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# EMPIRICAL LITERATURE REVIEW ON FINANCIAL INCLUSION AND POVERTY REDUCTION

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## Abstract

In the economic system of countries, financial inclusion plays a vital role. The multi-dimensional concept of financial development is financial inclusion. It ensures access and use at an affordable cost to all individuals of the basic formal financial services. This is obvious because of the global financial crisis when financial institutions continue to provide credit, savings, insurance, payment and transfer services. Thus financial inclusion has an impact on the lower income groups proportionally and significantly. The theory of financial inclusions were reviewed in this paper. Important theories such as Gerschenkron's Great Spurt theory, theory of classical economics, theory of social welfare, finance-growth-nexus theories and theory of contemporary development have been discussed in this Section. The second part was dealt with in Sri Lanka and other regions for the review of empirical studies. Finally, the results showed that many important variables affect poverty alleviation. The main variable of poverty alleviation and the reduction of income inequality within the nation are literacy, household economic status, infrastructure levels and economic policies. This paper concludes with the summary of the empirical review of financial inclusion studies and provides recommendations for the future direction of research.

## 1. Introduction

Funding inclusion can be defined as having access to useful and affordable financial products and services that meet its financial needs by individuals, companies and any other segment of society. This term was also defined as the proportion of banked persons and companies (or non-banked for measuring financial exclusion (FE) (Rastogi & Ragabiruntha 2018). Leeladhar (2006) reviewed that financial inclusion is providing timely and affordable banking services to underprivileged groups and low-income sections in the society.

The multi-dimensional conception of financial development is financial inclusion. It ensures that all individuals have access to and use of formal basic financial services at an affordable cost. Credit, savings, insurance, payments and transfer facilities are essential formal financial services. Without these services, individuals often rely on informally available and cash equity financing; exclusion is probable to have unreasonable, negative impacts on low-income groups. The promotion of financial inclusion therefore plays a major role in alleviating poverty and reducing income inequalities in one country. The study was aimed to study the relevant theories connection with the financial inclusion and poverty reduction. Therefore, the following theories were reviewed.

## 2. Theoretical review

The theories are explained by scholars studying social economic growth who have tackled the connection between financial inclusion and poverty reduction. Most of them look at the challenges created by conventional banks that leave out the marginalized "poor".

### 2.1 Gerschenkron's Great Spurt Theory

The theory described the impact of industrialization in transforming an underdeveloped economy into a modern industrial economy and emphasized that there should be veritable break from the earlier system or a rapid industrial development (Balami, 2006). He emphasizes that type and the industrial development method depends on the degree of backwardness in each economy. The economies backward once shaped into separate classes supported the extent of industrialization. In his study economies were categorized in to four as very backward, backward, moderate and advance. Further emphasizes that activities in factories, involvement of banks and policy support of state will help in development and transition of a very backward economy. Although the idea suggests the appliance of capital intensive technique within the production process so as to spark the good spurt, it is very well recognizes the importance of a sound financial system ready to capture all the economic activities of the people within the economy for the economic processes and improved standards of living being desired to be achieved. Although some authors believe that the idea won't work for an economy with an outsized labor like in Nigeria as it discourages the utilization of labor which could increase the extent of unemployment and reduce the quality of living of some people (Okoye 2017).

### 2.2 Classical Economics Theory

In the classic wealth of nations of 1776 Adam Smith initially discussed the concept of free market economy. In the economic situation, the economy had to work alone, with supply and demand interacting to create a balance in a country's economy, he advocates the invincible hand.

This theory is based, according to Adam smith, on the concept of a laisser-faire concept. This is a free market concept which requires minimum to no government intervention, it gives full freedom for the people to make their own economic decisions. It allows business to allocate their economic resources as per the interest of their customers. Bagehot (1873) in his classical Lombard street highlighted that the banking system carries a paramount importance in intervening and funding productive investments in economic growth and encourage innovation.

In this regard, Schumpeter (1912) is very explicit: thus, the banking officer is not so much a middleman as a producer of this commodity in the commodity buying power. Further emphasized greater financial products and services, mobilizing savings, assessing projects, overseeing risks, monitoring managers, and assisting transactions are prerequisites in achieve technological innovation and economic development.

### 2.3 Theory of Social Welfare

Bergson (1938) emphasized that value judgment is an essential requirement in achieving an extreme economic welfare. He believed that the theoretical justification in financial regulation in general, is predicated on the notion of theory of social welfare. The main objective of this theory is to resolve the problems arising out with credit with the help of basic project analyzing tools.

It argues that the social value of a financial institution 's performance is its profundity, value to users, cost to users, width , length and scope. The extent or the terms of the loan agreement, the cost of price and transaction borne by users, the number of users, the financial and organizational capacity of the loan holder, and the number of goods offered, including deposits, is commonly responsible for their excesses the amount or poverty.
Rhyne (1998) agrees with the theory and states that sustainability is the result of enhancing the social welfare but not an end. This theory has relevance in financial insertion as finance institutes pay more attention on the poor than on the rich. Because the society is considering a loan given to a poor widow as a valuable finance aid than giving a loan to a rich person. Deeper outreach usually increases not only social value but also social cost because the less privileged people are unable to signal the capability and commitment to repay (Conning 1999). Woller et al.,(1999) noted that a financial institution can continue to provide assistance without sustainability. However, more sustainability reinforces incentive structures, which serve to maximize the expected social value less the reduced social costs over time.

**2.4 Finance-Growth Nexus Theories**

The theories of Bagehot (1873) and Solow (1956) were developed in the Financial Growth Nexus. These theories support that financial advancement builds a productive atmosphere for growth through 'supply leading' or 'demand following' and limited access to finance significantly influence on constant income disparity as well as sluggish growth. Access to proper finance system is a prerequisite in achieving accelerated growth and reduced income disparities along with poverty. Further People will be given an opportunity to penetrate the economy and take part of the development process and reinforce themselves in facing any kind of economic shock. There are different opinions on this theory by Economists.
Those who argue on demand view claim that the financial system doesn't stimulate economic growth; rather the financial system does.

Economists favoring the financial growth argue that according to (Goldsmith 1969, McKinnon 1973 and Levine and Zervos 1996) there should be an energetic financial sector to enhance growth in an economy. It is argued by the ones who favors supply leading theory that financial markets were developed in line with the increased demand of financial services in developing economies. Therefore, the development of financial markets reflects growth in other sectors of the economy. This theory has made a positive connection between financial inclusion and economic development or reduction of poverty.

**2.5 Modern Development Theory**

Limited entrance to finance is a crucial factor in unrelenting poverty and slower growth, Hoff and Stieglitz (2001).Aa certain part of the population faces in difficulties in accessing financial services in an immature financial system and as a result, they were looking for financial aids from different type of informal financial providers with high rate. This is specific for low-income households due to mismanagement and irregular financing requirements and the insensitive medical expenditure. In mature financial systems, financial institutions have proper appraisal techniques which allow them in financing people and firms who are at the edge and assist them in their socio-economic development. World Bank 2008 emphasized that free and fast access to finance possibly will expedite poverty reduction and in the absence of an inclusive financial system may frame poor individuals and small enterprises to depend on their own funds that they have for education and investments to take part in the development process.

**3 Empirical Review**

Many models in development economics show that financial inclusion may alleviate the poverty. Voica (2017) emphasize poor and vulnerable people should have easy accessibility to affordable financial services to attain viable economic growth and it allows a quicker integration of socially excluded people to reach economic development. Park and Mercado (2018) examined that there is a substantial contribution of financial inclusion in reducing poverty rates employing various indicators in Asian developing countries. Increased financial inclusion result in declined poverty rate. The result shows that the relationship between poverty rates and financial inclusion is negative. They concluded that financial inclusion vastly contributes in reducing and mitigating poverty and lessen income disparities. Gunarsih, Sayekti and Dewanti (2018) investigated financial inclusion in Indonesia and the strategies to reduce poverty. Financial inclusion is the main driving force towards economic growth and poverty mitigation, easily accessible finance system creates new jobs, strengthen the ability of individuals and firms in fighting economic shocks and increase investments in human capital. In the absence of inclusive financial system, the firms and individuals must depend on their own limited resources in satisfying their financial needs.

There is an increasing number of services in financial institution and number of credit accounts in 2012-2017 and as result, decreased number in poverty in the same period. They suggest that increasing of financial inclusion accompanied by decreasing in poverty, the higher the financial inclusion the lower the poverty. This argument supported by negative correlations between financial inclusion indicators and poverty. Hussaini and Chibuzo (2018) highlighted that microfinance moderates the relationship between financial inclusion and poverty reduction. Research findings show that the effects of financial inclusion in poverty reduction are positive and significant.

Poor and vulnerable people in the society are likely to take the benefit of available financial services in investing which will increase their level of living standards. Olokoyo and Babalola (2017) evaluated the contribution of financial inclusion as a promoter in poverty mitigation in Nigeria referring to activities in financial inclusion between 1992 and 2016, the results shows that financial inclusion activities such as enrolling of new customers to the system, promoting of current and savings accounts, expansion of loans to the agricultural sector significantly contribute in per capital income of the people and poverty mitigation. As a result of higher rate of the loans charged by DMBs may lead to a lower par capital income of poor and increase their level of poverty.

The impact of financial inclusion on poverty reduction in Ekiti state, Nigeria was examined by Sanya and Olumide (2017), study comprised 168 adult households in Ekiti state, drawn from six Local Government Areas of the state using multistage sampling technique. Two groups were drawn from each of the Local Government Area, creating a total of 12 groups, descriptive statistics and multinomial logit were employed in analyzing data. The descriptive analysis of the data showed that the number of commercial banks across the state was extremely low with limited bank services were available such as ATM, money transfer, union bank transfer etc. Informal financial sector such as ‘Awiko’ contributions, Ajo, Esusu etc. were dominated savings and procurement of loans due to this limited banking services. Procedures for opening new accounts were somehow difficult that discouraged most of the intending savers and new account openers. Bank robbery and money snatching were uncontrolled in the studied rural areas. Further the study discovered that the rate of patronage of bank services and bank products. It is concluded that more commercial banks branches and cash centers should be opened across the three senatorial districts of the state to grant access to bank products and services.

Aguera (2015) studied the importance of financial inclusion and highlighted FI as one of the main influencing factors in economic development and lessening poverty. Access to finance create new jobs, strengthen individuals and firms in fighting economic shocks and boost investments in human capital. Aguera argued an absence of an inclusive financial system cause individuals and firms to depend on their own limited funds in meeting their financial requirements.

Microfinance is significantly influence on the income and the expenditure of households, (Lavong, 2015). Study found that though the impact of microfinance is positive on the household income and expenditure it is statistically insignificant. Imoisi(2014) analyzed Impact on Poverty Alleviation in Nigeria and found out that the relationship between microfinance and living standard in Nigeria is positive. Further stated that 78% of respondents who obtained microfinance loans had initiated their own business, 67% had invested in expanding their existing business and 24% had invested on acquiring new technology for upgrading their business and 9% of them invested in exporting their manufactured goods.

Abel, Grace and Willie (2014) examined the factors influencing on lessening poverty in household who obtained microfinance loans in Zambia and found out that most of the respondents have improved their standard of living with the help of microfinance schemes. Study done in Malaysia by Sayed (2015) analyzed the Impact of Microfinance on lessening poverty and concluded that the impact caused by AIM is positive on household income of women borrowers who are actively in the scheme for three years rather than the new borrowers.

Rahman (2010) studied “Islamic microfinance: an ethical alternative to poverty alleviation” and concluded that Islamic finances with free interest has an important role in the development of the poor and small entrepreneur’s standard of living. Further debated the ethical perspective of Islamic view and the principals of microfinance and concluded that Islamic microfinance has an ethical contribution on the socio-economic development of the less privileged people and small-scale entrepreneurs. Haneef et al.,(2015) investigated the combination of Waqf-Islamic microfinance in reduction of poverty in Bangladesh. Data were measured using software from AMOS and the findings show that a strong relation between Is MF and Takaf Wakaf resources is established, and takaf human resources are used to mitigate poverty and project funding and integration of all three structures.

Cyn-Young and Ragelio (2015) studied the relationship between financial inclusions, poverty, and income disparities in 37 countries in developing Asia and concluded that the extent of financial inclusion can be determined by country-specific factors and macroeconomic variables. Further found that demographic factors and per capita income has a significant impact on financial inclusion and FIs lessens the income disparity and poverty. Finally, financial inclusion efforts can be improved by enforcing robust regulations on finance, rule of law and administration of financial contracts.

Financial inclusion can be used as a strategical tool in inclusive growth in Nigeria (Migap et al.,2015). Nigerian financial inclusion index was compared with the similar economies with upper middle-income levels inside and outside Africa and observed that Nigerian financial inclusion indicator is narrow compared to other similar economies. A case study of Nkweder (2015) took Nigeria into account as a case study. The study covered the period

1981-2013 and found that the relationship between financial inclusion and Nigerian economic development has been negative. Onaolapo and Odetayo (2012) studied financial inclusion in Nigeria from the viewpoint of banks who are in microfinancing , survey design method was used and concluded microfinancing for less privileged people in the society encourages new job creation, alleviate poverty and socio -economic development.

Joseph and Varghese (2014) have studied financial inclusion in the Indian context and addressed the financial inclusion impact for India's socio-economic development. Activities were investigated between June and November 2013 in five private sector companies and five State banks. In-home and in-house ATM use has been used, as proxies for the financial inclusion variable in rural and semiurban areas in India, how many bank branch branches are available at service, credit cards and debit cards per client. Results shows that considerable amount of people are still needs to be absorbed into the system despite an inclusive banking initiative in the country. The financial inclusion in Zimbabwe was reviewed by Chitokwindo, Mago and Hofisi (2014). Qualitative research methodology and exploratory approaches were employed and found that financial inclusion takes different forms and contributes significantly to rural poverty.Study recommended in develop the rural banking sector for local resource mobilization and business development.

Descriptive study and content analysis were used in the study done by Nwankwo and Nwankwo (2014) and analyzed the sustainability of financial inclusion to rural dweller in Nigeria,. The study commented that the sustainability of financial inclusion to rural householders in Nigeria remains the mainstream for economic growth. Increased usage of mobile phones promoted the mobile money transfer systems in Sub Saharan Africa, Munyanyi (2014) showed that mobile money transfers are significant promoter of financial inclusion in Zimbabwean rural communities. A cross sectional study was carried out to study the population, results showed that increased access to financial services result in improved financial inclusion. Chithra and Selvam (2013) in their study emphasized that socio-economic factors like Income, Literacy and Population are having a notable correlation with the extent of financial inclusion. Physical infrastructure for connectivity and information too showed a considerable involvement in financial inclusion. Out of the banking variables deposit and credit penetration showed a considerable involvement in credit-deposit ratio and Investment ratio showed no substantial association with financial inclusion.
Most of the concepts and empirical evidences found in early studies support the argument that financial inclusion reduces poverty. But Naime and Gaysset (2018) in their study revealed that there is no relationship between financial inclusion and poverty. The Generalized Moment method (GMM) or Generalized Lead Squares (GLS) were used to assess the impact of financial inclusion on income disparity, poverty and financial stability using econometric models and a large sample of 8 MENAs over the period 2002-2015. Empirical results showed that financial inclusion reduces income gaps, but population size and inflation increase earnings gaps. Other empirical results show that financial inclusion has no effects on poverty, but population, inflation, and trade openness are having a substantial contribution in increasing poverty. Those suggest that there are still inconsistent results in financial inclusion and poverty research. Some empirical research supported the concepts and arguments that financial inclusion alleviate poverty while the other did not.

The effects of microfinance on the mitigation of poverty on credit amount, payments, accessibility and interest rate, as independent variables, have been investigated by (Wijewardana and Dedunu,2017). Correlating test results show that statistically significant poverty alleviation associations in four IVs and regression tests indicate that the amount of loan, reimbursement capacity and microfinance loan holders of Anuradhapura District have statistically significant positive impact for mitigation of poverty. The negative and statistically significant impact of interest rates on poverty alleviation at level 0.05 and the impact on loan accessibility at level 0.05 is statistically significant. The study identified that there is a significant contribution of microfinance in reducing the poverty level of poor people in Anuradhapura. The findings of the study recommended that poor people in the area needs be facilitated with loans with lower interest rate and the amount of loan facilities needs to be increased by microfinance institutes to improve the living standard of people.

Anurdhapura and Polonnaruwa both districts are situated in the province of North Central. Kaluarachchi and Jahfer (2014) investigated the micro financing and poverty mitigation in the district of Polonnaruwa while Wijewardana and Dedunu (2018) focused on Anurdhapura. The study focused on investigating the micro financing and poverty mitigation in the district, microfinance beneficiaries in the area were randomly selected for the study. Loan amount, ability of repayment, access to loan facilities and rate of interest were identified as independent variables of the study and poverty alleviation was identified as the dependent variable and concluded that microfinance schemes for poor in the area has a considerable contribution in improving the living standards of poor and contribute poverty alleviation in the area.

Samurdhi saving and credit scheme was initiated by the Sri Lankas' government to alleviate the poverty among less privileged people in Sri Lanka. Wide network of Samurdhi bank branches were opened across the country to serve poor people in the country. Jayasuriya (2007) investigated the Impact of Samurdhi saving and credit programs in poverty mitigation in the district of Kegalle. Data was collected from 20 Samurdhi holders from five Samurdhi banks from Kegalle district. Findings indicated that Samurdhi credit scheme has a significant contribution in improving their living standards of people in the area, most of them have graduated to higher loans for the development of their own project resulting high level of employment.

Microfinance and Livelihood Development in Coastal Communities in Eastern Sri Lanka was studied by Thilepan & Thiruchelvami (2011). Study was carried out to investigate the involvement of microfinance in developing the livelihood of coastal communities in the district of Trincomalee. The study found that microfinance has a significant influence on people's income and savings level. Accordingly, 39.5% of respondents' level of income is said to be increased and 14.2% of respondents' private savings to be increased. Despite the level of financial inclusion in Sri Lanka is relatively high the usage of digital products is minimal. Debit and credit card usage, phone banking, and e-banking are still to be improved.

There is a wide network of banks and non-bank financial providers offering a range of financial products and services in Sri Lanka .Despite the growth and expansion of financial institutions , there are number of gaps in the existing system which need to be addressed such as cost and quality of the services provided, the sustainability of financial institutions, people's knowledge on the financial services and products, and repayment capacity.

**4 Determinants of Financial Inclusion**

The contribution of the "poor" in financial inclusion is an essential requirement in mitigation of poverty. It is necessary to set up the determining factors of inclusive finance to create suitable policies to get the society involved in terms of financial inclusion services. In this section, an attempt has been made to examine some of the social-economic factors that dictate financial inclusivity.

**4.1 Literacy level**

The level of education of the population measured by the average number of years of schooling has been known to be positively correlated with the process of financial inclusion (Kuri & Laha, 2011). Financial literacy is an important for an individual in making decisions with their financial resources. It includes skills and knowledge in everyday usage and long-term vision and planning. It is argued that standard classroom lectures do not impact on financial inclusion, but strategic and targeted interventions have an impact financial knowledge. Areas with high level of financial literacy have high levels of financial inclusion compared to areas with low financial literacy levels.

**4.2 Economic status of households**

The possibility of seeking banking services increases with the increase in income level of individuals, households, and states. Higher income levels translate to high levels of financial inclusion (Park & Mercado 2015). Individuals with higher income levels are seeking financial services than the individuals with low income levels. The probability of becoming a bank customer increases with higher degree of economic status of the households.

**4.3 Level of Infrastructure Development**

Gonzales (2007) identified physical infrastructure for connectivity and information as having considerable involvement in financial inclusion. Road networks, telephone networks, access to information play a vital role in facilitating accessibility and awareness of financial services. The number of access points such as bank branches and Automated Teller Machines (ATMs) are positively related to financial inclusion. Inherently people in rural areas tend to be financially excluded due to low levels of infrastructure development and financial services investments in the area compared to urban dwellers.

**4.4 Economic Policies**

Financial inclusion involves financial intermediaries in designing products and services, regulations, processes and training staff and plan and deliver tailor made financial services and products. In modern day business it is compulsory for any system to create hospitable condition for all section in the society to achieve economic power and self-reliance. Financial institutions should make sure that there is a reliable bank branch network with easy accessibility to facilitate its customers in developing and growth activities. In turn the economic agents facilitate in growth, development, investment, generation of employment and development of infrastructure, which are now well recognized in the literature (Hartog & Oosterbeek, 1993).

**5 Conclusion**

The necessity in increasing savings to accelerate investment, socio- economic development of emerging economies and poverty reduction have been highlighted by most of the early financial strengthening theories.

There has been mixed evidence to support the efficacy of this approach. The global micro-finance movement has quickly been overtaken, promoting the benefits of providing direct financial services to the poor. Finance services with easy and quick access allow individuals and firms in managing their limited resources and achieving a higher standard of living. It plays a crucial role in a country's economic development. But both theoretical and empirical, differing views on financial inclusion are relatively new and fragmented, as is the relationship to economic development. Most recent and cross-border studies have been carried out. Evidently, there is point in putting questions to us, particularly in relation to Sri Lanka, about the relations between financial inclusion and economic development.

Above discussed evidences describe the contribution of financial institutes in Sri Lanka in enhancing financial inclusion. Despite the households and individuals are provided with a wide range of financial products and services the difficulties encountering by small and medium enterprises (SMEs) in accessing adequate funds are yet to be addressed. No sufficient data is available to reveal the extent of which level that SMEs have access to proper finance in Sri Lanka. Several studies have identified access to finance is as one of the main restrictions in Poverty reduction. This subject is not studied and reviewed due to non-availability of sufficient literature.

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