CHAPTER 1
INTRODUCTION

1.1. Introduction
In the course of development, socio-political and economic systems undergo changes in their institutional structures at different points of time. But, the pace and course of these changes may vary from one system to another. There are marked differences between developed and developing countries in their economic organisations, interactions of the individuals and the institutions mediating interactions. Both institutions and market play the role of mediation, which facilitates transactions. Under many circumstances, actual functions of the markets, however, deviate from the neo-classical position of perfect information with cost-less transactions (Stiglitz 1989, 1990; North 1989).

As individuals have bounded rationality, it is necessary to have human co-operation and co-ordination. Since such co-operation is often missing, the transactions become costly and hence, the institutions matter (North 1990). Generally, market transactions have uncertainties arising from incomplete information on the individual behaviour in the process of interactions. Institutions play an important role\(^1\) in reducing the adverse impact of imperfect information, and transaction costs that emerge from pervasive risks, incomplete markets, information asymmetry and the moral hazard (Bardhan 1989). Institutional innovations reduce transaction costs by lowering the costs of information and spread of risk. They also transfer uncertainty into ascertainable risks and develop contractual enforcement mechanisms.

Transaction costs incurred in operationalising economic systems act as a hindrance to economic growth as the costs involved in measuring performance, fulfilling contracts and enforcing agreement are likely to be high (North 1992).

\(^1\) History has witnessed changes in the institutional structure and its resulting impact on the costs of transactions and production. In the primitive society, with dense social network and division of labour and specialisation, cost of transaction was low whereas the production costs were very high. But, as trade expanded and personal transactions gave way to impersonal exchanges, property rights and enforcement of contracts were developed to reduce market imperfections.
Therefore, the transactions of such kind which extend to the future with uncertainty impose transaction costs. Generally, transaction costs imply those costs incurred in organising, monitoring and enforcing rules of institutional arrangement. They consist of *ex-ante* and *ex-post* costs. The former relate to the costs on adverse selection of a risky member, whereas the latter relate to the incomplete enforcement of the contract due to moral hazard such as dispute resolution, renegotiations, monitoring the contract, bonding the contractual parties to continue work together. Generally, an efficient economic system with inter-linkages brings down these costs. On the other hand, in less developed countries with market failures, transaction costs tend to be quite high. Thus, in those economic systems with costly information and asymmetry of knowledge, the market imperfections due to cheating, shirking and free riding, etc., are very high (North 1992). Effective institutions raise the benefits of co-operative solution by reducing the costs of defection and hence, the potential gains of trade are realisable (North 1991). Efficiency of an institution depends upon how well it copes with opportunism, the existence and the strengths of surrounding auxiliary institutions and how well it exercises penalty on those who break the rule (Lin and Nugent 1995).

The institutions prevalent in less developed countries are not advanced enough to accommodate changes easily and hence, they are characterised by institutional imperfections. The institutional framework for dealing with these imperfections is also less effective. In these countries, market failures are quite common and non-market ameliorating institutions are meagre (Stiglitz 1989). Thus, high transaction costs prevent the economies to grow and societies to develop in those countries. Moreover, informal institutions like customs, caste and social sanctions influence market outcomes and lead to low level equilibrium trap or barriers to entry for some members (Basu 1984). Social institutions provide certain kinds of economic systems to prevail and the costs of making changes in the informal institutions are costly compared to formal ones. These propositions are well
supported by empirical studies\textsuperscript{2}, which have brought out the significant role played by the socio-political institutions in the economic development of countries.

As the institutions in less developed countries are not well developed, enforcement of contracts tends to be ineffective. Inability of the society to develop effective and low cost enforcement of contracts results in stagnation and underdevelopment (North 1990). Therefore, enforcement is costly as it is expensive to find out that a contract has been violated, and it is also expensive to measure its violation and impose penalties. In a world of impersonal exchange and incomplete information, co-operative behaviour breaks down unless institutions are created to provide information. Under such situations repeated interactions and knowledge about each other reduce the costs of enforcement. But, once the society develops, there is a necessity for greater specialisation and the number and variability of valuable attributes. Here, reliable institutions are needed to enable individuals to enter into complex contracts with minimum uncertainty about whether the terms of contract can be realised (North 1990).

The appropriate forms of contract between parties to a transaction help in overcoming the problems of market failure due to adverse selection and moral hazard. It is easier to enforce contracts in a group having members with common interests. Collective action among the members in a group with common interests reduces the costs of contracting and free riding, once they find it profitable to act collectively rather than individually (Olson 1965). When any group finds the existing contractual alternatives inefficient, inequitable or both, transaction costs may go up and it engages in collective action to change the contracts so as to reach a cheaper outcome (Nabli and Nugent 1989). The costs of transacting can be minimised through cooperative action among the members with repeated

\textsuperscript{2} A study of over 100 years of comparative development experience in 40 less developed countries shows that a single most important explanatory variable was the institutions, namely, political and administrative organisations (Reynolds 1983). The significance of the institutions was clearly exposed by another study conducted in 1961 by Adelman and Taft (1967) in 74 countries. It reveals that 24 socio-political variables related to institutional performance accounted for 70 per cent of the variation in the per capita income of these countries.
number of dealings for the partners with lesser number of players or with perfect information about each other. In the real world, these may not be possible due to increased transactions with imperfect information and impersonal exchange, but the repetitive nature of the transaction can bring a co-operative solution.

In the static equilibrium model developed by Olson (1965), defection is the dominant strategy. On the other hand, in the dynamic interactions of Prisoners Dilemma game, tit for tat is the dominant strategy (North 1990; Young 1998). Thus, on occasions where interactions that are going to happen in the future are expected to be less, non co-operative behaviour is the dominant strategy for members entering into collective agreement. But, repeated interactions and their experience with others develop expectations which lead to actions and precedents, leading to a co-operative solution. The co-operative outcome or collective action that emerge from the repeated interactions is aided by selective incentives (Olson 1965). These incentives can be both positive and negative. Positive incentives encourage active participation and leadership, whereas negative incentives prevent members from violating group rules and decisions. Mechanisms need to be in place for the group members to have repeated interactions. The extent to which the mechanisms and incentives work in collective action groups is, however, not adequately analysed in the existing literature. This study seeks to probe whether mechanisms and incentives work in collective action groups formed to address imperfections in the rural credit market.

1.2. Rural Credit Markets in Developing Countries

Unlike the market for goods and services, credit market dealings have future implications. A credit market transaction is said to be complete only when the amount borrowed is repaid on time. Generally, the duty of the lenders is to ensure that borrowers are creditworthy, utilise the loans for low risk productive activities and make timely repayment (Huppi and Feder 1990). In order to ensure that the transactions are completed, the lenders have to bear the costs involved in screening, monitoring and enforcing repayment of the loans. These costs
represent the transaction costs of credit market dealings incurred by the lenders. In the real world, the transaction costs in the credit market are positive. In other words, a party to a credit transaction does not have perfect information about the other party. Moreover, there are imperfections due to concealment of information on creditworthiness on the part of the borrowers, which relate to the issue of moral hazard. Therefore, the difficulty to get information about uncertainties imposes another constraint for both lenders and borrowers (Hoff and Stiglitz 1993). Similarly, borrowers have to bear costs of transacting due to imperfections in the formal credit market. The transaction costs are likely to go up on account of complicated procedures, political interference, distant location, cultural gap between the officials and borrowers, short banking hours etc. (Rajasekhar and Vyasulu 1990). Such imperfections leading to the problems of adverse selection and moral hazard restrict the access to credit for the poor. Costly transactions result in a Pareto inefficient level of outcome and result in welfare loss, which gets reflected partly in the resources absorbed by transactions and partly in the suppression of exchanges that would otherwise have been mutually beneficial to the lenders and borrowers.

Several innovations in the credit market were made to reduce transaction costs arising from information asymmetry. The targeting and sustainability were the guidelines of institutional innovations in the credit market for a long time (Hulme and Mosley 1996). As the informal credit institutions of the developing countries could not meet all the credit needs of the rural poor, institutional changes were made and subsidised credit programmes were introduced. However, the proposed objective of improving the access of credit to the poor could not be realised. On the contrary, these programmes resulted in a more unequal distribution of credit leading to the rich cornering the benefits. Recognising the problems of the credit

3 Since transactions in the real world are incomplete and involve costs, the neo-classical model with costless transactions is unrealistic.

4 Moral hazard arises when an individual takes an action to maximise his own welfare to the detriment of others in a situation where informational problems prevent the assignment to the individual of the full damage caused by his action.

5 Adverse selection arises when commodities are distinguished on the one side of the market (usually, the sellers) but are treated as identical by the other side of the market (the buyers). In such a case, the sellers (here, lenders) may withdraw from the market (credit market) and this results in zero trade (no credit transaction).
market, the Ohio School (Adams et al 1984) advocated free play of the market forces and argued for the following. First, the sustainability of the institutions was possible only when the financial institutions functioned independently. Second, targeting of the poor should not be at the cost of financial sustainability of the institutions. Third, the interest rate ceilings imposed by these specialised banks sidelined the capacity of the poor to contribute savings, which had the potential to ensure good loan recoveries (Braverman and Gusach 1986). There were some criticisms on this School also. First, the free play of market forces in the credit market would lead to an unequal distribution of credit. Second, the School had not given due importance to the social rate of return and poverty impact of these institutions.

1.3. The Research Problem
Combining the merits of both sustainability and targeting of the credit institutions, a new financial institution, called micro-finance group, emerged not only to address the imperfection in the rural credit markets but also the concerns relating to poverty alleviation and women empowerment. In these groups, the transaction costs arising out of the credit market dealings could be reduced through repeated interactions, familiarity of the members and small size of these groups. Since these were small groups and members of such groups belong to similar socio-economic background, they could undertake collective action in the selection of the creditworthy borrowers, monitor the utilisation of the loan and ensure the timely repayment of loans. This allowed the lenders to shift a part of the burden associated with borrower selection, loan administration and repayment enforcement onto the borrowers. Similarly, borrowers would be able to save transaction costs by not having to undergo the cumbersome procedure of filling out lengthy applications, and undergoing project and collateral appraisal (Bhatt and Tang 1998). Under micro-finance groups, large number of poor people without adequate individual physical collateral could access credit based on the social collateral. The peer pressure was the main force behind continued existence of the group. The joint liability provided incentives to (and/or compels) the group members to undertake those actions, which reduced uncertainty in the
credit market (Ghatak and Guinnane 1999; Bhatt and Tang 1998; Morduch 1999b). Thus, collective action within the group was the key aspect of micro-finance groups. The reliability and the sustainability of micro-finance institutions, however, depended on how well it could enforce the contract among the members. Micro-finance groups arrive at certain rules and regulations to ensure that the mechanisms concerning the contractual relations were in operation. Similarly, the members were provided with adequate incentives to promote cooperation or to avoid the emergence of non-co-operative outcome.

Institutional mechanisms and incentives involved in the selection of borrowers, monitoring the utilisation of the loans and ensuring repayment of the loans were, thus, important in micro-finance programmes. The incentives and mechanisms for the selection of borrowers aimed to rectify the problems of adverse selection, whereas, monitoring of the utilisation of loans looks into moral hazard problems and enforcing repayment tried to avoid the chances of free rider problems. Therefore, the incentives of carrots and sticks (Lin and Nugent 1995) - positive and negative- for the repayment of the loan needed to be provided. The chance of getting a next and bigger loan could be considered as a positive incentive whereas punishment in case of default could be considered as a negative incentive to reduce free rider problems. Since the members dynamically interacted at different points of time, incentives are to be directed to the members to avoid chances of free riding. The mechanisms like compulsory weekly savings contributions, familiarity among the members, provision of loans based on their need, repayment of loan in various instalments etc., were built into the system to ensure collective responsibility among the members and ensure timely repayment of the loan (Patten et al 2001).

The theoretical foundations for micro-finance (i.e., institutional economics) and collective action for good outcomes in micro-finance group state that institutional regulations play a major role in the reduction of information asymmetry and incentive problems. It is in this context that a study on the incentives for and processes of collective action in different types micro-finance groups, the impact
of mechanisms and incentives in undertaking collective action and the pattern of selection, monitoring and repayment become important. Some of the questions that can be raised in this context are as follows. What have been the institutional mechanisms and incentives provided to the members in selection, monitoring and repayment? Do micro-finance programmes select the most needy? Or, do they select members/borrowers on the basis of risk bearing capacity? How is the monitoring and supervision pattern of the borrowers? Does this make any difference to the selection of activities for which loans have been taken? What kind of training programmes have been organised for the poor and what impact does this have? What types of economic activities have the micro-finance group members undertaken? What has been the repayment pattern among different types of groups and members? How are the members repaying the loans? What have been the institutional regulations and incentives for all the above? Do they work? If yes, how? If not, why? This study seeks to address these questions in the specific context of micro-finance programmes of Kerala state.

1.4. Micro-Finance Programmes in India

In India, micro-finance programmes have been promoted both by the government and the non-governmental organisations. India joins hands with other developing countries like Bangladesh, Sri Lanka and Indonesia in this regard. These are small groups of poor women engaging in activities of savings and lending operations. Such groups are called Self-Help Groups (SHGs) in India. The concept of SHG is wider, and is not the same as the micro-finance group. In the context of micro-finance, a SHG consists of 10-15 members. SHG members can be both men and women. However, 90 per cent of the SHGs in India have only women as their members (NABARD 2004), who periodically contribute a fixed amount of savings and borrow from the savings fund thus created. In most of the cases, the formation of SHGs has been facilitated by the NGOs, although the government has also been an active player. Southern states of the country have a

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6 SHG is defined as a democratic and viable entity at the grassroots level which involves all members in the formation, implementation and monitoring of their programmes meant for their development and empowerment through the resources raised on their own strength. (This definition was provided by the participants in a workshop on Self-Help Promotion organised by GTZ/SHF at ISEC, Bangalore)
strong presence of SHG, whereas northern states like Bihar and Madhya Pradesh are relatively SHG backward in so far as the presence of SHGs is concerned (Dasgupta 2005).

It is assumed that the groups of poor women members with similar socio-economic conditions have better access to information about the creditworthiness of the members. This, in turn, reduces the transaction costs of selection, monitoring and repayment (Namboodiri and Shiyani 2001). The programme has received wider appreciation and support from government, multilateral agencies etc. The initiatives from the National Bank for Agriculture and Rural Development (NABARD), in the form of SHG-Bank linkage programme, have provided good boost to the SHG movement in the country. SHG-Bank linking through SHGs and the existing decentralised formal bank network have been extended to the outreach of micro-finance services to the poor in India.

By March 2004, 6 lakh SHGs and 16.7 million poor families had been linked to the formal banking system of the country. This unprecedented growth of savings and lending operations among the poor changed the hitherto notion that the poorest cannot save and are not creditworthy (Rutherford 2001). Over time, the Indian banks have been lending to the group as a unit, without collateral, relying on self-monitoring and peer pressure within the group for repayment of these loans. The bankers are ready to lend to these poor women groups as they exhibit a high repayment rate of more than 95 per cent (NABARD 2004) and also they are instructed from the central bank to earmark a certain proportion of their lending to SHGs. Thus, the major bottleneck faced by the poorest, i.e., lack of access to credit to make investment, is sought to be resolved through the establishment of micro-finance groups. In recent years, development programmes of the government have also sought to target the poor through the SHGs. Starting with the Rashtriya Mahila Kosh and the Indira Mahila Yojana, the government has used the SHG approach in many of its anti-poverty projects. The most important of the government programmes using the SHG approach is the Swarnajayanti Gram Swarojgar Yojana (SGSY) launched in 1999.
1.5. Objectives
The objectives of the study were to:

1) understand the existence and the nature of collective action among micro-
finance group members;
2) examine the mechanisms and incentives incorporated for collective action
among micro-finance group members while selecting the borrowers,
monitoring the utilisation of the loans and enforcing repayment; and,
3) analyse the impact of mechanisms and incentives for collective action
among micro-finance group members while selecting the borrowers,
monitoring the utilisation of loan and enforcing repayment.

1.6. Hypotheses
1) Appropriate mechanisms and incentives have not been incorporated in
micro-finance groups for collective action in the selection of borrowers,
monitoring and enforcing repayment of loans;
2) Micro-finance groups do not select creditworthy borrowers, monitor the
utilisation of the loan and enforce loan repayment; and,
3) There are no differences between government and NGO initiated micro-
finance group members in terms of their socio-economic profile and their
performance in terms of selection, monitoring and repayment.

1.7. Methodology
This study was undertaken in the specific context of Kerala because the micro-
finance developments in the state offered scope for comparing the functioning of
institutional mechanisms and incentives in government and NGO micro-finance
programmes. In Kerala, micro-finance programmes have been promoted both by
the government and NGOs. But the interventions of NGOs in micro-finance were
prior to those of the government. Many NGOs made attempts to alleviate poverty
and empower the poor through micro-finance in socially and economically
backward regions of the state. Some of these NGOs had promoted credit unions,
which, however, had problems of free riding due to their large size. The SHG
movement in the other states inspired the NGOs in Kerala to form small micro-
finance groups (consisting of about 15 women) for socio-political and economic empowerment (Rajasekhar 2000).

The state government also took keen interest in micro-finance groups after the successful implementation of the Community Development Society of Alapuzha, organised as part of the decentralisation efforts in the 1990s. In 1999, the Government of Kerala, in collaboration with NABARD and Government of India, had set up Kudumbashree - State poverty Eradication Mission of the Government of Kerala. This programme, which was part of the peoples’ planning campaign of the state, introduced Neighbourhood Groups (NHGs) involved in micro-finance at the grassroots level through local self-governing institutions all over the state and aimed at women empowerment and wiping out absolute poverty from the state within a period of ten years. This programme, proposed by the Left Democratic Front (LDF) government, mainly aimed to strengthen gram sabhas introduced at the grassroots level, since gram panchayaths in the state were very large in terms of population size. It was assumed that women participating in NHGs could bring their local issues to the gram sabhas held at the ward level. The mobilisation of savings, and labour could be undertaken through NHGs organised and promoted during the Peoples’ Planning Campaign of decentralisation programme of the state. This was considered to be essential given the precarious situation of revenues in the state. NHGs received wide popularity, since the government had decided to direct 10 per cent of the plan fund for women through them.

Urban poverty alleviation programme introduced in 1992 in the Alapuzha municipality was Community Development Society which developed a nine point criteria for the identification of the poor.

Grama sabha is the assembly of the ward level members of a panchayath where they discuss issues relating to their priorities, execution, implementation and assessment of the programmes.

The purpose and the functions of the NHGs are the same as that of the SHGs, though NHGs are introduced and promoted by the government of Kerala through the state poverty eradication mission.

Democratic decentralisation of planning implies that people can be involved not merely in numbers, but in taking decisions on how to improve their lives and their communities while planning, implementation and evaluation of projects suitable to the local conditions.
Wayanad district of Kerala was selected for the study, as this district was not only poor in relative terms but also provided an opportunity to make comparison between the government and NGO micro-finance groups. The proportion of tribals in the district was the highest in the state. The incidence of SHGs was also the highest. In the district, the micro-finance groups were being promoted both by the government and the NGOs.

Two panchayaths - Sulthan Bathery and Noolpuzha – were randomly selected from Sulthan Bathery block, where micro-finance programmes were flourishing. Since the total number of NHGs and SHGs (initiated by NGOs) or the universe was not available due to problems of dual membership, we selected an equal number of groups from these panchayaths. Moreover, equal number of groups were selected based on the assumption that both the categories of groups performed more or less equally. Accordingly, 8 NHGs and 8 SHGs were selected from each of these panchayaths and a total of 32 NHG/SHGs were selected randomly. From each of these groups, 6 members were randomly selected and thus, a total of 192 members were selected for the study. Interview schedule was used for collecting information from the sample member households. The information collected included demographic profile, access to loans, utilisation and repayment of loans, the use of mechanisms and incentives in the selection, monitoring and repayment of loans. A group questionnaire was used to conduct focus group discussions at the group level, and a format was obtained to collect the quantitative data on the micro-finance operations at the group level. Checklists were prepared to gather information about the groups from bank officials, NGO and government personnel.

1.8. Organisation of the Study
This study has been presented in nine chapters, including the introductory chapter.

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1 In absolute terms the per capita income of Wayanad was the highest in the state due to lower level of population. But, considering the socioeconomic conditions of the marginalized sections which constitute the majority of the district, deprivation of the people were more.

2 Dual membership and multiple memberships arise as some members maintain membership in more than one organisation at a time.
The second chapter discusses the theoretical and empirical literature pertaining to the institutional dimensions of the credit market with special reference to micro-finance programmes. Micro-finance programmes have been introduced by the developing countries to address rural credit market imperfections. Under these programmes, the principle of joint liability shifts the responsibility of ensuring repayment from the lenders to the borrowers. As incentives and mechanisms play a significant role in facilitating the collective action, these have been discussed. The chapter also brings out the group and member specific factors contributing towards collective action among micro-finance group members. The challenges before the growth of micro-finance groups have also been discussed.

The third chapter explains the emergence and growth of micro-finance programmes in India and Kerala. As in the case of other developing countries, group-lending programmes have been adopted to improve access to credit for the rural poor in India since 1990s. In India, both the government and non-government institutions have played significant roles in the promotion of micro-finance groups. In this chapter, we have discussed how SHG bank linkage programme facilitated the spread of micro-finance groups. The challenges before the growth of micro-finance groups in India have also been discussed. The evolution and the growth of government and NGO initiated micro-finance programme in the Kerala scenario has also been provided.

The fourth chapter discusses the various ways in which data for the present study were collected and examines how the objectivity of the study was ascertained with help of various methods and instruments of data collection.

The fifth chapter discusses the factors contributing towards the growth of both NGO initiated and government initiated micro-finance programmes in Wayanad district of Kerala state. The significance of micro-finance programmes in this district has been explained in terms of socio-economic composition of the people. Cross tabulation and means test have been carried out to analyse the differences
between the NGO and government initiated groups in terms of group and member specific variables that have a bearing on collective action.

The sixth chapter discusses collective action in the selection of borrowers. After discussing the mechanisms and incentives adopted by the groups, collective action in the selection of borrowers have been examined in terms of the amount of loans received by the members and the selection procedure followed in the groups.

The seventh chapter examines the issue of monitoring in the utilisation of loans. The various types of monitoring prevalent at the group level and the incentives of the members for monitoring have been discussed. Monitoring has been examined in terms of various income generating activities undertaken by the members. Finally, the chapter analyses the various factors, which have played significant roles toward the perception of the members regarding their monitoring characteristic.

The eighth chapter analyses the issue of enforcing repayment of the loans borrowed. This has been examined in terms of the various repayment mechanisms and incentives followed across the groups. The chapter also deals with different repayment sources. It has examined the various factors, have which played significant roles toward delay in repayment. Finally, the chapter discusses the issue of how members make repayments in the absence of IGAs adopted by a majority of the members.

The ninth chapter provides the conclusion of the study, where we discuss the major findings of the study and put forth their implications on theory and policy.