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Attitude towards Interest-free Financing among Small Traders and Farmers in Multan

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It is frequently asked whether the modern economy can function without interest. This question has acquired some urgency in wake of the recent ruling of Supreme Court banning interest in Pakistan. In this respect every expert has his own opinion. Some pronounced that great harm will result from the banning of interest. Others have the opinion that such pronouncement is based on lack of understanding of the modern economic system, as well as the nature of the Islamic prohibition of interest.

However, the banning of the rate of interest has affect on the economic activity, i. e. especially on the small traders and farmers. It is commonly argued that this change in capital market has two important effects on the economy. It increased the capital supply while price reduces, thus improving efficiency. And it makes also possible to produce more with relatively less cost, thus has positive effect on the growth of the economy.

Considering the above we need to know the attitude of business community towards Islamisation and what they would like to see in the process of transformation. Are they envisaging any problems, if the system is transformed as proposed in the Supreme Court judgment? What steps they are taking to adopt their business practices to the Supreme Court ruling? Do they have any suggestions how to make this transformation least painful for them?

For achieving the above, a survey has been conducted in the urban as well as in the rural areas of Multan. One specific aspect which has been highlighted in this survey is the current practice of money lending that is done at informal level outside the banking channels. It has been observed that the business community in Pakistan

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borrowers and lends money informally at very high rates of interest though for short periods to meet their business needs. The amount lent and borrowed in such a way runs in million and thousands of transactions are carried out daily. There was moneylender's act enforce in Pakistan to protect such private lending and borrowing, without the banking channels. But nobody probably benefited from the act because moneylenders have their own means to recover money and they do not need the help of law to recover their money and interest. The act will cease to have effect from March 31, 2000. It will probably not effect these money lending activities in urban as well as in the rural areas of Pakistan (where sahookars exploit the poor farmers by lending them money). This activity will still continue even if there is no law to protect such lending. But by June 2001, a law will be passed that will prohibited lending or borrowing on interest and there will be penalty if anyone does this.

This study is not presenting the theoretical background of the concept of interest in Islamic as well as in the Secular system. Interested readers can see the secular concept in the literature, e.g., Knight (1936); Lange (1936); Robinson (1953); Sraffa (1960); Dorfman, Samuelson and Solow (1958) and Mathur (1989). Similarly, the well-defined Islamic point of view regarding interest can be seen in the literature, e.g., Ibn Abidin (*Radd al-Mukhtar, Bab al-riba*), Choudhury (1979); Ahmad (1977); Mannan (1975) and Naqvi (1978).

Whereas Zaman and Zaman (2000); Choudhury (2000); Hoshmand (1995) and Looney (1996) discussed in detail the working of the modern economic world in the interest free environment.

However, this study concentrates on the following three issues:

- (a) What will happen to the moneylending business in the urban markets and *sahookar* business in the rural areas?
- (b) What alternative will they be using?
- (c) People still be needing money to borrow. They will be willing to do anything that the *sahookar* or moneylender will ask them to do but the *sahookars* and moneylender will not take the risk. What will they do?

This study has three sections. Section I presents the attitudes of the traders towards interest free system whereas Section II presents the attitudes of the farmers. Section III presents the concluding remarks and the summary.

In the following Sections (I and II), the results from the survey conducted in the two markets of Multan (Cantt. and Hussain Agahi) and also from the farmers of a selected village are presented. Approximately, the above two markets in Multan have 90 percent share in the business. Only the registered traders are approached (50 from each market).¹ The primary data is taken from Excise and Taxation Department of Punjab. The traders are classified according to their declared assets. Farmers are classified according to the size of land which they are cultivated.

¹See Appendix I.

I. ATTITUDE OF THE SMALL TRADERS

The information about the informal loans were collected from the traders. It was very astonished to know that more than 80 percent of the total borrowed amount is from the informal sector. Table 1 depicts the volume of their loans borrowed from formal and informal sector. It is observed from the Table 1 that the degree of loans from the formal sector is increasing with the size of assets. It is also observed that a huge amount of lending and borrowing is taking place in the informal sector.

Table 2 depicts the different sources of the borrowings from the informal sector. Two major sources are observed, one is from friends/relatives and other is from sahokars. The rate of borrowings from sahokar is positively corrected with the size of the assets. From the above Tables (1 and 2) it is observed that traders with the high volume of assets are borrowing more from the formal sector and from semi-informal sector (Sahokar). (The rate on which they are borrowing is ranging from twenty five percent to forty percent, depends upon the condition of the terms.)

Table 3 explains the rate of interest on which the financial transactions are taking place in the informal sector.

Table 1

Loan from Formal and Informal Sector

Declared Assets*	Volume of Borrowed Amount in %	
	From Formal Sector	From Informal Sector
Less than one Million	3.0%	97%
One Million to 2 Million	11%	89%
2 Million to 3 Million	13%	87%
3 Million to 5 Million	19%	81%
Above 5 Million	39%	61%

Source: Survey conducted by the authors.

*Those assets which the traders have declared on their income tax returns

Table 2

Sources of Loan from the Informal Sector (%)

Declared Assets	From Friends/Relative	From Sahokar
Less than one Million	98	2
One Million to 2 Million	67	33
2 Million to 3 Million	54	46
3 Million to 5 Million	45	55
Above 5 Million	26	74

Source: Survey conducted by the authors.

Table 3

Term Structure in the Informal Sector

Time Period	Rate of Interest*
Less than one Month	40%
One month to 6 Month	30%
More than 6 Month	25%

Source: Survey conducted by the authors.

*This rate is the weighted average.

It has been observed that the rate of interest is based on the time period, i.e., high rate for short period and relatively low rate for long period. Table 3 depicts that sahokars are earning more from the short-term loans. It is important to note that short-term loans have higher velocity than the long-term one. Most of the traders informed that sometimes the borrowing period is less than one day. However, the minimum rate, which is charged by the lenders, is equal to the rate per month and not the rate per day.

The share of short and long-term loans from informal sector can be seen in the Table 4.

It is observed that the composition of the short- and long-term loans is not significantly different among the different groups of the traders. All of the traders irrespective belonging to any class are required both long and short-term loans. No one is biased towards any type of the loan. May be it is the nature of the business and requirement of the market to borrow different types of loans at different time periods. It is very much astonished to know that moneylenders recover their money through own means. They are not used to seek help from any act or law. Every trader was believed that the blessing from Allah (SWT) is no more if their business will run on interest. It is also observed that the system will be continued even after the judgment of the Supreme Court. When it was asked that why the borrowing will be continued even no one is believing on interest and hundred percents are in the favour of banning the interest from the economy. Table 5 depicts the summary of the answer.

Table 4

Share of Short- and Long-term Loans from the Informal Sector

Declared Assets	Short-term	Long-term
Less than one Million	52	48
One Million to 2 Million	44	56
2 Million to 3 Million	57	43
3 Million to 5 Million	47	53
Above 5 Million	40	60

Source: Survey conducted by the authors.

Table 5

Reasons of Borrowing from Informal Sector

Declared Assets	Easy Process	Short-term are Not Available	Government Tax Department	Others
Less than one Million	80	10	5	5
One Million to 2 Million	80	9	5	6
2 Million to 3 Million	70	20	5	–
3 Million to 4 Million	60	20	10	10
5 Million Above	30	40	30	–

Source: Survey conducted by the authors.

The major reasons narrated by the traders is the easy process and especially short terms are not quickly available. Some traders informed that if they have transactions with the formal banking sector then they feel insecure because of the Department of Income Tax. Traders having assets above five million are more afraid from the Revenue Department of the government and the degree of insecurity is higher than the other groups of traders.

Consensus was found among the traders that the system of borrowing from informal sector will not be affected after the Supreme Court judgment regarding to the banning of interest rate. They expect that there should not be any hurdle in the continuation of this business in most of the urban centres. Because the moneylenders are not normally seeking help from the law and act for their recoveries. So this judgment will not disturb their system.

Informal banking has a vital role in the markets of Multan. Normally, one informal bank is run by one or two individuals. These banks have sufficient number of account holders. Due to some reasons, most of the depositors of the informal banks do not ready to deposit their funds in the formal banks. This is because of number of reasons; may be they are not able to run their own business or they have the black money.

They receive the profit on the monthly basis on their deposits. This system was so systematic, reliable and has a few chances of moral hazards. The rate, at which they deposit, is also greater than the market rate of interest. *Amanah* is given as the title of these accounts. Most of the financial funds, which are circulating in the market, are dependent on these accounts. Generally, the financial transactions

are taking place on personal guarantee. In some cases, gold and registration of the property are also considered as the security. All of this business is running on the mutual understanding and confidence. No one was worried about the future of this business. They are fully confident that the judgment of the Supreme Court will not affect the financial transactions of the informal sector. It is important to note that the defaulter rate is less than 5 percent and this rate is not significant at this rate of interest. They also informed that in the past they did not recover the money through any law so the present practices may be continued in the future. Among them who are supplying the financial funds to the traders only one of is supplying on the basis of Murabaha. All depositors and borrowers are entirely satisfied from the working of the present system of the informal sector and they have not any complaint against the system.

II. ATTITUDE OF THE FARMERS

For our analysis a village from the Multan district was selected for the understudy project. All households of the village were approached. Households are classified according to the size of the land, which they are cultivated, or the size of their ownership. All of the respondents informed that the loan in kind is issued from the formal sector and none of them is from the informal sector.

However, most of the cash is supplied by the informal sector. Table 6 depicts that the degree of borrowing from formal sector is increasing with the size of land. It implies that access to such financing in a majority of cases is limited to those with large land holdings as well as social and economic status in the community. Here, also like the urban centres the rate of interest was found higher than the market rate. It is interesting to note that most of the borrowings are from the different companies of pesticides. Another interesting feature which was observed in the rural areas that most of the financing are from the side of pesticides companies. In contrast to the urban centres, the friends and relatives are charging interest in the rural areas. In the rural areas it was also observed the near about all loans are based on interest. Rate is high relative to the urban centers. May be the supply of funds is limited in the rural areas than urban centers. It has been observed that the farmers of the developing countries face severe constraints in terms of availability and access to capital markets, but also in affordability of such capital. The fact that the transaction costs of banks as well as the cost associated with the risk of lending rising, borrowers have difficulty accessing the capital market [Hoshmand (1995)]. Some farmers informed that they borrowed also from the urban centres.

Table 7 depicts the sources of loans and their share in the rural areas of Multan.

Table 6

Loans from Formal and Informal Sectors in the Rural Areas

	Informal	Formal
Less than 5 Acres	100%	0%
5 Acres to 15 Acres	100%	0%
15 Acres to 25 Acres	98.5%	1.5%
25 Acres to 50 Acres	88%	12%
50 Acres and above	76%	24%

Source: Survey conducted by the authors.

Table 7

Sources of Loan (%)

	From Friends	From Sahooakar	From Pesticides
Less than 5 Acres	78	22	–
5 Acres to 15 Acres	75	25	–
15 Acres to 25 Acres	48	14	38
25 Acres to 50 Acres	22	18	60
50 Acres and above	6	15	79

Source: Survey conducted by the authors.

No one was in opine that the banning of interest rate from Supreme Court will have affect on the lending-borrowing system in the rural areas. Every one was complaining that the process of the banks is not an easy one and is very much cumbersome. They said that the attitude of the bank management is hostile to some extent towards small traders and farmers. There is also a common complaint about the some non-official constraints, which are imposed by the bank officials before sanctioning the loans. Small farmers are also not feeling very ease with the recovery officers of the banks. In the informal sector, a smooth system of recovery is prevailing in the rural areas. It is also based on the mutual understanding and trust.

Apparently it was concluded after conducting the survey that the judgment of Supreme Court has not affect on the lending-borrowing system of the informal sector in urban as well as in the rural areas of the District Multan.

III. CONCLUDING REMARKS AND SUMMARY

As it is discussed by Zaman and Zaman (2000) and Choudhary (2000) that the interest free economy relative to the interest based economy grow faster in the present scenario. Most of the business and investment in the modern world is equity based and interest based. More circulation of capital will reduce the price, in return the cost of production will reduce the chances of obsolescence and also minimise the chances of the abandonment from the market. Theoretically, it has been shown that

replacing the traditional interest based system with some type of profit sharing arrangements makes the Islamic system an equity based system which is better able to absorb, and adjust to, shocks that can lead to financial crises. They also pointed out that Islamic-banking principles may offer the potential for removing some of the inefficiencies. But as it is observed from our survey results that the most of the lending and borrowings are taking place in the informal sector. So even if the formal sector will work without interest it will be difficult for us to reap the fruits of this system. Following suggestions are emerged from the survey results:

- (i) Processing of the loans from the formal sector and access to every one should be an easy and simple one.
- (ii) It is also observed from the survey results that the black money is the main source for the supply of funds in the informal sector. If we want to Islamise the system then real efforts should be done for the reduction of the corruption. Because corruption is the main source of black money.
- (iii) Traders and farmers both are believing that interest is not blessed for their business but they are not allowed by the present system to get the benefits and also compelled to borrow from the informal sector.
- (iv) This is the duty of the government to provide the incentive to the borrowers and depositors for the promotion of this system and also to propagate it. Good and polite behaviour of the management of the banks is the necessary condition for the success of this system.
- (v) As it was discussed by Zaman and Zaman (2000) and Choudhary (2000) that interest free system is more suitable than interest based system especially for growing economy but this can be only done if the size of the informal sector will be reduced.

APPENDIX I

What constitutes a small business is not well defined in the literature. It is dependent on the social and economic structure of the concerned country. The relevant statistical data is not necessarily available in all countries and therefore definitions are often adopted within the constraints set by data availability [Burns and Dewhurst (1986)].

Consequently two approaches can be adopted in defining small businesses. The first one stresses the distinctive differential features of small and large businesses in terms of such factors as management, ownership, employment and market share. The second approach emphasises the role of statistical criteria in forming the definition, and the range of each selected criteria determines the size of the business. These criteria include such variables as the number of employees, the annual turnover, profits, output and capital invested. Whether the definition is on a

qualitative or quantitative basis, it must be applicable, unambiguous and appropriate for the purpose of any investigation. [Al Hajjar and Presley (1996)].

In this study the number of employees and capital invested is used as a criteria for the small traders and for the small farmers the size of the land is used.

The final questionnaire is based on the pilot survey.

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