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Perception and Role of Informal Rural Finance in Developing Countries: the Example of Tanzania

Anacleti K. Kashuliza*
Department of Rural Economy, Sokoine University of Agriculture, Morogoro, Tanzania

Abstract — Negative perceptions on the value of informal rural finance or credit which are prevalent in a number of developing countries are compounded in the case of Tanzania because of the country's *Ujamaa* and socialist policies. Consequently, informal rural finance has been neglected both in terms of research and policy planning. This paper attempts to fill part of the research gap on informal rural finance in Tanzania, and to contribute to the growing body of knowledge on this subject in the developing countries. The paper briefly investigates the policy and perception scenario on informal rural finance in Tanzania in the last two decades. Based on empirical data collected through village surveys in three regions of the country, the paper describes the sources of informal credit for smallholder farmers in those areas, and assesses the use, repayment, terms and conditions of such credit.

1. Introduction

The establishment of formal credit institutions in the agricultural-based developing economies some 40 or more years ago was, among other reasons, linked to the belief that local or informal lenders such as merchants, landlords and shop owners exploit small farmers by charging them exorbitant interest rates (Adams, 1984; Von Pischke, 1981). It has been widely held that, through such rates, informal lenders extract substantial monopoly profits, that they regularly take advantage of the economically weak, and that they do not provide legitimate economic services (Adams, 1984). Thus, to counter exploitation of the rural poor by the 'unscrupulous' informal money lenders, credit had to be made available to farmers through formal institutions at cheap (subsidized) interest charges.

Similarly, policy and research with regard to rural credit have been limited to a one-sided emphasis on the role of formal financial institutions: commercial and nationalized banks, specialized agricultural development agencies set up by the government or international donors, village and regional co-operatives, or projects initiated by private non-governmental organizations (NGOs) at home and abroad (Bouman, 1990; Braverman and Guasch, 1986; Von Pischke *et al.*, 1983). Thus, until the last decade, little attention had been paid to the potential development role of the informal financial or credit sector.

The emerging view about informal lenders from studies conducted in the 1980s in a number of developing countries is that, in general, they perform legitimate economic functions in the rural financial markets. Their operations are frequently more cost-effective and useful for the poor than those of formal credit institutions, co-operatives and commercial banks (Von Pischke *et al.*, 1983). Adams and Graham (1984) point out that informal lenders are now thought to provide valuable services and in general impose lower costs on most borrowers than had been generally thought. Further, they argue that the opportunity costs of money lent in the informal market by merchants or farmers are usually ignored by those who criticize informal lenders' charges on loans. While it may be true that some money lenders impose exorbitant or usury charges on their loans in some rural settings in the developing economies, a number of studies have demonstrated that informal lenders do not always receive returns that are much beyond their transaction costs. Research in India by

*Current address: Department of Agricultural Economics, Wye College, Wye, Ashford, Kent TN25 5AH, U.K.

(a) the excess demand of both consumption and production credit in the rural areas in the country which could not be satisfied through the formal credit system;
(b) the very large area of the country to be covered, which made it difficult for the formal institutions to extend their network to villages in some remote areas. By the same token, the leadership was constrained in its ability to enforce its policy decisions and regulations because it lacked the machinery for reaching down to the village level (Hanak, 1985); and
(c) even in rural areas where formal credit institutions operated, they rationed credit in accordance with the type of crops grown, viability of enterprise (farm size, expected incomes, etc.), and creditworthiness, thereby creating hurdles to other potential borrowers who had instead to satisfy their credit needs through informal sources.[4]

After the mid-1980s Tanzania undertook considerable steps, under the IMF and World Bank supported Economic Recovery Programme (ERP), to orientate the economy towards the market approach. Consequently, the Government legalized private participation in a number of economic activities, such as in crop and food marketing. Booth (1990) observes that the general business climate has improved beyond recognition under these policies, with *de facto* and even *de jure* encouragement of activities that a few years back carried prison sentence for 'economic sabotage'. Other recent studies on economic activities in Tanzania suggest that the informal sector is contributing substantially to the growth in the economy. Maliyamkono and Bagachwa (1990) estimate that in 1986–1987, activity in the parallel economy in Tanzania represented the equivalent of 30% of the recorded Gross Development Product (GDP).

However, in spite of some increased private sector participation in economic activities in the country in the last few years, the distinction between what is informal and legal, and what is informal but still illegal, remains on the whole rather blurred and confusing to many of the participants in informal sector dealings. The 'illegality' of the informal credit sector and *ipso facto* curtailed openness on the part of participants in such dealings explains in part the paucity of studies on informal credit in Tanzania.[5]

3. Role of informal finance at the village level

3.1. *Data sources and collection*

The primary source of data and information presented in this section derives from village studies conducted by the author and a team of enumerators between August 1990 and March 1991 in 24 villages (eight districts) in Morogoro, Iringa and Mbeya regions.[6] The overall field study was global in character and dealt with a range of credit issues including farmer access, use and repayment of both formal and informal credit. The study villages were selected from lists of recipient villages of formal credit (between 1987 and 1990) in the respective districts.[7] A simple random technique was then employed in selecting a total of 458 smallholder farmers for the study within the chosen villages. This sample included borrowers of formal and informal credit, and some non-borrowers. Relevant additional information at the village level was obtained through informal interviews with key informants such as the extension agents, village leaders and progressive farmers. Discussions with some of the identified money lenders at a later stage of the study complemented the study's findings.

Out of the total farmer sample of 458 farmers, only 157 farmers or about 34% of the selected farmers provided useful information on informal credit dealings. The number of borrowers from informal sources was lowest in Iringa (where, incidentally, the highest amounts of formal credit among the surveyed villages were received), and highest in Morogoro.

The low response rate on informal credit was not unexpected in view of the socio-political situation explained earlier. Several respondents appeared to be rather wary in giving out information on informal credit dealings. Indeed, personal guarantees had to be given to some money lenders (businessmen) and their clients, on the confidentiality of their names before they agreed to discuss their informal credit transactions with the research team. Therefore, although ERP liberalization policies have provided an impetus for the revival of informal sector activities in rural and urban areas alike in the country, lack of a facilitating legal environment means that 'openness' about such activities is still curtailed.[8] This is both unproductive and unnecessary because it prevents the informal credit market from performing optimally in serving the rural people and by implication the general economy.

3.2. *Results of the field study*

The results reported below relate to the sub-sample of respondents who provided useful information on informal credit. In view of the reasons already expressed above on the reluctance of some informal credit participants to reveal information on informal

Table 2. Estimates of credit value and interest charges by source (1989–1990 season)

Source	Credit value (shs)*	Interest rates (%)†
Relatives‡	100–5000	0–10
Shop owners	1000–10,000	25–100
Businessmen§	10,000–30,000	20–30
Large farmers‖	5000–8000	25–50
Formal credit	1500–6000	20–30

Notes: *At the time of the study, 1 U.S. dollar was equivalent to about 200 Tanzanian shillings (shs).
†Calculation of annual interest rates is approximate because some of the loans are usually paid back after a few months. Attempts have been made to normalize all the interest rate figures on annual basis. They are reported in nominal terms.
‡Includes relatives, neighbours and friends.
§Businessmen here refer to the Iringa town lenders (*Tajiri*).
‖Includes medium- and large-scale farmers.
Source: Field survey, 1990–1991.

The category of businessmen who own sunflower oil processing machines in Iringa town and some small-cum-medium farmers who cultivate sunflower in the maize-growing villages in Iringa rural district (including some of the villages surveyed in this study)[10] presents a unique case in informal credit dealings in Tanzania. Lending by these businessmen or *Tajiri*[11] is a slight modification of the traditional village money-lender operations portrayed in the general literature.[12] The study identified three of these types of money-lenders in Iringa town (the regional capital), some 60–90 kilometres from the target villages, who have developed a unique system of lending to small-cum-medium scale farmers in villages where maize and sunflower are the major crops.

This type of lending is tied to a guarantee of getting sunflower seed from the farmers at the time of harvest. Loans (of between shs 10,000 and 30,000) given to farmers through this arrangement exceed in size loans available to small farmers from official sources several times over. For instance, the ceiling for official input credit to individual farmers in Iringa rural district is estimated at about shs 6000 for the 1989–1990 season. This type of informal credit was made available to farmers in fertilizer as well as cash form (so that some cash could be used in hiring tractor and labour services). The fertilizer required by the participating farmers was purchased and transported to their households by the *Tajiri*. The cost of fertilizer and transport, and any other services provided by the *Tajiri*, contributed to the total loan to the borrower farmer. These lenders also practised a minimum level of monitoring and supervision of farming activities of the borrower farmers, and they were usually present at the time of harvest to collect the crop. The sunflower produced was bought by the *Tajiri* at the official price. Loan repayment (by farmers) were directly deducted from the crop sales at this stage.

Table 3 provides a summary of the key activities financed through the various informal credit sources described above. The majority of the respondents (40%) borrowed from informal sources to finance home consumption and social obligations. The next most important use of credit was for the purchase of agricultural inputs (33%).

3.4. *Informal credit terms and interest rates*

Interview results with regard to respondents who used credit from neighbours, relatives and friends suggests that, in general, interest charges are not imposed on such loans except where payment is delayed beyond the agreed time. The extra charge, which is not standardized, could come in the form of a fine or penalty imposed by elders or village leaders. Charges of between 5 and 10% of the total value of the loan were frequently mentioned for these types of loans. The estimated interest charges on informal credit from the various sources are presented in Table 2.

Overall, loans from neighbours, relatives and friends are usually paid back in the agreed time because of the bearing of social pressure.[13] Such loans, as described above, are mainly acquired for compelling and immediate household consumption requirements and are largely given on trust between

Table 3. Main activity financed through farmer's informal credit (1989–1990 season)

Activity	Number of respondents	Percent of respondents
Access to production inputs*	51	32.7
Hiring labour and tractor services	27	17.3
Home consumption and social obligations	63	40.4
Other uses	15	9.6
Total	156	100.0

Note: *In cash or kind.
Source: Field study, 1990–1991.

Table 4. Farmer preference in borrowing from formal or informal sources (1989–1990 season)

Source	Mbeya	Morogoro	Iringa
Total sample (No.)	152	149	157
	Percentage distribution		
Formal sources	93.7	90.0	90.0
Informal sources	4.7	7.5	6.7
Indifferent	1.6	2.5	3.3
Total (%)	100.0	100.0	100.0

Source: Field study, 1990–1991.

proportion of farmers prefer to borrow from formal sources, only a few of them actually have access to such credit. Therefore, many of these same farmers continue to use services from the informal credit sector or make use of their own savings in satisfying their production and consumption needs.

4. Linkages between informal credit and other rural markets

Interlinkages between informal credit and other agrarian markets have been adequately studied in India and a number of other South Asian countries.[15] However, little work has been carried out on this subject in Africa. We could not locate any single intensive study on the subject in the case of Tanzania. Studies on rural credit in Tanzania have almost exclusively focused on the role of formal credit in production, and problems and performance of credit institutions and their intermediaries.[16] Very little work has been done on informal finance, let alone exploring its interlinkages with other rural markets.

Because of the limited scope of our field study and the low response rate on informal credit dealings in the surveyed areas, we can only offer a few general comments on the subject in question:

(a) There are strong links between informal credit and the labour market in the rural areas. We observed this in respect to fertilizer loans given out by large-scale farmers to selected smallholder farmers. The latter repay back through provision of their labour in weeding and harvesting of the larger farmer's crop. Such tasks are simplified by working in rotating labour groups. Who benefits the most from these transactions? Probably the large-scale farmers. This is because they would be paying much more if they hired labour at the market rate. However, we should not ignore the fact that the participating small farmers get access to production inputs (credit) at relatively lower borrower transaction costs than those farmers who depend on formal credit sources.

(b) Informal credit is strongly linked with product markets. We observed that in some rural areas (such as Mbeya rural district), repayment of credit is frequently made through provision (to the lender) of some previously agreed amounts of a harvested crop for credit which was originally provided in cash.

(c) Linkage between the vegetable oil market and informal credit was evident in the case of the informal loans provided by the Iringa town lenders. Who is benefiting the most from these credit arrangements? Probably the farmers who receive credit at their 'door step' with practically zero borrower transaction costs. Is the arrangement sustainable (for instance in view of the fact that similar or higher quality vegetable oils are increasingly being imported into the country)? Could these credit arrangements be copied in other rural areas of the country? These and other related questions can be answered thoroughly only through further research on the subject.

(d) There are implicit and explicit linkages between the informal and formal credit sectors. Most of the large-scale farmers mentioned earlier in (a) actually obtain their farm inputs through formal credit channels. Due to a number of factors such as possession of small collateral and limited means of transport, smallholder farmers are, by and large, better-off borrowing from the large-scale farmers, than attempting to procure the same sort of credit directly from the credit institutions or their intermediaries. In the course of the field study, we observed a related semi-formal credit arrangement involving the main credit institution in the country [The Co-operative and Rural Development Bank (CRDB)], and some private input distributors (or input stockists) which was being implemented in Iringa region on an experimental basis. The input stockists were expected to pass over the inputs to farmers on their own terms. That is, the recognized credit client to the bank was the input stockist. Are the small farmers absorbing only part or all of the middle lender's transaction costs in these credit arrangements? Should semi-formal arrangements be encouraged to grow and be relied on in reducing the high institutional costs of administering small loans? Would such credit be accessible to the poorer farmers in the villages? Again, such questions can be satisfactorily answered only through further research.

(e) Linkages between informal credit and savings of the type described in West Africa (*Esusus*, *Tjangos*, *Tontines*, etc.), are also thought to exist in some well as the flexibility of getting the credit in cash or kind.

More research is definitely required on some of the points raised by the study before any definitive recommendations relevant for policy design are made. On the other hand, further research and analytical studies which go beyond the descriptive stage of the credit arrangements (to explore linkages, transaction costs, and social and economic benefits of such dealings),[8] are currently being constrained by secrecy and lack of 'openness' on the part of the credit market participants. Although cultural and social factors do account for part of that dilemma, the *raison d'être* relates to the legal implications of being involved in such dealings (and therefore the possibility of releasing self-incriminating information). Therefore, the key to understanding Tanzania's informal credit markets and their linkages to other rural markets lies in (a) a further liberalization of the country's political and economic systems, and (b) a clear definition of a genuine and facilitating legal environment for informal sector activities.

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Notes

1. Furthermore, some studies on borrower transaction costs have demonstrated that the cost of formal loans are in some developing economies much higher than those of informal credit. For instance, Fernando (1986) estimates that more than half of the formal credit in Sri Lanka is cheaper than the formal credit.
2. The Declaration's initial implementation resulted in the nationalization of the major means of production including financial institutions (banks), most industries, and a number of sisal and coffee estates. Other policy developments soon followed including the 'Leadership Code' and 'Villagization'. The Arusha Declaration is presented in detail in Nyerere (1968). A number of authors have written on the implementation, successes and failures of the *Ujamaa* policy in Tanzania. Some of the outstanding works in this area include: Bienen (1970), Mwansasu and Pratt (1979), Coulson (1982) and Hyden (1980).
3. This conclusion partly stems from the author's own experience in his home district of Muleba (Kagera region). In the majority of villages in this district, informal credit transactions (of goods, services and money) have always taken place and they are part of everyday life; they include '*Kukopa*', '*Kutila*', '*Kukwatillza*', and many others. Details of these transactions could justifiably be a subject of a different paper. It is worth noting that some of the disputes emanating from such informal dealings — for example, wilful defaults — have regularly been settled through the formal apparata (such as the ruling party and government offices at the village and ward level, and through local courts).
4. For details on the performance and problems of formal financing institutions in Tanzania, see Kimei (1987), Mmari (1985) and Kashuliza (1986, 1992).
5. The majority of studies on rural credit in Tanzania have related to the role and supply of credit to farmers by formal credit institutions. Only a few studies have so far presented some modest details on informal credit sources and use by small farmers in Tanzania. They include the FAO study (1975?), Amani *et al.* (1987), Mlambiti *et al.* (1991) and Ndanshau and Hyuha (1991). This state of affairs is not at all unique to Tanzania. In a recent paper, Bolnick (1992) notes a similar problem in the case of Malawi and states that until recently research on informal finance has largely bypassed that country. Indeed with the exception of a few countries in West Africa such as Cameroon and Nigeria, studies on informal rural finance in Africa have been rare until recent years.
6. The study villages where the interviews were conducted are: Magulilwa, Lulanzi, Nzihi, Magubike, Utelewe, Nganda, Makoga, Igosi (Iringa region); Mbalizi, Idiga-Songwe, Ihombe, Njelenje, Magamba, Itumpi, Isansa, Msia (Mbeya region); Melela, Mangae, Doma, Msongozi, Dumila, Magole, Kitete-Ukaguru and Msowero (Morogoro region).
7. This study approach of beginning with a list of villages where formal credit had been used is supported by the fact that only a few villages in any given district actually receive formal credit for their members in a year (season) out of the total number of villages in those districts (i.e. formal credit has generally been channelled to individual smallholder borrowers through their villages). On the other hand, based on results of a few studies done on the subject in the country (see fn. 5), and a lot of other studies in other developing economies, we can safely assume that informal credit services are much more widely spread amongst villages in the rural areas. In other words, this approach guarantees us farmer samples of both formal and informal credit users in the same location for a meaningful comparative analysis. On the contrary, a straightforward random sample selection of study villages at the district level (without bias towards villages where formal credit was used) would not guarantee the inclusion of villages where formal credit was used. An additional criterion in selecting the study villages was easy of accessibility on account of limited resources for the research.
8. As is usually the case with rural societies, some social and cultural factors may have a role to play in influencing the degree of secrecy on lender–borrower transactions. We are optimistic, however, that the role of such factors in influencing the low response rate experienced in this study are minimal compared with the effect of the political-cum-legal conundrum.
9. Our personal experience in Muleba district (see fn. 3) supports this view strongly. In this district, virtually everybody in the rural areas engages in the informal credit market by either lending, borrowing, or doing both.
10. Five farmers involved in this arrangement were interviewed in Magulilwa village, one of the villages selected for the field study.
11. *Tajiri* (which means a rich or wealthy person in

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