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"**Microfinance and India's Informal Sector**"

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Microfinance and India's Informal Sector

Abstract

This paper explores the potential of digital lending to improve credit access for India's informal sector, which continues to face significant barriers to formal finance despite major advances in digital payment systems. Through a comparative review of experiences in Kenya, Brazil, China, and Bangladesh, it assesses both the possibilities and the challenges associated with fintech-based lending models. The analysis shows that digital platforms can widen credit availability, but inadequate regulatory oversight may result in excessive debt and borrower exploitation. The paper therefore argues that India should promote fintech innovation alongside effective regulation and strong consumer protection to expand fair and inclusive lending for informal enterprises.

Introduction

India's economic reforms since 1991 have reshaped its growth trajectory, but the benefits remain uneven. The informal sector, accounting for nearly half of GDP and over 400 million workers, continues to operate largely outside the ambit of formal credit (Hazra & Mitra, 2024). The launch of the Pradhan Mantri Jan Dhan Yojana (PMJDY) in 2014 and the adoption of Aadhaar-based eKYC brought millions into the banking system. UPI subsequently transformed payments, processing more than 85 billion transactions in FY24, making India the global leader in real-time payments (Visa & A.T. Kearney, 2018; Kumar & Bfsi, 2024). Yet, while payments infrastructure has been democratized, credit access remains deeply exclusionary. Nearly half of Jan Dhan accounts remain dormant (USAID, 2019), and informal lending networks still dominate, often with predatory interest rates.

Regardless of the numerous attempts by the government, public and even the private sector, the magnitude of exclusion is staggering. PwC India (2019) estimates an MSME credit gap of ₹69.3 trillion, with 90% of small enterprises considered "credit invisible" to formal financial institutions. Schemes such as Mudra and PM-SVANidhi attempted to bridge this gap but have faced limited uptake due to collateral requirements, paperwork, and limited digital integration. Meanwhile, unregulated digital lending apps proliferated; by 2021, over 60% of lending apps in India were illegal, leading to coercion, fraud, and consumer distress (IMF, 2022). The Reserve Bank of India (RBI) responded with its Digital Lending Guidelines in 2022, mandating disbursals through regulated entities, transparency in loan pricing, and data protection measures.

Globally, comparable experiments highlight both potential and pitfalls. Kenya's M-Shwari expanded instant mobile credit but fueled debt traps, with default rates exceeding 20% (Visa & A.T. Kearney, 2018). Brazil's PIX system, coupled with Bolsa Família, demonstrated how state-backed instant payments can integrate with inclusive credit. China's Ant Financial scaled credit access through behavioral scoring but faced concerns over surveillance and monopoly power (PwC, 2019). Bangladesh's microfinance revolution pioneered credit inclusion, but digital extensions through bKash and BRAC microloans show both promise and risks of over-indebtedness (Banerjee et al., 2015). This does imply that most countries, which may or may not have started the journey to development alongside India, do tackle the challenge of non-credit informal economy and structural barricading.

This paper frames the problem statement: How can lending be democratized, as payments were through UPI, to empower the informal economy? It argues that facilitated digital lending, through regulated fintech innovation, can help informal enterprises transition toward formality.

The analysis uses three complementary policy frameworks, policy transfer, policy change orders, and advocacy coalitions to assess comparative models and their lessons for India.

Informal Finance in India

Informal finance dominates India's credit landscape. Moneylenders, chit funds, and rotating savings and credit associations (ROSCAs) remain the primary sources of borrowing for informal workers, often with exploitative terms (Hazra & Mitra, 2024). Self-help groups (SHGs) and microfinance institutions have played important roles in extending credit to women and marginalized groups, but integration into digital platforms has been slow (Gupta & Verma, 2018). The result is a dual financial system, ie, formal in structural appearance but reliant on informal practices in use.

The digital payments revolution, to a large extent, has been transformative. UPI has lowered transaction costs and expanded access dramatically, supported by interoperable infrastructure and state–fintech collaboration (Visa & A.T. Kearney, 2018). Yet, lending remains fragmented. Mudra and PM-SVANidhi provided credit guarantees but failed to achieve scale due to various, sub-step hurdles. Nearly 48% of Jan Dhan accounts are dormant, reflecting lack of active credit usage (USAID, 2019). The Default Loss Guarantee framework (RBI, 2022) aims to replicate UPI's success in lending by standardizing processes, enforcing transparency, and curbing predatory practices. This has enabled fintech to think in the direction of lending to grassroots, with a wider scope than there existed previously.

Fintech offers new pathways. In Karnataka, digital platforms improved record-keeping and enabled micro-lending for unorganized retailers, though challenges of literacy and regulatory oversight persist (Supriya & Betgeri, 2020). PwC India (2019) identified emerging models:

invoice discounting, POS-based lending, peer-to-peer (P2P) platforms, and Buy Now Pay Later (BNPL). PwC (2021) further emphasized fintech's role in serving the underserved through co-lending and alternative credit scoring. However, the magnitude required for the informal sector to take is a lot bigger than what is being extended as of now.

M-Shwari and Tala in Kenya offered instant mobile loans in order to facilitate micro-loans for the informal sector. However, the lack of a security for the lenders themselves and the inability of the borrowers to pay, led to over-indebtedness as 31% of them defaulted within ninety days (Visa & A.T. Kearney, 2018). Brazil's PIX integrated with Bolsa Familia, a government agency that lends to the marginalised, but with the intent of breaking cycles of poverty by making loans contingent upon the borrowing family investing on human capital (Centre for Public Impact, 2019). This collaboration, according to researchers, has demonstrated how state-backed digital rails can link payments and lending (Visa & A.T. Kearney, 2018). In China, the idea behind Ant Financial's Sesame Credit was to provide loans and encourage virtues of reliability by providing credit based on behavioral data. However, there rose more important, pressing concerns about the Chinese state of monopolistic surveillant capitalism(PwC India, 2019). Bangladesh's crediting initiatives have been globally recognised, acclaimed and even critiqued to large extents. Bangladeshi microfinancing institutions managed to extend credit to millions, particularly women. Kbash and BRAC pilots do demonstrate a great potential, but researchers, time and again, have raised flags of risking over-indebtedness (Banerjee et al., 2015).

The risks of digital lending are significant. IMF (2022) documented over 60 illegal lending apps in India in 2021, many linked to fraud and harassment. In Kenya, mobile lending created debt stress; in China, data-driven scoring sparked privacy concerns. Bangladesh's

microfinance faced political backlash over coercive recovery practices. Without robust consumer protection, digital lending risks reproducing exploitation in digital form (Gabor & Brooks, 2017).

Methodological Frameworks

Dolowitz and Marsh's Policy Transfer (2000) framework examines how policies are borrowed across contexts. India's UPI drew global attention as a transferable model. This framework helps to frame answers to questions like whether the lending innovations from Kenya, Brazil, China, and Bangladesh can be adapted within the Indian structure. Key dimensions include what is transferred- digital credit design, why- to bridge credit gaps, and constraints of regulation, literacy, state capacity. Hall's Order of Policy Change (1993) distinguishes incremental, which is first-order; adjustment, being the second-order; and paradigm shifts, third-order. Applying this: Aadhaar-based eKYC is a first-order tool; Mudra and DGV are second-order policy settings; embedding fintech credit into welfare architectures represents a third-order paradigm shift. The Advocacy Coalition Framework by Sabatier (1988) plays a significant role in the policy ecosystem, especially when the initiatives for the grassroots are debated and rationalised. This framework highlights the coalitions shaping policy. In India, coalitions of fintechs, NBFCs, and the RBI are central. In Kenya, Safaricom dominates. In Brazil, the Central Bank anchors inclusion. In China, state–platform alliances drive ecosystems. The strength of coalitions around consumer protection and literacy shapes outcomes.

Analysis & Discussion

The RBI's 2022 Digital Lending Guidelines represent a significant institutional response. By mandating that all loans be disbursed through regulated entities, prohibiting pass-through via

unregulated apps, and requiring transparent disclosure of costs, DLG aims to curb fraud and restore trust (IMF, 2022). The Account Aggregator framework further facilitates consent-based sharing of financial data to improve creditworthiness assessment. These measures represent a second-order policy change, adjusting settings without yet transforming paradigms. For a third-order shift, lending must be embedded into welfare systems, much like UPI integrated payments. India's DLG allows for fintechs to finance the first default, of up to 5% of the portfolio. While there are fintech firms trying to navigate the lending to farmers in customised, payable ways (DGV), the financing comes from the venture capital of the firm itself.

Bangladesh pioneered microfinance through Grameen Bank and BRAC, but digital extensions via bKash now allow microloans through mobile wallets. These innovations improved last-mile reach but risk replicating over-indebtedness. Studies show that while microfinance improved consumption smoothing, it had limited impact on long-term poverty (Banerjee et al., 2015). The absence of strong consumer protection mechanisms means Bangladesh's digital lending remains market-led and vulnerable.

Comparing India and Bangladesh highlights different pathways. India's DLG is regulatory-first, emphasizing consumer protection, institutional safeguards, and transparency. Bangladesh's model is market-first, building on microfinance and mobile money but with weaker regulation. India could learn from Bangladesh's last-mile penetration, while Bangladesh could adapt India's regulatory frameworks. Together, they highlight the trade-off between reach and protection.

Kenya's M-Shwari demonstrated how telecom-led platforms can instantly democratize credit. Yet, lack of regulation led to widespread defaults, with 31% of borrowers delinquent

within 90 days (Visa & A.T. Kearney, 2018). While consumer access has improved, long-term sustainability remains questionable.

Brazil's Central Bank-led PIX system integrates instant payments with welfare transfers, laying the groundwork for inclusive credit. PIX demonstrates how strong state capacity can anchor inclusion. Yet, lending integration remains partial, with urban–rural divides continuing to persist.

China's Ant Financial scaled lending through Sesame Credit, using behavioral data to extend microloans. This expanded inclusion rapidly but raised concerns of surveillance capitalism, algorithmic opacity, and platform monopolies (PwC, 2019). While effective at scale, China's model underscores the risks of unchecked platform power and the opacity only increasing barriers.

Arguments

Proponents argue fintech democratizes credit: collateral-free loans, faster disbursement, and integration with digital ecosystems lower costs and expand access (PwC India, 2019; Supriya & Betgeri, 2020). For MSMEs and informal workers, fintech bypasses traditional collateral barriers and accelerates formalization.

Critics caution that digital lending risks replicating informal exploitation in digital form. In Kenya, mobile loans led to over-indebtedness; in Bangladesh, microfinance created debt traps; in India, illegal apps exploited borrowers through coercion and fraud (IMF, 2022; Banerjee et al., 2015). In China, algorithmic scoring raised privacy concerns. Without safeguards, fintech lending risks disempowering the very populations it seeks to include.

Conclusion

India's digital payments revolution, driven by the Unified Payments Interface (UPI), has become a benchmark for democratizing financial access globally. Yet, while payments have been universalized, lending remains exclusionary, particularly for the informal economy that employs over 80% of the workforce. The unmet credit gap for micro, small, and medium enterprises (MSMEs) is estimated at ₹69.3 trillion, with only 16% met by the formal sector (PwC India, 2019). Informal workers remain dependent on moneylenders, chit funds, and self-help groups, perpetuating cycles of exclusion (Hazra & Mitra, 2024). This paper reframes the problem: how can lending be democratized in the same way payments have been? It argues that fintech-driven lending, if embedded within robust regulatory safeguards, can help informal enterprises transition toward formality. Comparative lessons highlight both opportunities, alternative credit scoring, platform-enabled microloans, state-backed instant credit, while covering risks, including over-indebtedness, surveillance, and exclusion. Payments in India were democratized through a state–market partnership anchored in UPI. Lending remains the unfinished agenda of financial inclusion. Comparative lessons from Kenya, Brazil, China, and Bangladesh show that while fintech can broaden access, it can also create new vulnerabilities. India's DLG framework provides a regulatory foundation, but a paradigm shift requires embedding lending into welfare systems, strengthening advocacy coalitions for consumer protection, and leveraging fintech innovation responsibly. By balancing reach and safeguards, India can replicate the success of UPI in lending, enabling informal workers and enterprises to transition toward formality. The paper concludes that democratizing lending requires a hybrid approach of state infrastructure, fintech innovation, and consumer protection.

Acemoglu's Why Nations Fail highlights the prime importance of having inclusive financial institutions for a state to prosper. That being said, it is imperative that technocratics reverse-engineer their approach if the idea is truly to uplift the informal economy.

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