pervasive influence of village-wide norms (the going daily wage, the standard sharecropping contract, the prevailing interest rate, etc.) on the terms of individual contracts has been observed in a number of other villages studies in India.

[58]. It should be borne in mind that the information presented in Table 17 is restricted to cash loans that were outstanding at the time of the survey. Since cash loans often have a short duration, this table does not give a reliable idea of the total number of loans issued in different years; however, it does provide useful indications about the distribution of interest rates in different years, and this is what concerns us here.

Table 17

INTEREST RATES ON INTEREST-BEARING CASH LOANS, BY DATE OF ISSUE

Interest rate (%/month)	Number of loans issued by four regular moneylenders in different years[a]			Number of loans	No. of loans outstanding at the time of the credit survey (1984)
	before 1982	1982	1983	1984[b]	
1.5%	Mohan (1)				1
2%	Harpal (1)	Mohan (1) Gulabo (1)			3
3%	Gulabo (1)		Mohan (1)		2
3.5%	Harpal (1)	Harpal (2) Gulabo (2)	Harpal (1) Gulabo (1)	Gulabo (1)	8
5%		Gulabo (1)	Nisar (1) Gulabo (3)	Gulabo (4)	9

[a] For want of better information, only loans outstanding at the time of the credit survey in 1984 have been recorded in this table. This is the main reason for the small number of loans issued in early years.

[b] The coverage of loans issued in 1984 is quite incomplete, as the credit survey took place in the middle of that year.

Note: For clarity we have, in this table, regarded the traditional adhanni system (see text), equivalent to 37.5% per year (or 3.125% per month), as identical with 3% per month, and indeed we have no indication that the two rates are considered as different. Similarly with 40% per year vs 3.5% per month, 25% per year vs 2% per month, and 19% per year (one quarter-anna per rupee per month) vs 1.5% per month.

time of the initial contract, and (2) the "standard" interest rate on cash loans has been steadily increasing in recent decades, from 2% per month in the 1950s to 5% per month in 1984. But this does not mean that differences in interest rates on outstanding loans can be entirely attributed to differences in dates of issue, and that in any particular year a well-defined standard rigidly applies to all credit contracts. There are, in fact, three important sources of departure from the prevailing norm.

First, there are periods when the standard interest rate is undergoing change, and within those periods it may not be completely clear what the current standard actually is. When we re-visited Palanpur in 1985 and 1986, we were consistently told that the "going rate" for interest-bearing cash loans was 5% per month, and our survey data suggest that this standard was already widely accepted by mid-1984.[59] During the survey year itself, however, the move to this new standard (from the earlier standard of 3.5% per month) was still in progress, and it would have been hard at that time to describe 5% as the accepted norm. As Table 17 suggests (and this is also corroborated by direct enquiry), it is Gulabo, the elderly widow, who took the lead in setting the new 5% standard -- until 1984 most loans at that rate had been issued by her. Between 1982, when Gulabo first charged 5% on a loan, and 1984, when she charged 5% on <u>all</u> her loans (except one for which she obtained a collateral), and when even "occasional lenders" were found to apply that standard, the bulk of cash loans were issued <u>either</u> at the "old" interest rate of 3.5% per month <u>or</u> at the "new" rate of 5% per month, with the latter rate becoming gradually more common.[60] There was, during that period, some ambiguity about the current standard.

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[59]. Out of 7 interest-bearing cash loans issued in 1984 and recorded in our credit survey, 6 were given at an interest rate of 5% per month (5 of these 7 loans were given by Gulabo and the other two by occasional lenders).

[60]. During that period, three "concessional" loans were also issued, at a rate lower than 3.5% per month (see Table 17): one by Gulabo to a relative and two by Mohan who, as will be explained shortly, is a somewhat unusual moneylender and often lends at concessional rates.

Second, there are variations in lending policy between different moneylenders, which can include some deviation from accepted interest rates. The most important example concerns Mohan, an affluent Murao farmer who charges lower interest rates than other moneylenders and often gives interest-free loans (see Tables 14 and 17).[61] One of the likely motives for this tendency to lend at concessional rates is calculated patronage. For instance, in order to cultivate his large landholding with little family labour, Mohan depends on regular and loyal services from several agricultural labourers; giving them interest-free loans is a helpful means of maintaining a good rapport with them, which Mohan explicitly uses. However, some of Mohan's interest-free loans (e.g. to a destitute widow of the Passi caste) would be hard to explain in this way, and some people in the village also attribute his soft lending policies to paternalistic or altruistic dispositions, possibly related to his being childless.[62] Be that as it may, it is clear that the 5% standard does not apply to Mohan.

Finally, individual moneylenders occasionally discriminate between different clients, charging higher interest rates to some than to others. Usually, this takes the form of granting loans at "concessional" rates to relatives, tenants, or persons with whom the lender has some other kind of special bond. A comparatively low interest rate may also apply when the borrower provides a collateral (e.g. Gulabo gave a loan at 3.5% per month in 1984 to a Teli farmer who gave her the ownership certificate of one of his buffalos for the duration of the loan). Conversely, an acquisitive moneylender may charge an unusually high interest rate to a borrower who is desperate to obtain a loan after being turned

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[61]. Mohan has several outstanding deora loans (see Table 14), and for those loans he does follow the standard rule of charging 50% in kind. Informal evidence, however, suggests that he does not always enforce full repayment, at least from poor borrowers.

[62]. The view that Mohan's compassionate attitudes are related to his having no children was expressed by several commentators in Palanpur. For instance, one very poor agricultural labourer who occasionally gets an interest-free loan from him said: "Mohan thinks that he has no children because he has done something wrong in an earlier life, and he hopes that his good actions will bring him reward in future lives".

down by other lenders; the most obvious example of this type of price discrimination based on temporary monopoly power is that of gambling-related lending.

On the whole, the application of village-wide contractual norms is clearly less rigid in the case of cash loans than in the case of kind loans. An identifiable norm usually does exist for interest rates on cash loans, and moneylenders tend to refrain from departing from that norm unless they have compelling and socially "legitimate" reasons to do so (e.g. a special relationship with the borrower); in particular, we find little indication of moneylenders discriminating between different borrowers based on their perceived trustworthiness, endowments, track record, and related characteristics.[63] As the preceding discussion indicates, however, there are periods of transition when a single norm may not apply, and there are also other possible sources of interpersonal variations in interest rates on cash loans.

A full explanation of this particular contrast between kind loans and cash loans will not be attempted here.[64] We shall merely observe that kind loans and cash loans are, in an important sense, complementary. Deora loans in kind provide a simple, predictable and well-tested system to enable poor households to plan for their subsistence needs over the year. Cash loans complement this basic structure, by providing additional short-term borrowing opportunities on terms that can be -- to some extent -- adjusted according to the circumstances of the borrower and the lender. It is more helpful to consider cash and kind loans as two aspects of one credit system than to contrast them as if each stood on its own.

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[63]. Kaushik Basu (personal communication) reports a similar observation for the village of Navadhi (Hazaribagh district, Bihar): local moneylenders charge a uniform interest rate to all borrowers. As it happens, the standard interest rate in the late 1980s was the same as in Palanpur (5% per month).

[64]. For a general discussion of the contrast between "personalised" and "standardised" contracts in rural India, see Drèze, Lanjouw and Sharma (forthcoming).

5.3. <u>Occasional Lenders</u>

So far in this section, we have concentrated on "regular moneylenders". Before moving on, it may be useful to comment briefly on the contribution of "occasional lenders" to the credit market. As explained in section 1, we consider as an occasional lender any person who had at least one interest-bearing loan outstanding at the time of our credit survey in 1984, and who was not a regular moneylender.

We were able to identify 14 such lenders. Most of them (10 to be precise) had only one interest-bearing loan outstanding, and only one had more then three loans outstanding. Almost half of the 23 loans issued by these 14 occasional lenders were <u>deora</u> loans in kind. Out of 12 cash loans, 8 bore an interest rate of 3 to 5 per cent per month, and the remainder were issued either on the basis of "usufruct mortgage" or under unknown terms.

We have recorded only two cases of interest-bearing cash loans issued by occasional lenders during the first half of 1984 (recall that our credit survey was carried out in mid-1984). Interestingly, both loans were given at an interest rate of 5% per month, supporting the notion, discussed in the preceding section, that this interest rate had already become the new "standard" in 1984.

The single occasional lender with more than three loans outstanding in 1984 is an interesting case. This lender, who appears in Table 15 under the name of Triloki, is an upwardly mobile farmer who belonged to the second-richest decile of the per-capita income scale in 1983-4. He reported four <u>deora</u> loans (issued in 1983, and adding up to 300 kgs of wheat) and one interest-bearing cash loan. He also told us that, seven or eight years earlier, he had made the mistake of lending 175 kgs of wheat to two poor individuals (a Jatab labourer and the village barber) for consumption purposes, which he never recovered. He further explained that in 1983, being "more experienced", he had taken care to lend wheat only for sowing purposes, and that he was much more hopeful of recovering his loans this time. He may be disappointed, and join the ranks of those who have failed in their attempts to earn effortlessly through money-lending. But if his new lending strategy proves effective, and if his economic status continues to improve, it is also possible that this "occasional lender" will gradually emerge as another "regular moneylender".

While occasional lenders account for a relatively small share of outstanding interest-bearing loans (about half of the corresponding figure for regular moneylenders), the fact that there are as many as 14 of them in a small village of 143 households is quite impressive and is an important aspect of the structure of the market. As we saw earlier, not everyone can be a successful moneylender, even with a lot of money; in that sense, established moneylenders enjoy some potential monopoly power. The fact that the regular moneylenders have, to some extent, segmented their clientele (with, for instance, Nisar having built a special relationship with Jatab borrowers) further enhances this feature of the local credit market. But the possible entry of occasional lenders, which Triloki's story aptly illustrates, qualifies these observations. At the very least, the monopoly power of regular moneylenders, such as it is, has to be seen as potentially contestable.[65]

5.4. Motives and Characteristics of Borrowers

Since interest-bearing loans from village lenders are the most expensive source of credit, and since advance planning of cash flows gives many households a good chance of obtaining loans, if necessary, from alternative sources, loans from village lenders (especially cash loans) are usually taken to deal with some

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[65]. A more extreme assumption, which has been used in some recent analyses of informal credit in developing countries (e.g. Aleem, 1990, Hoff, 1992, Hoff and Stiglitz, 1992), is that the structure of the market conforms to the "monopolistic competition" model. This model, however, relies crucially on the assumption that there are substantial fixed costs in moneylending; while such costs have been well documented in some specific contexts (see Aleem, 1990), it is difficult to see what they might be in the case of Palanpur.

unanticipated and pressing need for extra resources, e.g. as a result of illness. Given that poor households tend to be more vulnerable to this kind of distress, and to have more restricted access to other sources of credit (such as institutional credit or collateral-based credit from urban moneylenders), one would expect the clients of village lenders to consist mainly of poor households.

There is much formal and informal evidence that this expectation is basically correct, but needs to be qualified in at least three ways. First, we have to remember that in a village like Palanpur wealth is often held in the form of rather illiquid or indivisible assets such as land, agricultural equipment, buildings and animals. As a result, even relatively affluent households can be affected from time to time by a pressing need for cash that leads them to knock at the door of a village moneylender. In fact, Palanpur moneylenders themselves have been observed to take interest-bearing loans from other private lenders -- though usually outside the village -- in times of temporary cash shortage (e.g. to cope with wedding expenses).

Second, it should also be borne in mind that not all loans from village lenders are expensive. While the standard interest rate in Palanpur is now 5% per month, which is certainly high, we have seen that "concessional" rates apply in a variety of circumstances. For these concessional loans, it is more doubtful that the typical pattern is one where the borrower is a poor household in a situation of distress.

Third, moneylenders are often reluctant to give loans to very poor households, on the grounds that they have little capacity to repay. This is what prompted Mahavir, the landless labourer mentioned in the introduction, to assert that nowadays "no-one gives a loan to a poor man" -- a statement which we have also heard from other respondents. Moneylenders themselves sometimes told us of their reluctance to deal with indigent borrowers. A related observation, made by some labourers, is that deora loans are not easy to obtain for those who have no land ("mehanat se milta hai", "it takes a lot of effort [for a landless labourer] to obtain these loans"). This assertion is consistent with our survey data, and with the notion that deora loans are essentially based on using the borrower's harvest as a quasi-collateral (see section 5.2).

Finally, the survey data indicate that Jatab households did not have a single cash loan outstanding in 1984. This is primarily a reflection of the fact that village lenders are reluctant to lend to Jatabs (this was repeatedly confirmed in informal discussions with borrowers and lenders). Like urban moneylenders, village lenders are convinced that Jatabs are "protected" by the government.[66] It is possible that some of them also consider Jatabs as unreliable partners, either out of prejudice or from past experience. Deora loans, however, are considered by lenders to be relatively safe, and, as we saw earlier, Jatabs frequently borrow on those terms.

5.5. Trends in Interest Rates

Using information from earlier surveys of the village (in 1957-8, 1962-3 and 1974-5), as well as recall data collected in 1984 and 1985, we can infer that the recent course of the "standard" interest rate for cash loans in Palanpur has included the following steps: 2% per month in the 1950s, 3% per month in the mid-1970s, 3.5% in the early 1980s, 5% per month in the mid-1980s. This involves an increase of real interest rates from about 2% per month in the 1950s to a little over 4% per month in the mid-1980s.[67]

An interesting aspect of this increase in interest rates over time is that it has

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66. Relatedly, the also believe that lending to Jatabs is illegal in Uttar Pradesh. We found no mention of such a restriction in legal documents, but the issue here is more the perception of the law than its actual content. Similarly with the notion that Jatabs are protected by the government, for which we found no independent support.

67. The annual inflation rate, negligible in the 1950s, was of the order of 7 per cent in the 1960s, 9 per cent in the 1970s and 9 per cent for the first half of the 1980s (calculations based on the Wholesale Price Index series reported in Chandhok et al, 1990).

taken place along with a major expansion of credit from public institutions. In 1957-8, the total amount due by Palanpur residents to public lending institutions was only Rs 7,322.[68] By 1984, this figure had increased to Rs 339,607, or about Rs 64,000 at 1957-8 prices. It would have been reasonable to expect such a large expansion of subsidised credit to lead to a decline, or at least to prevent a sharp increase, in private interest rates. This, in fact, has not happened.

One possible explanation is that, over the period under consideration, the transformation of agricultural technology (the so-called Green Revolution) has caused a surge in credit demand and in the marginal productivity of capital, only partly compensated by the expansion of institutional credit. This argument is quite appealing, since an increase in the marginal productivity of capital (which is also the opportunity cost of funds for money-lending farmers) would lead to an increase in interest rates charged by village moneylenders under a wide range of assumptions about market structure. Even today, however, the marginal productivity of capital in agriculture can hardly be higher than, say, one per cent per month in real terms (otherwise one would see some farmers in Palanpur getting quite rich in a relatively short time). Thus, we can safely assume that the opportunity cost of capital for money-lending farmers has increased by less than one percentage point (in monthly terms) since 1957-8. Meanwhile, real monthly interest rates have increased by a little over two percentage points. Thus, it is not obvious that the recent increase in the marginal productivity of capital provides a satisfactory explanation for the entire increase of interest rates over the survey period; the adequacy of this explanation would depend on the precise assumptions about market structure, default rates, and other bases of the wedge between real interest rates and the opportunity cost of capital.

Another hypothesis is that the propensity of borrowers to default has increased; this, too, would lead to an increase of interest rates in a wide range of

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[68]. Ansari (1964:56). At that time, the Farmers' Service Society was the only source of institutional credit in Palanpur.

models. Palanpur villagers are certainly fond of saying that borrowers have become less honest and reliable than they used to be. And it is plausible that, as mutual dependence among members of the village society declines (e.g. because of closer integration with the wider economy), and as the personal bonds of the traditional social order weaken, less reliance can be placed on the concern of a borrower for his or her reputation.[69] But the notion that default has become more common may also reflect misplaced nostalgia for the "good old days", or some other cheerful illusion about how things used to be in the past.

A third line of argument is the following. Interest rates in Palanpur reflect some monopoly power on the part of a small number of regular moneylenders who have the ability to enforce repayment. Further, the expansion of institutional credit, with a pronounced bias in favour of privileged households, has largely taken care of <u>anticipated</u> cash requirements, leaving the distress cash needs of poor households to be met by village lenders. As a result, the demand for private credit, which may have shrunk in quantitative terms, has also become more <u>inelastic</u>, leading, under monopolistic pricing, to an increase in interest rates.[70] Institutional credit may also have soaked up the "good risks", leading village lenders to deal with greater exposure to default by charging higher interest rates.

In connection with the last argument, the findings of another detailed empirical study of credit in rural India, by M.J. Bhende (1983, 1986), are highly relevant.[71] This study includes an instructive comparison between three villages of Maharashtra and Andhra Pradesh. In the first village, Aurepalle, institutional

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69. Opportunities and incentives to default may also have changed. For instance, there is now greater scope for out-migration, which is a major escape route for those who have accumulated crippling debts.

70. A similar possibility emerges in some models of monopolistic competition in rural credit markets; see Hoff and Stiglitz (1992). Note that the effect of an expansion of institutional credit on private interest rates depends not only on the degree of monopoly power among moneylenders but also on the extent to which they were initially able to exercise price discrimination between different borrowers.

71. See also Walker and Ryan (1990: chapter 7).

credit is poorly developed, and private moneylenders are the main source of credit. As a result, a large amount of borrowing from private sources is found among all classes of households, and interest rates are relatively low (between 18 and 24 per cent per year). By contrast, in the other two villages (Shirapur and Kanzara), institutional credit is well developed, with a major bias in favour of large farmers (as in Palanpur). For these two villages, where interest rates charged by private lenders range from 25 to 120 per cent per year (again, much as in Palanpur), the author makes the following observations:

> In Shirapur and Kanzara moneylenders operate on a small scale. Moneylenders serve a residual group of individuals who cannot obtain credit from institutional sources or their friends and relatives. They are high risk clients paying correspondingly high costs.[72]

Thus, counter-intuitive as it may seem, there is a distinct possibility that the growth of subsidised institutional credit in rural India has sometimes exerted an upward pressure on private interest rates. This development, if real, is especially striking in view of the fact that one of the major official motivations for promoting the growth of public lending institutions in rural India has been to break the monopolistic power of moneylenders and drive down rural interest rates.[73]

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[72]. Bhende (1986:A-123). In a comparison between two villages of Tamil Nadu, Konur and Gokilapuram, Swaminathan (1990b) also notes that "Gokilapuram, the village with greater access to formal credit, [and] higher levels of production... had higher rates of interest on informal credit transactions" (p.46). Further, the evidence on change in Gokilapuram between 1977 and 1985 (a period of rapid expansion of institutional credit) "contradicts the widely-held view that the expansion of formal banking systems, and improvements in agricultural production, lead to a reduction in the rates of interest charged in the informal sector" (pp. 8-9). For a different view elsewhere, see Iqbal (1988), Athreya et al (1990) and Harriss (1991).

[73]. Many official documents on this subject, from the British colonial administration onwards, explicitly refer to that objective. To cite one early example, in its discussion of the need for "the establishment of agricultural banks", and after reviewing money-lending practices in rural areas, the Famine Commission Report of 1880 (Appendix 1, p.194) argued: "One of the greatest advantages consequent on the establishment of such [agricultural] banks will be that money-lenders will necessarily lower their rates, and the cause of the cultivators' grievance, the exaction of high rates of interest by the money-lenders, will be removed without difficulty" (emphasis added).

6. Comparative Overview and Conclusions

6.1. Credit Institutions in Comparative Perspective

There is a great deal of variation in the nature and functioning of credit institutions in different parts of India.[74] In this section, we present a brief comparison of our empirical findings on credit institutions in Palanpur with those of similar studies elsewhere. The comparison suggests two interesting features of regional variations in credit institutions: (1) in many respects, the functioning of specific institutions is remarkably similar in different regions, and (2) to a large extent, regional variations take the form of differences in the institutional composition of the credit market.

To begin with, we note that the broad categorization of credit sources outlined in section 1 of this paper for Palanpur seems to be widely applicable, even though the precise content of each category varies (for instance, there are many different kinds of "urban moneylenders"). Accordingly, the discussion in this section continues to be structured around the four major sources of credit identified there.

Public lending institutions

As noted in section 5.5, formal institutional credit has dramatically expanded in Palanpur during the last 40 years or so. There is considerable evidence that a similar expansion has taken place in most regions of India, leading to a major change in the composition of rural credit in favour of institutional sources.[75]

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[74]. The term "credit institution" should be understood here in a broad sense, which refers to different arrangements through which people can borrow and lend.

[75]. See e.g. Bell (1990) for a discussion of the evidence. The author argues that official figures may overstate the importance of formal institutional credit, but the basic trend is firmly established.

The contribution of formal credit institutions to rural development is hard to assess. Farmers and agricultural labourers are certainly in great need of well-functioning credit arrangements at reasonable rates, but the failures of public lending institutions are also far from negligible. We have noted their bureaucratic, corrupt and inequitable mode of functioning in Palanpur, and it is fair to say that similar -- though not always equally critical -- observations on institutional credit in rural India have been made in a large number of other studies.[76]

The distributionally regressive impact of public lending institutions, in particular, has been extensively documented.[77] This can take at least four different forms: (1) larger farmers have a disproportionate share of subsidised institutional credit (this finding emerges in most available studies); (2) larger farmers have higher default rates, largely due to their greater clout and privileged connections (Bhende, 1986, Sarap, 1987); (3) larger farmers effectively pay lower interest rates, because they take larger loans with lower transaction costs (Banik, 1992); (4) disadvantaged groups are the principal targets of fraudulent accounting practices (as our case study of Palanpur illustrates). As Bell and Srinivasan (1985) aptly put it with reference to institutional credit in rural Punjab, "the ruling principle appears to be: 'to him that hath shall be given', although the poor are by no means wholly excluded" (p.10).

Urban moneylenders

As in Palanpur, the main urban-based sources of informal credit in rural India usually consist of pawnbrokers (often goldsmiths) and/or traders.

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[76]. For some relevant evidence, see Kamble (1979a, 1979b), Bhende (1983, 1986), Swaminathan (1986, 1990b), Copestake (1987), Dey (1987), Gupta and Shroff (1987), Chen (1988), Sarap (1986, 1987), Braverman and Guasch (1989), Drèze (1990b), Gill (1990), Walker and Ryan (1990), Olsen (1996), among others.

[77]. See Bell and Srinivasan (1985), Binswanger and Rosenzweig (1986b), Bhende (1986), Iqbal (1988), Bouman (1989), Krishnan (1990), Banik (1992), among others. For a telling case study, see Sarap (1987).

The basic rules of pawnbroking in different regions tend to be strikingly similar to those described in section 4 for Palanpur.[78] Common features of particular interest are the lending strategies of pawnbrokers, the range of interest rates, the link between interest rate and collateral type, and the relationship between the value of the collateral and the value of the loan. For instance, it seems to be a common practice among pawnbrokers to ask for a collateral of about twice the value of the loan.[79] Another finding of interest is that the role of pawnbrokers in the rural economy has been growing quite rapidly in recent years, in some regions at least (Bouman, 1989). This expansion may be a reflection of the growing links between the rural and the urban economy, and also of growing opportunities for profitable "arbitrage" between public lending institutions and the informal credit market in rural areas.

Several recent studies bring out the important -- and growing -- role of urban-based traders as moneylenders in some regions of India. These regions tend to be those with a relatively advanced and commercialized agriculture, and well-developed economic links between rural and urban areas, e.g. Punjab (Bell, 1990) and parts of Tamil Nadu (Swaminathan, 1990b, Harriss, 1991), Maharashtra (Bouman, 1989) and Andhra Pradesh (Da Corta, 1993). The role of traders as rural moneylenders is not new (see e.g. Harper, 1958, for a detailed account of the moneylending activities of arecanut merchants in Mysore in the 1950s), but it does seem to have grown quite rapidly in recent years, along with other links between urban-based traders and the rural population. Having said this, the importance of trade-linked credit in India's rural economy appears to have been somewhat exaggerated in some recent studies, to the point of being transformed into a ghost

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[78]. See Bouman and Houtman (1988) and Bouman (1989) for an enlightening survey, and Sarap (1987, 1991b) and Swaminathan (1990b) for more recent case studies.

[79]. See Platteau, Murickan and Delbar (1985: 79), Bouman (1989: 83), Swaminathan (1990b: 27-28), for evidence from Kerala, Maharashtra and Tamil Nadu respectively; also section 4 of this paper.

"stylised fact".[80]

Loans from traders often consist of advances on future sales of agricultural produce, and this has led some researchers to consider them as a form of "interlinkage". It is not entirely clear that the term "interlinkage" is more helpful than the term "advance" in this context. Essentially, trade-linked credit consists of treating future sales as a quasi-collateral, much as in the case of seasonal loans in kind (where the future harvest plays a similar role, as discussed in section 5.2). There is no great advantage in obscuring the operation of this fairly transparent arrangement by using the term "interlinkage", with its convoluted connotations. Note also that borrowing from a trader does not necessarily take the form of an advance on future sales. Traders have cash, and often belong to mercantile castes with high business skills; it is quite natural for them to supplement their trading activities with some money-lending, without necessarily "interlinking" the two.

Interest-free credit

The empirical evidence on interest-free credit in rural India is relatively meagre. Many studies of rural credit list "friends and relatives" as one of the relevant sources, and mention that it is generally interest-free. But few studies explicitly investigate the role and functioning of interest-free credit.

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[80]. See particularly the otherwise enlightening symposium papers on "Imperfect Information and Rural Credit Markets" published in World Bank Economic Review, September 1990. Hoff and Stiglitz (1992: 7) go so far as to say that "the dominant role of trade-linked credit in informal lending" is "a striking empirical regularity in the data obtained by different investigators working in various Asian developing countries", and add that "the only exception of which we are aware arises in the village of Palanpur, India" (sic). But the only India-based study cited by the same authors in support of this point (namely Bell, 1990) clearly shows that, while trade-linked credit is indeed important in Punjab (as mentioned by Hoff and Stiglitz), it is of minor importance in Bihar and Andhra Pradesh (the other two states included in Bell's study). The literature cited in this section confirms that the actual importance of traders as a source of credit in rural India varies widely between different areas, from insignificant (e.g. Rudra, 1982:67, Athreya et al, 1990; Walker and Ryan, 1990: 199; this study) to considerable (see studies cited in the text).

For Palanpur, we have noted that interest-free credit within the village is quite limited, and that interest-free credit from outside the village essentially comes from relatives, particularly in-laws. The fact that most studies have little to say on interest-free credit suggests that it is generally of limited importance in quantitative terms. One qualification is that a good deal of interest-free credit may be "hidden", not only from nosy investigators but also from other villagers and even household members. Even when hidden interest-free credit is relatively small in aggregate quantitative terms, it may be quite important for the economic security of poor households. Chen (1988), for instance, finds that in Maatisar village (Gujarat), "most of the reciprocal credit between kin and caste-neighbors is negotiated woman-to-woman, often without the knowledge of men" (p.22), and that these small credit transactions make a significant contribution to the survival strategies of deprived households.[81]

Another qualification is that interest-free credit is quite important in certain specific environments. In some coastal Indian villages, for instance, short-term reciprocal interest-free credit is extensively used by fishing families to cope with individual day-to-day fluctuations in catches (see Platteau and Abraham, 1987, and Platteau, 1990). One reason for the effectiveness of interest-free credit as an insurance mechanism in that environment is that individual day-to-day fluctuations in catches are to a large extent uncorrelated. The situation is quite different in settled agrarian villages like Palanpur, where the problem of covariate risks reduces the scope for active systems of reciprocal interest-free credit. As discussed in section 3.3, however, the contrasting incidence of interest-free credit in these two settings may also reflect other factors than the covariance of income fluctuations. Another consideration of possible importance is that the agrarian

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[81]. On this, see also Abraham (1985) and Gupta et al (1987). Similar remarks can be made about rotating savings associations, which are quite popular in many parts of India; see e.g. Harper (1958) and Oommen (1993) on chitu fundus in Karnataka and Kerala, respectively, Bouman (1989) on bishi mandals in Maharashtra, Walker and Ryan (1990) on chit funds in the ICRISAT villages, and the earlier literature cited in these studies. On the economics of rotating credit and savings associations, see Besley, Coate and Loury (1993).

economy is more heterogeneous and unequal, making it harder to foster relations of reciprocity or mutual solidarity. This view is consistent with the fact that cooperative savings and reciprocal credit arrangements have also been observed, despite much covariate risk, in societies that have a relatively egalitarian tradition, such as the Santhals of eastern India.[82]

Village lenders

Village lenders are found in different guises -- the professional moneylender, the agriculturist-moneylender, the occasional lender, and others. Interestingly, professional moneylending appears to be among the many traditional "crafts" that have been massively displaced in recent decades by modern state-based and market-based institutions (including, in this case, public lending institutions and urban traders). Available survey estimates confirm that the number of professional moneylenders in rural India is now quite small (e.g. one for every 23 villages or so in Uttar Pradesh according to Ghatak, 1976, p.13). During the pre-independence period, professional moneylenders were more common; they often belonged to particular castes or communities, and in some areas they had developed highly sophisticated ways of spreading their activities over several villages, gathering and sharing information on borrowers, assessing their creditworthiness, keeping complicated accounts, recovering unsecured loans, etc.[83] Another interesting type of professional moneylender was the itinerant moneylender, who apparently specialised in short-term consumption loans to

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[82]. See e.g. Rogaly (1994), p.159. Note also that, in many societies, mutual support appears to increase rather than decrease in the early stages of a collective food crisis (Dirks, 1980; Torry, 1979), contrary to the prediction of an analysis focusing on covariate risk only. It is an interesting possibility that, in some circumstances, covariate risk enhances rather than undermines mutual insurance arrangements, by promoting empathy and solidarity.

[83]. Irfan Aleem's (1985) detailed study of the operations of the urban-based Beoparis in Sindh (Pakistan) offers interesting insights into some of these practices, in a different context. See also Sarap's (1986) account of the operations of Lal Bangla lenders in rural Orissa, and Walker and Ryan (1990: 201-206) on traditional moneylending practices in the ICRISAT villages.

high-risk groups.[84] Even during the colonial period, however, professional moneylenders did not have anything like a monopoly of credit transactions, and in some regions they represented only "a very minor element among the vast world of rural moneylenders" (Pouchepadass, 1983, p. 139, on colonial Bihar; see also Whitcombe, 1972, chapter 4).

Today, most rural moneylenders are simply affluent members of the village community, often landowners who combine moneylending with agriculture or other occupations (see e.g. Bell, 1990, Table 5). If one includes "occasional lenders", village lenders represent a substantial portion of the rural population. In Maatisar, for instance, 18 per cent of all households engage in some form of moneylending, not including interest-free lending (Chen, 1988, p.6); in Palanpur, the corresponding figure is 14 per cent (see section 1).[85] The common notion that the typical rural moneylender is an unchallenged monopolist does not stand any scrutiny.[86]

There are several reasons why people borrow from village lenders, despite the fact that they charge higher interest rates than public lending institutions. First, the borrowers may have no alternative, given that institutional credit is

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[84]. "The 'Kabuli' (or 'Peshawari', or 'Punjabi', or 'Mughal') was a familiar figure throughout Northern India [in the 19th century], coming from Afghanistan or the North-West frontier, selling warm clothing or blankets on credit at the start of the winter at exorbitant prices, or simply lending money at rates no less so. After the harvest he returned to claim his dues, using intimidation and sometimes violence." (Pouchepadass, 1983: 141).

[85]. Bell (1990: 308) reports a somewhat lower estimate (6.3 per cent) for a sample of households in Andhra Pradesh, Bihar and Punjab; a large-scale survey based on rapid investigation methods, however, is bound to produce an underestimate of the true figure, as the author himself points out.

[86]. As always, there are exceptions. One notable example of monopoly situation, occasionally mentioned in the literature, is the isolated tribal village where an enterprising (and often exploitative) outsider has implanted a trading-moneylending outpost. Interestingly, in the tribal belt of Chota Nagpur, "the term 'diku' (outsider/alien) was initially applied to the moneylenders" (Thapar and Siddiqi, 1991).

rationed. Second, they may be reluctant to borrow from public lending institutions out of fear of being cheated, or of facing sanctions in the event of non-repayment, as the withdrawal of Jatab borrowers from cooperative credit in Palanpur illustrates.[87] Third, compared with public lending institutions village lenders are widely perceived to lend quickly, without formalities, for any purpose, and often without demanding a collateral (Bailey, 1964: 128; Chambard, 1980: 31; Bhende, 1983; Bouman, 1989; Swaminathan, 1990b: 23; Pal, 1994). The first reason has received most attention, and supports the notion that village lenders essentially provide a residual borrowing option, exercised (mostly by disadvantaged borrowers) when cheaper forms of credit are unavailable.[88] The other reasons, however, also seem to be quite important in some circumstances.

The coexistence of cash loans with seasonal loans in kind is mentioned in many studies. The <u>deora</u> system, as described earlier for Palanpur, seems to have a wide reach in north India (and a long history, as noted in section 5.2). In fact, among the studies we are aware of, most of those where seasonal loans in kind are mentioned describe the basic arrangement as one where grain loans have to be repaid with an interest of 50 per cent in kind after the harvest.[89] It is a remarkable fact that the basic terms of seasonal loans in kind should be so similar in different parts of north India, and so stable over time, despite wide variations in market structure, economic environment and related factors.

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[87]. The fact that poor people often have deep apprehensions about borrowing from public lending institutions is a common finding of recent studies of "anti-poverty programmes" in India; see e.g. Krishnan (1990: 51) and Srivastava (1996).

[88]. For a detailed analysis of this feature of the relationship between formal and informal credit, see Bell (1990), and Bell, Srinivasan and Udry (1991).

[89]. These studies include Bailey (1964), Chambard (1980), Chen (1988), Karam Singh (1970), aside from the historical studies cited in section 5.2. Walker and Ryan (1990: 203) also mention that seasonal loans in kind in the ICRISAT villages in south and western India bear an interest rate of 50 per cent (25 per cent in the case of short-duration crops). This also appears to be the standard practice in West Bengal (Rudra, 1982: 71).

Another common finding of much interest is the comparatively low incidence of default on seasonal loans in kind, discussed in section 5 for Palanpur. In a study of credit transactions in two villages of Orissa, for instance, Bailey (1964) notes: "The paddy loan is only given to those who themselves have land, and the lender has first call on the harvest after it has been threshed. <u>I cannot remember any cases of default</u>, or, indeed, any disputes about this kind of transaction" (p.112, emphasis added). Pouchepadass (1983) makes similar observations on seasonal kind loans in colonial Bihar: "These debts were always short-term, covering a matter of a few months, and were secured by the following harvest, which explains why, unlike the majority of cash loans, <u>they were most generally reimbursed during the year that followed</u>" (p.142, emphasis added). These statements apply almost word for word in Palanpur today.

In the case of cash loans, there is more diversity in the findings of different studies. For instance, some studies (e.g. Walker and Ryan, 1990) report that cash loans from village lenders are generally unsecured, as in Palanpur, while other studies (e.g. Swaminathan, 1990b) suggest that the use of collaterals is common. Even cash loans, however, do have certain widely-observed features, including the following: they are usually short-term; they are often, but not always, taken for consumption purposes; the clients are generally poor households; the incidence of default is much lower than for institutional loans, but higher than for seasonal loans in kind; interest charges are stated in monthly terms, and are calculated on the basis of simple interest;[90] in a particular locality, a "standard" interest rate can often be identified, but interpersonal variations can also be observed, depending inter alia on the relationship between the borrower and the lender. Interestingly,

[90]. An interesting observation made in several studies (and which also applies in Palanpur) is that the lender often insists on regular payment of interest, but not of the principal. This makes sense: if a borrower pays interest regularly, the lender is better off continuing the relationship rather than trying to recover the principal to lend to some other client, who may or may not repay regularly. Whitcombe (1972: 165) also notes that in 19th-century north India, "the principle on which a creditor operated was not to recover his principal with the profit of added charges for its use but to <u>secure a regular source of income</u> from high charges on money or goods loaned" (emphasis added).

at least two studies indicate that, on average, poor borrowers pay higher interest rates than richer borrowers even within the informal sector.[91]

We end by noting that the upward trend in interest rates in recent decades, observed in Palanpur, is not an isolated phenomenon. Studies of informal credit in the 1950s and 1960s tend to report nominal interest rates ranging between 6 and 18 per cent per year, much lower than the rates of 60 per cent per year or more that are standardly reported in recent studies.[92] This suggests that our earlier discussion of the failure of institutional lending to contain the rise of private interest rates in Palanpur may have wider relevance.

6.2. Concluding Remarks

Based on the preceding account of credit transactions in Palanpur, it is hard to avoid the broad conclusion that the credit market does not work very well. The market is heavily segmented, with different rationing mechanisms regulating the allocation of credit from different sources, leading to the persistence of a wide spectrum of interest rates (ranging from 0 to 300 per cent per year and more) within the village.[93] Interest-free credit is governed by relatively rigid social norms, and quite limited in scope. Institutional credit is nominally cheap, but allocated on the basis of cumbersome procedures, and also risky for those who are unable to protect themselves from fraud. Those who are unable or unwilling to borrow from institutional sources have to fall back on private moneylenders.

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[91]. See Sarap (1987) and Swaminathan (1990b:22). The first study even suggests that, for a given collateral, the poor pay higher interest rates.

[92]. See Harper (1958), Ghatak (1976), Chambard (1980), Leaf (1984), among others. As stated earlier, the annual inflation rate was negligible in the 1950s, and a little below 10 per cent in the 1960s, 1970s and 1980s.

[93]. Segmentation and rationing may be a requirement of "constrained" efficiency in credit allocation with asymmetric information and transaction costs, but it would be hard to argue that these features of the credit market in Palanpur primarily reflect efficiency requirements.

They standardly pay nominal interest rates of 2.5 to 3 per cent per month, if they have jewelry or some other collateral acceptable to urban-based goldsmiths and traders, and 5 per cent per month if they have no alternative than to approach village lenders. And even at the hard rate of 5 per cent per month (about 4 per cent per month in real terms), credit is not always available.

The problematic nature of credit arrangements has extensive ramifications in Palanpur's economy. Some illustrations follow:[94]

Inactive land market: Land sales in Palanpur are uncommon, with less than one per cent of the village land changing hands every year (on average) through purchases and sales. The rising marginal cost of credit (as the amount borrowed increases), together with the lumpy nature of land transactions, is one reason why the reservation price of buyers is often below that of sellers.[95]

Retail buying: In Palanpur, domestic supplies are often bought in small quantities at regular interval, rather than in bulk, despite the much higher cost of piecemeal buying. High credit costs help to account for this practice.

Slow pace of technological change: Palanpur farmers (small and large) are well aware of the high returns to modern inputs. One of their most frequent statements about farming practices is "paidawaar laagaat ke oopar hai", i.e. "one reaps as one spends". Inadequate credit facilities, however, have slowed down the adoption of modern cultivation methods.

Low educational investments: High discount rates discourage long-term

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[94]. Note that, in each case, restricted access to credit at reasonable rates is only one of the causes of the observed phenomenon. The other causes need not concern us here.

[95]. For further discussion, see Drèze, Lanjouw and Sharma (forthcoming). On credit-market imperfections and land transactions, see also Binswanger and Rosenzweig (1986a).

investments, of which educational investment is one example. This may have contributed to the persistence of widespread illiteracy in Palanpur, even among male children. As recently as 1993, only half of all male children aged 6-10 (and less than one third of female children in the same age group) attended school.

Low incidence of cash rents: In the absence of credit-market imperfections, there are mutual advantages in switching from share-rent to cash-rent contracts in the event (now quite common in Palanpur) where the tenant is less risk-averse than the landlord. Cash rents, however, are always paid in advance, and, in the absence of convenient credit arrangements, they are still largely confined to situations where a cash crisis forces the lessor to reduce his or her reservation price.[96]

Absence of landless tenants: As agriculture in Palanpur has become more capital-intensive, landless households have been virtually excluded from tenancy contracts.[97] One reason for this is that credit facilities are particularly restricted for landless labourers, who therefore find it difficult to contribute their share of non-labour inputs in sharecropping contracts (or, even more, to pay advance cash rents).

Limited development of non-agricultural self-employment: Non-agricultural employment of Palanpur residents consists overwhelmingly of wage employment outside the village. Self-employment occupations outside agriculture, such as they are, mostly involve activities requiring low levels of investment, such as rickshaw-pulling and petty trade.

Emergence of implicit-credit arrangements: Given the problematic nature of explicit credit transactions, there are potential gains in implicit-credit

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[96]. For further discussion, see Sharma and Drèze (1990).

[97]. A similar development has been observed in many other regions of India; see Sharma and Drèze (1990).

arrangements if the receiving party has a higher discount rate than the effective lender. The viability of these arrangements arises from the fact that, unlike explicit credit contracts, they tend to be relatively secure, being part of a broader relationship between the two parties. Some examples of implicit-credit arrangements were given in the introductory section.

Economic insecurity: Inadequate credit opportunities exacerbate economic insecurity among Palanpur households, by making it harder for them to deal with unanticipated income fluctuations. This point may be worth mentioning in view of the recent influence of empirical research suggesting that Indian village economies achieve something close to "full insurance" (Townsend, 1994). Our observations in Palanpur, where there are plenty of transparent examples of the influence of idiosyncratic income fluctuations on current consumption, lend little support to that thesis. The conclusions to be drawn from these earlier investigations are probably more in the nature of methodological lessons than of practical insights on Indian village economies.[98] That also seems to be the message of other studies on this subject (see Alderman and Paxson, 1992).

On the positive side, the limitations of private credit arrangements suggest that there may be some potential for positive intervention. That this potential is real is well illustrated by the dazzling success of well-designed and well-managed credit programmes such as the Grameen Bank in Bangladesh and SEWA in India. The reasons why public lending institutions in rural India fare so poorly in comparison call for further investigation, and must inform future initiatives in this field. On this issue, one important lesson from this case study is that the institutional flaws on the supply side deserve no less attention than the behaviour of the borrowers.

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[98]. On some of the methodological issues, see Ravallion and Chaudhuri (1995). In principle, there may be "full insurance" even in the absence of well-functioning credit arrangements, but in practice it is difficult to see how the former could be achieved without the latter.

Consider, for instance, the issue of low repayment. In analysing this problem, the tendency has been to focus on the inadequate incentives that the borrower has to repay (this concern is prominent, for instance, in "principal-agent" models of the relationship between borrower and lender). Accordingly, a solution is often sought in the direction of better repayment incentives, based for instance on group lending and other means of "making the poor creditworthy" (Pulley, 1989).[99] There is much to learn from these analyses, and indeed, our own interpretation of the relative success of seasonal loans in kind in Palanpur (section 2.6) points inter alia to the role of better repayment incentives. Improving repayment incentives, however, is only one part of the problem, and probably not the hardest part. If public lending institutions in Palanpur were honestly and efficiently managed, we doubt that they would have much difficulty in recovering a large proportion of their dues even without introducing major changes such as a shift to group lending.[100]

The main problem is not so much that means of enforcing repayment are not available, but rather that the use of these means has been undermined by endemic corruption and inertia. In particular, as we saw in section 2, bank managers have poor incentives to recover their loans, and sometimes even have positive incentives not to recover them.[101] More generally, our case study of

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[99]. Several authors have suggested that the success of the Grameen Bank is largely due to the use of group lending. To our knowledge, however, there is no solid evidence of this link. The Grameen Bank's own Managing Director, Muhammed Yunus, takes the view that the Bank can lend equally successfully to groups and individuals (Mahajan, 1995:64). And SEWA's lending schemes in Gujarat, which are no less successful, make little use of group lending. On the limitations of group lending, see also Riddell and Robinson (1995), Hulme and Mosley (1996), and Jain (1996).

[100]. Available confiscation procedures, for instance, could be used with good effect by targeting a few rich defaulters. This would strike terror in the hearts of other borrowers and boost repayment levels, and this approach would be not only effective but also equitable.

[101]. Similarly, cancellation of institutional loans has been used by various political parties as a major electoral plank (used most irresponsibly in 1990, when the central government announced massive cancellation of debts to rural banks and credit

public lending institutions in Palanpur suggests that the failure of these institutions is hard to understand without paying close attention to the politics of rural credit, including the role of institutional credit as an instrument of patronage, the use of debt cancellation as an electoral tactic, the nexus between credit cooperatives and political leaders, the unequal distribution of power among borrowers, and the lucrative rewards of "transfer entry". This is where the real contrast between these institutions and the successful credit programmes of organisations such as Grameen Bank and SEWA may well lie.

This diagnosis may seem discouraging, in so far as dealing with institutional corruption is a more exacting task than, say, clubbing borrowers into groups. There are, however, some signs of a growing willingness to address issues of institutional corruption in India, if needed through sweeping reforms. An extension of this resolve to rural credit is long overdue.

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cooperatives in spite of a mounting fiscal crisis). Popular slogans in recent elections include "we will vote for those who cancel our debts".

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