

MICROFINANCE AND THE POOREST

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I. INTRODUCTION

The advent of microfinance has raised high expectations regarding poverty alleviation in the developing countries. Timing of this innovation has coincided with the decline of the welfare state in many developed countries and ascendancy of a social philosophy giving rise to an era of residualization of the social policy. The new philosophy has set the agenda for removal of poverty in the developing countries in terms of actions to expand poor people's opportunities, empower them, and increase their security. Promoting opportunities for the poor people entails – among other things – access to financial systems. This role has been assigned to microfinance. It is argued that microfinance provides “a vision of poverty reduction that centers on self-help rather than direct redistribution” (Cull, *et. al.* , 2008). In other words, microfinance is seen as a part of the package of workfare policies which have come up as an alternative to the social transfers.

Anti-poverty effectiveness of social transfers has been widely recognized. But the case for social transfers has been weakened due to slow growth experience of countries like Sweden which have been providing generous social transfers. Regarding anti-poverty effectiveness of microfinance, its proponents are quite optimistic. But their optimism is not shared by many. A number of studies have sought to examine the anti-poverty effectiveness of microfinance. Most of these studies¹ do not find enough evidence to support the hypothesis: microfinance helps the poorest. Though a few studies including

¹We quote a few of these studies : (i) An African Development Fund (ADF) report states, “The objective of linking the poor to more formal financial institutions has not been reached, and the expected results, generation of income and employment, did not materialize” (Canadian Co-operative Association, 2000). (ii) Another evaluation study states, “There is a consensus amongst the experts interviewed for this study that micro-enterprise lending on its own does not ... improve the livelihoods of the majority of the poorest ... support from microfinance institutions would not be sufficient. Other types of intervention would need to be examined” (Bango, *et. al.*, 1999). (iii) An Asian Development Bank evaluation study of microfinance on rural households found that the impact was “negative on households with per capita incomes less than P34,428 ... The finding suggests that targeting microfinance on the poorest households may not be the most appropriate way to help them escape poverty” (Asian Development Bank, 2007).

Khandekar (2005) are supportive of this hypothesis. He finds that the “impact of microfinance is slightly higher for extreme poverty than for moderate poverty.” Khandekar (2005) uses land-holding as a proxy indicator of poverty. This is questionable. All landless or marginal land holders are not necessarily poor. We examine this aspect in the Indian context and find that a large number of these households are likely to be non-poor.

Lack of empirical evidence has not, however, diminished the enthusiasm of the proponents of microfinance. The failure is attributed to mis-targeting. It is argued that the problem is the design of microfinance institutions (MFIs) and the solution lies in improvement in their design. We discuss this issue in a subsequent section and hold that this has been, by and large, a futile exercise.

The perception that microfinance plays an important role in poverty alleviation has attracted substantial assistance from international donors and local governments. In fact, a large number of the MFIs in the developing countries owe their existence to such subsidies. But the aim of many international donors is to help the poorest which calls for effective targeting. We, however, find that targeting is not feasible. If targeting does not work, should microfinance still be subsidized ? This is not an easy question. This has to be answered within the whole context of the relationship between microfinance and poverty alleviation. The MFIs provide subsidized credit. But it is not cheap credit. Rates of interest charged by them lie in the range of 18-36 per cent. These rates are much higher than the lending rates of the commercial banks.

But the poor lack access to the commercial banks due to lack of collaterals. This problem has been overcome by the MFIs with the help of group lending and progressive lending techniques. The MFIs have, to a considerable extent, substituted the traditional money lenders who usually charge exploitative rates of interest. This is the role which has made microfinance an important tool for poverty alleviation programmes. But there is a catch too. The techniques developed by the innovators of the mission-oriented MFIs have also been adapted by many profit-oriented MFIs who charge very high rates of

interest.² Their success has given rise to a new paradigm in the field of microfinance - financial sustainability which remains a distant dream for MFIs in Asia and Africa since many of them are unlikely to survive without subsidies. Apparently, there is a conflict between financial sustainability and expansion of outreach. At this stage, financial sustainability has to take a back seat. Given the pro-poor potential of microfinance, financial sustainability may remain a low-priority objective even in the long run.

The emphasis of the proponents of financial sustainability is on the access to credit; for them cost of credit does not matter³. This is implausible. For decades, text books on Indian economics⁴ have been highlighting the problem of rural indebtedness among the poor which is caused by the unbearable burden of usurious rates of interest. Access to credit is important but affordability is more important. Affordability is obtained with the help of subsidies which are provided to assist the poor borrowers of the MFIs. However it is not feasible to restrict the clientele of the mission-oriented and subsidy-based MFIs to the designated poor. Thus it becomes pertinent to ask these two questions: should the MFI industry be left to the market forces? Should the poorest be assisted with the help of other types of intervention?

²There are, however, some exceptions. The rate of interest at BancoSol in Bolivia has been 20 per cent in 2006 though it was 70 per cent in 1992 (Otero, 2006). It may, therefore, be argued that affordable credit can also be provided by the profit-oriented MFIs. But this seems unlikely. Experience of MFIs in Asia and Africa does not bear this out where without subsidies almost the entire MFI industry, arguably, would cease to exist.

³If we look at the borrowers merely as clients, it is true that price is a low-priority for them. It is due to the myopic vision that the poor clients are unable to think anything outside their present situation. They are unable to perceive the results of their decision to borrow. If they have easy access to credit they are likely to overspend particularly on social consumption. But at the time of repayment, they are quite often compelled to reduce consumption of more essential needs including education and health care.

⁴For example Mitra and Chatterjee (1954) state : The high rates and the system of compound interest ... led to the exploitation of the *ryot* who was “as easily shorn of his gains as the sheep of its fleece” (p. 77). The *ryot* means the cultivator.

Besides the poor, who are the clients of the MFIs? Those who are not able to get credit from the commercial banks have to turn towards the MFIs. Obviously they are not the resourceful people. Though they may be designated as non-poor in the context of the official poverty lines but they do not differ much from the designated poor people. They are not affluent. They are not amongst the elites since the latter have access to the commercial banks. It is therefore pointless for the elites to capture the MFIs. By default, microfinance is for the poor masses which include both the poor and the near poor. Subsidization of goods and services consumed by the masses is not uncommon. Public expenditures on health care and school education, for example, target not only the poor; the masses are also targeted. Subsidies, therefore, should depend on the merits of the use of microfinance.

The proponents of microfinance presume that it provides livelihood finance. It is further presumed that more microfinance means more income generating activities for the poor. These expectations have not been fulfilled due to predominance of other uses. The key issue thus boils down to the purposes for which microfinance is being sought. There are four categories of uses : (i) for productive purposes; (ii) to meet the expenses in the event of emergencies due to sickness and unemployment, etc; (iii) for social ceremonies and festivals, etc; and (iv) for the repayment of old debt. Had the microfinance been used exclusively for the first category; the anti-poverty effectiveness of microfinance would have been quite impressive. But control over end use of microfinance is an elusive goal. The problem arises, to a certain extent, due to supply-side orientation of mission-oriented MFIs. The emphasis is on the expansion of the outreach. Even dumping of the loans on the targeted poor has been observed. This can prompt the targeted poor to borrow for less essential purposes and cause a cut down of more essential consumption at the time of repayment. In such a situation, microfinance is not a solution, it becomes a problem. The emphasis should be on the propriety of use which calls for a demand-side orientation.

The paper is divided into 5 sections. Section II details the difficulties in the use of various visible indicators of poverty for the purpose of targeting the poor. Section III provides a profile of the poor and the near poor households in rural areas of India with

the help of consumer expenditure data. Section IV examines the pattern of use of microfinance. Concluding comments are given in section V.

II. FINDING THE POOR

Who are poor and how can they be identified? This assumes importance when the subsidized services - in this case microfinance – are to be solely targeted to the poor. Poverty line is usually defined with reference to income or consumer expenditure level. Poverty line in India, for example, is drawn in terms of minimum level of consumer expenditure per person per month.

To identify the poor, the ideal approach would be to have a complete information on the level of household income or consumer expenditure level. Such information is not available. In India, for example, sample surveys are conducted to collect data on consumer expenditure. Income or consumer expenditure data on a census basis are not collected. It is, therefore, customary to use proxy indicators to identify the poor households. Khandekar (2005), for example, has used land-holding as a proxy indicator of rural poverty in Bangladesh. Landless and marginal landowners are categorized as poor in the rural areas. Is this a reliable approach? We examine this aspect in the Indian context with the help of National Sample Survey (NSS) data. For this purpose we furnish the land-holding data for the poorest 10 and 30 per cent. Table 1 shows landless and marginal land-holders, on the one hand, and the poor, on the other hand, are widely different categories. Two-fifth of the poor are precluded because they are neither landless nor marginal landholders.

The size of land-holding as a proxy indicator of rural poverty does not work. But this does not exhaust the list of easily visible indicators. Another approach has been to identify the poor neighbourhoods. It is, however, well recognized that all households who live in such areas are not necessarily poor. Secondly, all poor people do not live in poor neighbourhoods. For example, it may be around 50 per cent in the low stratum, around 20 per cent in the middle stratum, and around 2 per cent in high stratum of the neighbourhood. This approach has been adopted in a number of cases despite the

possibility of the exclusion of the deserving. The purpose of using this approach is to avoid high administrative expenses associated with an exercise aiming at a more accurate targeting.

Table 1

Composition of the poor as per size of land-holding in rural areas of India during 2004-05*

Size of land-holding (hectare)	Poorest 10 per cent	Poorest 30 per cent
0-0.01	24.8%	22.9%
0.01-0.40	33.9%	35.1%
0.40-1.00	19.9%	21.3%
1.00-2.00	13.1%	12.3%
2.00-4.00	6.5%	6.1%
4.00 and above	1.8%	2.3%
All	100%	100%

*Calculated from the NSS data

Source : Government of India (2007).

Another easily observable indicator is the type of construction of a housing unit. It may be argued that it is as easy as looking at the roof. A temporary flimsy roof made of straw, leaves, plastic sheets, etc. may be taken as a proxy for poverty. But in practice, this may not be true. In some cases, “many people who were living in poor quality housing ... were falsely included.” At the same time, many instances “were cited of people living in poverty while having reasonable housing conditions” (Simanowitz, Nkuna and Kasim, 2000, p.17).

A lack of water or electricity in a dwelling unit is another possible visible indicator of poverty. But many poor households may have these facilities and thus may, therefore, be excluded. Further, locational differences in the provision of these facilities may portray a false picture.

Level of education is strongly and negatively correlated with poverty. But this does not offer much help in the identification of poor households due to wide variation in income levels across different education groups. Even among the semi-literate and illiterate groups, the variation is quite substantial (Table 2). Only in case of college graduates, a distinction can be made since a very small number of families with college education are poor.

Table 2

Distribution of education between the poor and the non-poor, rural areas of India, 2004-05

Level of education	Poorest 10 per cent	Poorest 30 per cent	Non-poor (Top 70 per cent)	All
Illiterate	14.2%	39.4%	60.6%	100.0%
1-5	9.1%	28.9%	71.1%	100.0%
6-9	6.2%	22.3%	77.7%	100.0%
10-11	3.7%	15.0%	85.0%	100.0%
12-14	2.3%	10.7%	89.3%	100.0%
14 and above	1.5%	7.3%	92.7%	100.0%

*Calculated from the NSS data

Source : Government of India (2006).

The incidence of errors is thus likely to be enormous. The errors are of two types, many undeserving are included whereas many deserving are excluded. Targeting can be successful only when it is easy, clear and unambiguous; and the benefits are difficult to be claimed by the non-targeted groups. But this is difficult to obtain. One way out is an elaborate system of targeting which has been suggested by Simanowitz, Nkuna and Kasim (2000) in the context of microfinance. However, it is a highly expensive method. They, therefore, suggest the need for a balance between the level of accuracy required in poverty targeting and the resources required to achieve it.

However, even an elaborate system is likely to miss the target because of the transitional nature of poverty. Slipping into and slipping out is a widely observed phenomenon (see, e.g., Bane and Ellwood, 1986). The number of poor is likely to be less if it is estimated on a weekly basis than when it is on a monthly basis. The poverty estimates would still be higher if it is estimated on a yearly basis. It is evident from the findings of a study based on the US data by Ruggles and Williams (1989) : “poverty rate based on the annual income ... is about 11 per cent ... only about 5 per cent of the population were poor in every month ... over 26 per cent had at least one month in 1984 when their family incomes were below the monthly poverty threshold” (p.226).

In India too, poverty spells have been observed by Krishna (2004, 2006). These spells bring about departure of the enriched families from the poverty list along with the entry of the impoverished families. The list of the poor, therefore, needs to be updated frequently; but this is a very difficult proposition. Typically, these spells affect a large number of households whose incomes are near but not necessarily below the poverty line at the time of the survey. In other words, the population below a given poverty line has a floating nature. Targeting involves inclusion of the poor and exclusion of the near poor with reference to a particular period. In the subsequent period, the same list may not portray a correct picture.

Despite huge costs, an elaborate exercise has been undertaken in India to compile below poverty line (BPL) lists on the basis of aggregation of scores across the 13 indicators for ranking individual households.⁵ These lists have been scrutinized by a number of researchers. We refer to two such studies. Khera (2008) finds that 44 per cent of the households eligible for BPL cards had been excluded from the BPL list. Another study by Ram, Mohanty and Ram (2009) find that four out of every 10 BPL cards are going to the non-poor households.

⁵For an evaluation of this approach, see Sundaram (2003).

Regardless of the costs involved in the preparation of the BPL lists, it is difficult to make a distinction between the poor and the near poor. In fact, targeting does not work. Then what are the options before the mission-oriented MFIs? To answer this question it is imperative to examine the likely composition of the clientele of the MFIs. As argued earlier, the clientele of microfinance comprises of those who lack access to the commercial banking system. In India, these services are available to almost 40-60 per cent of the population (Demignc-Kunt, Beck and Honohan, 2008) which implies that clientele of microfinance would come from the bottom 60 per cent of the population whom we broadly refer as the poor and the near poor. The poor are those who would fall below the official poverty line and usually comprise the targeted group. This group comprises of those non-poor who have been included in the official list (Type II error). A substantial fraction of the poor are excluded from the list (Type I error) who are thus among the “non-poor”.

From the above, it is clear that targeting does not work. The alternative to the targeting is universal coverage. In case of microfinance it would mean coverage of the bottom 60 per cent of the population. Do they deserve the benefits? This question is answered with the help of the profile of the poor and the near poor which is discussed in the next section of this paper.

III. THE POOR AND THE NEAR POOR

Table 3 gives distribution of consumer expenditure in India. Poverty level in India is around 26 per cent in 1999-00 according to the Planning Commission. By and large, this corresponds to the level of international poverty line at \$1 per day. In the context of cross-country comparisons, two poverty criteria are used : \$1 per day and \$2 per day.⁶ The second criterion would put around 80 per cent of rural population in India below this poverty line.

⁶For the concept of \$1 per day and \$2 per day poverty lines see Chen and Ravallion (2001).

Table 3 suggest that poverty is a problem of the masses which confronts almost 80 per cent of India's population according to \$2 per day poverty line. In case of microfinance, however, we find that around 60 per cent of the population can be its clients. It is, therefore, pertinent to ask : are the remaining 34 per cent not deserving? Like the poorest 26 per cent, their educational, health and housing standards are abysmally low. They are unable to afford a reasonable level of expenditures on education and health care (Table 4). The distribution of these expenditures is highly unequal. The

Table 3

Distribution of consumer expenditure in rural areas of India, 1993-94 and 2004-05

Decile group of population	1993-94	2004-05
0-10%	4.1%	4.1%
10-20%	5.4%	5.3%
20-30%	6.3%	6.1%
30-40%	7.1%	6.9%
40-50%	7.9%	7.7%
50-60%	8.9%	8.6%
60-70%	10.0%	9.7%
70-80%	11.6%	11.3%
80-90%	14.2%	13.9%
90-100%	24.4%	26.4%

Source : Government of India (2006a).

expenditure on education in case of the poorest 70 per cent is less than the average level which itself is abysmally low. Due to provision of mid-day meals at the elementary education level, the participation of the children from the poor sections has improved. But secondary education remains a distant dream. Recently, there has been a paradigm shift with regard to secondary education. Earlier it was dominated by the public sector. Now the private sector is emerging as the dominant factor. The factor responsible for the decline of public sector secondary educational system is the steep decline in its quality

due to governmental neglect. For the poor masses, the private schools are unaffordable. This has led to greater educational inequalities.

Table 4
Level of personal expenditures on education and health by different consumer expenditure decile groups in rural areas of India, 2004-05

Decile groups	Expenditure on education	Expenditure on health
0-10%	1.5%	1.6%
10-20%	2.4%	2.5%
20-30%	3.6%	3.3%
30-40%	4.4%	3.7%
40-50%	4.9%	4.7%
50-60%	6.7%	5.6%
60-70%	7.7%	7.2%
70-80%	10.5%	9.8%
80-90%	17.1%	13.4%
90-100%	41.2%	48.2%
All	100%	100%

*Calculated from the NSS data

Source : Government of India (2007a).

Public expenditures on health care have also been quite low in India and in recent years there has been a steep decline in its level (Berman and Ahuja, 2008). It was 1.12 per cent of the gross domestic product in 1999-2000; it had declined to 0.97 per cent in 2004-05. This implies that public health care facilities are quite meager.

Data on personal expenditure on health care also presents a miserable picture. Table 4 suggests that almost 90 per cent of the population find it difficult to afford a reasonable level of medical care. Absence from work for even for a couple of days compels the poor and the near poor households to borrow; even small loans of Rs. 50 or Rs. 100 are sought in such situations (Reddy, 2007). Prolonged sickness brings much distress. The

unbearable burden gives rise to decline in economic position. The deterioration pushes the helpless families below the poverty line.

Those who fall below the official poverty line comprise the poor and their poverty is a matter of concern of both the social policy and the microfinance. But there are many others who also face various types of deprivation. Even if we assume the BPL lists are accurate even then it would exclude the near poor. It is a problem of mass poverty which encompasses both the poor and the near poor which can effectively be tackled by universal coverage. Even in case of universal coverage by the MFIs, the benefits of the subsidies are unlikely to be appropriated by the resourceful. They have a cheaper option – their access to commercial banks offers a much better bargain.

There is a need to depart from the narrow vision of poverty which is modelled around the concept of the official poverty line. The poverty line in India, for example, is based on a minimum desirable level of calorie intake. The level of consumer expenditure at which the average calorie intake equals the given calorie norm is designated as the poverty line. The other basic necessities including housing, clothing, medical care and education are just ignored (see, e.g., Jain, 1992).

The outcome of restricting the benefits of the MFIs to the poorest not is encouraging. A distorted picture emerges. The finding that microfinance has benefited the less poor more than the poorest is taken as an indicator of failure of microfinance. As a remedy, expansion of the outreach of the microfinance to the poorest is suggested. This has led to the quest for numbers giving rise to supply-driven expansion. The poorest are encouraged to become clients of the mission-oriented MFIs. Regardless of the investment opportunities they receive loans which are quite often used for consumption purposes including avoidable social celebrations. Repayment is not easy for them. They are likely to cut down their expenses on health and education. The problem of poverty in the event of such interventions thus gets compounded.

IV. PATTERN OF USE OF MICROFINANCE

The loans are taken from the MFIs for the following four purposes : (i) for

Table 5
Pattern of loans taken by three members of an MFI

Category	Purpose	Amount	Amount
(i)	Lease of land	10,000	
	Agriculture	500	
(ii)	Buying goats	10,000	20,500
	Grocery	200	
	Grocery	500	
	Consumption	500	
	Medical expenses	200	
	Fees for daughter's education	2,000	
	Son's education & repayment of old loan	20,000	23,400
(iii)	Marriage of grand daughter	10,000	
	Marriage of daughter	10,000	20,000
(iv)	Repayment of old debt	1,000	
	Repayment of old debt	5,000	6,000

Source : Padila (2005), p. 175.

productive purposes; (ii) to meet the expenses in the event of emergencies arising due to sickness, unemployment, etc.; (iii) for social ceremonies and festivals, etc.; and (iv) for repayment of old loans. Table 5 shows the typical pattern of loans taken by the members of an MFI.

The above pattern is a representative one. A number of studies portray a similar picture. We quote three reports pertaining to India which provide additional evidence. Two of them are official reports and the third one is a World Bank report.

A report of the Planning Commission (2007) states that about two-thirds of the estimated credit requirement of the poor is on account of consumption needs. Nearly three quarters of the consumption needs are due to emergencies like illness and household expenses during the lean periods.

A World Bank report (World Bank, 2004) also finds a similar pattern. According to the report, family emergency accounts for 28.76 per cent of the loans, social expenditure for 18.54 per cent and routine household expenditure for 11.61 per cent. Hardly 26.88 per cent are for investment purposes.

In 1976, an official committee (Government of India, 1976) examined the credit needs of the poor for the consumption purposes. The specific consumption needs identified by the committee were : (a) medical expenses – 33 per cent, (b) marriage – 33 per cent, (c) education – 13 per cent; (d) birth, death and religious purposes – 10% and (e) general consumption – 10 per cent.

Income enhancing effects of microfinance are thus likely to be limited because a major part of microfinance is for non-productive purposes though the urgency of many of these needs is unquestioned. Since a substantial part is used for consumption purposes it is doubtful that these purposes would have the support of the proponents of microfinance. However, the widely held belief that microfinance is livelihood finance does not find much support by the observed pattern given in Table 5. Though this does not mean that the anti-poverty effectiveness of microfinance is entirely blunted. Consumption smoothing is also important. As argued earlier, the near poor often slip into poverty and in many cases such a slip can be prevented with the help of microfinance.

However it is pertinent to ask : are other interventions not more effective? In particular, the neglect of health care and secondary education needs to be elaborated. Level of public spending on these social services is quite low. Despite impressive growth performance during the last two decades, public spending on these services as percentage of GNP has been declining. This is quite unusual in the context of the past experience of

the developed countries. Whether it is linked to the euphoria created by the success of microfinance and certain other developments is a moot question. But the fact remains that the government has abdicated its responsibilities in the field of social services. Microfinance plays an important role. But can poverty be removed without investments in human capital?

V. CONCLUDING COMMENTS

Microfinance is perhaps a victim of its success. Its missionary zeal is being hijacked by the adaptation of its technique by the market-oriented MFIs. Financial sustainability has become its current paradigm which challenges the very existence of many mission-oriented MFIs. It is forgotten that the poor had access to credit even before the advent of microfinance; money lenders had been there to provide loans and to charge exploitative rates of interest. The microfinance brought a revolutionary change by offering credit to the poor at affordable rates of interest.

The proximity of microfinance to the welfare-to-work approach has led to a gross exaggeration of its role in poverty alleviation. The widely held belief that poverty can be removed simply by providing access to finance seems to persist though it is not supported by facts. In this context, it is imperative to have a realistic assessment of the role of microfinance. We hold that microfinance can provide livelihood finance if adequate opportunities for micro entrepreneurs and self-employed exist. To generate more opportunities for the micro entrepreneurs and self-employed, policy to promote village and cottage industries has been followed in India since independence. But its impact has been quite limited.

The limited role of livelihood finance also becomes apparent in the context of the concept of “earning capacity poor” *a la* Haveman and Buron (1993).⁷ A family is poor

⁷Though this concept has been articulated in the U. S. context, this type of poverty is far more pervasive in countries like India.

according to this definition if full use of its earning capabilities would fail to generate enough income to lift the family out of poverty. In such a situation, microfinance does not deliver the goods.

Microfinance for whom? Those who have been left over by the commercial banks should be covered by the MFIs. They are likely to be either the poor or the near poor. This is a realistic approach for two reasons: (i) the targeting remains an elusive goal; and (ii) the differences between the poor and the near poor are quite small and both the groups lack access to basic amenities including health care and education; it is thus the problem of mass poverty which need to be addressed. It may either be livelihood finance or consumption smoothing finance – both of them have anti-poverty implications. The former enhances the income generating activities whereas the latter prevents a possible slip into poverty. However, loan-funded expenses on social celebrations are considered extravagant (see, e.g. Rao, 2001) and are likely to blunt the anti-poverty effectiveness of microfinance.

Lack of public expenditures on health and education has a debilitating impact on the anti-poverty effectiveness of microfinance. It is a pity that loans are sought to meet the medical expenses even in case of minor illnesses. Microfinance is not the right type of intervention in such situations.

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