Chapter 10
Micro-Finance and Poverty in India:
A State-Level Analysis of Impact Assessment

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ABSTRACT

During the last decade, microfinance has been recognised as one of the most important and innovative ways to address the financial needs of the poor. Despite being an issue with considerable policy implications, there are very few studies which empirically examine the impact of microfinance on poverty in the case of India. Analysing the formal and informal segments of financial system of India, the present paper provides an impact evaluation study of microfinance in India. The study is done on three dimensions of microfinance: 1) client outreach, 2) financial health, and 3) poverty reduction. The impact evaluation study is done following a unique methodology different from the widely used microfinance poverty penetration index. The paper incorporates impact of other relevant economic variables like infrastructure and banking sector development on poverty in the analysis, hitherto overlooked in literature. The result presented in the paper shows that the impact of microfinance on poverty alleviation in Indian states, when controlled for other variables, is not significant.

INTRODUCTION

The relation between finance and growth is well established in theory as well as practice. A growing body of research around the world has shown that well-developed financial systems are associated with faster growth in the real economy (Goldsmith 1959, Mckinnon 1973, Shaw 1973, Beck *et al* 2000, Honohan 2004, Rajan and Zingles 2003). During recent times, a crucial question drawing policymakers' attention worldwide is whether the overall growth of the financial sector of a country automatically trickles down to the extent of easing the credit constraint of the poor. It has often been observed that the formal

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financial markets, even developed, often tend to ignore the needs of the poor and marginalised section of the population. Hence, in most of the developing countries, where a substantial part of the financial sector is informal in nature, catering for the financial needs of the poor requires special attention. Thus, promoting an inclusive financial system is envisaged as a separate policy agenda from fostering the growth of financial markets in these countries.

The literature debates over the role of the state in financial market development, supervision and regulation (Krueger, 1990, Stiglitz 1993). The issue of state intervention becomes important especially in the context of channelling resources to small and marginal people as well as microenterprises. Typically, the credit market for small-sized loans are characterised by information asymmetry and moral hazard problems. Worldwide, countries have followed two alternative approaches to solve these issues; government intervention in the form of development finance institutions or encouraging participation of privately owned institutions with expertise in lending small-sized loans. In the later case, the role of the state becomes crucial in terms of supervising these institutions. A third way is to indirectly provide support to these micro-credit institutions through provision of refinancing through the formal banking system of the country; a classic example of the same is the self-help group-bank linkage programme introduced in India in 1992.

India provides an interesting case in this context. In India, these three approaches co-exist as a complementary mechanism to make the financial system of the country more inclusive. The state-led approach to make the financial system inclusive in India has been through the branch expansion of public sector banks and directed lending to the priority sectors. The market driven approach in India has taken the form of the establishment of private MFIs. A classic case of the third form, as delineated above, is the Self-Help Group-Bank Linkage programme (SHG-BL) pioneered by the National Bank of Agricultural and Rural Development (NABARD). In this programme, NABARD provides indirect assistance to commercial banks for providing credit to SHGs.

The contribution of the study lies in a) analysing the co-existence of the formal and informal financial system in India, b) a holistic impact evaluation study of microfinance in India following the two alternative approaches, hitherto un-attempted in literature. In addition, the present study aims to address some of the crucial gaps that exist in the literature of impact evaluation of microfinance programmes in India. First, despite being a unique example of co-existence of these three alternative models of microfinance, the literature lacks a systematic comparative analysis of the models in the Indian context. To the knowledge of the author, this is the first study which provides a comparative analysis of the state-led SHG-BL programme vis-à-vis the private MFIs in India in terms of impact evaluation. Secondly, previous impact assessment (IA) studies of MFIs in the context of India overlooks the importance of other economic variables in poverty reduction, which may lead to the possibility of overestimating the positive impact of microfinance. The IA study of the present study incorporates the impact of infrastructure development, GDP growth, banking sector outreach and industrialization in the analysis. In the absence of any standard variable to capture the state of infrastructure in literature, the study develops an index of infrastructure for Indian states. Third, the study uses state-level data for the IA analysis instead of household-level survey data used by previous studies, and thus provides a more macro-level analysis of the phenomenon.

The remaining part of the chapter is organised as follows: Section II provides the relevant literature review. Section III delineates an empirical assessment of the formal and informal micro-credit market in India. Section IV (a) describes the micro-finance institutions in their present form in India and briefly discusses the policy environment of the sector. Section IV (b) provides a comparative impact evaluation