The Future of Financial Inclusion and Its Impact on Poverty Reduction in India

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EXECUTIVE SUMMARY

Financial inclusion has emerged in the last ten years as an important movement to reduce poverty in the developing world. One of its foundations is digital banking, which started in Kenya in 2007 by utilizing cell phone text messages to conduct banking transactions. Nandan Nilekani, former President of Infosys, pioneered in India the creation of a unique ID using biometric and fingerprint data which has already reached a billion Indian citizens. Using its world-class information technology resources, India is striving to maximize the digitization of its economy as emphasized by the 2016 demonetization of its currency.

Keywords: Financial Inclusion, India, Brazil, Poverty Reduction, Universal Basic Income

INTRODUCTION

Financial inclusion is a 21st century phenomena enabled by digital technology to provide banking services and social benefits to low income citizens. Inspired by Kenya's extensive utilization of cell phones for banking transactions beginning in 2007, the developing world is on a path from informal cash based economies to official financial inclusion for most citizens. Over 90 developing countries have joined The Alliance for Financial Inclusion (AFI), a member owned organization, to promote and develop evidence-based policy solutions that improve the lives of the poor through the power of financial inclusion (Alliance for Financial Inclusion, 2016). Under its 2011 Maya Declaration, the AFI members commit to achieving concrete financial inclusion goals, implementing policy changes and sharing progress updates (AFI: Maya Declaration, 2016). In 2014, Prime Minister Narendra Modi advanced financial inclusion by offering free bank accounts and by attacking cash based transactions that seek to avoid government taxation. The 2016 demonetization of old 500 and 1000 Rupee notes has potentially accelerated this process.

IMPACT OF INFORMATION TECHNOLOGY IN INDIA

The implementation of the Universal Biometric Identification by the former President of Infosys, Nandan Nilekani, has helped lay the foundation for financial inclusion in India. The Unique Identification Number is known in India as the Aadhar Card because in Hindi, Aadhar, translates to foundation. This ID system uses biometric and fingerprint data to create a unique ID for all registrants enabling the government to provide social security, affordable credit and improve the subsidy leakage problem. The subsidy leakage problem occurs when government funds that are intended for the poorer sections of the society do not reach the recipients due to corruption or bureaucratic obstacles. Finance Minister Arun Jaitley claims that the Indian database of 1.2 billion bank accounts when linked with 900 million mobile phones and a billion Aadhaar numbers would ensure that government subsidies flow effectively to those who actually need them (Mathew, 2016).

Another important stride India has taken was a program launched by the Indian Prime Minister Narendra Modi in August 2014, to provide free bank accounts – Pradhan Mantri Jan-Dhan Yojana (PMJDY) (Gupta, 2015). It required relatively little documentary requirements by account holders and any Indian citizen could open an account at any business correspondent outlet. This account comes with multiple benefits including direct benefit transfer from the government, interest on deposits, accident insurance, access to overdrafts and pensions and other insurance products. The account can be opened with a zero balance and the form to open such an account is available both in English and Hindi (Pradhan Mantri Jan Dhan Yojana, 2016). This program has multiple major challenges as the adult literacy rate in India between 2008 to 2012 was only 62.8% (UNICEF: India, 2016). To mitigate this, the Department of Financial Services has established Financial Literacy Centers across the states. This program has focused on keeping these accounts alive and used by the citizens. Financial literacy is central to achieving this objective, as consumers will understand better the benefits of such accounts (Reserve Bank of India, 2016).

India has also recently granted in-principle approval to eleven payments banks under the Guidelines for Licensing of Payments Banks (Reserve Bank of India, 2015). Payments banks are a new model of banks developed by the Reserve Bank of India where a company, be it a telephone company, a supermarket company, or cooperative can set up a payments bank whose scope is limited to accepting deposits, payments, remittances, and providing mutual funds and insurance products. One of the larger restrictions in this case is that payments banks cannot undertake lending activities and that demand deposit balances should be invested in either government treasury bills or time/fixed deposits from commercial banks. This is done to avoid unnecessary risks by the payments banks. The eleven payments banks include communication companies such as Airtel, Reliance and Vodafone and more importantly, India Post which is the department of postal services (Mankotia, 2016). Bharti Airtel was the first to launch its mobile commerce arm, Airtel Payments Bank, in April 2017. It has already brought about 1000 villages under its initiative. It began using its 250,000 retail stores as banking points (higher than the total number of ATMs in India) and aims to grow to 600,000 over the next few years (Airtel Payments Bank, 2017 and Kurup, 2017). IPPB (India Post Payments Bank) was established as a public limited company on 17th August, 2016 and commenced operation in India in January, 2017 (Reserve Bank of India, 2017). IPPB will provide demand deposits, digitally enabled payments and remittance services of all kinds between businesses and individuals. The four key goals of IPPB are financial literacy, streamlining payments, financial inclusion, and ease of accessibility (India Post Payments Bank, 2016).

Another factor that helped boost financial inclusion in Kenya is Islamic Banking. Islamic Development Bank (based out of Saudi Arabia) will be the one of the first of its kind to have sharia-complied banking in India with its first branch in Gujarat (Dave, 2016). Islamic banking provides much needed services in India as these facilities could be used by the Muslim farmers and small businesses who prefer the Islamic banking/lending philosophy (Subramanian, 2016).

Demonetization of currency in late 2016 replaced existing legal tender of Rs.500 (US $7.5) and Rs.1000 (US $15) currency notes with new ones. In the short run, it disrupted India's massive informal economic sectors such as daily wage workers, micro-entrepreneurs, farmers, fisherman and contractual laborers. The effects were more severe in rural areas where cash is more dominant and there is limited accessibility to banks, ATM's and other financial institutions. However, the 2017-18 Indian Economic Survey predicts that in the long run, demonetization would boost bank deposits paving the way for sustainable low interest rates, escalate economic formalization and increase GDP (Government of India: Ministry of Finance, 2017). The IMF in its 2017 World Economic Outlook Update projected India GDP to grow to upwards of 7% (IMF: WEO Update, 2017). Additionally, bank deposits increased sharply. The volume of digital transactions doubled and the value of mobile transactions increased by 62% after enactment of the demonetization scheme (Pisa et al, 2017). Hence, the case for the digital financial system and monies in India is important because it could improve accessibility to financial services, decrease travelling costs and enhance convenience (Sharma, 2016). As of February 15, 2017, it is estimated that banks have opened about 3 million new accounts since the demonetization drive began on November 8, 2016 (Kumari, 2017). Furthermore, India Stack, "a set of application programming interface (APIs) that allows governments, businesses, startups and developers to utilize a unique digital infrastructure," was developed in India to move the nation towards a more cashless society (India Stack, 2017). A recent step was the launch of the Bharat Interface for Money App (BHIM) in late 2016 based on Unified Payments Interface (UPI) by the National Payments Corporation of India. UPI is a payment system that would enable immediate fund transfer to make and collect payments with ease (National Payments Corporation of India, 2016).

Additionally, demonetization had also created a cash crunch when it was introduced in 2016. According to the Reserve Bank of India (RBI), the adverse impact had been short lived and dissipated by February 2017. This action essentially removed 86% of the circulating currency curbing black monies and aiding digital transformation (The Indian Express, 2017). Furthermore, Nandan Nilekani, former Chairman of the Unique Identification Authority of India said that the shock given to the system will accelerate the digitization of the financial economy (The Times of India, 2016). To counterbalance the short term affects, the RBI infused new currency notes worth about $141.5 billion (The New Indian Express, 2017). The World Bank has recently predicted that India's 2016-17 growth rate would fall by about 1.1% to 6.8% and mentioned that the demonization had impacted the poor and the vulnerable the most since India is primarily a cash-based economy (Venkatesh, 2017). The strengths and weaknesses of demonetization will be analyzed over the coming years, but it has accelerated the digitization of the Indian economy. Paytm and Mobikwik are some of the mobile wallet companies that saw a huge increase in their user base and transactions after demonetization (Russell, 2017). Lastly, demonetization also increased the taxpayer base by adding about 9.1 million new taxpayers increasing tax collections significantly (India Infoline News Service, 2017).

Digital technology has the potential to enable poverty reduction. One ambitious proposal has been the Universal Basic Income (UBI) concept which has three components: universality, unconditionally and agency. Per the economic survey 2016-17 conducted by the Ministry of Finance, UBI would reduce poverty levels from 22% to 0.5%, if enacted in India with a proposed amount of 7,620 INR ($113) per year to each citizen and would provide a better targeting method. The Indian government's chief economic adviser, Arvind Subramanian, notes that the monies would come largely from recycling funds from the existing 950 welfare schemes sponsored by both central and state governments. These 950 schemes account for 5% of the GDP by budget allocation with food subsidies being the largest program followed by Urea Subsidy (Nitrogen Fertilizers) and the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS – An act that aims at providing a hundred days of wage employment to any adult citizen to perform manual work). Large welfare schemes of India such as PMAY, SSA, MDM, PMGSY, MGNREGS and SBM have significant distortions in implementation. The survey also argues that states such as Uttar Pradesh, Bihar, Chhattisgarh, Karnataka, have a large share of the population below poverty levels but receive less than equal share when it comes to the welfare schemes. On the other hand, states like Orissa and Rajasthan receive disproportionately higher shares of spending when compared to their share of poor populations. These variances are a result of a difference in administrative capacities and efficiency of local districts to spend state allocated resources. There have been significant improvements in targeting efficiency of the MGNREGS and Public Distribution System (PDS – Food and Kerosene) in the last decade. The most significant being that 95% of MGREGS wages were paid into beneficiary accounts reducing leakages of wage payments and the number of participating women increased to 56% in 2016-17 period compared to 40% in 2006-07 period. The survey also extrapolated that PDS leakages significantly decreased to 20.8% as of 2016. Universal Basic Income would potentially open up new possibilities for labor markets and help alleviate varying risks and shocks facing the poor who are trapped in the poverty cycle. It would also provide choice to the beneficiaries and alleviate the decisions by governments on how households consume public goods. Jammu and Kashmir Finance Minister Haseeb Drabu even put a proposal in the state budget for enacting UBI in 2017 (Choudhury, 2017). Therefore, "UBI is not a substitute for state capacity: it is a way of ensuring that state welfare transfers are more efficient so that the state can concentrate on other public goods" (Government of India: Ministry of Finance, 2017).

ROLE OF UN, IMF AND WORLD BANK IN FINANCIAL INCLUSION

In 2016 at a joint event of the IMF (International Monetary Fund) and the Center for Global Development on "Financial Inclusion: Macroeconomic and Regulatory Challenges," IMF Managing Director Christine Lagarde stressed in her opening remarks that, "The post-2015 Development Agenda squarely puts financial inclusion as a key objective for United Nations member countries" with 60 governments setting concrete financial targets (IMF: CGD Event, 2016). Furthermore, at a conference in New York City in late 2016, she mentioned that "technological change holds great promise in relation to financial inclusion. Expanding access to financial services can undoubtedly support economic development" and that "it is the private sector that ultimately must harness the technology" (Lagarde, 2016). Additionally, in 2015, the World Bank had committed to extending access to financial services through its "Universal Financial Access 2020 initiative" focusing on 25 countries where 73% of all financially excluded people live. The World Bank has also worked through multiple global trust funds including Financial Inclusion Support Framework (FISF), Harnessing Innovation for Financial Inclusion (HiFi), and the G20 Global Partnership for Financial Inclusion (GPFI) (World Bank: FI Strategy, 2017). As of June 2016, the World Bank has invested about $4 billion to support national authorities for financial inclusion.

The World Bank has committed to enabling 1 billion people of the 2 billion unbanked population to enter the formal economy through financial inclusion by 2020. India's unbanked population is crucial to achieving this goal (World Bank, 2016). In 2011 and 2012, the United Nations Development Program (UNDP) in a joint venture with the government of India aided 5,000 households in Pakur District in Jharkhand State to be linked to financial services. UNDP also helped the Rashtriya Swasthya Bima Yojana (a health insurance scheme for citizens below the poverty line) in enrolling 700,000 households (UNDP Financial Inclusion, 2012).

The United Nations Development Program (UNDP) in collaboration with United Nations Capital Development Fund (UNCDF) have developed programs and schemes that are very effective including the 'better than cash alliance' (BTCA) program, Pacific Financial Inclusion Program (PCIF), and Shaping Inclusive Finance Transformations (SHIFT) (UNCDF: Global Programmes, 2017). Additionally, UNDP Administrator Helen Clark, at a UNCDF management retreat said the UNCDF promotes financial inclusion in Less Developed Countries (LDCs) and that the UN system is moving towards the '2030 agenda' of sustainable development and eradication of poverty (Transforming Our World: The 2030 Agenda for Sustainable Development, 2015).

CONCLUSION

The Government of India has taken major steps towards financial inclusion in the last decade. India Stack is a set of application program interfaces that the government has launched that will help bring India to the forefront of moving its unbanked population to a cashless formal economy by 2020 (Nichol, 2017 and India Stack, 2017). India has also set a target of having 250 billion transactions through digital means by March 2018. The recent progress by Brazil in reducing poverty offers inspiration for India. In the 20th century, Brazil was frequently portrayed as a mostly poor country with a prosperous upper class. With the election of Lula da Silva as President in 2002 and implementation of the Bolsa Familia and Fome Zero (Zero Hunger) projects facilitated by digital banking, 40 million Brazilians out of 200 million, moved from poverty to working-class lives (Winter, 2016). The potential of technological development using biometric information and digital payments has been emphasized by the President of the Center for Global Development and a former IMF Director, Masood Ahmed. He believes these electronic initiatives should be accelerated, because they could provide the foundation for Universal Basic Income which would dramatically reduce absolute poverty in India (CGDEV, 2017).

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