FINANCIAL INCLUSION AND POVERTY ALLEVIATION IN INDIA IN THE POST-LIBERALIZATION PERIOD (1993-2012)

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DECLARATION

I, **ANU KIRAN KAHI**, hereby declare that the dissertation entitled **"FINANCIAL INCLUSION AND POVERTY ALLEVIATION IN INDIA IN THE POST-LIBERALIZATION PERIOD (1993-2012)"** submitted by me for the award of the degree of **MASTER OF PHILOSOPHY** is my bonafide work and that it has not been submitted so far in part or full, for any degree or diploma of this university or any other university.

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CONTENTS

LIST OF ABBREVIATIONS

ADB- Asian Development Bank

CDR- Cash Reserve Ratio

CSO- Central Statistics Office

CRR- Cash Reserve Ratio

MDG- Millennium Development Goal

NABARD- National Bank for Agriculture and Rural Development

NSSO- National Sample Survey Organization

PSB- Public Sector Bank

PSL- Priority Sector Lending

RBI- Reserve Bank of India

RRB- Regional Rural Bank

SLR- Statutory Liquidity Ratio

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INTRODUCTION

Economic growth accompanied by well being of people is all a welcome step for any country. No country wants its masses to be poor and India is no exception to it. As is rightly said by Mahatma Gandhi, "Poverty is worst form of violence."

It deprives people to fulfill basic necessities of life. Due to lack of resources poor people fail to realize their full potential which in turn retards growth process of the country. Poor people are often seen as trapped in vicious cycle of poverty which further worsens their condition. Poverty in every respect is a bane for country so every possible effort should be put in place to help people move out of this economic and social deprivation.

Poverty and inequality continues to remain the major concerns in economic development of a country. India houses largest number of poor people in the world. Though the percentage of poor below poverty line has decreased from 54.9% in 1973 to 27.5% in 2004 and 21.9% in 2011-12 but the actual number of poor has decreased very less from 321 million to 317 million due to rapid population growth (Inoue and Hamori, 2010). India like any other developing country is faced with a challenge of achieving higher economic growth rates which reduces poverty and inequality.

Indian economy witnessed higher growth rates after adopting the policy of Liberalization, Privatization and Globalization but this economic growth failed to translate itself into adequate poverty reduction. Because of this centralized growth in the hands of few and in some parts of the country, Government in its eleventh five year plan (2007-12) came up with the concept of 'Inclusive Growth' which means growth of all and of all sectors. It focuses on rapid growth which reduces poverty and creates employment, access to essential services in health and education especially for the poor, equality of opportunity, empowerment through education and skill development, environmental sustainability, recognition of women's work and good governance (Planning Commission, 11th Five Year Plan). In twelfth five year plan emphasis has been laid on 'Faster, More Inclusive and Sustainable Growth.' It defines inclusive growth approach as:

Inclusive growth should result in lower incidence of poverty, improvement in health outcomes, universal access to school education, increased access to higher education, including skill and education, better opportunities for both wage employment and livelihoods and improvement in provision of basic amenities like water, electricity, roads, sanitation and housing. Particular attention needs to be paid to the needs of the SC, ST and OBC population, women and children as also minorities and other excluded group. (GOI 2011:4)

Thus, now there has been an effort to achieve not just growth but inclusive and sustainable growth.

Among other factors finance plays an important role in the economic growth of the country. Well functioning financial system helps in the effective mobilization of savings, allocates resources and removes information asymmetries to help economic growth. As is said that

"Finance is, as it were, the stomach of the country, from which all the other organs take their tone."

William Ewart Gladstone, 1858

Many scholars have studied the importance and interaction between financial sector and economic development of the country. There emerged two schools of thought with conflicting views on the role of finance in economic growth while Robinson (1952) in his argument pointed out that the financial development played a passive role as a follower of economic development in response to increasing demand of funds, Lucas (1988) discarded the relationship between finance and growth and stated that finance is an "over-stressed" determinant of economic growth. However, now the contribution of financial system in economic development of a country is widely recognized and this relationship is continuously evolving over time thus demanding much more research. As finance is vital for economic growth so is Financial Inclusion for Inclusive Growth. Thus, to achieve the goal of inclusive growth, financial inclusion needs to be addressed first. The essence of financial inclusion aims at bringing the whole population under the ambit of formal banking which will broaden the resource base of the financial system particularly in rural areas which largely remains unbanked.

Poverty alleviation continues to remain the major objective of the government. It is striking that even after seventy years of Independence still we have a large chunk of our population reeling under poverty. Poverty is a state of social and economic deprivation which affects each and every aspect of life. Thus it is a duty of not just government but each and every citizen to do all in his capacity to make people better off. United Nations in the September 2000 declared eight development goals (known as Millennium Development Goals) following the Millennium Summit which were to be achieved by its members by 2015. The eradication of extreme poverty and hunger is their first goal which aims at halving the proportion of people whose income is less than $1.25 a day (United Nations Millennium Development Goals). Like many other countries of the world India has also reduced poverty significantly but still it is home to largest number of poor in the World. The number is particularly high in rural areas which is having more than 60% of our population and almost half of it is under poverty.

Along with poverty, inequality remains another major problem of Indian economy. No country can have prosperity amid rising inequality among its population. Both inequality and poverty needs to be analyzed simultaneously as there can be a case of declining poverty but increasing inequality which suggests the re-examination of our growth strategy.

During 1990s when IMF imposed economic reforms on India, poverty and inequality figured prominently in the debates of intellectuals and academic circles. There were instances of intensification of poverty and inequality in many Latin American and African countries after Globalization. The new economic policy required the Indian economy to undergo Liberalization, Privatization and Globalization. There were serious apprehensions that there may be similar deepening of poverty and inequality in India after the policy adoption. There are many studies analyzing the trend of poverty and inequality across Indian states post liberalization. Some agree that economic liberalization has reduced poverty (K. Sundaram and Suresh D. Tendulkar, 2003, Angus Deaton and Jean Dreze, 2002) but there are other scholars who argue that poverty and inequality both have either arisen or remained same (Chandersekhar and Sen, 1996, Sen, 1997, Tendulkar and Jain, 1995) after the implementation of NEP. Financial liberalization was an important part of new economic policy. Indian banking industry underwent major changes after the financial sector was liberalized. It became more competitive and market oriented. Rural and backward areas faced the brunt of new economic growth model the most. For the growth of financial sector, among other things Financial Inclusion is very important. Financial Inclusion means ensuring to have appropriate access to financial products and services when required by the people, particularly the weak and poor. The whole concept of financial inclusion among other things also aims at poverty reduction. It is believed that the poor continue to be poverty stricken as they lack credit and proper opportunities. Given credit they can exploit new avenues and move out of poverty to have a decent life. Affordable access and use of financial services helps people to generate income, manage unbalanced cash flow, have better flexibility to bear shock, etc. which raises their standard of living and help in overall growth of the economy.

Therefore it is important to look at the linkages between financial inclusion and poverty alleviation. To look at the determinants of this relationship and how does it affect the overall scenario of the country? This study will help to broaden the knowledge base regarding financial sector development and its impact on poverty which can guide some steps to be taken to have fully financially included population. In my research I am looking at the following research questions:-

1. What is the status of financial inclusion in India?
2. What is the relationship between financial inclusion and poverty across Indian states?

CHAPTER I

FINANCIAL INCLUSION AND POVERTY: A LITERATURE REVIEW

Financial Inclusion

Importance of finance has never been under estimated in India. India has a long history of providing credit to the needy through various sources. There was provision of *Taccavi* loans being given to poor farmers to buy seeds and agricultural inputs even in 18th century. With the enactment of the Cooperative Credit Societies Act 1904 there began the process of institutionalization of credit availability. After independence there was an intensification of efforts in this direction on the recommendations of All India Rural Credit Survey Committee 1954. The Imperial Bank of India was nationalized and converted into the State Bank of India in 1955. Thus there is a long history of providing credit to the needy but the theoretical framework of realizing the goal of financial inclusion formally started during 11th five year plan (2007-2012). Defining financial inclusion has never been an easy task. There is no uniform definition of financial inclusion, It changes from one country to another depending on the factors such as level of social, economic and financial development; the dependence of whole economic system on the financial sector; the relative importance of financially excluded people for the country; and also on the extent to which government recognizes the problem of financial exclusion in their country[1]. Different institutions and committees have defined it differently giving importance to various indicators. Few definitional aspects of financial inclusion are as under:-

Asian Development Bank has defined it as the provision of a broad range of financial services such as deposits, loans, payment services, money transfers and insurance to poor and low income households and their micro-enterprises. Its indicators of financial inclusion are deposits, loans, payment services, money transfers and insurance (RBI Report on Currency and Finance).

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[1] Report on Currency and Finance by RBI

As per **The World Bank** broad access to financial services means an absence of price and non-price barriers in the use of financial services. It uses access to financial services such as deposit, credit, payments and insurance as indicators of financial inclusion (World Bank, 2008)

United Nations (2006) defined financial inclusion as “A financial sector that provides ‘access’ to credit for all ‘bankable’ people and firms, to insurance for all insurable people and firms and to savings and payments services for everyone. Inclusive finance does not require that everyone who is eligible use each of the services, but they should be able to choose to use them if desired.” It gives emphasis on access to credit, insurance, savings, and payment services to measure financial inclusion.

Similarly there is no uniform definition across countries. Different countries have defined it differently according to their level of development and many other factors. In India also various definitions have been put forward by different committees and organizations. It can be defined as the process of ensuring access to financial services and timely and adequate credit when needed by vulnerable groups such as weaker sections and low income groups at an affordable cost (Dr. C. Rangrajan).[2] Broadly it refers to universal access to a wide range of financial services at a reasonable cost. These include not only banking products but also other financial services such as insurance and equity products (Dr.Raghuram G. Rajan)[3] . Other definition can be “Financial Inclusion is the process of ensuring access to appropriate financial products and services needed by all sections of society including vulnerable groups such as weaker sections and low income groups at an affordable cost in a fair and transparent manner by mainstream institutional players.” (Chakrabarty, 2011). Similarly CRISIL[4] also defines financial inclusion as “the extent of access by all sections to formal financial services such as credit, deposit, insurance and pension services.” Various components of financial inclusion are savings, bank accounts, financial advice and affordable credit, insurance, payment and remittance.

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[2] Report of the Committee on Financial Inclusion, January 2008.

[3] Report of the Committee on Financial sector reforms, September 2008.

[4] CRISIL meaning Credit Rating Information Services of India Limited is a Global analytical company providing Ratings, Research, Risk and Policy advisory services.

Process to realize the goal of financial inclusion was started by government way back in 1969 with the nationalization of banks. From time to time various steps have been taken by the government to have its people in the formal banking process but still a large number of people remain excluded. Those who are financially excluded mainly include marginal farmers, landless laborers, oral lessees, self employed and unorganized sector enterprises, urban slum dwellers, migrant, ethnic minorities and socially excluded groups, senior citizens and women (Report on Currency and Finance, RBI). As per the 59^{th} NSSO round, 73% of farmer households do not have any access to formal source of credit. This exclusion is particularly acute in Central, Eastern and North-Eastern regions which accounts for 64% of financially excluded farmer households in the country. About 51.4% of farming households lack access to both formal and informal financial sources. Around 80% of non-cultivator households do not have access to credit from any source. Indebtedness to formal financial sources is only 19.66% in these regions. Out of 640 districts, 256 districts spanning over 17 states and 1 UT have critical levels of exclusion to formal credit sources. Such a large extent of financial exclusion cannot do better for the country in any way.

Lack of awareness, Low incomes, poverty and illiteracy leads to low demand of financial services and thus resulting in exclusion of such people. Similarly there are many bottlenecks in the supply side which include distance from branch, branch timings, burdensome documentation and procedures, unsuitable products, language barriers and staff attitude which leads to exclusion (CRISIL Inclusix). Scholars have analyzed a number of physical and geographical barriers to Financial Inclusion. The various factors resulting in financial exclusion are: (1) access exclusion meaning financial service providers will restrict the access of financial services for some people whom they think are risky subjects; (2) condition exclusion i.e. there can be an instance when the conditions attached to use a financial product makes it unviable for some sections of the society to benefit from it; (3) price exclusion, sometimes the price of using a financial product is so high that it becomes unaffordable for some people; (4) marketing exclusion- by the way of targeted marketing and sales some people are effectively excluded, and (5) self-exclusion- sometimes people do not opt for a financial product owing to fear of refusal to access financial product by service providers (Kempson and Whyley, 1999;

Kempson et al., 2000; Connolly and Hajaj, 2001)[5]. There is a need to create awareness among the masses regarding different financial products so as to encourage them to come into the ambit of formal banking system rather than relying on informal sources of credit which are generally exploitative. This will also help in improving the effectiveness of social welfare schemes by diminishing the extent of leakages in welfare disbursement and help government to replace goods based welfare schemes by cash subsidies like direct benefit transfer.

Various dimensions can be worked on while looking at Financial Inclusion such as analyzing the linkages between financial development and economic growth, poverty reduction, social development etc. Before proceeding further it is important to look at poverty and its trend over time in India.

Issues in Measurement of Poverty in India

Poverty in India and across the world has always been a topic of debate and discussion. No country can progress without eliminating higher levels of poverty. In simple words it can be explained as an economic condition where a person is unable to meet his both ends and is forced to starve. There can be both absolute and relative poverty. Absolute poverty is the one where a person cannot meet the basic requirements of life such as food, clothing, drinking water, etc. whereas relative poverty is the one where people lack income to maintain an average standard of living in the society. Absolute poverty needs to be tackled first followed by relative poverty. In India, notion of absolute poverty is mainly used by government and policy analysts in their debate to reduce poverty.

Dadabhai Naoroji in his book “Poverty and Un-British Rule in India” first attempted to estimate poor in India. He used diet required at the subsistence level to calculate poverty line based on 1867-68 prices and came up with poverty line ranging from Rs 16 to Rs 35 per capita per year. After that there were attempts by National Planning Committee (1938) whose poverty line ranged from Rs 15 to Rs 20 per capita per month. Similarly Bombay Plan (1944) came up with Rs 75 per capita per year as poverty line.

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[5] Report on Currency and Finance by RBI

Concrete attempts to measure poverty started only after Independence with the establishment of NSSO (National Sample Survey Organization) in 1950. NSS (National Sample Survey) conducts survey both annual and quinquennial, collecting information on different socio-economic indicators such as employment-unemployment status, health, household consumption, education, etc. to enable policy makers to analyze the status of different aspects of life and formulate future policies accordingly. Quinquennial rounds of NSSO collecting information on Consumer Expenditure Survey (CES) are mainly used to have estimates of poverty. 27th round (October 1972- September 1973) was the first quinquennial round on Consumer expenditure survey and from then it is held after every five years.

V.M. Dandekar and N Rath in 1971 were the first to argue for calories based poverty lines. They proposed income which is adequate to provide 2250 Calories per day per person in both rural and urban areas should be considered as the poverty line. In 1979, Alagh Committee came up with different calories requirements for rural and urban areas. They came up with calorie requirement of 2400 calories per person per day in rural areas and 2100 calories per person per day in urban areas and till now this poverty line is calculated on the basis of expenditure or income needed to have this much of calorie intake.

In 1993, Lakdawala Committee was formed to review the process of poverty estimation. The committee further expanded the scope of national rural and urban poverty lines as suggested by Alagh Committee by providing state specific poverty lines so as to reflect inter-state difference in price. It advocated that poverty lines should be constructed and updated using the Consumer Price Index of Industrial workers (CPI-IW) in urban areas and Consumer Price Index of Agricultural Labor (CPI-AL) in rural areas (Report of the Expert Group to Review the Methodology for Measurement of Poverty, Planning Commission, 2014).

Table: Poverty Ratio as per Expert Group (Lakadawala) Method

Year	Poverty ratio (%)		
	Rural	Urban	Total
1973-74	56.4	49.0	54.9
1977-78	53.1	45.2	51.3
1983	45.7	40.8	44.5
1987-88	39.1	38.2	38.9
1993-94	37.3	32.4	36.0
2004-05 (URP)	28.3	25.7	27.5

N.B.: URP means Uniform Recall Period where on a recall period of 30 days consumer expenditure data for all items are collected.

With time different Committees were formed to look into the matter of methodology and revise it as per requirement of the time. There is general consensus among different stake holders of the society that poverty has declined over time since Independence. But reduction in poverty became a much more debatable topic after India adopted the policy of Liberalization, Privatization and Globalization (LPG) in 1990. Different viewpoints were put forward regarding the declining trend of poverty during 1990s. Some scholars conform to the Planning Commission claims of declining poverty while others reject this. For example K.Sundram and Suresh D. Tendulkar in 2003 computed poverty estimates by using different measures of poverty for the year 1993-94 and 1999-2000. Their results showed that there is decline in both rural and urban poverty. Head count ratio of both rural and urban poverty witnessed a reduction of 9% and 5.5% respectively during 1993-94 to 1999-2000. Other measures of poverty also supported the decline. Summary of their findings is as below:

Poverty as measured by Sundram and Tendulakar using different measures of poverty:

	All India Rural		All India Urban		All India all areas	
	1993-94	1999-00	1993-94	1999-00	1993-94	1999-00
HCR	37.85	28.93	28.8	23.09	35.47	27.32
Pov-gap	0.0825	0.0579	0.0672	0.0504	0.0785	0.0558
FGT	0.0267	0.0173	0.0232	0.0160	0.0257	0.0170
Sen's Index	0.1145	0.0806	0.0932	0.0695	0.1089	0.0775
No. of Poor	249,441	210,498	67,675	63,827	317,116	274325

Source: Economic and Political Weekly, January 25, 2003.P-335.

While comparing the poverty levels of NSS 50th, 55th, 61st and 68th round there is a problem in comparing the 55th round with 50th round. Due to changed methodology 55th NSS round cannot directly be compared to the 50th round. In the consumer expenditure Survey of 55th round the expenditure on 'the food group'[6] was collected on two time periods of 30 and 7 days among the same set of households. Critics believe that to over rate expenditure the information collected on 7 day reference period was extrapolated to 30 day reference period by multiplication. This is believed to give wrong numbers and show less poor than their actual number.

Also in 55th round, the information on some items such as clothing, footwear, durables, education and institutional health care was collected on 365 day reference period while for other items it was based on 30 day reference period. Therefore mixed reference period (MRP) is used in 55th round unlike uniform reference period (URP) in 50th round. Adjusting for this change in questionnaire and using employment- unemployment survey Scholars have come to the conclusion that there is decline in poverty over time. For example Angus Deaton and Jean Dreze (2002) estimated poverty ratio for rural and urban at an all India level. The summary of their findings is as under:-

[6] Food group consists of items like food, paan, tobacco and intoxicant.

Head Count Ratio	All India Rural		All India Urban	
	1993-94	1999-00	1993-94	1999-00
Official estimates	37.1	26.8	32.9	24.1
Adjusting for changes in questionnaire	37.1	30	32.9	24.7
Revising the poverty line	33	26.3	17.8	12

Source: Economic and Political Weekly, September 7. 2002.

Similarly K.Sundaram (2001) also estimated poverty by using employment and unemployment survey whose summary is as under:

	All India Rural		All India Urban	
	1993-94	1999-00	1993-94	1999-0
Poverty ratio	39.36	36.35	30.37	28.76

Source: Economic and Political Weekly, August 11, 2001.

Tendulkar Committee under the chairmanship of Suresh Tendulkar was constituted in 2009 to review the methodology of poverty estimation and address the inadequacies of earlier used methods. Society in the mean time (1993 to 2009) had evolved tremendously and therefore it was not viable to use old ways and processes to calculate poverty in the country. Recommendations of the Tendulkar Committee advocated for the following changes:-

- To do away with poverty estimation based on the amount of calorie intake,
- Suggested a uniform poverty line basket (PLB) across rural and urban India.
- To correct spatial and temporal issues the committee suggested for a change in price adjustment procedure,
- Earlier poverty lines assumed that health and education are provided by state and therefore need not to be included in the calculation of poverty lines but Tendulkar

Committee argued for incorporation of private expenditure on health and education while estimating poverty,

- It recommended using Mixed Reference Period (MRP) rather than Uniform Reference Period (URP) as were used in previous estimates.

Going by Tendulkar Methodology, there is decline in poverty ratio from 45.3% in 1993-94 to 21.9% in 2011-12. During the same period rural poverty has declined from 50.1% to 25.7% and urban poverty has declined from 31.8% in1993-94 to 13.7% in 2011-12. This is a positive development which should be cherished but at the same time more efforts needs to be placed to eradicate the existing levels of poverty also and provide everyone a decent life.

Year	Poverty ratio (%) Rural	Poverty ratio (%) Urban	Poverty ratio (%) Total
1993-94	50.1	31.8	45.3
2004-05	41.8	25.7	37.2
2009-10	33.8	20.9	29.8
2011-12	25.7	13.7	21.9

Poverty estimated by expert group (Tendulkar) Methodology

As far as state level poverty is concerned, certainly there has been a decline but the regional disparity still continues to persist. Punjab has least rural poverty whereas 39.26% rural population of Madhya Pradesh is under the brunt of poverty. Rural Bihar has been able to successfully alleviate its population out of poverty from 63.2% in 1993-94 to 32.035 in 2011-12. Tamil Nadu has been able to bring down its rural poverty from 51% in 1993-94 to 15.8% in 2011-12 and Kerala from 33.9% to 9.1% during the same period. In Orissa, it has declined from 63% to 35.7% where as in Assam the percentage has gone down from 54.9% in 1993-94 to 33.9% in 2011-12. Thus overall there has been a significant reduction in rural poverty but in general Southern states have done well in pulling rural people out of poverty. Eastern states have also reduced poverty but it still continues to be one of the highest in eastern parts of the country. Therefore, there is a need to have more active involvement of people and government to contain high poverty levels.

Table- Rural poverty ratio over time across Indian states.

STATES	1993-94	2004-05	2011-12
Andhra Pradesh	48.1	32.3	11
Assam	54.9	36.4	33.9
Bihar	63.2	54.6	32.03
Gujarat	43.1	39.1	21.5
Haryana	40	24.8	11.6
Karnataka	56.6	37.5	24.5
Kerala	33.9	20.2	9.1
Madhya Pradesh	45.87	54.2	39.26
Maharashtra	59.3	47.9	24.2
Orissa	63	60.8	35.7
Punjab	20.3	22.1	7.7
Rajasthan	40.8	35.8	16.1
Tamil Nadu	51	37.5	15.8
Uttar Pradesh	49.4	41.94	28.52
West Bengal	42.5	24	22.5

Source- Tendulkar Expert Committee report

Looking at the urban poverty rates across Indian states, we can see that in general urban poverty rates are less as compared to rural poverty rates but again a huge disparity across Indian states can be clearly seen. Kerala has lowest urban poverty of 5% whereas in Uttar Pradesh urban poverty is as high as 24.54%. Punjab which had lowest rural poverty has 9.2% urban poverty. Though Kerala has lowest Urban poverty at 5% but its Andhra Praedesh which has done commendable job in reducing its poverty ratio from 35.2% in 1993-94 to 5.8% in 2011-12. This is followed by Tamil Nadu where urban poverty ratio has declined from 33.7% in 1993-94 to 6.5% in 2011-12. Here in case of urabn poverty also we can see that eastern states like Bihar, Orissa, and Uttar Pradesh has high poverty ratio as compared to other states particularly southern states. Thus on the whole this is very evident that poverty is much more deep rooted in eastern India than in any part of India thus more concrete efforts needs to be put in place so as to reduce poverty here.

Table showing urban poverty ratio across Indian states at different time periods.

STATES	1993-94	2004-05	2011-12
Andhra Pradesh	35.2	23.4	5.8
Assam	27.7	21.8	20.5
Bihar	43.9	38.7	29.6
Gujarat	28	20.1	10.1
Haryana	24.2	22.4	10.3
Karnataka	34.2	25.9	15.3
Kerala	23.9	18.4	5
Madhya Pradesh	30.32	32.4	22.52
Maharashtra	30.3	25.6	9.1
Orissa	34.5	37.6	17.3
Punjab	27.2	18.7	9.2
Rajasthan	29.9	29.7	10.7
Tamil Nadu	33.7	19.7	6.5
Uttar Pradesh	36.34	33.31	24.54
West Bengal	31.2	24.4	14.7

Source : Tendulkar Expert Committee Report

Before proceeding further it is important to look at the linkages between Financial Inclusion, Poverty and inequality which are the main topics of our analysis.

Relating Finance and Poverty

There is no denying in the fact that finance plays an important role in the economic activity of the country. The direction of causality between Finance and growth can be divided into three categories: ***supply-leading response school of thought*** which states that financial development leads economic growth***; demand-following school of thought*** proposing that growth leads financial development; and ***bidirectional school of thought*** which states that there is bidirectional causality between financial development and economic growth[7]. Though the direction of causality is still a debatable issue but existing historical and econometric evidence do suggest that better functioning financial markets have a positive effect on future economic growth (King and Levine, 1993; Levine,et.al 1999; Levine, 2004).Long back in 1912, Schumpeter in his growth theory highlighted the

[7] Adusei, Michael (2014). Does Economic Growth Promote Financial Development? Research in Applied Economics, Vol. 6, No. 2

role of banking system as financial intermediary in economic development by providing credit to new entrepreneurs who induces technical change. Modern financial theory further put emphasis on the intermediation role by financial institutions in bridging the information asymmetries between borrowers and savers by the process of savings mobilization, capital fund allocation, monitoring the use of funds and managing risk which together contributes to economic development (Levine, 1997).

There have been many cross country and country specific studies which establish a positive link between financial development and economic growth and between economic growth and poverty reduction but there is a need to look at the direct linkages between financial development and poverty. Contradicting views have been put forward regarding the impact of financial development on the incomes of the poor. Some theories propound that financial development works in the favor of poor by enhancing growth and reducing inequality. There are several channels through which a poor is helped by financial development. First, by addressing the causes of financial market failure such as information asymmetry and high fixed-cost of lending to small borrowers, financial development can improve the opportunities for the poor to access formal finance (see Stiglitz, 1998; Jalilian and Kirkpatrick, 2001). Because of high unit cost of small scale lending, the poor cannot borrow against future earnings to invest and as is argued that lack of access to finance is one of the main reasons for persistent poverty (Levine, 2008), thus, a sound financial system enables the poor to access financial services, particularly the credit and insurance-risk services, thereby strengthening the productive assets of the poor, enhancing their productivity and increasing the potential for achieving sustainable livelihoods (World Bank, 2001a; Jalilian and Kirkpatrick, 2001).

Direct link between financial development and poverty alleviation emanates from the availability of accessible financial instruments, services and institutions for poor households (Holden and Prokopenko 2001). Even without using financial services directly, poor households can be benefitted from financial development by the way of economic opportunities (Beck et al., 2009; Gine and Townsend, 2004; and Townsend and Ueda, 2006). Financial development enhances economic activity and boosts the demand for both skilled and unskilled labor. This increases income of the poor and reduce income inequality. Thus by creating job opportunities for the poor financial development alleviates poverty and tighten income distribution. Similarly, financial development intensifies competition in the non-financial sector by reducing entry barriers for new firms and this increased competition could reduce discrimination in hiring workers and expand the economic opportunities of poor people (Becker, 1957)[8]. There is another set of theories which predict that financial development mainly helps the rich. According to them poor generally rely on informal and family connections for any financial help so improvement in the formal financial sector will not do any best for poor people.

Causal relationship between poverty reduction and financial development in developing countries find that through growth enhancing effect development in financial sector contributes to poverty reduction up to a certain threshold level of economic development (Jalilian and Kirkpatrick, 2005). While financial development can reduce poverty but at the same time financial instability can specifically hurt poor the most and dampens the good done by financial development to poverty reduction (Jeanneney and Kpodar, 2005). Income of poorest 20% population in countries with better financial system in place can grow faster than the average GDP per capita in respective countries (Beck et al.,2004).

Odhiambo (2008), in a country specific examination of South Africa analyzed the dynamic causal relationship between financial development, economic growth and poverty reduction using a trivariate Causality model.

In a study done by Meghana Ayyagari and others, they have examined the effect of financial sector development on changes in rural and urban poverty. They have taken financial inclusion (bank branch penetration) and financial deepening (bank credit to SDP) as two measures of financial sector development. Their results show that financial depth has a negative and significant impact on rural poverty in India. However there was no effect of financial depth on urban poverty rates. Financial depth has more significant impact on poverty reduction as compared to financial outreach. Fostering entrepreneurship in rural areas and by helping people to migrate to urban areas are the two primary channels which contributes to poverty reduction in rural areas. Generally

[8] Kpodar, Kangni and Singh, Raju Jan(2011). Does Financial Structure Matter for Poverty? Evidence from Developing Countries. Policy Research Working Paper 5915

this migration is from rural primary and tertiary sectors to urban tertiary sectors. In another study by Inoue and Hamori, they have used unbalanced panel data of 28 states covering a period from 1973 to 2004. They have estimated poverty ratio explained by financial deepening while taking international openness, inflation rate and economic growth as control variables. Their results show that financial deepening and economic growth alleviate poverty whereas international openness and inflation aggravates poverty. Financial deepening has a considerable positive effect on poverty ratio in both rural and urban India.

Another study by Jalilian and Kirkpatrick also tries to establish the relationship between financial sector growth and poverty reduction and emphasizes that this relationship has a complex set of inter dependencies. Growth of financial sector can affect poverty both in direct and indirect ways. Direct impact is through more credit access by people which helps in raising their incomes and hence reduction in poverty. Indirect way can be through economic growth. Their results also showed that increase in financial deepening has a negative impact on poverty. They laid stress on distribution of income as an important factor reducing income inequality rather than growth in itself. In determining the casual link between poverty and financial development, they suggested that the impact of financial development on economic growth is most pronounced at lower income levels implying that poorer developing countries will gain most from development of financial sector.

The link between finance and poverty is interwoven in many ways, for example, Jacoby (1994) found that in Peru lack of access to credit perpetuates poverty as poor households are unable to provide appropriate education to their children. Dehejia and Gatti (2003) and Beegle et.al (2003) showed that countries having poorly functioning financial systems tend to have high rates of child labor. Looking at the rural Indian households Jacoby and Skoufias(1997) showed that households having no access to credit market reduce their children’s schooling more on receiving some transitory shock compared with those having greater access to financial markets.

Relating Finance and Inequality

Just as Finance helps in economic growth and poverty reduction, similarly it plays a pivotal role in reducing income inequality. But different opinions have been propounded by economists regarding the intensity and conditions under which financial development helps reducing inequality. There are models implying that financial development enhances growth and reduces inequality. As per these models Galor and Zeira, 1993) imperfections in financial market such as information asymmetries, transaction costs and costs of contract enforcement may prevent poor entrepreneurs from accessing financial services as they lack collateral, credit histories and connections. These credit constraints direct the flow of credit from poor entrepreneurs to rich and high return projects. This will reduce the efficiency of capital allocation and intensify income inequality. Thus an improvement in financial sector will reduce poverty and inequality by relaxing credit constraints and improving the allocation of capital and accelerating growth. Capital market imperfections result in limited borrowing by the people as a result of which high investment occupations are beyond the reach of poor people who therefore choose to work for wealthier employers and thus wage contracts are to be seen as substitutes for financial contracts. Therefore, the pattern of occupational choice is determined by the initial distribution of wealth which in turn determines saving and risk bearing capacities of people and fosters in new distribution of wealth (Newman and Banerjee, 1993). Therefore it is necessary to remove capital market imperfections so as to have equitable distribution of wealth in the society. Economic state of stagnation and prosperity crucially depends on the initial distribution of wealth.

Similar to Kuznets proposition that income inequality rises at lower levels of economic development, tapers off at middle level and finally declines at higher level of economic development, Greenwood and Jovanovic (1990) predicted an inverted U-shaped relationship between income inequality and financial sector development. At early stages of development there are credit market failures resulting in high transaction costs and thus those having certain level of assets (high income groups) are likely to be benefitted from financial system. As is known that poor people do not save much and accumulation of wealth is slow process so income differences widen up resulting in increased income inequality. Over time as financial sector grows and transaction costs decline, this enables poorer sections of the society to avail financial services and generate income which eventually results in decreasing income inequality in the society. Some models also suggest that if financial development has negative impact on income inequality, this can slow down aggregate growth and increase poverty. According to this theory rich has higher saving rate than poor and if financial development reduces income inequality, this will hamper aggregate savings in the economy and thus slowing down of growth process with adverse impact on poverty (Bourguignon, 2001a).

In a cross country analysis taking into account different measures of financial development and poverty reduction, Beck, Kunt and Levine, 2004, looked at the effect of finance on income growth of the poor while controlling for average per capita GDP. Their findings show that financial development has disproportionately positive impact on poor. It alleviates poverty first by improving the allocation of capital and boosting economic growth and secondly by relaxing credit constraints on the poor and reducing income inequality. With financial development there is decrease in poverty gap.

To analyze the relationship between financial inclusion, poverty and inequality it's important to look at the evolution of banking sector in India which will give us some insight regarding the development of finance and its impact on Indian society.

Early phase of Indian banking – Up to 1947

Banks constitute a major part of India's financial sector which has a long history of existence. Evolution of banking in India is similar to that of the world which believes that money lenders accepting deposits and issuing receipts paved the way for the banking sector to flourish. India has a long history of banking as activity of money lending can be traced back to Vedic period (2000 to 1400 BC). *Kautilya's Arthashastra* (400 BC) contains reference of creditors, lenders and lending rates (Central Banking Enquiry Committee, 1931). During medieval period there was a provision of giving loans to farmers to buy necessary agricultural inputs (Taccavi loans).

There was an extensive network of Indian banking houses sprawled across cities and towns of commercial importance. Indian bankers had their own inland bills of exchange called '*hundis*'[9]. There was no system of securities and banking mostly worked on mutual trust and confidence. During pre-independence era there were mostly private banks organized as joint stock companies. For example Bank of Bombay, Bank of Hindustan, the General Bank of Bengal and Bihar, Presidency Banks, etc. These banks were mainly concentrated in urban areas. In the mean time Imperial Bank of India was formed with the amalgamation of three Presidency banks in 1921. RBI was formed on 1st April, 1934 on the recommendation of the Indian Central Banking Enquiry Committee (1929). Banking sector before independence was not much organized and expanded. Its only after independence that banks were given so much importance and efforts were made to make them accessible.

Banking after Independence

When India got independence the state of economy was totally devastated. India's handicraft was lost, peasantry was indebted and landless, industrial sector was in very fragile condition, most of the people were living in servitude, etc. Similar was the condition of banking sector. Almost entire Indian banking was in private hands, even the Reserve Bank was not completely state owned. Scheduled commercial banks[10] had much more deposits than the non-scheduled commercial banks whose number though was far more. Also there was inequitable distribution of banks across India. West Bengal had largest number of scheduled commercial banks followed by Madras and Bombay. With respect to non-scheduled commercial banks, Madras had largest number of such banks followed by West Bengal and Bombay.

Devastated Indian economy also bore the brunt of partition which divided unified India into two entities viz: - India and Pakistan. Partition had social, economic and political repercussions which left two nations in a state of despair. Banking sector also suffered at

[9] Hundis are the oldest form of credit instruments that were used as early as the 12 century AD. Deposits were accepted by some indigenous banks under the 'Khata putta' system but Multanis and Marwaris did not accept deposits and relied on their own funds, see Bagchi (1987).

[10] The 'scheduled' banks were those which were included in the second schedule of the RBI Act. It also included those banks of British India which had paid-up capital and reserves more than Rs. 5 lac in aggregate.

the hands of this partition. In 1947, 17 out of 38 banks that failed were in West Bengal only. The following year was even worst as it witnessed the closure of 45 larger banks (having paid up capital of about Rs. 4 lakh). Repeated bank failures led to the loss of faith in the banking industry. Financial savings started flowing in the postal department which was considered safer than banks. Therefore there was a huge task before the government to make banking industry more reliable and develop it on modern lines. Nationalization of RBI on 1st January 1949 was the first step in this direction. Banking Regulation Act (earlier known as the Banking Companies Act, 1949) was strengthened to allow RBI to extensively supervise the banking sector. This also granted power to RBI to control over the opening of new bank branches and offices, power to inspect account books of banking companies and preventing voluntary winding up of licensed banking companies[11]. From time to time such regulations like Banking Companies (Amendment) Act 1961, Deposit Insurance Corporation Act, 1961, etc was passed to plug the loopholes in the banking sector. With the initiation of planned economy, first five year plan (1950-51 to 1954-55) defined the role of banks, financial institutions and central bank in the following way:

"Central banking in a planned economy can hardly be confined to the regulation of the overall supply of credit or to a somewhat negative regulation of the flow of bank credit. It would have to take a direct and active role, firstly in creating or helping to create the machinery needed for financing developmental activities all over the country, and secondly, in ensuring that finance available flows in the direction intended."[12]

Thus banks were given a bigger role of regulation as well as directed use of credit. Both rural and urban areas were in dire need of formal institutional credit for different purposes and the shortage was more acute in rural areas. The All India Rural Credit Survey 1951-52 recommended the creation of strong, integrated state sponsored bank with a network of branches all over the country. This recommendation was accepted and the State Bank of India Act was passed on 8th May 1955 which was basically the nationalization and conversion of Imperial Bank into State Bank of India. This paved the way for expansion of commercial banks into rural areas. State Bank of India was asked to

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[11] See 'Evolution of Banking in India (RBI report).
[12] First Five Year Plan (GoI 1952)

open 400 branches in semi-urban areas and start agricultural lending even at a loss. SBI opened 416 centers from 1955 to 1960 covering their treasury centers and other rural and semi-urban places having population more than 25,000.

With the Five Year Plans in place and quest of industrial development, it was seen that there is more deployment of credit to Industry and commerce as compared to Agriculture sector. The All India Rural Credit Survey Committee (AIRCS) 1954, found that only 9% of rural credit is provided by formal credit institutions and money lenders, rich landlords and traders cater for 75% of rural credit need. On the suggestion of AIRCS cooperatives because of having local character were entrusted to lead the Integrated Scheme of Rural Credit. To give new direction to co-operative credit movement and co-coordinating its growth with the development of rural areas following recommendations were made:-

(1) Reorganizing and strengthening primary co-operative societies;
(2) Crop loan system is to be introduced instead of usual security oriented;
(3) To integrate co-operative credit with co-operative marketing & procuring activities and to provide suitable training arrangements for personnel of co-operative credit institutions
(4) Also to reorganize and strengthen state and central co-operative banks so as to be in a position to extend required support to primary institutions for providing credit to agriculturists.[13]

These recommendations were implemented by RBI and State Governments as a part of second five year plan which lead to an increase in the number of branches of co-operative societies from 837 in 1951 to 2375 in 1965 and loans made by these societies also increased many folds. Despite these structural changes and expansion of formal banking to rural and semi-urban areas, generally credit requirement of agriculture, small scale industries and rural craftsman did not receive adequate attention and continued to lag behind. It was seen that deposits mobilized from rural and semi-urban areas was used to finance industries and organized trade rather than catering to the needs of rural people.

[13] Pai, D.T.: "Overview of Banking Development 1947-2007"

In 1969, a major breakthrough came into the banking sector of the Indian economy with the nationalization of 14 banks. Central bank was committed to increase the penetration of banks in rural areas and also to equalize population per bank branch across all states. This nationalization of banks was a part of social and development banking which aimed at a) to provide banking services in previously unbanked or under banked areas; b) to provide substantial credit to specific activities, including agriculture and cottage industries; and c) to provide credit to certain disadvantaged groups such as, Dalit and Scheduled Tribe households. Lead bank scheme and specific branch license policy were the two main tools to achieve government's objective. Lead Bank Scheme was launched with a view to mobilize deposits on a massive scale, to enhance lending to weaker sections and to be a chief instrument for branch expansion. District wise there was designation of 'lead bank' which was given the responsibility of surveying the credit needs of the population, to develop banking and credit facilities in its respective district. Launch of 'lead bank scheme' had a major role in spreading the banking facilities to unbanked areas of the country. With the surge in the number of bank branches there was a tremendous decline in the population per office from 65,000 in June 1969 to 31,660 in December 1975. Rural areas accounted for about 50% of the new branches opened during this period increasing their share in total branches from 17.6% to 36.3%.[14]

The introduction of social and development banking ushered a new era in the development of banks in India particularly in rural areas which were earlier not considered to be a problem of commercial banks. Now credit advances to agriculture was included in the policy of commercial banks. Reserve Bank of India (RBI) gave directives to attain the objective of social and development banking. This included targeted expansion of rural bank branches, ceiling on interest rates and setting guidelines for the sectoral allocation of credit. This was also the time when Green revolution was in initial phase and government wanted all constraints to be cleared off in the successful implementation of green revolution which aimed at making India self sufficient in food grains. Among other things one of the objectives of nationalization of banks was to have an easy accessibility to credit in rural areas particularly by rich farmers. To ensure easy and affordable credit, in 1977 as a part of the aforesaid programme, RBI imposed 1:4

[14] RBI report ' Evolution of Banking in India' page no.25

branch license policy. As per new branch licensing policy, to open a new branch of commercial bank in already banked area, commercial banks were required to open four new branches in unbanked rural areas. This led to huge penetration of bank branches in rural areas increasing from 1443 in 1969 to 35134 by 1991 (Ramakumar, 2013, p. 1)

Priority sector lending was second most important feature of social and development banking. It was to ensure that credit should not be a constraint in any productive activity. From 1970s banking was actively used as an instrument of growth, to reduce income inequalities, concentration of economic power and imbalance in banking facilities across different regions of the country. Thus, it was needed to direct credit towards weaker and neglected ones on priority basis. A target of 40% of advances was set for "priority sector lending" which included agriculture and allied activities (18%), micro and small enterprises, poor people for housing, students for education and other low income groups and weaker sections (10%). In 1980, government directed to give 25% of priority sector lending to weaker sections which included rural particularly SC/ST households by 1985. Differential interest rate scheme was started in 1972 according to which loans were given at concessional interest rates on advances made by public banks to low income groups so as to help them to engage in productive and gainful activities. The differential interest rate was fixed at 4% per annum which was 2% below than the bank rate.[15] Since rural credit was an important component of 'green revolution' so nationalization of banks led to the huge growth in credit allocation to the agriculture. Although the impact of 'green revolution' on rural India is itself a debatable issue as many studies have pointed out its biased nature because this increase in credit allocation to agriculture was not uniform across all regions, crops and classes. It has been argued that 'green revolution' helped mainly rice and wheat crop of whose benefits were mostly accrued by rich classes of farmers farming in the irrigated areas of north-west and south of India (Patnaik, 1975; Griffin 1975, Bhalla and Chadha 1990).

The regulation of banking sector and government's emphasis on its promotion in rural areas was based on the fact that rural credit markets are highly imperfect. Policy of social and development banking helped in the mopping up of savings from richer rural areas

[15] Bank credit to agriculture in India: Trends in the 1990s and 2000s, Ramakumar, R. (2013)

and lend these savings as loans to savings deficient areas. Deposit mobilization and spread of banking along length breadth of the country were the two most significant achievements of nationalization.

In the meantime it was realized that commercial banks were not well trained to cater well to the needs of small and marginal farmers and co-operative banks did not had adequate resources to meet their requirements. Thus there was a need to have such a structure which knows the know-how of a professional bank and at the same time is familiar with local conditions. Thus in 1975, Regional Rural Banks (RRBs) came into being on the recommendations of Narasimhan Committee. They were established mainly to develop rural economy and provide credit for the development of agriculture, trade, small industries, local artisans, labourers, etc.

Nationalization of banks along with introduction of directed credit and regulation of interest rates proved very beneficial for the rural economy. There was an increase in the share of rural branches from 17.6% in 1969 to 58.2% in 1990. Also the credit- deposit ratio increased from 37.6% in 1969 to 60.6% in 1981 to 1990 in rural areas. Thus overall the purpose of nationalization of banks materialized significantly and rural areas largely came under the ambit of formal banking. Looking at the success of bank nationalization and need to ensure credit delivery more efficiently RBI in April 1980 nationalized six more private banks. These were Andhra Bank, Corporation Bank, New Bank of India, Oriental Bank of Commerce, Punjab and Sind Bank, and Vijaya Bank and their nationalization increased the number of public sector banks to 28 constituting 91% deposits of the banking sector.

Expanding banking network to cover all possible areas, directed lending, interest rate regulation and many other initiatives taken by RBI and Government to have an easy accessibility of credit made public sector banks non-profitable with high non performing loans and lacking proper lending incentives. There was a dire need to bring in required reforms to cure ailing financial sector. Thus, on the recommendations of Narasimhan Committee report, financial sector reforms were introduced in 1991. Narasimhan Committee appreciated the progress made by banking industry in spreading its services across rural and semi-urban areas and thereby its role in financial intermediation and economic growth. But at the same time it highlighted its poor health and ailing services. This was the time when Indian Economy was undergoing some radical transformations in the backdrop of serious balance of payments problems. These financial reforms were part of larger structural reforms surrounding almost every aspect of the economy like trade, external sector, industry, etc. Major reforms proposed by Narasimhan Committee and respective enactment includes:-

- Reduction **in Statutory Liquidity Ratio (SLR)** which resulted in decrease in SLR from 38.5% in 1992 to 25% in 1997.
- **Cash Reserve Ratio (CRR)** was reduced from 15% in 1991 to 4% in 2002.
- Definition of **Priority sector lending (PSL)** expanded to include industries also. Although the 40% lending to Priority sector did not change but it was seen that with the inclusion of industries, more and more funds were directed towards industries.
- In 1992, **competition** was enhanced in banking sector by allowing establishment of banks in the private sector.
- By 1993, the **branch licensing** policy was done away with.
- **Interest rates** were deregulated to match market rates more closely. Minimum lending rate was abolished in 1996.

Banking and Financial sector reforms were guided by guided by *'Pancha Sutra'* or five principles viz:- 1) cautious and sequencing of reform measures; 2) introduction of norms that were reinforcing; 3)introduction of complementary reforms across sectors (monetary, fiscal, external and financial sectors); 4)development of financial institutions and 5) development and integration of financial markets.[16] This led to reduction of SLR (Statutory liquidity ratio) and CRR (Cash Reserve Ratio), decontrolled interest rates, reduction in the volume of directed credit, slashing of priority sector lending and paved way for private banks to operate. Thus Indian banking sector became competitive and profit based.

[16] Report on Currency and Finance, 'Evolution of Banking in India', RBI, page no. 37

This was a huge setback for the rural areas as far as banking facilities are concerned. Urban and economically prosperous areas became attractive destinations for banks to provide banking facilities as compared to rural areas which lacked such incentives. Rich and prosperous states reaped the benefits of financial liberalization by attracting more banks and becoming a hub of development. This led to polarization of banking activity in some areas further widening the inequality between the regions. Countries around the world are giving thrust to promote financial inclusion by passing different laws and regulations. In France the banking act was on 1984 passed making access to bank account a legal right. In 1995, German banking industry accepted the recommendation to provide current accounts on demand. In South Africa in 2004 low cost bank account called 'Mzansi' was launched to have inclusion of financially excluded people. In 2005, 'Financial Inclusion Task Force' was constituted by United Kingdom government to monitor the process of financial inclusion (Mehar, 2014). In the mean time it was realized in India that leaving banking sector on market forces is hampering the financial growth in rural areas. To again tread on the path of financial inclusion and inclusive growth the concept was brought to limelight during the Mid Term Review of Monetary Policy (2005) by RBI and there started a whole array to have 100% financial inclusion at an earliest.

CHAPTER II

DATA AND METHODOLOGY

To look at the relationship between finance and poverty, secondary data has been taken from different sources like NSSO (National Statistical Survey Organization), RBI (Reserve Bank of India), Census, and CSO (Central Statistical Office), etc. NSS conducts quinquennial survey for different socio-economic indicators such as employment-unemployment, household consumption, health, education level, debt and investment, livestock holding. It also includes various indicators related to agriculture and industry, information on different social and religious groups.

Poverty is measured by different ways and some of the important concepts in poverty measurement are:-

Poverty line: It is defined as the income or consumption expenditure level which enables to have basic calorie intake as calculated by policy makers and small payment for non-food expenditures.

Head count ratio: It is the proportion of people in the society who earn income which is less than the prescribed poverty line. This is a most common measure of poverty.

Poverty gap (PG): It indicates the amount of money which is to be given to poor so as to bring them at the level of poverty line. It shows the depth of poverty. It differs even when head- count ratio is same. Suppose there are two societies where number of poor and total population are same but in first society poor have less income than the poor of second society, Poverty gap index for first society would be higher than the second one though they had same head-count ratio.

Squared poverty sap (SPG): It shows the concentration of poverty in the society. It is calculated as the normalized weighted sum of the squares of poverty gaps.

Lorenz curve: It represents the relationship between cumulative proportion of income and cumulative proportion of population in income distribution. It shows inequality in the society. Lorenz curve at 45 degree line represents the perfect income equality.

Gini Coefficient: It is the most commonly used measure of inequality. It ranges between 0 and 1, where 0 representing the perfect income equality and 1 representing the perfect income inequality.

$1 a day poverty line: It is generally used by international organizations for comparing poverty levels across different countries with different currencies. Millennium Development Goals has set its poverty target in terms of this. It refers to an income level of $1.08 per person per day based on 1993 dollars and adjusted for purchasing power parity (PPP).

All the above definitions have been taken from ADB (2004) report.

Poverty Gap Index is given by

$$G = H\,(z-\mu^*)/z$$

Where,

G= poverty gap ratio

H=head-count ratio

Z=poverty line,

μ^*= the mean income of the poor living below poverty line.

Sen's Index of Poverty is given by

$$P=(q/n)*(1/л)[л-\upsilon\,(1-G_p)],$$

Where,

P= Sen's Poverty index

(q/n)=the head-count ratio,

Л= poverty line,

G_p= income inequality among the poor.

Here Head-count ratio as a measure of poverty has been used using NSS Consumption Expenditure Survey data for the 50th (1993-94), 55th (1999-2000), 61st (2004-05) and 68th (2011-12) round.

Head-Count Ratio: H= (q/n)

H= head count ratio

n= total population

q= number of people living below poverty line.

Calculation of poverty line is defined on the basis of calorie intake. It is defined as a level of income or expenditure required by an individual for the intake of 2400 calories in rural areas and 2100 calories in urban areas. Those who do not earn enough income so as to have this much calorie intake is considered as below poverty line. In India Planning Commission provides poverty line figures for both rural and urban areas.

NSS data is available in a grouped form which is grouped as (a) the percentage distribution of estimated number of persons, and (b) the average consumer expenditure per person. MPCE (Monthly Per Capita Consumption Expenditure) quintiles are generally grouped into 12 expenditure classes with first class indicating the poorest quintile. For the estimation of poverty ratio, quintile class in which poverty line lies is broken by interpolation and the frequency of this class is added to the frequencies of other previous classes whose sum gives head- count ratio. Poverty lines are given by Planning Commission of India. Due to changed questionnaire NSS 55th round poverty ration cannot be directly compared to other rounds. The data for 55th round has been taken from ICIER (Indian Council for research on International Economic Relations, 2006) For the Financial inclusion, data from RBI's Basic Statistical Returns (BSRs) has been taken in this study. These are published annually and provide information on almost all indicators of banking industry such as number of accounts, credit, deposit and employees, etc. BSR reports of 23rd (1994), 29th (2000), 34th (2005) and 41st (2012) has been used for analysis purpose. Three indicators of Financial Inclusion have been taken into consideration. These indicators are:

- Bank penetration
- Credit penetration
- Deposit penetration.

To study **bank penetration,** numbers of bank accounts per capita are taken. It can tell us how well people are using banking services. Just having a bank office or branch will not solve the purpose of financial inclusion. It is to be seen with its usage. Number of **bank offices** has also been taken for both rural and urban areas across states. Bank office consists of branches doing banking business (either accepting deposit or offering credit to their customers) as well as administrative offices. Administrative offices are those which offer inclusive administrative support to their branches. These include Head Office, Zonal Office, Regional Office, Local Office, Training centre, clearing cell, etc. (Reserve Bank of India)(See Appendix 1 and 2)

For **Credit penetration,** credit amount per capita has been taken as an indicator for both rural and urban areas. Credit penetration gives us an idea how much credit people are taking from banks for different purposes. Per capita credit penetration captures the deployment of credit by per person in an area. Higher credit penetration means more money is circulated in the economy by banking Chanel (See Appendix 3 and4).

Similarly for **Deposit penetration,** per capita deposit amount has been taken for both rural and urban areas. Deposit penetration can tell us about how much people are saving in the banks. Higher deposit penetration means banks can mobilize more savings for credit purpose which in turn will boost the economic activity of the region (See Appendix 5 and 6).

Both RBI and NSS use different time periods and ways to classify rural-urban areas. NSS classify regions into only rural and urban areas whereas RBI classifies regions into rural, semi-urban, urban and metropolitan. For our analysis RBI data of rural and urban areas has been grouped together as ‘rural’ and data from urban and metropolitan areas has been grouped together as ‘urban’. Similarly, there is difference in the time period for which data is collected. NSS collects data from 1st July- 30th June which is an agricultural year but RBI collects data on the basis of financial year i.e. from 1st April to 31st March therefore in the analysis of these two data there will be some inaccuracy.

Other variables taken include PCNSDP (Per Capita Net State Domestic Product) at factor cost (at constant prices) and literacy rates. CSO (Central Statistical Organization) provides data for NSDP. PCNSDP has been deflated in accordance with 2004-05 base year. Literacy data has been taken from census 1991, 2001 and 2011. The required equation for analysis is

$$PovertyRit = \beta 0 + \beta 1\ X_1 it + \beta 2\ X_2 it + \beta 3\ X_3 it + \beta_4 X_{4it} + \beta_5 X_{5it} + \beta_6 X_{6it} + \varepsilon it,$$
$$i = 1,\ldots,18,\ t = 1993,\ldots,2012. \qquad \text{(Eq. 1)}$$

Here $PovertyR_{it}$ is a rural poverty measure of state 'i' in time 't'. Other variables are as:-

X_1 is number of offices in rural areas in state 'i' in time 't',

X_2 is the per capita deposit penetration in rural areas of state 'i' in time 't',

X_3 is the per capita credit penetration in rural areas of state 'i' in time 't',

X_4 is the Literacy rate of the state 'i' at time 't',

X_5 is the PCNSDP of the state 'i' at time 't', and

X_6 is the number of per capita accounts in rural areas of the state 'i' at time 't'

ε is an error term.

Similarly for urban areas the equation is:-

$$PovertyUit = \beta 0 + \beta 1\ X_1 it + \beta 2\ X_2 it + \beta 3\ X_3 it + \beta_4 X_{4it} + \beta_5 X_{5it} + \beta_{6\ X6it} + \varepsilon it,$$
$$i = 1,\ldots,18,\ t = 1993,\ldots,2012. \qquad \text{(Eq. 2)}$$

$PovertyU_{it}$ is urban poverty measure of state 'i' at the time 't'. While other variables are defined as

X_1 is the number of offices in urban areas in state 'i' at the time 't',

X_2 is the per capita deposit penetration in urban areas of state 'i' at the time 't',

X_3 is the per capita credit penetration in urban areas of state 'i' at the time 't',

X_4 is the Literacy rate of the state 'i' at the time 't',

X_5 is the PCNSDP of the state 'i' at the time 't',

X_6 is the number of per capita accounts in urban areas of state 'i' at the time 't'

ε is an error term.

From the existing literature we have evidence that Bank penetration, credit penetration and deposit penetration all are negatively related with poverty (Meghana et. al, 2013; Inoue and Hamori, 2010). Easy and affordable access to credit enables the poor to exploit better opportunities of life which will help him in earning higher income. Trickledown effect of growth is always talked about that once we have higher growth rates it gets transferred to all sections and regions of the society. With high per capita net state domestic product it is assumed that it will benefit society by creating more employment and lowering the poverty. Literacy is always considered as an important tool to combat poverty and other form of deprivations. It enables us to engage ourselves in gainful employment and thus reduce poverty.

CHAPTER III

STATUS OF FINANCIAL INCLUSION IN INDIA

Introduction

A strong and stable financial system is an important driver of economic growth and development. Availability of appropriate banking facilities can accelerate economic activities by mobilizing funds. India recognized the importance of Financial Inclusion at the very beginning of Independence and put in different mechanisms to have a well developed financial system. Although even during the pre- colonial times there was a well developed system of banking and Indian bankers had their own inland bills of exchange usually called *'hundis'*[1] . These were part of informal credit system based on mutual trust with no legal binding. With the advent of British rule there came formal banking system in India and from then onwards there is focus on its development. Despite of having such a vision India is still struggling to have 100% Financial Inclusion. In 2005, Financial Inclusion was first introduced in India as a pilot project in Union Territory of Pondicherry by the then Chairman of Indian Bank K.C.Chakrabarty. Manglam village was the first village to have 100% financial inclusion and was declared as a model village by the Indian bank[2]. The objective of Financial Inclusion is to bring people under the ambit of formal banking services so as to have required financial services at their disposal when required. Lack of which can be detrimental for socio-economic growth. To become global leader in true and absolute sense India needs to have 100% Financial Inclusion as soon as possible.

India's financial system consists of money market, forex market, capital market, debt market, etc to fulfill the needs of different participants of the economy. Reserve Bank of India is the central bank of India and chief regulator of financial services across the nation. It initiated the process of financial inclusion long back as reflected in various

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[1] Hundis are the oldest form of credit instruments which were used to transfer funds from one place to another, to borrow money and as bills of exchange for trade transactions.
[2] Financial Inclusion a massive task: Gokarn, 'The Hindu' August 6, 2010.

initiatives taken by it from time to time such as co-operative movement, bank nationalization, lead bank scheme, setting up RRBs etc. but more concrete and serious efforts started taking place only after the 11th Five Year plan when government talked about 'Sustainable Growth' at length. It was realized that growth in the hands of few and concentrated regionally cannot do well for the people. This was high time to chart out new growth strategy which can result in sustainable and equitable growth. To achieve this goal of 'Inclusive Growth' financial Inclusion needs to be achieved first. Importance of finance in driving growth is a well established fact and therefore Inclusion of all people in the formal banking system cannot be compromised at any cost. India is having a large population outside the reach of formal banking. Following are the few statistics to highlight the extent of financial exclusion in India:-

- Out of about 600,000 villages in India only around 36,000+ had a branch of commercial bank.
- Only 40% population had bank account.
- Population of those having any kind of Insurance cover was as low as 10%.
- Percentage of people having debit card and credit cards was just 13% and 2% respectively.[3]

Census also collects figures on households availing banking services in India. It only collects information if a household has a bank account or not. Taking only this indicator we have very less population under formal banking. Figures from census 2011 and its comparison with census 2001 have been given below:-

[3]Speech "Banking as a Fundamental Right" by Dr. K.C. Chakrabarty Deputy Governor, RBI at 27th National Conference of the AIBEA at Kochi on February 9, 2013.

Percentage		
	2001	2011
Total	35.54	58.70
Rural	30.11	54.44
Urban	49.52	67.77
R-U difference	19.4	13.3

Source: Census 2011

India is second most populous (1.22 billion) country in the world and has largest (40%) unbanked population in the world. There has been considerable improvement in the number of households using banking services from 35.54% in 2001 to 58.70% in 2011. Taking into account the different initiatives taken by RBI and government the rate of growth is slow and unremarkable. Still a major portion of our population is unbanked.

Though financial exclusion is not only confined to India but given the size of population and potential demographic dividend such a high level of exclusion should not be taken lightly. Financial exclusion is a global phenomenon but the extent of exclusion is more in poor and developing countries. There are estimates suggesting that more than half of the world's adult population (about 2.5 billion) lack access to basic financial services such as bank account, credit access, any kind of insurance, etc. and major portion of these people resides in developing countries.

There have been many attempts to measure and explain Financial Inclusion by different countries, banks, scholars, etc. taking into account different indicators depending on the level of development and need.

Sarma (2010) formulated Index of Financial Inclusion (IFI) using indicators like banking penetration (BP), availability of banking services (BS) and usage of the banking system (BU) for different countries for the year 2004. It is a multidimensional measure similar to that of HDI, HPI, GDI[4], etc. ranging from 0 to 1. Here 0 means total exclusion and 1 means complete inclusion. Banking penetration is measured by proportion of people

[4] See UNDP's Human Development Reports available at < www.undp.org>.

having bank account or banked population. Availability of banking services is measured by the number of bank branches and ATMs per 100,000 populations. Merely having a bank account is not enough until it is used regularly. Thus usage of bank account forms an important component of IFI. It has been measured by the volume of credit and deposit as proportion of country's GDP. In this cross country analysis India stood at 29th position out of 49 countries with success in individual parameters as BP (0.18), BS (0.10) and BU (0.38). Financial inclusion in India is very poor as compared to other countries such as Austria which is at rank 1 is having 1 penetration and availability index and 0.88 usage index.

CRISIL INCLUSIX:-The CRISIL has formulated an index using various measures to look at the extent of financial inclusion in the country for the period 2009-2011. They have taken branch penetration, deposit penetration and credit penetration to calculate CRISIL Inclusix which is a relative index having a scale of 0 to 100, with 100 indicating the maximum score available. The parametres taken, its significance and interpretation is as follows:-

Table 11: Dimensions and parameters used to measure financial inclusion

	Parameters	**Significance**	**Interpretation**
Branch Penetration (BP)	No. of bank branches (both SCBs & RRBs) per lakh of population in a district	Measures the ease with which people in a particular territory can access banking services	The higher the better
	No. of loan accounts per lakh of population in a district	Measures the extent of access to loan products offered by banks in a particular territory	The higher the better
Credit Penetration (CP)	No. of small borrower loan accounts as defined by RBI per lakh of population in a district (small borrowers = borrowers with a sanctioned credit limit of up to Rs. 2 lakh)	Measures access to credit for small borrowers, who typically face financial non-inclusion	The higher the better
	No. of agriculture advances per lakh of population in a district	Measures farmers' access to credit	The higher the better
Deposit Penetration	No. of savings deposit accounts per lakh of population in a district	Measures the extent of access to savings products offered by banks in a particular territory	The higher the better

Their finding shows CRISIL Inclusix of 40.1 for 2011 at an all-India level. Though there has been an improvement from 37.6 for 2010 but it is still low. Southern region's score is 62.2 for 2011 and is leading in all the three dimensions. Western region and Northern region stood second with respect to penetration of branches and deposits respectively. Most of the states from Eastern and North-Eastern region scored poorly on the said index. Among all the three parameters at an all India level, credit penetration (CP) was lowest at 36.8 compared to deposit and branch penetration which scored 48.3 and 41.0 respectively. Here is its brief summary:-

Region	Inclusix 2009	Inclusix 2010	Inclusix 2011
Southern Region	54.9	58.8	62.2

Western Region	33.9	35.8	38.2
Northern Region	33.3	34.8	37.1
Eastern Region	24.3	26.3	28.6
North-Eastern Region	23.8	26.5	28.5
All India	35.4	37.6	40.1

Source: CRISIL (2013)

Working on the similar methodology as that of Sarma, Chattopadhyay (2011) computed an Index of Financial Inclusion (IFI) for 23 states of India covering a period from 2006-07 to 2009-10. Over all IFI for India is 0.33 i.e. medium financial inclusion (0.3-0.5). Kerala has highest financial inclusion (0.54) among the states. Though this figure is not very encouraging because the state still needs to go (1-0.54=0.46) a long way to have 100% financial inclusion. Manipur ranked lowest in IFI ranking with just 0.01 IFI.

Following is a table showing state wise Index of Financial Inclusion.

State	Penetration	Availability	Usage	IFI	IFI Rank
Kerala	0.7	0.81	0.28	0.54	1
Maharashtra	0.62	0.29	1	0.53	2
Karnataka	0.72	0.47	0.46	0.53	3
Tamil Nadu	0.7	0.43	0.38	0.48	4
Punjab	0.45	0.69	0.29	0.45	5
Andhra Pradesh	0.56	0.3	0.41	0.41	6
All India	**0.27**	**0.22**	**0.55**	**0.33**	**7**
Himachal Pradesh	0.42	0.4	0.18	0.33	8
Sikkim	0.28	0.33	0.34	0.32	9
Haryana	0.39	0.5	0.12	0.32	10
West Bengal	0.24	0.38	0.23	0.28	11
Gujarat	0.32	0.3	0.16	0.26	12
Uttar Pradesh	0.28	0.31	0.15	0.24	13
Meghalaya	0.21	0.28	0.14	0.21	14
Tripura	0.31	0.22	0.08	0.2	15
Orissa	0.26	0.23	0.11	0.2	16
Rajasthan	0.25	0.22	0.12	0.19	17
Arunachal Pradesh	0.2	0.16	0.14	0.17	18
Mizoram	0.13	0.26	0.09	0.16	19
Madhya Pradesh	0.18	0.21	0.08	0.16	20
Bihar	0.15	0.24	0.08	0.15	21
Assam	0.17	0.17	0.07	0.13	22
Nagaland	0.03	0.04	0.07	0.05	23
Manipur	0	0.01	0.01	0.01	24

Source: Chattopadhyay (2011)

Overall India has not been able to achieve very impressive level of financial inclusion for which many reasons can be given like low number of bank branches and penetration of banking activity i.e. low number of bank accounts as a proportion of total population. Thus there is a need to have further deep penetration of bank branches so that more and more people can have accessibility. Also there is huge disparity across different states with North-Eastern states having very low level of financial inclusion. This can be attributed to many reasons like late development of banking in the Northeast. Prior to nationalization of banks in 1969 there were hardly any banks there except in Assam because of the presence of tea and oil industries. There is high level of non-performing assets (NPAs) in the region due to unavailability of some activities financed by banks and lack of adequate meeting with the borrowers. Thus there is a need to improve credit culture so as to develop healthy relationship between creditors and borrowers (Chakma, November 2014).

Going by census 2011, on the data of households availing banking services we can see a wide disparity across India states. On the one hand we have 80.7% households in Uttranchal which are using banking services and on the other we have Assam and Bihar with only 44.4% and 44.4% respectively households under formal banking system. This disparity needs to be narrowed down so that all states can have access to formal banking system. See Appendix 7.

Along with this Credit- Deposit ratio has also been looked to have some sense of the rural- urban distribution of credit. Though it is not a direct measure of financial inclusion but it is capable enough to have a glimpse of distribution of credit and distribution.

Credit- deposit ratio

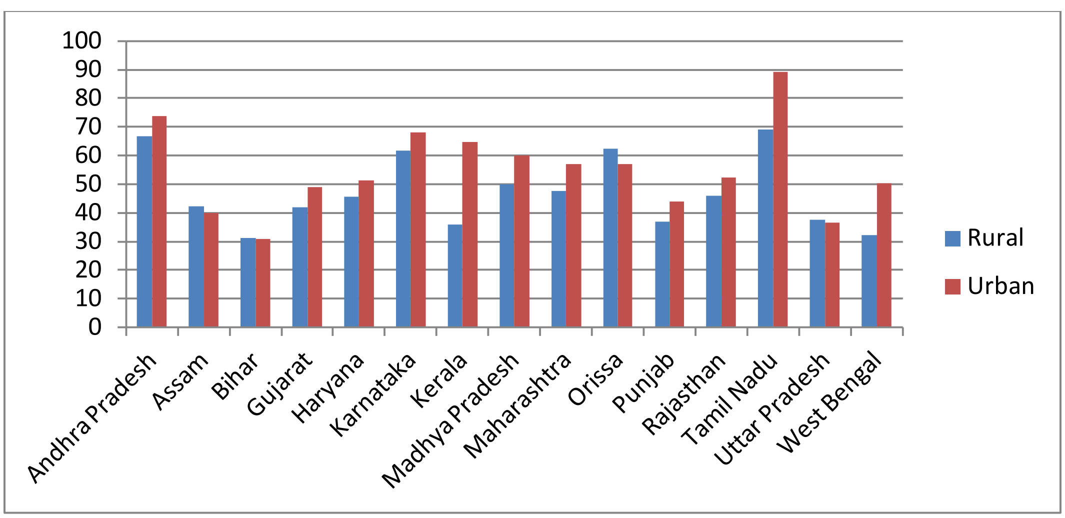
Credit- Deposit Ratio (CDR) is the proportion of loan assets that has been created by the banks from the deposit that they have received. It is an indicator of bank's health also. High Credit- Deposit ratio means that bank has lend most of its deposits as loan and similarly low Credit-Deposit ratio means that the banks are underutilizing the deposits that they have received. High credit-deposit ratio can also be interpreted as more credit creation by banks which will expand its resource base and help in its growth over time.

Generally it's has been seen that in the backward and under developed areas like mostly central, eastern and north-eastern India have recorded poor credit-deposit ratio. The matter of poor C D ratio first came in the eyes of RBI in 1980, that the most of the backward regions of India have yet not attained the national average of C D ratio. RBI advised PSBs (Public Sector Banks) to achieve a CDR of 60 percent in their rural and semi urban branches on a continuing basis. This was done in order to encourage reduction in inter-regional imbalance in credit delivery and to persuade banks to lend in the same areas where they mobilized deposits.

In a country like India where commercial banks plays an important role in the formation of financial system of the economy and receives a large part of the household saving as deposits, it becomes an interesting case to look at the trend of Credit-deposit ratio over time in both rural and urban areas.

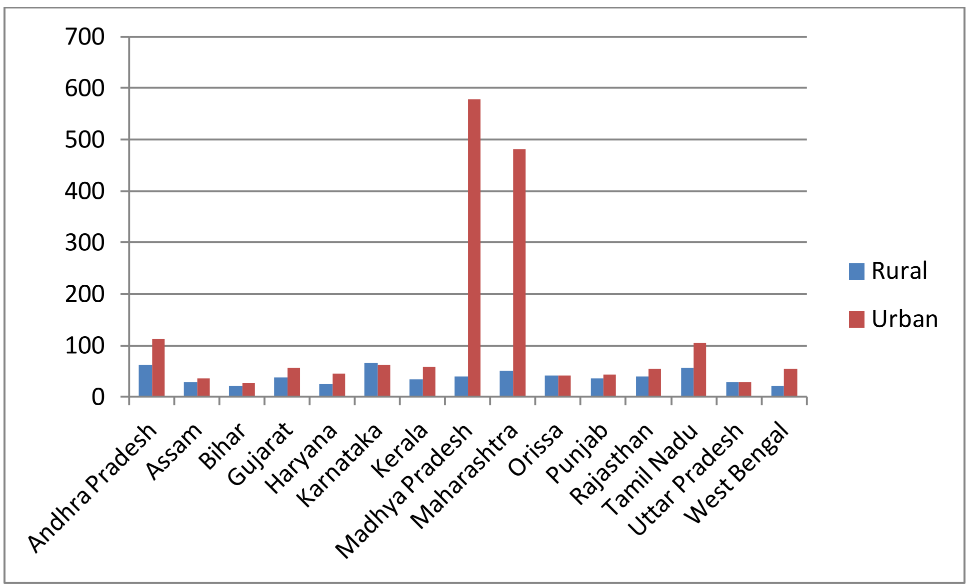
Looking at the credit-deposit ratio in rural and urban areas in 1993, we can clearly see that there are very few states which are having credit-deposit ratio of 60% in both rural and urban areas. In most of the cases, CDR in rural and urban areas of the respective states is almost comparable except in states of Tamil Nadu, Kerala and West Bengal where there is significant difference between the deposit mobilization and credit given for both rural and urban areas. Only in Assam, Bihar and Orissa we can see that rural areas have higher CDR as compared to urban CDR. This may be because these states had very low level of urbanization at that time so whatever be the deposits and credits, they were to be used in rural areas only. Though they have rural CDR higher than the urban CDR but it is still very low at a meager value of 30%-40%.

Figure 3.1: CDR in both rural and urban areas in 1993.



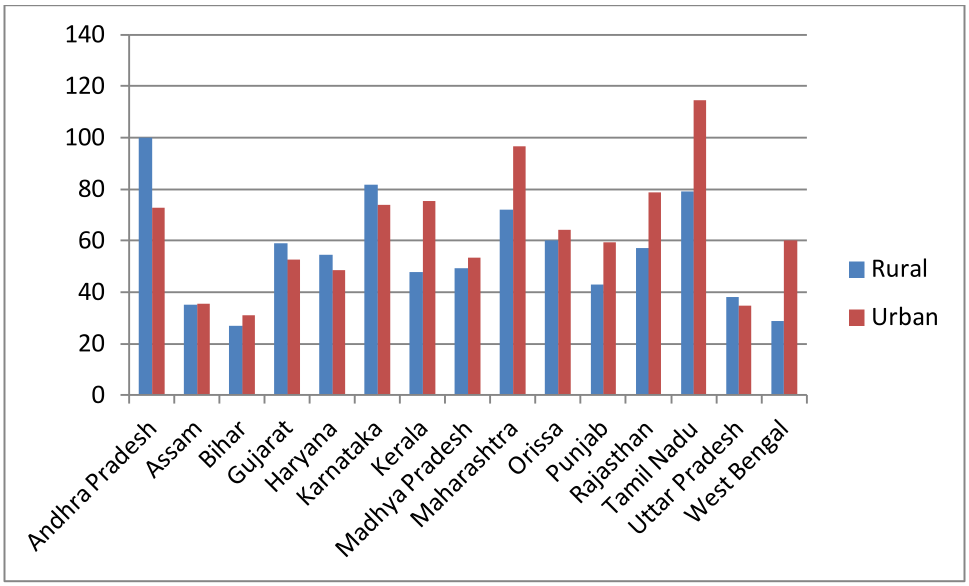
Looking at the CDR of rural and urban areas in 2000, we can see a very peculiar type of trend. Here in both rural and urban areas, CDR is low and again here too urban areas in general have higher CDR than the rural areas. But in Maharashtra and Madhya Pradesh urban areas have very high Credit- Deposit ratio up to the tune of more than 500%. This can be both beneficial and dangerous. As is already mentioned that high CDR shows prosperity of banks but at the same time it should be properly checked that to whom this credit in the form of loan is being given. Poor lending can make the whole system vulnerable. From this figure it can also be concluded that deposits from other areas are given as credits in the urban areas of these two states. This can intensify the regional imbalance in the country.

Figure 3.2: CDR in rural and urban areas in 2000.



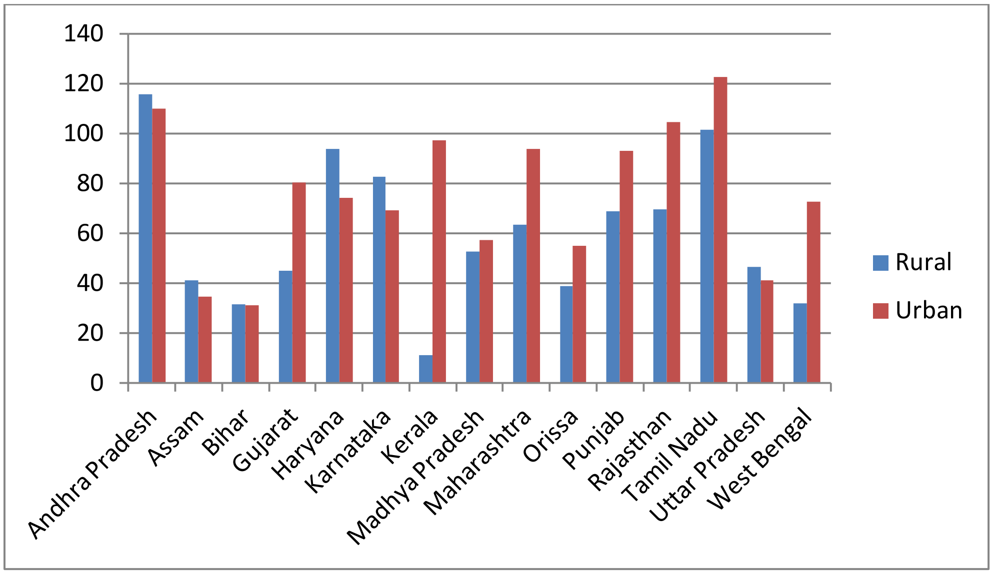
In 2005, the Reserve Bank of India launched a mission to have all its population financially included. The banks were given directives to have put in place all possible mechanism so as to achieve the desired goal. Because of these directions, rural areas too started becoming prosperous. CDR was higher in rural areas of many states which is a positive sign for the overall development of the rural areas. Andhra Pradesh achieved 100% CDR in rural areas. Karnataka, Gujarat and Haryana also witnessed higher CDR in rural areas as compared to urban areas. Though this is very desirable achievement but looking at the value of the ratio we can see that apart from few states, most of the states have low CDR in the range of 40-60%. Assam and Bihar continues to have one of the lowest CDR in both rural and urban areas. This shows that these two states have continued to lagged behind in the development of its facilities. Tamil Nadu, Maharashtra, Karnataka and Kerala have been able to achieve high and maintain equitable CDR in both rural and urban areas.

Figure 3.3: CDR in both rural and urban areas in 2005.



From the Credit- Deposit Ratio of year 2011 we can see that in general there is an increase in the CDR in both rural and urban areas except for few states. Tamil Nadu has continued to maintain high CDR for urban areas followed by Andhra Pradesh. Kerala witnessed lowest CDR for rural areas and highest difference between rural and urban areas. Bihar and Assam continues to witness one of the lowest CDR for both rural and urban areas. Most of the states have high urban CDR than rural CDR except for few states like Andhra Pradesh, Assam, Haryana, Karnataka and Uttar Pradesh.

Figure 3.4: CDR for both rural and urban areas in 2012.



Conclusion

In the analysis of different measures of financial inclusion it has been found that India is having low level of financial inclusion. There is high disparity across the Indian states in their level of financial development. Southern states have done far better than the rest of the world. Particularly pathetic condition prevails in Northeast India which has lowest financial inclusion followed by eastern and central states. This calls for an urgent need to pursue the goal of financial inclusion more vigorously. All stakeholders like RBI, Government, and NGOs have to work in coordination so as to have fully banked population. Special efforts are required for the development of banking in Northeast India. Weak market linkages should be strengthened by developing infrastructure. Communication and commutation are two important pillars of development so there is a need to invest in building roads, air links, rail connectivity, etc. to have overall development of the region. Due to its topography and scattered settlements it becomes very expensive to construct brick and mortar structures so cost efficient methods should be developed. First effort should be directed towards providing banks and banking facilities and then towards making people aware of banking services. Financial literacy is very important and an effective tool to motivate people to use banking services. Also banking services should be made available as per the requirement of the people i.e. people oriented banking should be promoted. As far as credit- deposit ratio is concerned, we have seen that over time rural areas continues to have lower Credit- Deposit ratio as compared to urban areas. Moreover, there is huge regional disparity between the states. States like Assam and Bihar continues to have lower CDRs for both urban and rural areas whereas for Southern states we have high CDRs though there also there is disparity between rural and urban areas. Thus looking at the CDR, we can say that the Reserve Bank of India and government should look into the matter of difference in CDR for both rural and urban areas and across states and should aim at achieving equitable credit deposit ratio for both rural and urban areas. Household savings constitute the major part of deposits in India so RBI should put inadequate measures so that these savings remain safe i.e. for the sake of growth of banking industry credit as loans should be given to trust worthy lenders. There is also a need for RBI to put in place strict regulations to maintain 60% CDR in both rural and urban areas. Flight of deposits from rural to urban areas should be prevented. Credit should be used for the development of the area from where deposits have been generated. Thus there is a need to have such a policy in place which ensures highest level of financial inclusion along with equitable CDR in both rural and urban areas for proper development and growth of the Nation.

CHAPTER IV

REGRESSION ANALYSIS OF FINANCIAL INCLUSION AND POVERTY IN URBAN AND RURAL AREAS

Introduction

Poverty in India and across the world has always been a topic of discussion and great debate. From centuries it has haunted mankind. Poverty is not just economic condition but also a state of social deprivation. It is not only related to not having sufficient income but has its many other manifestations like hunger and malnutrition, limited access to education and other basic services, social discrimination and exclusion. Poor people lack participation in decision making in civil, social and cultural life. So there is need to provide them such means so that they can sustain themselves in the long term to defeat poverty.

Policies of government are always aimed at poverty reduction directly or indirectly. We live in a world of paradox where we have high economic growth rates in one hand and at the other we have a large chunk of our population reeling under poverty. Eradication of extreme poverty is one of the Millennium Development Goals adopted by United Nations which was to be achieved by the end of December 2015. Though looking at the pace and progress made till now, like many other goals this will also miss the target. Growth is always considered as a best remedy for poverty. For growth finance is of utmost importance so to provide finance in the right amount and right time is always on the priority list of government.

Direct links between poverty and finance is an interesting field of research. In this chapter I will look at the linkages between finance and poverty in India post liberalization. Poverty estimates are based on NSSO (National Statistical Survey Organization) household consumption expenditure survey. Since 1990s India has achieved significant economic growth but as thought it could not contribute much towards poverty reduction. Trends of poverty after the implementation of new economic policy have been a matter of intense controversy. Some scholars' support Planning

Commission's stand that poverty has reduced as a result of new economic policy. But there are others whose advocate the worsening of poverty after new economic policy came into effect.

By using head count ratio as measures of poverty and different financial inclusion indicators we have analyzed the relationship between financial inclusion and poverty reduction in both rural and urban areas. Since it is a panel data so to choose the right model for analysis Hausman test was conducted. This is generally conducted to choose between the fixed effect and random effect model. It tests the null hypothesis that the coefficients estimated by the efficient random effects estimator are same as that of fixed effect estimation. From our test for the rural area the Chi square statistic is significant so we have used fixed effect model.

When rural poverty was regressed over all the estimators of financial inclusion and other control variables like literacy rate of the state, per capita net state domestic product none of the variable was coming out to be significant so we left few variables like bank penetration (measured as number of accounts per capita), PCNSDP (Per Capita Net State Domestic Product). We regressed our equation again though this time also offices came out to be significant at 5% level along with literacy rate which is highly significant at 1% significance level. Coefficient of credit though is negative but insignificant. This goes with most of the findings emphasizing on the expansion of bank branches. This result to some extent is in line with the findings of many scholars such as Stiglitz, 1998 and Jalilian and Kirkpatrick, 2001 whose research found that financial development can help poor by addressing financial markets failures. Also increase accessibility of the formal banking can open up many opportunities for small borrowers by decreasing high cost of lending. Literacy rate has a negative impact on rural poverty and is highly significant at 1% level. Thus our result supports the research done by Raghbhendra Jha and many others claiming that poor literacy along with low asset ownership is amongst the many other reasons for existence of rural poor.[1]

[1] Jha, Raghbendra. Rural Poverty in India: Structure, determinants and suggestions for policy reform

Model for rural areas.

$$PovertyRit = \beta0 + \beta1\ \ X1it + \beta2\ \ X2it + \beta3\ \ X3it + \beta4\ X4it + \beta5\ X5it + \beta6X6it + \varepsilon it,$$

$i = 1, \ldots, 18$, $t = 1993, \ldots, 2012$.

Variables defined in Methodology chapter

Table 1: Regression Results for financial inclusion and poverty reduction

Dependent variable	Poverty
Variable	coefficient
Constant	67.89***
	(10.75)
Offices	-.0068 **
	(.0028)
Credit per capita	-.000258
	(.0005)
Deposit per capita	.0000629
	(0.0003)
Literacy rate	-.3839 ***
	(.129)
R-Square	0.43

NOTE: 1. No. of observations

2. Standard errors are reported in parentheses.

3. *, **, *** indicates significance at the 90%, 95%, and 99% level, respectively.

For urban areas also we conducted Hausman test. The Chi Square statistic is significant in the test. So, here also we are running a fixed effect regression model. The results for random effect are as under:-

Model for Urban areas

$PovertyU_{it} = \beta 0 + \beta 1\ X1it + \beta 2\ X2it + \beta 3\ X3it + \beta 4\ X4it + \beta 5\ X5it + \beta 6X6it + \varepsilon it,$

$i = 1,\ldots,18,\ t=1993,\ldots,2012.$

Variables defined in Methodology chapter

Table 1: Regression Results financial inclusion and poverty reduction

Dependent variable	poverty
Variable	coefficient
Constant	36.72 ***
	(6.77)
Offices	-.0091 **
	(0.003)
Per capita NSDP	-.00007
	(0.00016)
Literacy rate	0.0175
	(0.14)
Credit	-.00001
	(0.0001)
Deposit	9.04
	(0.0001)
R-Square	0.55

NOTE: 1. No. of observations

2. Standard errors are reported in parentheses.

3. *, **, *** indicates significance at the 90%, 95%, and 99% level, respectively.

In urban areas none of our financial inclusion indicators are showing any significant effect on poverty. For offices we have negative relationship with poverty which is significant at 5% level. Apart from that we have negative coefficients with per capita net state domestic product and credit but they are not significant. Similar results are shown by some scholars such as Meghana et al. the result of which state that financial inclusion in not effective in reducing urban poverty. This may be because in urban areas dearth of finance is not as severe problem as that in rural area. One of the major reasons for poverty in rural areas is lack of timely credit but in urban areas there is whole lot of other issues responsible for poverty.

Conclusion

There is a need to look at poverty in both urban and rural areas differently. With single approach we cannot reduce poverty in both areas. Policy aiming at poverty reduction should be made keeping in mind the distinct nature of both areas. Common measure of financial inclusion for both areas cannot help in achieving the desired target of 100% financial inclusion and minimum poverty. For rural areas spread of banking facilities can reduce poverty as it provides cheap and affordable credit. Studies have shown credit and deposit penetration as negatively co-related with poverty (Levine and Beck, 1998). But in this study credit is negatively related to poverty but is not significant. Financial deepening is more effective in reducing poverty as compared to financial breadth (Ayyagari et. al, 2013). But the results in my study has shown that its financial breadth which reduces poverty more effectively than financial deepening in both rural and urban areas though with different level of significance. Higher literacy can reduce poverty in rural areas but no such relation was seen in urban areas. Expansion of bank branches can be an effective tool to reduce poverty in both rural and urban areas. This will enable people to come in formal banking system and through that in the mainstream economy which will help them to better use different services and less chances of exploitation.

CONCLUSION

With the efforts of Government and RBI, there has been an increase in the number of people coming in the main stream of banking but still a major percentage of rural population is outside the formal banking system. There can be many reasons for that like denial by bank to open bank account in case of not having minimum deposit to open an account. RBI initiative of no frill account is a positive step in this regard but not much development has been made on this front. We need to put in place stringent laws and make banking as a fundamental right and duty of people. There have been such laws at some places across the Globe like in Canada where everyone having proper identification has the right to open personal bank account without any denial from bank on account of being unemployed, previously bankrupt, no minimum balance, etc. Similar law is applicable in United Kingdom.

India has still very low level of financial inclusion as has been analyzed from different sources. As per census data, 2011 we have only 58.7% of our households availing banking services in India. This is also marred by huge disparity across states. This needs to be addressed soon. There should be development of all aspects of society simultaneously. It has been seen that states having low level of households availing banking services have also done poorly on other economic indicators like poverty, employment, social development, etc. The low demand of financial services can be attributed to low incomes, illiteracy, lack of confidence, poverty, etc. Both financial inclusion and poverty are mutually reinforcing thus there is a need to encourage poor and illiterate people to come to mainstream banking. This can be done by making compulsory that all households should have at least one bank account whose usage can be ensured by transferring social security money to their accounts like that of pension, medical aid, education, etc. This can now be achieved more easily with the help of ADAHAR cards providing unique identification number to an individual and helping him to reap benefit of schemes like Direct Benefit Transfer (DBT) which among other things also aims at financial inclusion. People can use this money efficiently and with the saved one productive investment can be done so as to generate income and step up their ladder of hopes and joy. Along with implementation of the scheme there should be effectively tracking of its progress so as to evaluate its potential in achieving the desired goal.

Both RBI and Government has taken various efforts include re-orienting priority sector lending to have specified listed targets so as to include marginalized and excluded people. Agricultural sector and small and medium enterprises are also being taken into account for making them more productive and remunerative. From my research there is need to have more and more banking offices i.e. financial breadth to reduce poverty in rural areas. Credit penetration and deposit penetration did not have significant relationship with poverty. Though Credit penetration is negatively associated with poverty but its coefficients are insignificant in both rural and urban areas. On the financial inclusion front, some states mainly from south has done well whereas the other states like from Eastern India there is absolutely very low levels of people having or using banking services. Since having higher number of offices can be a big boost to alleviate poverty so it is required to expand financial breadth of the country as far as possible.

Prime Minister's Jan Dan Yojna is a big leap towards achieving Financial Inclusion. It enables poor and less resourceful to have zero balance bank accounts and operate them with minimal savings. This will inculcate the saving habits in the poor and will direct them towards investment and better prospects of life. More and more such policies needs to be put in place to attract people towards formal banking and reduce their dependence on informal sources which are more exploitative than being helpful. Though the effects of this scheme still needs to be analyzed but if it works and attains its goal this can be a big boost to towards India's dream of having 100% financial Inclusion.

There is a need to spread knowledge about benefits of banking among masses particularly in rural areas. Providing banking facilities to the far flung rural areas will involve huge initial cost. Therefore it is required to have special budget allocation for the full fledged spread of banking. Since we have seen that expansion of bank branches reduces poverty therefore effort and policies should be put in place to have maximum possible expansion of banks. Along with expansion of banking facilities people should be made aware of those facilities.

Financial literacy which means educating people about different financial services and encouraging them for their use should be promoted in far flung and backward areas. Bank employees should also be made sensitive towards the illiterate and ignorant people. They should make them confident to use financial services. Rules and regulations should be simplified so that a person with basic minimum education should be able to apprehend the procedures of the bank. Government should try to link all welfare schemes with the banks so that people can inculcate the habit of banking and come under formal banking to achieve the goal of 100 % financial inclusion. Regional Rural Banks, NABARD and Self Help Groups can be very helpful in expanding the banking sector to rural areas as they are well versed with know-how of the local conditions and thus can better execute the plan of spreading financial services to rural areas.

APPENDIX 1

State wise distribution of bank offices at different time intervals in rural areas.

STATES	1994	2000	2005	2012
Andhra Pradesh	3726	3620	3676	4814
Assam	1114	1081	1064	1249
Bihar	4419	4423	4427	5278
Gujarat	2440	2366	2363	3103
Haryana	1031	1085	1152	1674
Karnataka	3218	3236	3261	3925
Kerala	2486	2675	2879	3662
Madhya Pradesh	3785	3606	3514	4283
Maharashtra	3369	3391	3339	4280
Orissa	1908	1927	1936	2609
Punjab	1694	1782	1888	2827
Rajasthan	2635	2632	2613	3364
Tamil Nadu	3063	3048	2986	4592
Uttar Pradesh	7029	6937	6964	5720
West Bengal	3025	2280	2857	3364

APPENDIX 2

State wise distribution of bank offices in urban areas at different time intervals.

STATES	1994	2000	2005	2012
Andhra Pradesh	1153	1606	1843	3519
Assam	141	182	208	390
Bihar	557	655	730	1552
Gujarat	1106	1366	1444	2445
Haryana	305	423	540	1348
Karnataka	1276	1604	1853	3212
Kerala	557	643	730	1344
Madhya Pradesh	719	956	1109	2119
Maharashtra	2550	3043	3369	5328
Orissa	266	320	369	710
Punjab	553	766	876	1519
Rajasthan	569	733	868	1572
Tamil Nadu	1530	1858	2035	3049
Uttar Pradesh	1731	2126	2409	4476
West Bengal	1351	1669	1804	2697

APPENDIX 3

State wise distribution of credit (in lakhs) in rural areas at different time interval

STATES	1994	2000	2005	2012
Andhra Pradesh	509113	1083987	3277899	9613585
Assam	82444	142999	363514	1290402
Bihar	245706	467208	636550	2078159
Gujarat	336630	649887	1838714	3791831
Haryana	160989	230087	963825	3622354
Karnataka	365727	975140	2183445	5628009
Kerala	382176	955858	2305512	1280513
Madhya Pradesh	278577	563774	1098918	2274333
Maharashtra	284984	740497	1824006	5853329
Orissa	148405	320088	913705	2314301
Punjab	343034	775378	1596818	5909382
Rajasthan	205645	450053	1140923	4087098
Tamil Nadu	493821	1019285	2604811	11262524
Uttar Pradesh	611053	1133167	2630619	6400760
West Bengal	226703	340785	793987	2649508

APPENDIX 4

Statewise distribution **of** credit (in lakhs) in urban areas at different time interval

STATES	1994	2000	2005	2012
Andhra Pradesh	689490	1893901	4774817	28807618
Assam	47818	127117	263562	1222001
Bihar	150877	372699	851710	3553375
Gujarat	545275	1718093	3512066	17550283
Haryana	130993	359219	926961	7955185
Karnataka	673089	1932798	5976486	23651588
Kerala	267402	665631	1571546	8236260
Madhya Pradesh	334872	952599	1985514	9040998
Maharashtra	3759627	12234417	34516078	134614042
Orissa	100576	209181	730509	3568676
Punjab	257156	749009	1696699	8082271
Rajasthan	227312	663313	1800287	9607440
Tamil Nadu	1283025	3869003	8773991	35359233
Uttar Pradesh	517442	1197958	2992032	12663567
West Bengal	1069366	2377859	5063468	21226401

APPENDIX 5

State wise distribution of deposit (in lakhs) in rural areas at different time interval

STATES	1994	2000	2005	2012
Andhra Pradesh	761846	1743804	3277899	8301137
Assam	195484	493500	1034178	3140945
Bihar	784131	2312768	2284459	6299244
Gujarat	802895	1752847	3117431	8440665
Haryana	354029	908219	1770053	3866563
Karnataka	593884	1475639	2668176	6797259
Kerala	1063567	2766553	4821815	11574090
Madhya Pradesh	558070	1444429	1507032	4179483
Maharashtra	596746	1480022	2526750	9216676
Orissa	237595	777817	1522429	5947727
Punjab	929448	2160072	3714554	8599731
Rajasthan	446968	1148151	2002413	5882921
Tamil Nadu	716124	1809677	3294921	11105418
Uttar Pradesh	1621742	4054895	5463689	13898407
West Bengal	702456	1591885	2747063	8258798

APPENDIX 6

State wise distribution of deposit (in lakhs) in urban areas at different time intervals

STATES	1994	2000	2005	2012
Andhra Pradesh	932694	1692122	6544574	26216562
Assam	119960	350942	743987	3516110
Bihar	491235	1427577	3218628	13791167
Gujarat	1113552	3079862	6651361	21868431
Haryana	255203	797104	1905253	10717867
Karnataka	988783	3115427	8100160	34210815
Kerala	413451	1137941	2084031	8481907
Madhya Pradesh	557850	164409	2031859	8564102
Maharashtra	6579311	2538457	35694174	143769996
Orissa	176846	496584	1139454	6499094
Punjab	585688	1711458	2862510	8690503
Rajasthan	433089	1235732	2279909	9180196
Tamil Nadu	1438877	3707817	7663590	28786616
Uttar Pradesh	1409864	4212595	6915215	25458462
West Bengal	2121138	4383025	8444877	29135721

APPENDIX 7

Percentage of households using banking services as per census 2011.

State	Households (%)
Andhra Pradesh	53.1
Assam	44.1
Bihar	44.4
Gujarat	57.9
Haryana	68.1
Karnataka	61.1
Kerala	74.2
Madhya Pradesh	46.6
Maharashtra	68.9
Orissa	45
Punjab	65.2
Rajasthan	68
Tamil Nadu	52.5
Uttar Pradesh	72
West Bengal	48.8
Chattisgarh	48.8
Jharkhand	54
Uttranchal	80.7
All India	58.7

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