



Research Paper

**Exploring the Rationale of Existence of Informal Finance in Contemporary Indian Society
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Abstract

India is a country where the majority of population is engaged in the unorganized sector. Unorganized sector is recognized by the acute absence of security in terms of work, working conditions, wage rate, and amenities to be provided to the workers. Thus, a significant proportion of Indian workforce is far away from the guaranteed earnings and social security measures. On the other hand, cost of living is getting very costly day by day. Therefore, it has become very difficult for the common masses to get livelihood to cover the day to day cost of living and making enough provisions for the future uncertainties. Informal finance is the last resort for the poor and marginalized sections to address their day to day financial issues as when arise. Formal finance has its own procedural and systematic limitations. Furthermore, its outreach and volume are limited that is inadequate to cater the vast financial needs of the most populous and diverse country. Therefore, it is inaccessible to the common masses. That is why informal finance has become an integral part of Indian society. And it has been a very popular source of fund among the marginalized people, and micro and small entrepreneurs. Informal finance has also its strengths and weaknesses that suit the under developed and developing economies. As weak financial literacy, skewed development and expansion of formal financial institution, widespread poverty and agrarian society are hallmarks of emerging economies of the world that pave the way for expansion and outreach of informal finance across society.

Keywords: Unorganized Sector, Informal Finance, Formal Finance, Marginalized, and Emerging Economy.

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Introduction

Developmental economists have realized the inherent complexities in delivering credit to rural masses in giant agrarian countries like China and India. The establishment and maintenance of rural financial institutions is a very complex and costly affair. The operational difficulties of rural financial intermediation have been accelerated by the state developmental strategies that attempts to ensure industrialization and urbanization at the cost of agricultural production. The well-established rural households prefer informal credit to formal credit. The emerging economies of the world have taken informal finance as a strong indicator of deficiencies in the formal financial system. The marginalized section is badly exploited by loan sharks and different illegal curb market operators when it is beyond their limit to approach and access to formal credit. Therefore, state needs to take initiatives to end informal finance by expanding the outreach of state run financial intermediaries. However, small business operators and farmers will continue to have strong faith in informal credit in India

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and China. The fundamental underlying reason behind the ever presence of informal finance in the contemporary society is that the formal finance is incapable of serving the financial needs of society. Thus, informal finance is not just the signal of weakness and inefficiency in the formal financial system but also an outcome of local political, institutional, and market interactions. Furthermore, informal finance exists even in advanced industrialized economies of the world. The ever presence of informal finance in India can be attributed to a large number of factors, including incompetency of formal financial system to fulfil the demand for the credit (Tsai, 2004).

Informal financing refers to the financing that happens in the absence of a formal financial intermediary between lenders [surplus or supply side] and borrowers [deficit or demand side]. Informal financing channels operate within grey area or beyond legal boundaries that is loan sharks. Informal financing is very much popular in newly established, smaller, and less audited or unaudited firms. Informal financing can be classified into constructive informal financing and underground informal financing. Constructive informal financing is related to the growth of firms. Informal financing is the most preferred source of fund when formal finance is unavailable. Informal financing sources include rotating savings, moneylenders, interpersonal lending, trade credits, loan sharks, private money house, pawnshops, credit organizations, etc. Trade credit and interpersonal lending are constructive informal financing sources. Constructive informal credit sources like family borrowing and trade credit based on relationship. Loan sharks and private money houses charge interest at higher rates. Credit cooperatives consists of rotating savings, credit organizations, rural cooperative foundations, mutual funds, etc. Trade credit is positively associated with good progress in firm when size of firm is large and number of competitors is negligible. Formal and informal financing are substitutes and complements as one boosts and backs economy in the absence of other (Allen et al., 2019).

Review of Literature

India banking system does not seem to be successful in expanding financial inclusion. The Invest India Foundation [IIF] has analysed data on borrowers with bank accounts who borrowed from sources other than banks. It has been observed that roughly one-third non-bank borrowers borrowed from the local moneylenders, and around half of them borrowed from friends and relatives. Two-thirds of all borrowers were rural borrowers. Banks are still today facing stiff competition from the informal credit sources. Thus, local moneylenders continue to hold a significant share in rural and urban loan or credit space. Majority of loans taken outside the banking system are consumer loans, i.e. non-productive loans. Financial exigency and medical treatment are two major reasons in half of the non-banking borrowings. Non-bank borrowings are preferred to bank borrowings because of the availability of fund at a very short notice and no compulsion of collateral. According to a survey report of Boston Consultancy Group [BCG], the condition of financial exclusion is very pathetic in Indian scenario that is evidenced by the fact that around one-third population of the country is engaged in formal banking system (“Informal lenders”, 2007).

Most of the citizens in developing economies of the world have almost negligible access to formal credit sources and hence, they solely depend on informal credit sources. Usually it has been observed that lending rates are higher than that of deposit rates within the same geographical area. Deposit rates range between 10-20 percent and lending rates range between 40-80 percent per annum. There has been observed a huge gap in lending rates within the same local credit markets. The rich borrow more funds at relatively lower interest rates. Gap in interest rates is not associated with default by borrowers. Under informal sector credit sources, default is almost non-existent. Access to reasonably priced credit sources is a major issue for the poor (Banarjee & Duflo, 2010).

The concept of informal finance is very old, and its regulation and supervision are beyond the control of the central bank or any other financial authority. According to a study, it has been observed that a large population

of the emerging economies is involved in informal finance. The informal financial institutions have not lost their significance despite of ongoing expansion of formal financial institutions. Noticeable changes have been observed in informal finance during the last hundred years. Informal finance is not just an age old conventional practice, but a deliberate attempt to address the needs and demands of contemporary society. Informal financial institutions are expected to exist alongside banks and micro financial institutions, even when access to formal finance improves substantially (Seibel, 2014).

Informal finance mechanisms are heterogeneous and omnipresent. It includes rotating savings and credit associations (ROSCAs), accumulated savings and credit associations (ASCAs), money lender, loan brokers, indigenous bankers, etc. These informal finance mechanisms may be conventional or non-conventional, ranging from lucid to complex; and driven by diverse needs like consumption, entrepreneurial, saving and investment, etc. The core characteristic of informal finance is intimate relationship between client and informal financial institution. There are different approaches to define informal finance. Informal finance can be defined as 'non-institutional finance'. In another approach, it can be defined as 'unregulated finance'. Informal finance can also be observed as a type of finance which is personal relationship oriented. Informal financial is not very popular in developed economies of the world, where the development of formal financial institutions has reached its zenith. The coexistence of formal and informal financial institutions is not an exception. Players of informal economy depend on informal finance to finance their entrepreneurial activities (Aliber, 2015).

Majority of Indians looking for the financial assistance have no option to avail credit without willingness to pay interest at higher rates. No workers engaged in the informal sector have access to formal credit. As a matter of fact, the access to credit is very much restricted in India that is evidenced by the fact that hardly one-tenth citizens of India have access to formal credit. It can be easily inferred that roughly one billion people do not have access to formal credit in India, i.e., around one-third population of the country. Therefore, informal financing is very much popular in Indian society to fill the gap in availability of formal credit. A substantial population is out of the coverage of formal credit system because of two major reasons. Majority of population does not have formal credit history and hence, banks do not have enough information about their creditworthiness. Therefore, they are asked for collateral while applying for the loan. Moreover, majority of people are not in position to pledge something against loan. Thus, most of the people are unable to access and afford formal loans, and hence, informal loans are getting popular in the society (Sen, 2017).

Finance has a substantial place in the current economic scenario of the world. Indian economic reform had been driven by the elimination of unnecessary and unreasonable restrictions on markets. The underlying objective of the economic reform in India was to let the market discover the price and demand of products and services in the market. International trade and industrial activity have been major outcomes of the idea of economic reform. The most visible and worth mentioning economic reform in the financial sector was the modernization of stock market that paved the way for open access to capital market. Management of household finance is the building block of improving business finance. There has been high level of informal and unsecured debt [including loans from local moneylenders and other informal credit sources] in India. The levels of life insurance and non-life insurance penetration are extremely low. There are numerous explicit and implicit challenges in the expansion and development of formal financial institution coverage in India. Strong leadership, coordination and cooperation of stakeholders, and introduction of new players are inevitable to address the prevailing inefficiencies of the formal financial institutions. Moreover, shift from informal to formal credit needs proper development of formal financial institutions and financial products (Singh, 2017). It has become a well-established fact that investment slowdown is delaying recovery in Indian economy. Private investment that is the main engine of growth, has become inactive. The investment slowdown is so high that it has surpassed the government's macroeconomic stimulus in the form of increased public investments. The private investment slowdown is noticeable in the informal sector of the economy. Corporate

sector is not the basis of downfall. The private investment slowdown can be attributed to slowdown in the household sector investment. Corporate savings are growing whereas household savings are declining. On the one hand, household consumers are net savers; on the other hand, government, corporates, and unincorporated enterprises are net spenders. The savings are primarily stored in banks and insurance companies, and net spenders raise funds from these sources. Corporate sector can borrow from overseas and raise funds from capital markets. Informal sector depends on domestic savings, largely through banks loans, to finance its investment. Government macroeconomic stimulus may not be the right policy prescription to tackle slowdown in private investments. Fiscal deficit reduction, immediate clean-up of the bank loans mess, and restoration of banks' health may play role crucial in reviving private investments (Mehra, 2018).

State government's decision to waive the farm loans taken by the farmers from the nationalized banks was undoubtedly a big relief to the farmers. According to a study of RBI, it is possible that farmers may shift from formal sources of credit to informal sources of credit because of absence of formal institution initiatives to extend them credit ahead. Loan waiver schemes launched in many states as a debt relief measure has a substantial role in curbing household debt. However, this scheme has no documentary proof of growth in investment and productivity of the beneficiaries of loan waiver scheme (Prabhu, 2018).

According to a report of Dun and Bradstreet, Two-thirds financial needs of micro, small and medium enterprises (MSMEs) are met by informal credit sources like local money lenders, friends, and family members, relatives, etc. Remaining one-third financial needs of MSMEs are fulfilled through equity finance and institutional finance. There is an urgent need of expansion of formal credit sources. The government has been running many schemes to address the financial requirements of MSMEs. Micro and small enterprises are fighting with the prevailing financial crisis scenario across the country. However, final call and crucial steps have to be taken by the government and private players so as to address the financial problems of the MSMEs (Soni, 2019).

According to National Bureau of Economic Research, promotion to formal sector does not bring significant improvement in business outcomes. Formalization is a developmental process whereby small and informal enterprises develop capabilities required to operate in a more formal, global economy. But informal sector cannot be forced to formalize. It is convenient for the state to supervise and to tax the firms falling under formal sector. However, forced formalization for the benefit of the state can adversely impact society. The informal sector offers large employment opportunities in the country like India, where unemployment is a major concern. Therefore, it becomes inevitable to look into the drawbacks of formalization. The current scenario of job, income and growth in India makes reorientation of government policies towards informal sector (Maira, 2020).

The formal credit system of India is uncongenial to the informal sector workers and micro entrepreneurs. It is very difficult for micro entrepreneurs to obtain a small size personal loan to address the cash flow requirement of their businesses as they do not have papers and collateral securities that are essential to obtain formal credit. Thus, they are deprived of the formal credit system. The vicious cycle of financial exclusion can be destroyed through the newly evolved financial instrument called returnable grant [RG]. Under the returnable grant, there is an expectation to repay the grant, either in lump sum or in EMIs over a predetermined time period. However, there is no legal obligation to repay the grant. It is interest free and there is no provision for the financial penalty. Repayment rate is higher under the returnable grant. The returnable grant can be helpful in making the way for formal credit to the informal sector workers and entrepreneurs (Nooruddin, 2020).

India needs to learn about the provision of interest free banking window in the financial system of the country. This can be understood very well from the experience of United Kingdom, Malaysia and other countries having such provision in place. The major side effects of overlooking this arrangement may be observed in two forms. Firstly, the major financial resources may flow into the informal channels. Secondly, finance can be denied to those who need it most. Financial inclusion has been the most significant goal of the government policy. A large Muslim population in the country follows the Shariat Law that states that interest is strictly forbidden. Therefore, it is possible that Muslims adhering to the Shariat Law do not subscribe to interest bearing banking products that may lead them to financial exclusion. It has been observed that many countries have followed Islamic banking system in their traditional banking system. However, India has not taken any such an initiative so far. It has been observed that the deposit account density in high proportion Muslim population districts is substantially lower. Faith based financial exclusion is significant in Kerala, West Bengal, Jharkhand, Rajasthan and Maharashtra. An insignificant private initiative has been taken to offer interest free banking services to the concerned population via cooperative societies (“The need”, 2020).

Farmers have to deal with ever growing natural calamities like floods and droughts every year that ruin crops. Joblessness and loss of crops forced the poor and marginal farmers to obtain credit from local moneylenders during the pandemic. Normally farmers running in financial crisis take loans from the local moneylenders and non-government organizations in order to offset their agricultural losses and for fulfilling their household expenditure. This informal credit is very costly because of extraordinary interest rates. Informal credit is excessively popular among farmers as its procedure is easier than formal credit. Relatives, friends and non-government organizations are the most common sources of informal credit for agriculturist community. Knowledge gap and systematic barriers are major roadblocks for farmers in obtaining credit from formal sources. It has been observed that non-government organizations and micro financial institutions are better sources of agricultural credit. Credit needs of farmers are abrupt that have to be addressed instantly. Therefore, their credit needs do not allow much waiting time. Farmers need training on financial literacy and digital technology in order to facilitate the use of mobile financial services to smoothen disbursement and repayment of loans (Anowar, 2021).

Loans taken for the purpose of personal consumption should be avoided. However, loans intending to accelerate income generation capacity [i.e. production loan, house loan, and education loan] are usually preferred. On the one hand, majority of Indians do not have regular source of income and severely suffer from income instability; and on the other hand, their consumption expenditure is uniform and ever growing. Larger portion of the consumption expenditure is met by debt. The salient features of Indian household debt are that Indians are gradually getting over indebted and inefficient, informal and expensive credit sources are on the verge of replacing formal and economic credit sources from the society. Indian household debt in terms of percentage of GDP has increased to more than three times from 2011 to 2021. Mortgage loans and gold loans are two most preferred categories of Indian household debt. Mortgage loans and gold loans account for the one-third Indian household debt. Ever growing demand for the education and healthcare services and extraordinary hike in their costs are major determinants of increase in Indian household debt. Stability in income and good credit score are prerequisite to avail institutional and affordable credit. However, irregular income and no or unsatisfactory repayment record compel majority of Indians to fulfil their basic consumption needs through the informal and expensive credit sources. Household debt is not absolutely disadvantageous to the society. The main issue of Indian household debt is that the major source of household debt is informal credit that is very costly and unaffordable but easily accessible to common people of the society. Therefore, the poor and needy people have limited access to formal and affordable credit sources. Thus, institutional credit has a greater opportunity to ensure its outreach to a larger population of the country (Chakrabarty, 2022).

Objective of Study

This research article is focused on two major objectives:

- To highlight the concept and characteristics of informal finance.
- To figure out the underlying reasons behind the existence of informal finance in contemporary society.

Research Methodology

This research article is exploratory cum descriptive by nature. It is primarily based on secondary sources of facts and figures, which include research journal articles, newspaper articles and editorials, magazine articles, and related articles available on different websites.

Informal Finance: Concept and Characteristics

It is very difficult to present a universally acceptable definition of informal finance due to its worldwide presence and inherent cross cultural variations. Therefore, no universally acceptable definition of informal finance is available in the contemporary world. Informal finance is also known as non-bank or non-institutional finance (Aliber, 2015). Informal finance refers to the fund procured through personal contacts and relationships (Allen et al., 2019). It may be for commercial and non-commercial (i.e., personal or consumption needs oriented) activities. It is mostly unsecured by nature and short term in terms of duration. Informal finance is usually offered in small denominations for short period and at higher interest rates (Anowar, 2021). This type of finance is largely accessed by the poor, marginalized people, and small and medium sized firms. It is financed by individual moneylenders, friends, and relatives, who are economically very sound and strong ("Informal lenders", 2007). Under this category of finance, personal relationship between client and creditor is of prime significance, and formalities are nominal against the formal finance (Aliber, 2015).

As far as characteristics of Informal finance are concerned, they are personal contact based, instant need driven, nominal formality, security or collateral free, financial illiteracy induced, higher interest rate driven, government regulation and control free, economically vulnerable and marginalized client based, commercial or consumption need oriented, etc. There is a great role of personal contact or relationship in the process of obtaining informal finance as usually informal credit is offered to the well-known individuals only. Thus, good personal relationship between creditor and client plays a pivotal role in the informal finance (Aliber, 2015). It is used for the fulfilment of immediate personal and business needs wherein not much time is available to the debtor to plan for the fund procurement. There is almost no or nominal formality because of intimate relationship between debtor and creditor, and absence of security in the informal financing process. The lack of financial literacy among people paves the way for more demand to informal finance in the society. Informal finance is beyond the government control and its users are from the economically weaker and marginalized sections of the society (Allen et al., 2019). Therefore, informal finance is normally provided at unreasonably high interest rates. Informal finance is very much popular among economically weaker and marginalized people for consumption and constructive purposes (Aliber, 2015). However, business class people use the same for constructive and commercial purposes.

Existence of Informal Finance in Contemporary Indian Society: Underlying Rationale

Informal finance is very much popular in emerging economies. However, it is not as prevalent among the developed economies of the world as in case of developing economies (Banarjee & Duflo, 2010). It is worth mentioning fact that formal and informal sources of finance coexist in both developing and developed economies of the world but their degree of prevalence varies depending on the level of development and penetration of formal financial system. Formal finance is a well-developed, regulated and government controlled institutional finance but informal finance is an undeveloped, unregulated and non-institutional finance (Aliber, 2015). Government has taken numerous initiatives to bring everyone under the umbrella of formal financial system in order to protect the poor and marginalized people from the exploitation of private

moneylenders. The twenty first century formal financial system has been developed very much as compared to the formal financial system in the past. The modern development of formal financial system could not make informal financial system irrelevant and insignificant because of the inherent weaknesses and incompetencies of the formal financial system and some demographic attributes of Indian society, which include lengthy formalities, time consuming and complex procedure, inconvenient process, irregular development of formal financial system, lower financial inclusion, poor financial literacy, regular and instant financial needs, limited access and availability of funds, etc. (Tsai, 2004).

To raise funds through formal sources of finance is a very difficult and cumbersome task because of underlying rigorous formalities, complex procedures, lower financial literacy, etc. Formal finance has its own inherent limitations that are evidenced by its limited accessibility and availability (Chakrabarty, 2022). A substantial population of the country is engaged in the unorganized sector that depends on informal finance to meet up its diverse financial needs (Seibel, 2014). Lower financial inclusion and weak financial literacy in the country result in greater dependence of society on informal finance. The poor financial literacy and irregular development of formal financial system have disabled the formal financial system to serve the society to their capacity (Tsai, 2004). Moreover, widespread poverty and relatively poor financial awareness in the country have made informal finance a universal phenomenon. Poverty led frequent and immediate financial needs of the masses have made informal finance very significant in the current scenario of the society (Banarjee & Duflo, 2010). Thus, infrastructural, demographic and systematic issues are the main underlying reasons behind the omnipresence of informal finance in Indian society.

Conclusion and Way Forward

Informal finance is an age old mechanism of providing financial support to the members of society by the members of society, i.e., interpersonal finance mechanism. It is primarily based on personal contact and intimate relationship, and it does not involve lengthy formality and complex procedure. However, informal finance has its inherent advantages and disadvantages. India is such a country where majority of population is economically vulnerable because of widespread poverty and unemployment. A large population of the country is involved in the unorganized sector where future is full of uncertainties. Healthcare, education, food, etc. are getting very expensive and unaffordable for the larger population of the country. Thus, cost of living has exponentially gone up because of ever growing price levels. Government has taken multiple initiatives to ensure the outreach of formal financial institutions to every citizen of the country. However, formal financial institutions are incapable of addressing the diverse financial needs of the large heterogeneous population of the country due to its inherent constraints. Therefore, informal finance seems to be the most vital source of finance as it backs and boosts economy when formal finance is unable to drive economy properly. Thus, informal finance is an unavoidable component of developing economy, where formal financial institutions are not in position to fulfil the diverse financial needs of the economy. The role of informal finance in an economy depends on the status of formal financial institutions in the economy as informal finance is crucial when formal financial institution is weak and vice versa.

Informal finance is a universal phenomenon, however, its significance depends on the positioning of formal financial institutions in the economy. Informal finance is supplementary to formal finance in the current economic scenario of the world as informal finance steers and supports economy in the absence of formal finance. This the fundamental reason behind the coexistence of informal and formal finance worldwide. The noticeable presence of informal finance in the contemporary Indian society despite of record development in the modern banking system and consistent improvement in financial inclusion is an important issue deserves to be analyzed minutely and thoroughly. There are many factors responsible for the strong presence of informal finance in the twenty first century society, including ever growing poverty and unemployment, increasing price

levels, poor financial literacy, infrastructural gap, developmental disparity, etc. It seems to be next to impossible to think of an emerging economy in the absence of informal finance in the current economic scenario. Thus, informal finance has become an inevitable and integral element of an economic system. Therefore, on one hand, government must focus on the development of formal financial institutions and financial inclusion in the country; on the other hand, it should harness the inherent potential of informal finance in the interest of economy and its citizens by having reasonable control through close surveillance on informal finance related activities. Informal finance is the cornerstone of an emerging economy like India. So, it should be preserved and promoted until and unless it adversely affects economy and goes beyond the legal framework of the country.

Conflict of Interest

This research article is not a part of any ongoing or submitted project work. There is no involvement of any kind of financial assistance in this work.

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