



Reforming rural finance and economic development in India: Enhancing sustainability and equity

Narbda Rana

Department of Economics, Government Meera Girls College, Mohan Lal Sukhadiya University, Udaipur, Rajasthan, India

Abstract

This study critically examines the current state of rural finance in India, highlighting the systemic issues and proposing comprehensive reforms to enhance both sustainability and equity. The traditional monitoring of rural loans has shifted from lenders to borrowers, with borrowers being more concerned about losing collateral than lenders are. This dynamic has led to the imposition of usurious interest rates, where default often results in the seizure of collateral rather than a genuine concern for loan recovery. This study advocates for a multi-faceted approach to address these issues, emphasizing the need for substantial public investment in ecologically sustainable agriculture and rural infrastructure. It also calls for targeted market support for vulnerable crops and a significant overhaul in the rural financing system. This includes professionalizing staff, simplifying processes, and regulating interest rates to ensure fairness. Drawing on global public sector reform experiences, the study argues for a shift from mere efficiency to effective outcomes. The proposed reforms include enhancing the democratic and professional nature of Primary Agricultural Credit Societies (PACS), reinforcing the Self-Help Group (SHG)-bank linkage program, and ensuring strict public scrutiny of Microfinance Institutions (MFIs). These measures aim to create a more equitable and sustainable rural finance system, better supporting the socio-economic development of India's rural areas.

Keywords: Rural finance, collateral seizure, public investment, microfinance reform, agricultural support

Introduction

This brief history of rural credit in India covers the 19th and 20th centuries, with a focus on the latter's most significant events. The narrative highlights the key viewpoints that influenced policy shifts and documents their impacts. We begin by outlining the state of rural finance during the late colonial period. Throughout the study period, the challenges faced by rural India reveal a consistent pattern. The rural poor have long struggled with dependence on exploitative moneylenders and a flawed network of markets. After assessing the inadequate performance of cooperative credit institutions in India, we discuss the theoretical rationale behind the 1969 nationalization of banks and its positive effects on rural credit and economic development. However, we argue that some of the excesses following nationalization in the subsequent two decades set the stage for the changes of the 1990s. Although these changes have undoubtedly increased bank profitability, they have adversely affected the poor and limited access to affordable rural credit in underdeveloped regions. The resurgence of moneylenders is a clear indicator of this issue. By examining the two main approaches of the microfinance industry, we assess its efforts to address this problem. We argue that the Self-Help Group-Bank Linkage (SBL) strategy offers a promising way to enhance the security and empowerment of the most vulnerable individuals, especially in the context of farmer suicides. In contrast, the Microfinance Institution (MFI) model is unsustainable and could worsen the plight of the poor, while also potentially boosting the profitability of banks in remote rural areas.

Historical overview of rural credit practices and cooperative movement in India

The colonial era records reveal a wealth of documentation regarding exploitative moneylending practices. Among these, the Central Banking Enquiry Committee (CBEC) Report (1929) and its related provincial reports, such as the Madras Provincial Banking Report, stand out as particularly significant.

The MPBEC report, regarded as a classic, outlines how debt often accumulates over time. Frequently, a portion of the loan remains unpaid, transforming it into a promissory note. This debt might be repaid within a few years or could evolve into a mortgage obligation. Consequently, the creditor ends up with a large portion of the produce, leaving the ryot unable to repay short-term loans. Short-term borrowing thus often leads to long-term debt, creating a vicious cycle. The mortgage creditor obstructs the ryot from settling short-term debts, and since a significant part of the produce is directed to the long-term creditor, the ryot must take additional loans to continue farming.

According to the historic All India Rural Credit Study (AIRCS) of 1954, formal credit institutions met less than 9% of India's rural credit needs. In contrast, over 75% of rural credit was supplied by moneylenders, traders, and wealthy landowners. Despite being in existence for 50 years, cooperative credit societies contributed less than 5% of rural loans. The Cooperative Planning Committee of 1945 noted early signs of trouble within the cooperative movement, highlighting issues such as "frozen assets due to heavy arrears in repayment." Nevertheless, in the 1950s and 1960s, cooperative credit societies were seen as the future of rural credit. The AIRCS proposed an Integrated System of Rural Credit to be spearheaded by these cooperatives. By 1971, cooperatives' share of rural loans had risen to over 20%. Today, India's cooperative credit structure (CCS) is one of the largest rural financial institutions globally, with over 130 million members, including 60 million borrowers. The more than 100,000 Primary Agricultural Credit Societies (PACS) form the backbone of India's rural economy. Compared to commercial banks and Regional Rural Banks (RRBs), the CCS serves 50% more customers and impacts about half of India's population either directly or indirectly. The CCS offers services in dairying, weaving, textiles, crop cultivation, processing, and marketing. However, it has yet to fully realize its potential despite its

extensive reach. The Task Force for the Restoration of Rural Cooperative Credit Institutions attributes this to "severe degradation of governance." Although cooperatives were originally designed to be member-driven, democratic, self-governing, and self-sufficient, they have increasingly depended on government support for essential services. The Task Force highlights how state governments have become the main owners, managers, regulators, supervisors, and auditors of the CCS. The mutuality concept, which empowered cooperatives worldwide by integrating credit and savings functions, has been largely absent in India. This "borrower-driven" model, marked by regulatory arbitrage, recurring losses, deposit erosion, poor portfolio quality, and diminished competitive edge, has led to conflicts of interest. Even after independence, cooperatives have continued to be dominated by wealthier members of the rural elite, reflecting the same issues that plagued them during the colonial period.

In 1951, the AIRCS reported that banks' involvement in rural lending was below 1%. Private commercial banks maintained a minimal and indirect role in rural finance during the 1950s and 1960s. Although the AIRCS encouraged these banks to engage in agricultural marketing and processing, their direct contribution to farm output remained limited. A 1954 RBI directive mandated that for every branch opened in previously banked areas, banks should establish at least one branch in unbanked rural and semi-rural regions. However, the rural branches of commercial banks remained sparse (Meyer & Nagarajan, 2000, p. 172).

In 1955, the nationalization of the Imperial Bank of India led to the creation of the State Bank of India, which was assigned the task of initiating agricultural lending and establishing 400 branches in semi-urban areas, even at a loss. Despite these efforts, banks only accounted for 2.4% of the rural credit market by 1971, with most loans directed towards plantations. Their primary roles included investing in bonds issued by land development banks and financing agro-processing businesses. Through the end of the 1960s, a significant portion of commercial bank lending was concentrated in industry, trade, and commerce (62% each) (26 percent). Furthermore, within the industrial sector, lending was skewed towards large borrowers (Sen & Vaidya, 1997). Private Banks also often channeled advances to their affiliated companies or those with connections to their directors (Chandrashekar & Ray, 2005, p. 12).

Over the two decades following independence, cooperatives were largely controlled by the rural elite, and banks continued to exhibit an urban bias. It is important to note that only landowners were eligible to join PACS, leaving the landless poor without access to these cooperative institutions. Historically, Indian banks specialized in short-term trade credit against conventional collateral and largely neglected rural credit (Chandavarkar, 1984, p. 782). Established in 1921 by merging the Bombay, Bengal, and Madras Presidency Banks, the Imperial Bank of India was nationalized to form the State Bank of India, which became a significant player in rural banking after 1959. Similarly, Keynes observed a comparable trend in the British context during the 1920s (Keynes, 1927, Vol. II, pp. 366-45). In the post-Cold War period, state-led rural financing initiatives became more widespread in development contexts (Burgess & Pande, 2002, p. 3).

Impact of financial reforms on rural banking

In 1991, the Reserve Bank of India (RBI) established the Committee on the Financial System, chaired by M. Narasimham, to address the evolving economic landscape. This committee's report became central to India's broader economic liberalization efforts. It aimed to create a dynamic and competitive financial system that could support ongoing structural changes in the economy. Among its recommendations were the gradual reduction of directed credit programs and a move away from using the credit system for redistribution purposes. The report advocated for the deregulation of interest rates, the abolition of branch licensing requirements, and suggested that future branch expansion should be guided by "need, business potential, and financial sustainability."

The committee also proposed significant changes to capital adequacy standards and emphasized a market-driven, profitability-focused institutional framework to enhance global competitiveness. It envisioned a greater role for both domestic and international commercial banks. Table 1 illustrates that, following the committee's recommendations, the number of rural bank branches, which had peaked at over 35,000 in 1993, declined to approximately 30,000 by 2006. The share of these rural branches within the total number of bank branches also fell from its highest point of 58% in 1990 to around 45% in 2006.

Between 1977 and 1990, branch expansion focused on underserved areas, but this trend reversed post-1990. The period saw a reduction in rural branch expansions and an increase in mergers and relocations. For instance, the number of Regional Rural Banks (RRBs) decreased from 196 in 1990 to just 104 in 2006 (RBI, 2007). Efforts were made to reduce the total number of loan accounts, which fell from 659 lakhs in 1991 to 524 lakhs in 2001 before rising again.

Private Banks' market share in terms of credit and deposits grew significantly, reaching 18% to 19% by 2005, up from 4% in 1990. Public sector banks also saw improved profitability, and their non-performing assets (NPAs) as a percentage of total advances decreased (RBI, 2006, Appendix Table III.26). However, the proportion of rural loans declined from a high of 15.3% in 1987 to 8.4% in 2006, and rural deposit proportions also fell from 15.5% in 1990 to 10.8% in 2006 (see Table 1).

There is a possibility that these trends might reverse, as there has been a notable increase in rural loans from 2004 to 2006. Despite this, by the end of the 1990s, the rural credit-deposit ratio for commercial banks had dropped from a peak of about 69% in 1984 to just 41%. Although there has been a recent increase, it remains below the levels of the 1980s. Incremental credit-deposit ratios have also seen a significant decline, with rural branches falling from over 60% in the 1980s to under 35% in the 1990s, and semi-urban branches decreasing from about 49% in the 1980s to 30% in the 1990s (Shetty, 2005, pp.56-57). Regions with already slow development have experienced the sharpest declines in credit-deposit ratios, highlighting a setback from the gains made during the social banking era of the 1970s and 1980s.

The evolution and impact of microfinance in India

Microfinance has emerged to fill the gap left by the state's withdrawal from the rural credit market. Defined by both NABARD and RBI as the provision of small-scale savings, credit, and financial services to the impoverished to enhance

their income and living standards, microfinance includes two main approaches in India: Self-Help Groups (SHGs) and Microfinance Institutions (MFIs). The SHG model, which originated with NABARD's 1992 pilot project involving 500 SHGs, is a prominent model in India, whereas the MFI model is gaining traction internationally.

NABARD played a crucial role in developing India's unique SHG-bank linkage (SBL) model, leading to its formal recognition by the RBI in 1996 as a standard practice under "priority sector" lending. The Indian government's 1999 Union Budget further emphasized the national importance of this program due to the collaboration between NABARD and organizations like MYRADA, PRADAN, and DHAN. By March 2006, over 22 lakh SHGs had secured bank loans totaling 11,398 crores of rupees, benefiting more than 3 crore households. At that time, 162 MFIs in India had outstanding loans amounting to approximately Rs. 1,600 crores.

The microfinance sector in India, although still relatively small, has been growing rapidly. The proportion of rural bank credit distributed through SHGs rose from less than 1% in 2001 to over 6% in 2006. For instance, in 2001, cumulative credit disbursed through SHGs was 481 crores out of a total rural credit of 54,431 crores, representing 0.88%. This proportion increased each year, reaching 6.48% in 2006, with cumulative SHG credit of 11,398 crores out of a total rural credit of 1,75,816 crores.

Despite these advancements, the distribution of SHG credit remains uneven across India, with the south receiving over 54% of credit-linked SHGs and 75% of all SHG loans, while the north and northeast regions have minimal representation. Additionally, microfinance addresses several challenges that traditional banks face, such as bureaucratic hurdles, the intimidating experience of entering a bank branch, and stringent collateral requirements. The need for collateral and the restriction on credit use limit access for the underprivileged, making it difficult for them to secure loans even for essential needs like health and education.

Conclusion

In his 1981 Nobel Prize in Economics lecture, James Tobin addressed the concept of "particular egalitarianism," which he described as "non-market equitable distributions of goods fundamental to life and citizenship" during the Fifth Henry Simons Lecture at the University of Chicago Law School. Tobin suggested that such equitable distributions might be crucial for enhancing human capital and future earning potential, particularly in areas like education and medical care (Tobin, 1970, pp. 276–77). The issue of limited access to rural credit exemplifies Tobin's notion of "limiting the realm of disparity." In India, agriculture, once a major economic sector, struggled in the 1990s due to various problems, including insufficient rural finance. This has escalated into a severe agrarian crisis, marked by widespread farmer suicides and violence in over 25% of India's districts. Bhaduri (2006) argues that the high administrative costs associated with lending in rural areas are unavoidable. This is due to the typically small size of loans per borrower, the seasonal nature of agriculture requiring timely disbursement of loans, and the higher costs of servicing and monitoring loans in sparsely populated dryland tribal areas. Moneylenders can reduce costs partly due to their familiarity with borrowers. Moreover, lending often exploits the borrower's vulnerability and weak

negotiating position, creating a vested interest in maintaining the borrower's poverty to ensure compliance (Bhaduri, 2006, p. 165). Bhaduri highlights the risks associated with private lending, which are also observed in public sector banks where the poor remain profitable yet face significant challenges. The colonial era's linked marketplaces were characterized by rural borrowers being able to pledge only future labor, future crops, or already-encumbered land as collateral. Lenders could undervalue these difficult-to-market collaterals, shifting the default risk onto the borrower.

Monitoring has become less of an issue since borrowers are often more concerned about losing their collateral than lenders are. Additionally, there is a strong incentive to impose high interest rates, as failure to repay only leads to the lender seizing the collateral. In fact, one might argue that lenders might even prefer borrowers to default. This arrangement, which has been prevalent in India for centuries, is both clever and exploitative. To address the financial needs in rural India, we need several key changes:

1. **Substantial Increase in Public Investment:** Focus on ecologically sustainable, low-cost, and low-risk agriculture, as well as all forms of rural infrastructure.
2. **Market Support for Vulnerable Crops:** Provide market support for crops grown in rainfed areas, such as cotton, pulses, and oilseeds, which have become particularly vulnerable since the post-WTO period (GoI, 2007, C).
3. **Reform in Rural Financing:** This involves the professionalization of staff and the simplification of processes and personnel. Such reform should ensure that rural credit provision is sustainable both financially and environmentally. Insights from global public sector reforms are valuable here, shifting the focus from mere efficiency to genuine effectiveness.
4. **Interest Rate Regulation:** We support the Union Ministries of Rural Development and Women and Child Affairs' stance that the new microfinance bill should include a cap on interest rates of 33 percent.

Reforms driven solely by efficiency and profitability concerns have often failed, especially impacting the socially and economically disadvantaged. While rural banks in India could have benefited from adding professionals in agriculture, engineering, irrigation, livestock development, and rural enterprises, recent reforms have further weakened their human resource capacity.

To enhance the democratic and professional nature of Primary Agricultural Credit Societies (PACS), reforms suggested by the Task Force on the Revival of Rural Cooperative Credit Institutions are needed. Additionally, the Self-Help Group (SHG)-bank linkage program should be reinforced, with the state, particularly NABARD, covering promotional costs in the initial years.

Strict public oversight of Microfinance Institutions (MFIs) is necessary, including regulation of interest rate bands to ensure fair competition within the sector. Facilitating and connecting SHG Federations to various apex development agencies will enable them to serve as a mechanism for macro-finance, human development, and sustainable livelihoods for the rural poor.

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