GOVERNMENT POLICIES AND FINANCIAL INCLUSION

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ABSTRACT
Markets typically exist within the boundaries set by the state. The financial markets are no exception to this. Mobilisation and allocation of capital – the key roles of the financial system – are done within the framework defined by the government. From nationalisation of banks and significant economic ownership, to guiding the allocation of capital to priority sectors and regulating various aspects of the financial sector, the Indian government has played just about every conceivable role in the nature of final intermediates.

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Programmes and Policies
The government has also tried to increase financial access primarily through the Reserve Bank of India and other regulators. The most prominent strategy it has followed is the priority sector lending by banks, which requires banks to extend 40% of their lending to sectors defined as preferred (such as agriculture) by the government. Banks and insurance companies have been given targets to open savings bank accounts and provide micro insurance policies respectively. The government has also used direct influence over public sector institutions to ensure extension of services at its discretion. The Self Help Group-Bank linkage programme (SBLP); Kisan Credit Card (KCC) scheme for farmers; Rashtriya Swasthya Bima Yojana (RSBY); financing and refinancing of various cooperative banks, regional rural banks and public sector commercial banks that extend credit to rural clients, especially farmers; and various state level programmes for extending credit to rural areas are examples of more direct efforts. Many of these steps have had significant positive impact on financial access. For example, by March 2009, there were over 61 lakh savings-linked SHGs and over 42 lakh credit-linked SHGs across the country with cumulative credit of over Rs. 50,000 crore accessed since 1992. KCC has become the main source of short-term credit for farmers. As on March 2010, over 5 crore ‘no frills accounts’ had been opened. Cooperative banks and regional rural banks have the highest outreach with respect to branch penetration in rural areas.

Intensions and Consequences
However, these efforts are driven not just by an intention to enhance welfare, but also by electoral considerations, because financial services, particularly credit, are perceived to be effective tools for reaching the electorate quickly. Given the institutional infrastructure of India, credit can be quickly extended through the thousands of service points. Research by Professor Shawn Cole (Harvard University) shows that Indian public sector banks’ agricultural credit increases by 5-10 percentage points in an election year, with large increases in districts in which the election is particularly close. Clearly, the separation of political considerations and business objectives is hard to achieve, but this may have unintended consequences.

First, political exigency may not be compatible with innovation because the imagination and experimentation that goes into the development of real solutions cannot be dictated. So, for example,
though it is good to have Rs. 47,000 crore disbursed to farmers through KCCs, a closer look at the scheme’s lending mechanism reveals significant weaknesses. It allows considerable repayment flexibility with negligible monitoring and relies on land as collateral, which is very challenging to enforce for a lender. Similarly, less than 11% of ‘no frills accounts’ opened at RBI’s behest are actually used. This is because though the banks fulfilled the “targets”, not enough was done to ensure that clients access these accounts conveniently.

Second, government’s continuous and relatively unconditional support for certain institutions has distorted their incentives. For example, though many cooperative banks have performed very poorly (according to the Task Force on Revival of Cooperative Credit Institutions (2004), a quarter of them had eroded their net worth), the government has continued to refinance and re-capitalise them. Recent revitalisation efforts have tried to improve capacities of these institutions, but there is still little emphasis on addressing the basic issues of incentive alignment and financial design (product mechanism and pricing). This has created a “too political to fail” implicit guarantee system, not unlike the “too big to fail” implicit guarantee. This leads to a differential playing field between institutions backed by the government and private efforts, rendering the latter at a disadvantage.

Third, some government interventions, though looking beneficial in the stage one analysis, may have negative effects on the financial system in the long run. For example, the loan waiver schemes may help some people in the short run, albeit not the poorest, but they do so at the cost of changing the incentives facing the rural borrowers, giving a strong reason to delay repayments till the next loan waiver. A more complex example is of the interest rate cap on savings bank account. This cap, which probably comes with the implicit understanding that banks will use these low cost funds to lend to priority sectors, becomes regressive especially in rural areas, where, given the high transaction costs for using bank accounts, this low return on savings might act as an incentive to hold cash. This goes contrary to financial inclusion efforts.

Fourth, when governments venture into direct financial services provision, it creates competition between the government and the market. Since the government has discretionary powers, it can legislate or regulate its way out of any competitive situation. The recent micro finance Ordinance issued by the Andhra Pradesh government is an example of this. In AP, the commercial microfinance sector seemed to be posing a direct challenge to the government-run programme, which was reportedly leading to attrition in the latter. This then leads to the question: Can a market participant regulate objectively?

Creating distortions in the long-run

All these indicate that many of the government’s efforts, though often well-intentioned and having positive outcomes in the short-run, create distortions that may lead to inferior outcomes in the long-run. The exigencies of the political process have three underlying features: a) they restrict thinking only about immediate outcomes; b) their timelines are dictated by electoral cycles; and c) their focus is on easily visible outcomes. Perhaps that is why there is so much focus on disbursing credit and opening bank accounts, with little importance to sustainability and effectiveness of services. The governments could improve the design of their programmes and interventions, but the structural differences in workings of a political process and market institutions will remain. Should the government step back and just focus on regulating the system? There is no simple answer to this question. One way to approach this question is to ask: if the governments don’t intervene, would the markets anyway enter and contribute to financial inclusion? It is difficult to say for sure, because this requires predicting behaviour of markets under completely different situations. But what one can say is that markets more or less respond to incentives and are likely to pursue profitable strategies under conducive environments with low reputation and political risk.
Creating a conducive environment

So, the Government should focus on creating an environment where financial institutions and markets can expand in an orderly manner, minimising the need for direct government intervention. This can be done in many ways, especially by: a) providing public infrastructure (like connectivity; UID (one of the biggest contributions by the government to financial inclusion probably is the creation of the UID infrastructure compared to many direct interventions over the years); law and order; and currency chests to enable cash movements) that helps reduce transaction costs for serving remote areas; b) encouraging competition among financial providers (giving more bank licenses, creating level playing field); c) focusing on rules-based regulation to minimise political risk that springs from discretionary regulation by governments/regulators; and d) using quality research to assess the long-term implications of big policy decisions like loan waiver. These steps should help gradually improve the sustainability and quality of financial inclusion. Otherwise, we will continue with this sub-optimal equilibrium of short-term financial inclusion numbers at the cost of long-term sustainability and high quality service.

Is financial inclusion in India important?

The policy makers have been focusing on financial inclusion of Indian rural and semi-rural areas primarily for three most important pressing needs:

1. **Creating a platform for inculcating the habit to save money** – The lower income category has been living under the constant shadow of financial duress mainly because of the absence of savings. The absence of savings makes them a vulnerable lot. Presence of banking services and products aims to provide a critical tool to inculcate the habit to save. Capital formation in the country is also expected to be boosted once financial inclusion measures materialize, as people move away from traditional modes of parking their savings in land, buildings, bullion,

2. **Providing formal credit avenues** – So far the unbanked population has been vulnerable dependent of informal channels of credit like family, friends and moneylenders. Availability of adequate and transparent credit from formal banking channels shall allow the entrepreneurial spirit of the masses to increase outputs and prosperity in the countryside. A classic example of what easy and affordable availability of credit can do for the poor is the micro-finance sector.

3. **Plug gaps and leaks in public subsidies and welfare programmes** – A considerable sum of money that is meant for the poorest of poor does not actually reach them. While this money meanders through large system of government bureaucracy much of it is widely believed to leak and is unable to reach the intended parties. Government is therefore, pushing for direct cash transfers to beneficiaries through their bank accounts rather than subsidizing products and making cash payments. This laudable effort is expected to reduce government’s subsidy bill (as it shall save that part of the subsidy that is leaked) and provide relief only to the real beneficiaries. All these efforts require an efficient and affordable banking system that can reach out to all. Therefore, there has been

Why is financial inclusion needed in India? - Graphical representation
What are the steps taken by RBI to support financial inclusion?

RBI set up the Khan Commission in 2004 to look into financial inclusion and the recommendations of the commission were incorporated into the mid-term review of the policy (2005–06) and urged banks to review their existing practices to align them with the objective of financial inclusion. RBI also exhorted the banks and stressed the need to make available a basic banking ‘no frills’ account either with ‘NIL’ or very minimum balances as well as charges that would make such accounts accessible to vast sections of the population. Of the many schemes and programmes pushed forward by RBI the following need special mention.

A. **Initiation of no-frills account** – These accounts provide basic facilities of deposit and withdrawal to account holders makes banking affordable by cutting down on extra frills that are no use for the lower section of the society. These accounts are expected to provide a low-cost mode to access bank accounts. RBI also eased KYC (Know Your customer) norms for opening of such accounts.

B. **Banking service reaches homes through business correspondents** – The banking systems have started to adopt the business correspondent mechanism to facilitate banking services in those areas where banks are unable to open brick and mortar branches for cost considerations. Business Correspondents provide affordability and easy accessibility to this unbanked population. Armed with suitable technology, the business correspondents help in taking the banks to the doorsteps of rural households.

C. **EBT – Electronic Benefits Transfer** – To plug the leakages that are present in transfer of payments through the various levels of bureaucracy, government has begun the procedure of transferring payment directly to accounts of the beneficiaries. This “human-less’’ transfer of payment is expected to provide better benefits and relief to the beneficiaries while reducing government’s cost of transfer and monitoring. Once the benefits starts to accrue to the masses, those who remain unbanked shall start looking to enter the formal financial sector.

What more is to be done for financial inclusion?

Financial inclusion of the unbanked masses is a critical step that requires political will, bureaucratic support and dogged persuasion by RBI. It is expected to unleash the hugely untapped potential of the bottom of pyramid section of Indian economy. Perhaps, financial inclusion can begin the next revolution of growth and prosperity.

**Role of financial inclusion in India**

India scored very well overall (tying with Mexico for 5th place), thanks in part to reforms adopted in response to the Mor Committee’s recommendations in 2013. India scored at the very top in only one area, micro-insurance, reflecting longstanding attention to the need to provide insurance cover to lower income people. Since 2002, Indian regulations have directed insurance companies to attend to the low end of the market. However, it is noted that the regulations are highly directive, which may have an effect on slowing innovation.

India’s weakest score was in the core area of prudential supervision, due to two factors—first, the use of directed mandates to banks to fulfil policy aims (rather than reserving the scope of prudential regulation to ensuring solvency and liquidity) and second, the regulatory preference given to commercial banks, leaving weaknesses among the smaller institutions catering to lower income consumers. While the former is politically difficult to change, the latter is the subject of a number of reform proposals now in the process, such as the introduction of specialised payment banks.

**CONCLUSION**

As a key enabler for development, financial inclusion is firmly placed on the agenda of most governments as a key policy priority. Against this background, this round table provides a global and regional perspective on the policies and practices of financial inclusion. Using macro data, the
collection reveals the diversity in the efforts towards achieving financial inclusion and the need for a progressive approach in financial inclusion. Further to this, the round table provides the regional perspectives on the policies and practices of financial inclusion in India, South Africa, and Australia. Many national governments and international institutions have been leading major policy initiatives to bridge the gap between financial inclusion and the poor. The Pradhan Mantri Jan Dhan Yojana in India is an example of a state-led initiative towards universal financial inclusion taken up on a mission mode. There is no denying that this ambitious aim of a universal zero-balance, no-frills bank account faces many a hurdle. Bank staff has to gear up to meet the large increase in accounts, especially in the remote regions of the nation.

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