

Does Access to Formal Agricultural Credit Depend on Caste?

SUNIL MITRA KUMAR *

University of East Anglia, Norwich, UK

Summary. — This paper analyzes whether caste impedes access to formal agricultural credit in India. Credit is provided mainly through cooperative and commercial banks. Using national data, we find that cooperative banks discriminate against lower caste borrowers, and find weak evidence that commercial banks instead bias lending in their favor in accordance with affirmative action policies. We compare the organizational structures of the two types of bank, and explain discrimination by cooperative banks in terms of interest group capture at the district level by showing that discrimination takes place in those districts where higher castes dominate.
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1. INTRODUCTION

Social group identity is intricately related to economic outcomes, particularly in developing countries. In rural India, the historically entrenched caste system wields significant influence on economic outcomes, an indicator of which are the large differences in consumption expenditures between caste-groups (Deshpande, 2000). Caste can shape economic outcomes in two interlinked ways. The first is through socio-political processes and networks that operate largely independent of the State. These can determine cooperation within communities (Drèze & Sen, 2002), access to resources such as irrigation water (Anderson, 2011) and capital and labor inputs (Banerjee & Munshi, 2004), or educational and occupational choices (Munshi & Rosenzweig, 2006). The second is through the effect of group-identity on government policy and the provision of services such as public goods (Banerjee, Iyer, & Somanathan, 2005; Banerjee & Somanathan, 2007). In the second case, government policy might also attempt to alleviate historical disadvantage through affirmative action such as political reservation (Pande, 2003; Prakash & Chin, 2011), or quotas in government educational institutions (Bertrand, Hanna, & Mullainathan, 2010) and public-sector jobs (Weisskopf, 2004).

Financial inclusion forms an important strand of affirmative action policies in India. Burgess and Pande (2005) examine, for instance, how the large expansion of branch banking services to previously unbanked locations during 1969 to 1990 helped reduce poverty. Yet, the role of caste in determining access to formal credit has not been examined in the literature using national data. In this paper, I use data collected in 2003 and focus on how caste determines access to agricultural production credit. The latter is a crucial determinant of rural incomes, and therefore constitutes an important focus of financial affirmative action. The bulk of formal agricultural credit is disbursed through commercial and cooperative banks. Commercial banks are large and centralized entities under the direct supervision of the Reserve Bank of India¹ (RBI), whose lending is expected to conform to affirmative action policies and targets. Cooperative banks, in contrast, constitute a large network of decentralized, independent entities, many aspects of whose functioning are not directly controlled by the RBI.²

I first examine how the likelihood of borrowing any formal agricultural credit changes with caste, and find that caste is not a significant determinant of access once other household characteristics are taken into account. I then disaggregate

borrowings between commercial and cooperative banks, and use bivariate probit models to analyze the influence of caste. I find that caste is now significant, and that its influence differs radically for the two types of bank. Cooperative banks bias lending in favor of higher castes, indicating the presence of negative discrimination against lower castes, while commercial banks do not. Instead, there is weak evidence that commercial banks bias lending in favor of lower-caste households, in accordance with affirmative action policies for financial inclusion.

A possible explanation for this phenomenon is that cooperative banks' management structures are vulnerable to interest group capture through local political influence. Unlike commercial banks which work with centralized decision-making procedures under the direct supervision of the RBI, cooperative banks are organized in a three-tiered aggregating structure, spanning village, district, and state levels. The district-level entities are expected to act as mentors for village-level cooperatives under them. Given the organizational and political significance of the district in Indian administration, any capture by interest groups is likely to take place at this level, and might be reflected in the lending behavior of cooperative banks accordingly.

I test for the possibility of interest-group capture by defining caste dominance in the district in terms of agricultural land ownership, and analyze how the probability of borrowing changes according to the dominant caste. While the notion of dominant caste is multidimensional, Srinivas (1959) points toward land ownership being an important indicator of dominance.³ I find that the negative discrimination by cooperative banks is visible mainly in those districts where higher caste groups are dominant, and disappears otherwise, lending support to the theory of capture by caste-based interest groups. This is also consistent with several field studies which have studied lending practices in rural India using small samples (Drèze, Lanjouw, & Sharma, 1997; Jodhka, 1995; Sarap, 1990). Finally, I also examine whether caste influences the amount of credit borrowed, and whether interest rates and repayment rates differ according to caste.

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2. BACKGROUND

The caste system in India emerged as a hierarchical system of social groupings within Hindus, where occupations were hereditary, and marriages took place only within the same caste. While caste no longer determines occupation, it continues to play an important role through historically-acquired capital, both tangible (land, money, and other assets) and intangible—particularly networks. The Indian government categorizes castes into three major groups; the Scheduled Castes (SCs) who are the most disadvantaged (historically these were the Untouchables), the Other Backward Classes⁴ (OBCs) who are of middling disadvantage, and Others, the traditionally privileged higher castes. We exclude Scheduled Tribes (STs) from our analysis, an additional category employed to classify tribal peoples, since STs have not, historically, been part of the caste system.⁵

Recognizing caste-based socio-economic disadvantage as a major problem, government policies have sought to provide a “level playing field” through affirmative action in several areas. In financial services, affirmative action is based on caste as well as more generally defined socio-economic disadvantage. The first All India Rural Credit Survey Committee Report (Reserve Bank of India, 1954) recognized that access to financial services was strongly dependent on socio-economic status, and policy measures have since aimed to strengthen access in rural areas, particularly for small farmers.⁶

The majority of formal credit in rural India is disbursed through cooperative and commercial banks. Beginning from the Indian Cooperative Act of 1904 and the Cooperative Societies Act of 1912, cooperative banks today have 120 million members (Government of India, 2005), and are organized in a three-tiered structure: Primary Agricultural Cooperative Societies (PACS) at the village level, (district) Central Cooperative Banks (CCBs) at the district level, and State Cooperative Banks (SCBs) at the state level.⁷ Cooperative banks are decentralized, and the district and state units oversee and guide the village-level PACSs, helping them access financial resources and mitigate seasonal patterns in the excess demand and supply of funds by working as clearing centers. As Misra (2010) explains, districts—where CCBs operate—were chosen as the first level of aggregation in view of organizational considerations, since districts form the basic unit for civil administration.

The performance of CCBs and PACSs has been anything but encouraging, and as of 2003 they had large accumulated losses for which poor governance practices have been blamed (Shah, Rao, & Vijay Shankar, 2007). By design, CCBs are expected to mainly have institutional members in the form of PACSs, however individuals have formed an increasing proportion of membership, and constituted 86% of total members in 2007 (Misra, 2010). In 2005, the government of India (GOI) set up a committee to review the functioning of cooperative banks and recommend changes. The Vaidyanathan Committee report (GOI, 2005) took stock of several structural problems and made recommendations, which included appointing democratically elected managements, board members with “fit and proper criteria of eligibility” (GOI, 2005, p. 69), and professionally qualified CEOs. The committee noted that governance structures in cooperative banks were impaired “because of politicisation of these institutions, reflected in the fact that directors on Boards of Cooperative Banks are involved in active politics either at the State, District, and Taluka level” (GOI, 2005, p. 27).

Commercial banks, instead, function mainly as centralized institutions with a large network of branches. In 1969, the Indian government nationalized the 14 major commercial

banks to bring them under the direct control of the RBI, which enabled these banks to play a major role in pursuit of social objectives (Pande, 2007). The need was also felt for a social banking program that involved a major expansion in the number of branches, bringing financial services to nearly 30,000 previously unbanked rural locations during 1969–90 (Burgess & Pande, 2005; Burgess, Pande, & Wong, 2005). Alongside, “priority sector” lending has long been a focus of financial inclusion policies. Starting from 1968 when the National Credit Council advised banks to increase their finance to priority sectors, to 1985, when all commercial banks were given a target of 40% finance to this sector from their overall lending portfolio, the RBI has continued to encourage priority sector lending (RBI, 2008). The priority sector includes, among others, small and marginal farmers and “weaker sections”, where the latter include SC and ST households. As of 2002, the RBI specified that banks extend 10% of Net Bank Credit to weaker sections (RBI, 2002a). Policy guidelines urge banks to enable better access to loans for Scheduled Castes, and this includes lending at lower rates of interest (RBI, 2002b, 2004, 2006).

While the policy perspective remains one of improving financial inclusion for socially and economically disadvantaged, a key question is whether formal lenders—mainly banks—discriminate between borrowers on the basis of caste, i.e., base their lending decisions on factors which are not “objective” (Becker, 1971). The question of discrimination is distinct from overall issues of access, even as the latter are no doubt important for economic growth and alleviating poverty. Even in the absence of discrimination, profit-maximizing banks can be expected to base their lending decisions on the availability of collateral and past default behavior. Disadvantaged borrowers will have less assets to collateralize, so that even without discrimination, lower-caste borrowers will receive fewer loans on average. The question of discrimination is more serious than that of purely asset-based differences in access to credit, since it implies, if prevalent, that lower castes are less likely to receive credit *even if* they have sufficient assets to collateralize.⁸

Given the crucial role of bank credit in a population largely dependent on agriculture, this has serious implications for the larger policy agenda on reducing poverty. Yet there is relatively little empirical research on household credit transactions and questions of socio-economic disadvantage using quantitative data.⁹ What national-level research does exist tends to focus on the role of commercial banks. For example, Burgess and Pande (2005) estimate how access to financial facilities increased for poorer and SC/ST households as a result of the 1969–90 banking expansion, and Banerjee, Cole, and Duflo (2004) examine the functioning of nationalized and private commercial banks, and how their institutional structures relate to their expansion and lending practices.

Other studies on credit in India include Kochar (1997) who examines whether farmers are (formal) credit-constrained using data from Uttar Pradesh, and Pal (2002) who studies the determinants of household credit choices using data from three South-Indian villages, and finds that upper-caste households are more likely to borrow from the formal sector. Cole (2009) shows that Indian banks are liable to political capture since there is a marked increase in agricultural lending during election years. Finally, field-studies have analyzed borrowers and banks at close quarters and often over long periods of time (mainly in northern India), and concluded that caste-based discrimination does take place alongside questionable or corrupt practices, in certain types of banks (Drèze *et al.*, 1997; Jodhka, 1995; Sarap, 1990).

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