FINANCIAL INCLUSION IN KARNATAKA

ABSTRACT

Financial inclusion and inclusive growth are critical ideasthat have attracted attention of research in recent times. Inclusive growth empowers people from marginalized groups. In turn, this dependent on a number of factors, the most important being "financial inclusion", which plays a critical role in supporting inclusive growth and poverty reduction by providing regular and reliable sources of money to the vulnerable sections. In this direction, the Government of India in its drive for financial inclusion has taken several measures to increase the access to and availing of formal financial services by unbanked households. The goal of this report is to evaluate the nature and degree of financial inclusion as well as its impact on the socioeconomic condition of vulnerable households, with an emphasis on inclusive growth. This was investigated using theoretical background on financial access and economic growth, as well as primary data acquired from Karnataka’s Revenue Divisions.The results reveal that the nature and scope of financial inclusion are different. Access to, and usage of, the formal banking services open the way to positive and associated changes in socio-economic status for vulnerable households, leading to an inclusive growth, on which paper provides a model for increasing the inclusiveness and pro-poorness of the financial system.

Keywords: *Financial Inclusion, Impact of Financial Inclusion, Socio-Economic Status, Inclusive Growth*

1 INTRODUCTION

1.1 Background to the Study

In economic theory the term ‘inclusive growth’ is explained as the efficient and equitable apportionment of economic resources, whereby benefits touches all the components of the society. It is the participation of all sectors and areas of society in the economic growth and the achievement of growth benefits that achieve the growth equity goals.The term "inclusive growth" refers to "economic growth with equitable opportunity for all." It is nothing more than establishing chances for progress and making them available to all, particularly the impoverished (Ali & Zhuang, 2007).

Financial inclusion refers to the provision of financial services at an affordable rates to large segments of the disadvantaged and low-income populations.The Committee of Rangarajan, Government of India 2008 defines financial inclusion as 'the process to ensure that vulnerable groups, such as lower groups and low-income groups, have access to financial services and, where necessary, appropriate credit at affordable costs'. This is an endeavor to ‘mainstream the excluded,' which is critical to the inclusive growth process, which involves all segments of the population and economic regions.

Therefore, access to finance is a pre-condition for poverty eradication is an integral part of the growth process. But the in-ground reality the households of vulnerable sections are denied access to formal financial services. This is popularly known as financial exclusion, which occurs due to inaccessibility, distances, inadequate infrastructure, and low absorptive capacity of the poor households that hinders growth.

Data on indicators of access to finance at all Indian level, and in Karnataka, confirm a similar scenario. To study this problem further and to have an effective pro-poor financial inclusion policy that achieves the equity objective through poverty reduction, equal distribution of 3 resources and capacities is the need of the hour. This challenge of promoting inclusive growth by providing access to formal financial services is the background of this paper.

Since the inception of national plans, India has highlighted the importance of finance in achieving equal growth. The establishment of Rural Co-operatives, the Rural Regional Bank (RRB), NBABRD, the nationalization of commercial banks, government policies on social banking, rural credit, priority lending sector, lead-bank programs, interest rate ceilings, subsidies, etc., were a number and key measures.Even after this policy push to finance inclusion has taken place in India, there has been no formal banking service penetration in large household segments, and no access to financial services for the poor and marginal elements of society.

1.2 <u>Research Questions</u>

Given the dynamics and sensitivity of the matters covered in this dissertation, this work aims to provide the answers to the following research questions;

- To what extent has Financial Inclusion impacted the growth of the Karnataka economy?
- What are the key driving factors for the growth of Financial Inclusion in Karnataka over the last 10 years?
- What are the significant bottlenecks and challenges to the full adoption of Financial Inclusion in Karnataka?
- How has Financial institutions contributed to the growth of Financial Inclusion in Karnataka?

1.3 <u>Objectives of the Study</u>

The general objective of this work would be to investigate what the Impact of Financial Inclusion is on the economic status of Karnataka Households. The specific objectives of this work would then be the following:

- To understand the challenges facing the full adoption or implementation of Financial Inclusion policies in Karnataka.
- Assess the impact of Financial Inclusion on the Economy of Karnataka.

- To study the growth of Financial Inclusion in Karnataka over the last 10 years.
- To evaluate the role of Financial Institutions in the growth of Financial Inclusion.

1.3 Research Hypothesis

The following are the research hypotheses which are as derived from the research questions above in which considered as appropriately fitting for the purpose of this dissertation and would also be subjected to empirical investigations. These hypotheses have been stated in their null and alternative forms as given below:

- Ho - Financial Inclusion has not had any impact on the growth of the Karnataka economy
  H1 - Financial Inclusion has had significant impact on the growth of the Karnataka economy
- Ho - There are no key driving Factors for the growth of Financial Inclusion in Karnataka over the last decade.
  H1 - There are significant key driving factors on the growth of Financial Inclusion in Karnataka over the last decade.
- Ho - Financial Inclusion has had no bottlenecks and challenges to its full adoption in Karnataka.
  H1 - Financial inclusion has had significant bottlenecks and challenges to its full adoption in Karnataka.
- Ho - Financial institutions have not contributed to the growth of Financial Inclusion in Karnataka.
  H1 - Financial institutions have contributed significantly to the growth of Financial Inclusion in Karnataka.

1.4. Structure of the Study

The structure of this study is designed such that this work would have five sections in which the first section would be dealing with the introduction, the second section would be treating the reviews of theoretical literature (Literature review), the third section would be the theoretical framework of the literature. The fourth section would then comprise of the research methodology. Section five is the data analysis, while sectionsix explains the summarization of our findings, the recommendations prescribed, the conclusions drawn.

2 LITERATURE REVIEW

2.1 Dimensions of Financial Inclusion

An exploration of the supply and the demand side of financial inclusion reveals that internationally there is a wider perspective regarding the concept of financial inclusion. In India, presently, financial inclusion is limited to providing everyone with minimum access to the savings bank account. It is, having minimum facilities of banking by the general public or citizens of the country. Along with this, there are two extreme possibilities of access to finance. First, there is a group of customers who have access to all official financial services, and then there is a group of consumers who are financially excluded and refused access to the most fundamental financial products. Customers of banks who utilize banking services just for deposits and withdrawals without the flexibility of access to finance fall somewhere in the middle of these two alternatives.The multifaceted scenario shows that financial inclusion is a multifaceted notion with numerous characteristics relevant to the agenda of the specific region.

2.2. Role of Finance in Economic Development

The literature on finances' involvement in economic development advocates that, through the supply mechanism, finance development produces pro-growth circumstances in an economy. Adam Smith (1776) in the 18th century emphasized that the great volume of banks in Scotland was significantly related to Scottish economy development. Walter Bagehot (1873) and John Hicks (1969) believed that financial inclusion, through capital mobilization, played a crucial role in industrializing England. Schumpeter (1912) believed that a successful financial system leads to breakthroughs in technology.Joan Robinson argued in 1952 that ‘economic development and demand for financial services have a mutual relationship, and the economic system responds positively to this shift.' Simon Kuznets (1955, 1963) and Kaldor (1966) highlighted the early stages of development as the tradeoff between growth and social fairness until growth advantages permeate throughout the economy. According to the World Bank's (2005) literature on current development theory, "the progression of financial access, growth, and income dynamics of different generations are intimately related.”A group of social scientists (Aghion & Bolton, 1997; Aghion, Caroli, & Garcia-Penalosa, 1999; Banerjee &Newman, 1993; Galor & Zeria1993; Rajan & Zingales, 2003) contended that, due to capital market imperfections, vulnerable section households with high marginal productivity will have little money to invest in their education, and their occupational options will be limited due to low initial endowment.According to King and Levine (1993), financial access is a significant inducement for technical innovation. A well-functioning financial system opens the stage for more rapid and equitable growth. An index to measure access to finance by Patrick Honohan in 2004 in 160 countries revealed that economies with higher indices were advanced economies and societies with the deeper financial system had a low level of absolute poverty. Pitt and Khandker's Grameen Bank and MFI study in Bangladesh in 1998 found that the usage of credit had a significant and beneficial influence on household spending, assets, labour supply, and the chance of children attending school.Coleman's study on microcredit borrowers in northeast Thailand in the year 1999 proved an insignificant impact of credit on physical assets, savings, expenditure on health care, education, etc. 5 Gine and Townsend (2004), in their study between 1976 and 1996 on Thai households reveal that flexibility in financial access leads to an increase in access to credit services and explains the quick growth in per capita GDP in the economy. Burgess and Pande (2005) discovered, in one of the experiments on the Indian government's bank branch expansion policy conducted between 1977 and 1990, that there was a rapid increase in non-agricultural output and a decrease in poverty following the implementation of branching regulations and the opening of new bank branches. Kempson (2006) cites studies demonstrating a positive association between the Index of Financial Inclusion and the rankings of the UNDP Human Development Index (HDI), emphasizing nations with significant income inequality and less formal financial access.Demirguc Kunt and Levine (2007) argued that reducing financial market imperfections acts as a positive incentive resulting in the expansion of individual opportunities. According to the World Bank's research report on access to finance (2008), financial access can have both direct and indirect benefits for small businesses and poor households, making them more capable of taking advantage of investment opportunities and insuring them against risks. Cross-sectional data on Peruvian homes demonstrated that after receiving formal finance, there were favorable changes in household consumption expenditure, income prospects, and the number of children attending school. Therefore, without an inclusive financial system, impoverished people and small businesses must rely on their meagre savings and incomes to invest in economic and educational activities and capitalize on growth prospects.Even though the economic literature emphasizes the role of a well-functioning financial sector in the efficient allocation of resources and the exploitation of growth potential, Michael Thiel (2001) opined that the literature is less consensual on how and to what extent finance affects economic growth. In this regard, the current article aims to bring together empirical evidence of the influence of financial inclusion on the socio-economic status of vulnerable households in Karnataka's rural and urban areas.

3.THEORETICAL FRAMEWORK

3.1. Supply side of Financial Inclusion in the State of Karnataka

In December 2005, the regional office of the Reserve Bank of India (RBI) introduced Financial Inclusion in the state of Karnataka. The Rural Planning and Credit Department (RPCD) requested the State Level Bankers Committee (SLBC) of Karnataka to initiate the first phase of financial inclusion in the state. According to the SLBC report (2012), to provide formal financial services in Karnataka, there were 41 Commercial Banks (CB) with a network of 5122 branches. Along with this, there were other institutions like Karnataka State Cooperative Apex Bank (KSCAB) with 31 branches, nearly 21 District Credit Cooperative Banks (DCCB) with 615 branches and 4613 Primary Agriculture Cooperative Societies (PACS), about 6 Grameena Banks with 1256 branches, The Karnataka State Cooperative Agriculture and Rural Development Bank (KSCARDB) with 177 Primary Cooperative Agriculture and Rural Development Bank branches (PCARDB). Besides, Urban Cooperative Banks & other Cooperative institutions were also providing banking services in the State. According to the report, the number of people served by each bank branch in Karnataka was 8500, excluding PACS, and 5106 including PACS. 10 An examination of secondary data on universal access to formal banking services in the sample region across revenue divisions finds that formal banking access is offered to everybody without discrimination. (Table 1).

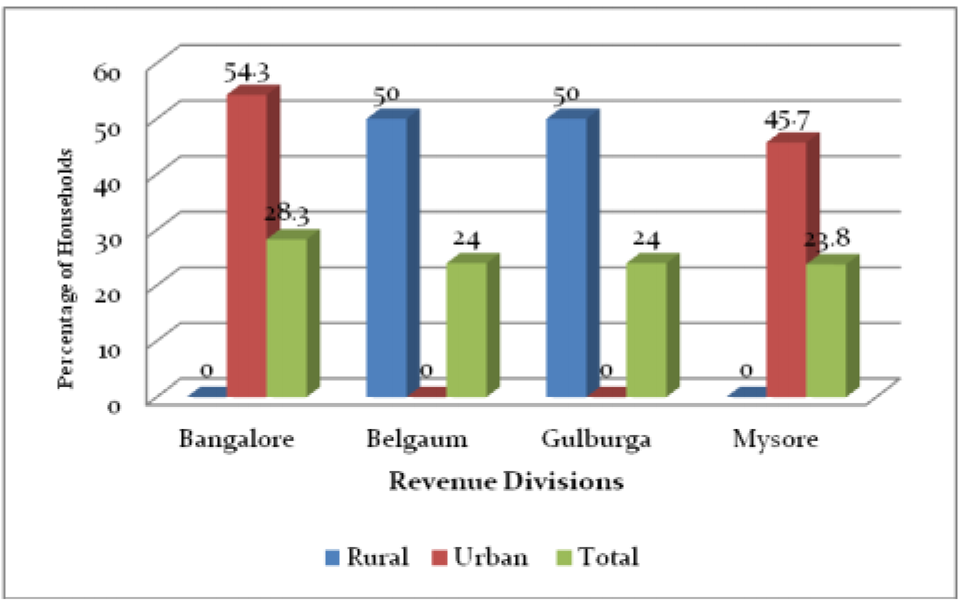
Table 1: Formal Financial Network Units Providing Access to Financial Services in the Sample Area

Taluks	Nationalized Banks	RRB	DCC Banks	KASKARD Banks	Co-operative Societies/Units
Mangalore	283	08	15	02	207
Anekal	44	04	01	02	141
Bijapur	43	19	08	01	519
Basavkalyana	14	11	07	01	347

Source: Districts Statistics, Official Website of Government of Karnataka 2013

3.2. Observations on Nature, Extent, and Impact of Financial Inclusion among the Rural and Urban Segments.

To study the nature, extent, and impact of financial inclusion among the rural and urban segments across the revenue divisions of Karnataka, nearly 1051 Below Poverty Line (BPL) households were selected. Out of this, nearly 504 were rural category households and 547 urban category BPL households. Across the revenue divisions, nearly 28.3 percent of urban households were from Anekal taluk in the Bangalore revenue division, about 24 percent each from Bijapur taluk of Belgaum revenue division and Basavakalyana taluk of Gulbarga revenue division. Around 23.8 percent of urban households selected were from Mangalore taluk of Mysore revenue division. Thus, about 48 percent of households selected were of rural category and 52 percent urban category households (Figure 2)



Source: Survey Data

Figure 2: Category of Households across Revenue Divisions

In terms of distance to banking services, nearly 78.6 percent of households had to travel less than 5 kilometers to access basic or other banking facilities, 20.6 percent of households were within 5 to 10 kilometers of formal 12 banking outlets, and only 0.8 percent of households had to travel more than 10 kilometers to access banking services.When compared to their urban counterparts, rural BPL households had a distance difficulty in accessing essential banking and other services, which was statistically significant, as shown by the Chi-Square test (X^2= 117.353, df=1, p=.0000.01, HS). (Table 2)

Table 2: Distance as Barrier in Accessing Banking Services

(Figures in percentage)

Distance as Barrier in Availing Banking Services	Region		Total
	Rural	Urban	
No	73.8	97.1	85.9
Yes	26.2	2.9	14.1
Total	100.0	100.0	100.0

Note: x^2 =117.353, d=1, p =0.000<0.01, HS

Source: Survey Data

CBs emerged as the primary route for delivering banking services among the 1051 rural and urban residents studied throughout Karnataka's revenue divisions.The majority of families had access to two or more official financial institutions to get banking services, and they were beneficiaries of government-sponsored poverty eradication, risk reduction, productivity enhancement, and human development initiatives. Across the revenue divisions, there was a disparity in access to and availing of formal banking services which were not penetrated the lower-income category, which started availing banking services in the recent past. In this regard, it was observed that, among 65.5 percent of the rural households, the nature of financial inclusion was below-average level. 13 Only 6.9 percent of rural households were in the above-average category and nearly 47.9 percent of the urban households had an above-average level nature of financial inclusion, while 9.1 percent were in the category of below average. In aggregate, about 36.2 percent of households had a nature of financial inclusion below average and 28.3 percent of households were in the above-average category. Across the revenue divisions, the difference between rural and urban households was statistically significant, confirmed by the Chi-Square test (x^2= 403.372, df=2, p=0.000<0.01 HS) (Table 3).

Table 3: Distribution of Households based on the Nature of Financial Inclusion

(Figures in percentage)

Nature of Financial Inclusion	Region		
	Rural	Urban	Total
Below Average	65.5	9.1	36.2
Average	27.6	43.0	35.6
Above Average	6.9	47.9	28.3
Total	100.0	100.0	100.0

Note: x^2=403.372, df=2, p=0.000<0.01, HS

Source: Survey Data

On average, in 79.2 percent of rural households, the extent of financial inclusion was below-average level. In aggregate, about 7.6 percent of households had the extent of financial inclusion above-average level. Among the urban households, nearly 31.2 percent of households had the extent of financial inclusion below average and around 56.5 percentage households had it above average level.

4. RESEARCH METHODOLOGY

Data was obtained from both primary and secondary sources. The sample survey method was used to obtain primary data from the sample region during fieldwork.A multi-stage sampling approach was employed to select population units. In this respect, direct interviews with the heads of vulnerable rural and urban families across Karnataka's revenue divisions were performed utilizing questionnaire schedules.The cross-sectional technique was used to collect primary data in order to provide a snapshot of the variables of interest at a particular moment in time. It was examined in order to make conclusions on the nature, scope, and impact of financial inclusion on rural and urban families' socioeconomic status.Both qualitative and quantitative techniques of assessment were employed to assess the features of population units. To summarize and evaluate categorical data, frequency and percentages were employed. The economic and social impact of financial inclusion on households in rural and urban areas was assessed using multiple regression analysis.Demand for Financial Services In the study, the total score of the individual sub-components of the constructs was obtained by adding up the scores of every question falling under those components, followed by standardization and sorting out using the property of normal distribution, when assessing the elements of financial inclusion and their influence on socioeconomic status The component of financial inclusion and its impact was examined independently, whereas the final component of inclusive growth was seen as a dependent component.Using normal distribution characteristics and percentile values, they were evaluated and classified as average, below average, and above average.

5DATA ANALYSIS

5.1 Correlation Analysis.

Correlation between the components of the constructs of the study was assessed by Karl Pearson's correlation coefficient by classifying it into three categories. The first category was 'strong correlation' if 'r' value was greater than 0.8, the second category, 'good correlation', if 'r' value falls between 0.5 and 0.8 and the third category was 'moderate correlation', if 'r' value falls between 0.3 and 0.5 between the components of the study. In aggregate, the correlation between the components of financial inclusion and inclusive growth and the component of the socio-economic impact of availing formal financial services and inclusive growth was measured as 'good' and 'strong' correlation ('r=0 .801' and '0.660' p<.01) respectively, statistically significant.

5.2 Regression Analysis

To evaluate the impact of availing formal financial services on the outcome of inclusive growth multiple regression analysis has been carried out utilizing 'inclusive growth' as criterion and 'financial inclusion' and 'impact of availing financial services' as predictors. The analysis was statistically significant ($t = 30.044$ & 26.257, $p < .01$), indicating that at the aggregate level, the components of 'financial inclusion' (nature of financial inclusion + extent of financial inclusion) and the 'impact of availing financial services' (material changes + cognitive changes + perceptional changes + relational changes after availing financial services) had a significant impact on the component of 'inclusive growth' confirmed by the values of Standard Beta ($\beta = 0.572$ & 0.500) respectively. This accounted for 0.622 of the variability as indexed by the R^2 statistic. The regression equation for predicting inclusive growth from financial inclusion and impact of access to finance was found to be $Y = 13.335 + 0.774 \times X1 + 0.848 \times X2$.

6. SUMMARY, CONCLUSION AND RECOMMENDATIONS

Based on observations, analysis, and findings, the paper draws the following conclusions:

(i) At the macro level of the Indian economy and throughout Karnataka's revenue divisions, there is a difference in financial inclusion. Even when financial inclusion measures are implemented, a large part of farmer households, the poor, and the marginalized sectors of society do not have access to financial services, and there is considerable inequality throughout the economy. The current analysis confirms the inequalities between revenue divisions within the state among households belonging to disadvantaged sections.

(ii) There is a favorable relationship between using financial services and the socioeconomic level of households belonging to disadvantaged groups. As a result, financial inclusion of disadvantaged households is essential. 22 may be considered as an important factor in the improvement of the socioeconomic status of the households.

(iii) The positive correlation between financial inclusion and inclusive growth may be considered as a factor to highlight the role of innovative, low-cost formal banking products in the process of inclusive growth.

(iv) Human development packages, risk mitigation packages, and productivity enhancement packages were available to disadvantaged households in addition to basic banking products. This occurrence demonstrates the importance of welfare programs in boosting the absorptive capacity of disadvantaged groups, allowing them to break out from the vicious loop of financial exclusion and become more bankable. As a result, when enhanced financial inclusion is pushed in a broader framework of economic inclusion with assistance packages, households belonging to the most disadvantaged segments of the economy will gain.

(v) The formal financial network has the potential to unleash the creative powers of vulnerable families, which are being driven by income and consumption increases in a large part of the population.

(vi) The formal banking system may improve the financial conditions and standard of life of disadvantaged households by allowing them to develop assets, income, and emergency reserves to confront unanticipated conditions and economic catastrophe. It also benefits from leakage-proof transfer and welfare benefits to the underprivileged parts of the community.

(vii) Financial inclusion broadens the banking network with a larger number of transactions leading to new opportunities to earn livelihood in the society which would lead to the inclusive growth of the economy.

(viii) The present analysis rationalizes the focus of governmental policy on financial inclusion in the context of the Indian economy.

(ix) The study confirms that financial inclusion is correlated to its impact, which leads to positive socio-economic status changes in the survey area for households, and emphasizes the necessity to place financial sector reforms which promote financial inclusion at the heart of the development agenda. The report provides a methodology to improve the integration of the financial system, contributing to the poor economic growth.

The model is explained in three stages (Figure 9)

<u>Stage I: Making Households Bankable by Improving the Absorptive Capacity.</u>

The first step of the model proposes strategies for making vulnerable families bankable, therefore improving their absorptive capacity and allowing households to break free from the vicious cycle of financial exclusion. Human development packages on basic education, primary health, vocational training, and other topics, as well as risk mitigation and productivity enhancement packages, will be launched at this stage. At this point, government-sponsored efforts in the media, banking networks, non-governmental organizations, and SHGs to improve financial literacy and primary understanding of families in obtaining formal financial services would be decisive. Local organizations and members join the stream to alleviate the fears that clients from vulnerable groups have about banking. Local volunteers who are well-informed will assist the households in strengthening their stance. In a genuine sense, the stage first phase represents the beginning of inclusive growth.

Stage II: Providing Basic Banking Facilities to BPL Households

In the second stage, the formal baking network will take a more compassionate approach to new consumers from the vulnerable sections, offering no-frill accounts, withdrawal convenience, and fewer limits on such accounts. Facilities such as e-transfer of benefits, financial guidance on how to properly use the available financial products, and delivery of all products at one location will be offered, increasing consumers' trust in using the formal banking network. This will also boost the financial network's commercial opportunities, resulting in low-cost banking.

Stage III: Innovative Strategies

The third stage, which is aided by creative tactics, aims to expand the reach of banking services. This is a period in which banks and other companies share infrastructure. The low-cost advantage that results at this stage can be passed to households in the vulnerable sections. Banks can open small extension counters in organizations providing public utility services such as local schools, primary health care facilities, village Panchayaths, farmers centers, railway stations, bus stops, and so on, to further expand the formal banking network.In this manner, the proposed strategy improves the absorptive ability of vulnerable-section households, making them more bankable. As a result, financial inclusion has increased access to formal finance and paved the way for a greater number of transactions, resulting in formalized and systematic banking, rapid economic growth, and new opportunities for production and employment in society, all of which contribute to inclusive growth.

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