Assessing the Role of Government-led Microcredit

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Using survey data collected in 2007 from three districts in Andhra Pradesh, this article assesses the performance of 72 primary agricultural credit cooperatives. It finds that these credit cooperatives tend to be used as political instruments and, as a result, borrowers prioritise all debt obligations to microfinance institutions, informal moneylenders and others, before primary agricultural credit cooperatives.

The authors suggest that if the performance of these credit cooperatives does not improve, a larger government role in the supply of credit may undermine the culture of repayment.

Perhaps one consequence of a diminished role for MFIs as credit providers for the poor may be an enhanced role for the government. A closer look at the evidence regarding the effectiveness of institutions with significant government involvement in providing access to credit for the poor is clearly warranted.

In this article we report findings from a survey conducted in three districts in AP in 2007 designed to assess the performance of rural credit cooperatives and in particular the primary agricultural credit societies (PACS). PACS are the lowest tier of the rural cooperative banking system. They focus primarily on providing short-term (seasonal) credit for agricultural purposes and are regulated by the National Bank for Agriculture and Rural Development (NABARD).

The experience of PACS may prove useful in shedding light on the debate surrounding the role of government intervention in access to credit for the poor, especially in rural areas.

We find evidence that PACS were used as political instruments. Borrowers responded by prioritising all debt obligations (MFIs, informal lenders, etc) ahead of repayment of PACS loans. This indicates that there is a weak culture around repaying institutions with significant government involvement. A private sector solution that is shielded from government interference may be desirable to that extent.

The article proceeds as follows. We first describe the data and the sources of credit used by the sample of households interviewed. We then discuss PACS management practices and the impact of politics on the culture of repayment.

Data

Our data includes 72 PACS from the districts of Anantapur, Mahabubnagar and Vizianagaram in AP with audited recovery rates as of June 2004 between...
25% and 75%. The data used in this article are part of the baseline collected for the assessment of a Government of India reform programme that followed the recommendations of a Task Force led by A Vaidyanathan which submitted its report on revival of rural cooperative credit institutions in February 2005. The programme sought to transfer funds to qualifying PACS so that accumulated losses would be wiped out, thereby meeting a minimum capital to risk weighted assets ratio (CRAR) of 7%.

We chose a sample of PACS in each of the three districts with repayment rates in 2004 just above and below the thresholds of 30% and 50%. The sampling in 2004 just above and below the thresholds of 30% and 50%. The sampling in 2004 just above and below the thresholds of 30% and 50%.

We then chose a representative sample of borrowing households and another sample of non-borrowers from the villages where the PACS operated. Since we had the proportion of PACS members in each village, we could weight responses from the members and non-members and report summary statistics that were representative of the villages where PACS operated.

In 2007, we interviewed 1,060 farmers from 106 different villages, of which 847 were PACS members and 213 were non-members. The population in these villages was mostly engaged in agriculture (82.6%) and only about half of household heads were literate. Half of the households sampled had total landholdings below 5.5 acres of land.

About 6% of households owned less than one acre, 40.2% had landholdings of less than five acres and the remaining 53.3% of households owned more than five acres of land. Among households with a PACS borrower, almost 42% owned more than five acres. These households would be classified as large farmers, providing little evidence that PACS prioritised marginal and small farmers. This lack of targeting would be consistent with cross-country evidence by Beck, Demirgüç-Kunt and Martinez-Pería (2008), who found no significant association between greater government ownership of banks and financial access across countries.

However, PACS administrative data indicate that only 12% of members are large farmers. So what explains this discrepancy in the data? As it turns out, PACS administrative data are based on landholdings recorded in the members’ passbooks, an official document that provides information about all plots registered in the name of the member. But a household may have more than one passbook. According to survey data, households own 1.74 passbooks on average. This suggests that about two-thirds of the members classified as small and marginal farmers according to their land passbooks live in households with total landholdings of more than five acres. Henceforth, we classify respondents into marginal, small and large farmers according to household landholdings rather than individual passbooks.

**Sources of Credit**

Figures 1 and 2 report the preferred source of credit and actual use by source at the time of the survey in 2007. It is noteworthy to observe the relatively limited role of self-help groups (SHGs), both as the preferred as well as the actual choice. The data show that only 6% of households had a loan with an SHG, and perhaps as a consequence, they were almost never the preferred source for credit (less than 2% of households rank SHGs above other sources). This is not too surprising, as SHGs target the poorest households in the community. Marginal farmers exhibited a slightly higher preference for SHG loans than small and large farmers, but they ended up borrowing the least from this source (less than 10% of households).

Informal loans, quite surprisingly, were the preferred and most used source, by a large margin among all groups of farmers. This is probably due to the higher flexibility they offer. Loans from PACS were the preferred source for marginal farmers, and indeed the dominant source of credit for marginal and the second source for small farmers, below informal credit. In sum, the larger penchant of marginal farmers for SHGs did not translate into greater access relative to small and large farmers, who also borrowed more heavily from formal and informal sources.

These differences in lending methodology are echoed in Table 1 (p 75), which reports the characteristics of loans for the sample by credit source. The main differences lie in collateral requirements, interest rate, maturity and average loan size. Both PACS and formal sources of credit require collateral. In terms of changes in the interest rate, informal loans charge nearly twice as much as loans from PACS and also have a shorter maturity. The problem with PACS, however, is that the average loan size was smaller (a median of Rs 10,000 versus Rs 20,000 for informal sources), and collateral is required. Indeed, half of the PACS borrowers said that they could not
cover expenses in agricultural inputs with a PACs loan plus cash at home. Most PACs members borrow from other, mainly informal, sources besides PACs.

**Table 1: Loan Characteristics**

<table>
<thead>
<tr>
<th>Source</th>
<th>Formal Sources</th>
<th>PACS</th>
<th>SHG</th>
<th>Informal Sources</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of loans</td>
<td>454</td>
<td>861</td>
<td>175</td>
<td>1,051</td>
</tr>
<tr>
<td>Median borrowed amount</td>
<td>20,000</td>
<td>10,000</td>
<td>7,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Mean borrowed amount</td>
<td>44,565.0</td>
<td>15,734.3</td>
<td>8,725.1</td>
<td>26,522.4</td>
</tr>
<tr>
<td>Standard borrowed amount</td>
<td>1,41,475.3</td>
<td>29,993.2</td>
<td>6,871.5</td>
<td>40,678.1</td>
</tr>
<tr>
<td>Maturity (months)</td>
<td>15.55</td>
<td>24.32</td>
<td>14.80</td>
<td>17.11</td>
</tr>
<tr>
<td>Annual interest rate (%)</td>
<td>20.10</td>
<td>16.85</td>
<td>19.07</td>
<td>31.71</td>
</tr>
<tr>
<td>Loans that require physical collateral (%)</td>
<td>91.41</td>
<td>98.14</td>
<td>4.00</td>
<td>8.09</td>
</tr>
</tbody>
</table>

This reliance on informal sources is consistent with the view that formal lenders and PACs in particular may ration credit. Two pieces of evidence from the survey support this view. First, 60% of respondents would like to borrow more from PACs at prevailing rates if they could. This percentage drops to 40% when asked about moneylenders. Second, about half of the respondents that requested credit in 2006 were rejected. Rejection rates among small farmers, at 60%, were higher than among large farmers (47%). Among marginal farmers, rejection rates were lower at 40% but so were credit requests. Only half of the marginal farmers report asking for credit compared to 76% of small farmers and 86% among large farmers. Anecdotal evidence suggests that marginal farmers request fewer loans because they anticipate being rejected, so that only the better potential applicants apply, explaining the lower rejection rates.

**PACS Management and the Role of Politics**

We also inquired into the management practices of PACs. The evidence pointed to a lack of proper incentives to improve repayment. Secretaries of PACs, for instance, were by and large remunerated using a fixed compensation scheme, unrelated to repayment or other performance measures. On average, these secretaries had only 1.5 years of formal education. They had been trained in accounting for less than two months, and had only an average of three years of experience as accountants. Presidents, on the other hand, had higher qualifications, but secretaries played a more important role in the day-to-day operations. Perhaps not surprisingly, the quality of record-keeping for more than 50% of PACs was poor and only 5% of PACs provisioned loan losses.

Questions about governance in the survey presented clear evidence of misalignment between the perceptions of members and those of PACs committee members and presidents. The perception of outside influence is a telling example: between 20% and 30% of members perceived that admission and termination of members and credit decisions were influenced by outsiders. In contrast, no president or committee member thought so. In addition, nearly 40% of members thought that PACs loan decisions tended to favour certain members, while less than 10% of presidents and committee members thought so. Respondents were usually sceptical about the motives of PACs management. They believed, with a probability of close to 50%, that PACs presidents do not look after members’ interests, and they assigned a probability of 40% to the proposition that the president would abuse his power in his own interest.

The first hint of the potential role of politics comes from looking at the political connections that PACs members and management had relative to non-members. The data showed that close to 60% of PACs members had the same political affiliations as the head or ward member of panchayat. In the case of presidents or committee members, this figure climbed to nearly 75%. Most committee members had the same political affiliation as the president.

Consistent with this finding, there is evidence that links the behaviour of government-run credit providers to the electoral cycle. Cole (2009), for example, found that agricultural credit increased by 5 to 10 percentage points in an election year, particularly in districts with high levels of electoral contestation. This pattern was not found in non-election years or in lending by private banks. Cole also showed that this pattern is costly as elections negatively affect loan repayment, and election-year credit booms do not increase agricultural output either. An explanation for why government-run lending institutions in India are more generous during elections comes from Cole, Healy and Werker (2012), who used rainfall, public relief, and election data to examine the reaction of voters to the response of governments to adverse shocks. They found that voters only responded to government relief efforts during the year immediately preceding an election.

Unfortunately, as borrowers take advantage of the lax enforcement of credit contracts, the culture of subsidies and frequent government relief undermines the culture of repayment. The data clearly show that farmers anticipated with probability over 50% that a relief package that benefited PACs (but not MFIs or informal lenders) would be announced in case of a drought. Since farmers would not benefit from a relief package if they repaid the loan before the announcement was made, all farmers had an incentive to wait (even after the loan due date) until the announcement (if any) was made.

We also asked farmers about their perceived probability for different events related to loan repayment, and their answers showed similar patterns (Table 2, p 76). For example, farmers perceived that in the event of a drought, their loan with a PACs would be rescheduled with a probability of 70%; this perceived probability dropped to 55% for commercial banks and to only 25% for MFIs.

The same pattern occurred with the perceived probability of loan forgiveness. Besides, PACs appeared more likely to issue loans in amounts lower than requested. (The difference between PACs and MFIs was nearly 30%). They were also less likely to issue new loans even if the previous ones were fully repaid. PACs were to be trusted less with savings and more likely to deduct a share of the
loan as a bribe. MFI loans, on the contrary, were perceived as 18 percentage points less likely to suffer this problem. Besides, loans from PACS were perceived as less likely to be repaid even if a good harvest followed a drought than were either loans from commercial banks or MFIs.

Finally, respondents were asked to provide a ranking of lenders they would pay first if they had an outstanding loan from different lenders but did not have enough money to meet all repayment obligations. As it turns out, PACS loans always appeared last in the repayment priority list, behind all other loan types. The first in the list was always a loan from an MFI. Thus, the frequent announcement of relief measures appears to undermine the culture of repayment.

### Conclusions

If an expanded role for government has to be the solution, care should be taken to ensure that the effects of government intervention have the intended consequences. There is strong evidence pointing to the crucial importance of government institutions for the functioning of the financial sector in general and access to credit in particular. However, instead of replacing private agents in the market, governments can make a more valuable contribution by securing an adequate environment for private credit institutions to flourish and by improving institutional mechanisms in ways that further the availability of credit to poor individuals. The range of policies that would contribute to this goal goes beyond the scope of this article. Building these institutions involves decision-making with long-time horizons, and the guidance provided by existing research is only partial and incomplete.

We have, however, some good indications of where the right path might lie. Providing good institutions, such as registries exhibit a strong correlation with higher ratios of private credit to GDP. Interestingly, information infrastructure, such as credit registries, matter more compared to creditor rights in poorer countries than in rich countries.

The experience of India in the 1990s also gives insights into ways the government can work to ensure that access to credit is available to those who need it the most. Visaria (2009) shows that the new expedited mechanism introduced for loan contract enforcement resulted in sizeable increases in loan recoveries, as market participants were able to bypass the inefficient court procedures then in place. Also, consistent with the evidence we presented in this paper, Caprio and Honohan (2004) advocate the importance of ensuring the independence of bank supervisors from the political sphere, and of the supervised entities themselves, in order for banks to promote social welfare and not their own or that of their officials.

In sum, in this paper, we have provided some evidence showing that government-controlled PACS may suffer from weak governance and poor management practices and may be prone to capture by politicians. This is consistent
with cross-country evidence that emphasises governance and institutional issues as critical in explaining differences in the performance of public sector interventions.

NOTES

1 The ordinance required that repayment collections occur at panchayat offices and retroactively waived loans if twice the principal had already been repaid. It further required registration of MFIs with district authorities, subject to cancellation at any time (Government of AP 2010).

2 PACS with repayment rates below 30% did not qualify for funding. PACs with repayment rates between 30% and 50% would receive one-third of the funds initially and one-third for every 10% improvement in repayment, while PACS with repayment rates above 50% would receive all the funds immediately.

3 We use stratification weights to report population averages.

4 Another government initiative that is often seen as a viable alternative to microfinance, especially in AP, is the self-help group (SHG) model based on teaching community members how to provide and manage financial services among themselves. Poor women come together in a group that meets periodically, each contributes savings to a group account that is then on-lent to members. To use the term coined by Stuart Rutherford in his 2000 book, The Poor and Their Money, SHGs are an example of a “promoter” approach.

5 The international evidence shows the same patterns. Ding (2005), for example, demonstrates that increased lending by government-owned banks right before elections is not specific to India but can be observed in data from 22 developing countries. Khwaja and Mian (2005) also find that in Pakistan, politically connected firms are able to secure larger and cheaper loans from state-owned banks and default on these loans much more than other non-connected firms.

REFERENCES


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This online service is a part of the project funded by the University Grants Commission (UGC) and executed by the Tata Institute of Social Sciences (TISS), Mumbai and the Economic and Political Weekly (EPW).

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*Individual students and research scholars in Indian universities and colleges are eligible for a discount of 25% on producing brief evidence of eligibility from the concerned institution.

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