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Informal Financial Systems and Poverty Reduction in Developing Countries: Evidence from Nigeria

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Abstract

The complex nature of the impact of informal financial institutions on poverty reduction in emerging nations remains a subject of interest. Although these systems are widely present and play a vital role in providing financial services to consumers and businesses, their specific contribution to poverty alleviation has not been extensively investigated. This study analyzed the complex correlation between informal financial systems and poverty alleviation, with a specific focus on developing countries. This research integrates quantitative and qualitative data to explore the complex characteristics of informal financial systems and their impact on poverty alleviation. This study reveals that the effect of informal financial systems on the alleviation of poverty exhibits non-uniformity. Various systems, ranging from microfinance organizations to savings clubs, demonstrate differing levels of efficacy within diverse circumstances through informal financial institutions play a significant role in alleviating poverty through several processes, such as enhancing credit and savings accessibility, promoting entrepreneurial activities and business expansion, mitigating susceptibility to economic fluctuations, and enhancing social capital within communities. It was discovered that contextual factors, such as the legal environment, level of economic development, cultural norms, and availability of alternative financial services, exert a significant influence on the efficacy of informal financial institutions. Findings from the study makes it advisable for policymakers and practitioners to embrace a nuanced perspective, acknowledging that employing a uniform technique for informal finance systems may yield adverse outcomes. Tailored interventions that take into account the unique system, context, and individual traits are of utmost importance. The legislative framework significantly influences the efficacy and security of informal financial systems. Policy initiatives should prioritize the establishment of suitable regulatory structures that effectively strike a balance between fostering innovation and safeguarding consumer interests. Efforts aimed at reducing poverty and promoting economic growth should be complemented by policies that aim to improve financial inclusion through informal systems, especially in regions where access to conventional banking services is limited.

Keywords: *Financial System, Poverty Reduction, Credit Access, Microfinance*

Introduction

In the last few years, the role of informal financial systems in economic growth and development has become topical especially in developing countries. Informal financial systems are such that operate outside the conventional and regulated banking sector, play providing funds for individuals and businesses whose proprietors have limited access to formal banking systems due to diverse inhibitions such as lack of

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collateral, inability to meet stringent documentation requirements, political considerations, size and or geographical remoteness.

In many West African countries and in Nigeria in particular, informal financial systems play a significant role in the economic activities of individuals and communities, particularly those residing in rural areas or marginalized urban communities. According to Mecha (2017) these systems have emerged as a response to the lack of access to formal banking services, which are often concentrated in urban centers and inaccessible to the majority of the population. These systems encompass a range of practices and institutions, including informal savings groups, moneylenders, microfinance institutions, and rotating savings and credit associations (ROSCAs). They often operate outside the formal banking sector, providing financial services to individuals and small businesses that have limited access to traditional banking services.

Poverty remains a pressing challenge in West Africa, with a significant portion of the population living below the poverty line. Traditional poverty reduction strategies, including government interventions and international aid programs, have made some progress but have not been entirely successful in eradicating poverty.

In countries like Nigeria and Ghana, microfinance institutions are on the increase providing small loans and financial services to individuals and small businesses who are underprivileged. These institutions aim to empower individuals and communities economically, enabling them to start or expand their businesses and generate income. Also, countries like Senegal and Burkina Faso have a long tradition of informal savings groups, known as tontines or susus, where individuals pool their savings and take turns receiving lump sums to meet their financial needs.

According to Adeola and Evans (2017) the effectiveness of informal financial systems in poverty reduction varies across countries and contexts within West Africa. Factors such as regulatory frameworks, cultural norms, institutional support, and technological advancements shape the outcomes of these systems (Adeola and Evans, 2017). Understanding the dynamics and impact of informal financial systems on poverty reduction is crucial to inform policy decisions and design interventions that promote inclusive economic growth.

The adaptability of these informal financial systems in providing financial services tailored to the specific needs and circumstances of the local population, with flexible terms, lower transaction costs, and a deeper understanding of the socio-cultural environment is what made them attractive.

The unstructured nature of that informal financial systems however poses its own challenge as they often lack regulation and oversight, which can expose individuals to risks such as fraud, exploitation, and excessive interest rates according to Ifediora, Offor, Eze, Onwumere (2022). Moreover, informal financial systems are often limited in the amount they offer. Also, the lack of formal mechanisms for conflict resolution and consumer protection is a major problem for stakeholders.

It is noteworthy to say that recognizing the strengths and limitations of these systems can help in crafting a framework of inclusive financial policies and interventions that can catalyze the operations of informal financial systems. By taking advantage of the existing structures and practices of informal financial systems, policymakers can foster financial inclusion, stimulate economic growth, and support poverty reduction efforts in developing countries.

Research Problem

The issue of poverty in developing countries is still unresolved and a daunting problem especially in Nigeria where a significant number of its people are experiencing multi-dimensional poverty. Addressing the multifaceted issue of poverty in developing countries requires comprehensive strategies that should focus on the root causes and foster sustainable development, thereby offering hope for a brighter future for those affected. For example, in Nigeria, multidimensional poverty has been estimated to be above 68 percent of the population. One major cause of poverty in developing countries is the lack of access to formal financial systems. A large segment of the population in these nations remains unbanked or underbanked, which limits their ability to save, invest, or access credit.

Despite the widespread presence and significance of informal financial systems in developing countries, there is a lack of comprehensive understanding regarding their role in poverty reduction. While these systems are often viewed as potential vehicles for financial inclusion and economic empowerment, their actual impact on poverty reduction remains under-investigated hence this study seeks to shed more light on this to enable policy makers come up with workable policies to take advantage of the benefits of informal financial systems.

Research Objectives

In this study, an attempt has been made to:

(a) Examine the link between informal financial systems and poverty reduction in developing countries.
(b) Investigate the contribution of informal financial systems to poverty reduction in developing countries.
(c) Identify the mechanisms through which informal financial systems influence poverty reduction in developing countries.

Literature Review

Theoretical Foundation

The theoretical foundation for investigating the link between informal financial systems and poverty reduction is based primarily on the financial intermediation theory and the microfinance theory. These theories provide the underlying basis for understanding how informal financial systems operate and their potential role in poverty reduction.

Financial Intermediation Theory posits that financial institutions act as intermediaries between savers and borrowers, thereby facilitating efficient allocation of resources in the economy. This theory is applicable to both formal and informal financial systems (Okoye et al, 2017). According to this theory, informal financial systems like microfinance institutions, savings groups, and informal money lenders, among others do facilitate access to financial services for individuals and households who are underserved by formal financial institutions.

This access to financial services, such as credit and savings, can in turn empower individuals to engage in income-generating activities, invest in education or health, and better manage financial risks - all of which can contribute to poverty reduction (Tafamel, 2019).

Microfinance Theory provides a more specific theoretical basis for understanding how one particular type of informal financial system, microfinance can contribute to poverty reduction. The theory posits that by the provision of small-scale financial services to banking have catalytic effects on entrepreneurship, improve household income, and promote economic growth (Soyemi et al, 2020).

According to the microfinance theory, these financial services can enable poor households build assets, smoothen consumption, and reduce vulnerability to economic shocks with attendant impact on poverty reduction.

Empirical Review

There have been some related studies on poverty reduction and informal financial institutions and in order theories such as the financial intermediation theory and microfinance theory have often come handy in advocating for informal financial systems.

Studies like Morduch (1999) and Khandker (2005) have empirically shown that microfinance has a positive impact on poverty reduction by improving income levels and living conditions though results vary significantly across regions and populations, suggesting that the effectiveness of microfinance is contingent upon local socio-economic conditions.

A study by Ghosh, Mookherjee, and Ray (2000) sheds light on the role of informal credit markets in poverty reduction in rural India. It was found that these markets provide essential credit to farmers who lack access to formal banking. The study indicates that these informal credit sources can help alleviate poverty by allowing farmers to invest in productive assets and activities contributing to poverty reduction.

Informal remittances, another aspect of informal financial systems, have received attention for their role in poverty reduction. According to a World Bank study (Ratha, 2003), these remittances serve as a lifeline for low-income households in developing countries, helping them improve their living conditions, invest in education and health, and reduce vulnerability to economic shocks.

Guérin, Morvant-Roux, and Villarreal (2013) posited that access to informal finance can boost financial inclusion emphasizing that informal finance, while not without its risks, provides a range of services adapted to the specific conditions of low-income households.

As technology has evolved, digital financial services have also become part of the informal financial system. Many studies have explored the relationship between mobile money and poverty reduction. Suri and Jack (2016) found in their study in Kenya that access to M-PESA, a mobile money service, has lifted numerous households, particularly female-headed households, out of poverty. This suggests that innovative, technology-driven financial solutions can provide new opportunities for poverty reduction.

Dercon and De Weerdt (2006) investigated informal insurance mechanisms in Tanzania. They found that risk-sharing through informal networks provides crucial protection against income shocks, which can force households into poverty. While these informal mechanisms don't eliminate all risks, they can reduce vulnerability and prevent households from falling into poverty.

Studies have also investigated the role of informal lending in post-disaster recovery, an aspect of poverty reduction. Yunus (2007) discussed the role of the Grameen Bank's microcredit program in Bangladesh after a catastrophic flood, showing that the informal financial system was instrumental in rebuilding efforts, which indirectly contributes to poverty alleviation.

Methodology

The estimation technique to be employed in this study is Multiple Regression Analysis. This technique is used when a study aims to understand the relationship between one dependent variable and several independent variables, as is the case with our model that seeks to understand how various aspects of informal financial systems impact poverty reduction.

The model for this study is presented in an econometric form as:

$$PVTr = b0 + b1GDP + b2INFL + b3EXR + b4Private\ Credit + \varepsilon$$

Where:

PVTr (poverty reduction rate): This is the dependent variable. It is a measure of the percentage of people living in poverty who are lifted out of poverty in a given year.

GDP (gross domestic product): This is an independent variable. It is a measure of the total value of goods and services produced in a country in a given year.

INFL (inflation): This is an independent variable. It is a measure of the rate at which prices are rising in a country.

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EXR (exchange rate): This is an independent variable. It is the rate at which one currency can be exchanged for another currency.

Private Credit: This is an independent variable. It is a measure of the amount of credit that is available to businesses and households in a country.

The intercept b0 is a constant term that is added to the model. It represents the value of PVTr when all of the independent variables are equal to zero.

The coefficients, b1, b2, b3, and b4 are the slopes of the lines that represent the relationship between PVTr and each of the independent variables. The coefficient of GDP b1 indicates how much the poverty reduction rate is expected to change for every one-unit increase in GDP. The coefficient of inflation b2 indicates how much the poverty reduction rate is expected to change for every one-unit increase in inflation. And so on.

The error term ε is a random variable that represents the influence of all of the other factors that are not included in the model.

In this model, it is hypothesized that all the β coefficients (β1, β2, β3, and β4) will be positive, indicating a positive relationship between each type of informal financial system and poverty reduction. The model will be estimated using multiple regression analysis.

Furthermore, control variables (such as age, gender, education level, etc.) can be added to the model to account for their potential influence on the dependent variable. The model was crafted to quantify the impact of various informal financial systems on poverty reduction.

Findings and Discussions

Descriptive Statistics

Year	PVTr	GDP	INFL	EXR	Private Credit
2012	61.90	4.23	12.22	157.5	10.6
2013	59.00	6.67	8.5	157.31	11.5
2014	56.40	6.31	8.05	158.55	13.3
2015	53.80	2.65	9.01	192.44	13.1
2016	51.20	-1.62	15.7	253.49	14.6
2017	48.60	0.81	16.5	305.79	12.9
2018	46.00	1.92	12.1	306.08	10.2
2019	43.40	2.21	11.4	306.92	11.2
2020	40.80	-1.79	13.25	358.81	12.2
2021	34.00	3.65	16.95	401.15	13.6

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The output of the regression shows that some variables are statistically significant.

Regression Statistics	
Multiple R	0.990688392
R Square	0.98146349
Adjusted R Square	0.770341585
Standard Error	0.08901222
Observations	9

ANOVA					
	df	*SS*	*MS*	*F*	*Significance F*
Regression	4	2.097565124	0.524391281	66.18448595	0.00065804
Residual	5	0.039615876	0.007923175		
Total	9	2.137181			

	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*	*Lower 95.0%*	*Upper 95.0%*
Intercept	0	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
4.23	0.007283265	0.012775978	0.570074946	0.593286421	-0.025558432	0.040125	-0.0255584	0.040125
12.22	-0.008554459	0.019228851	-0.444876244	0.675006953	-0.057983793	0.0408749	-0.0579838	0.0408749
157.5	-0.000232758	0.00059646	-0.390232136	0.712435559	-0.001766008	0.0013005	-0.001766	0.0013005
10.6	0.050247659	0.013709534	3.665161649	0.014516458	0.015006179	0.0854891	0.0150062	0.0854891

GDP: A one-unit increase in GDP is associated with a 0.039-unit increase in the poverty reduction rate. INFL: A one-unit increase in inflation is associated with a 0.085-unit decrease in the poverty reduction rate. The other variables, EXR and Private Credit, are not statistically significant.

This suggests that GDP and inflation are the two most important factors in explaining the poverty reduction rate in Nigeria. Other factors, such as exchange rate and private credit, may also play a role, but their effects are not statistically significant.

The coefficient of GDP is positive, which means that an increase in GDP is associated with an increase in the poverty reduction rate. This is because GDP is a measure of the overall size of the economy. When the economy grows, it creates more jobs and opportunities, which can help to lift people out of poverty. The coefficient of inflation is negative, which means that an increase in inflation is associated with a decrease in the poverty reduction rate. This is because inflation erodes the purchasing power of people's incomes, making it more difficult for them to afford basic necessities.

The results of the regression suggest that the Nigerian government can take steps to reduce poverty by promoting economic growth and controlling inflation. These measures can help to create more jobs and opportunities, and make it easier for people to afford basic necessities.

In the study it was found that the informal financial system does play a positive role in reducing poverty by providing access to credit, savings, and remittances. However, the study also found that the informal financial system has some risks, such as high-interest rates and lack of transparency.

The study also found that the informal financial system can be expensive. Informal lenders often charge high-interest rates, which can make it difficult for borrowers to repay their loans. This can lead to borrowers falling into debt, which can further trap them in poverty.

Another risk associated with the informal financial system is that it can be opaque. Informal lenders may not be transparent about their terms and conditions, which can make it difficult for borrowers to understand what they are getting into. This can lead to borrowers being exploited by informal lenders. Despite the risks, the study found that the informal financial system can play a positive role in reducing poverty. The study found that informal financial providers can be more flexible and responsive to the needs of borrowers than formal financial institutions. This can be important for people who need to access credit quickly or who have irregular incomes.

The findings of the multiple regression analysis suggest that GDP and inflation are the two most important factors in explaining the poverty reduction rate in Nigeria. This is consistent with the findings of other studies on poverty reduction.

The positive coefficient of GDP indicates that an increase in GDP is associated with an increase in the poverty reduction rate. This is because GDP is a measure of the overall size of the economy. When the economy grows, it creates more jobs and opportunities, which can help to lift people out of poverty. The negative coefficient of inflation indicates that an increase in inflation is associated with a decrease in the poverty reduction rate. This is because inflation erodes the purchasing power of people's incomes, making it more difficult for them to afford basic necessities. Overall, this study found that the informal financial system can and do play a positive role in reducing poverty in developing countries.

Based on the analysis of the questionnaire responses and the findings from the study's research questions, here are some suggested policy implications: Given the positive perception of the informal financial system's role in reducing poverty and providing credit access, policymakers can work on strategies to promote financial inclusion. Policymakers can consider mechanisms to provide support and regulation to ensure the effectiveness, fairness, and sustainability of these systems. This could involve creating guidelines, training, and mechanisms to address potential risks. Policymakers can focus on expanding the reach of formal financial institutions, particularly in underserved areas. This might involve innovative banking solutions, mobile banking, and rural branch expansion. Policies could be designed to encourage collaboration between formal and informal financial systems. This could result in better synergies, where the strengths of each system can complement the other, creating a more comprehensive financial ecosystem. Policies could be made to focus on developing and implementing financial education programs. This could empower individuals to make informed decisions about financial services and investments.

Conclusions and Recommendations

The study results showed that the majority of respondents believed that the informal financial system plays a significant role in reducing poverty. They also believed that informal lending practices provide better opportunities for impoverished individuals in developing countries compared to the formal lending system. However, they also acknowledged the risks associated with informal lending practices.

The study concludes that the informal financial system can play a positive role in reducing poverty, but it is important to be aware of the risks involved and to take steps to mitigate these risks.

The study concludes that the informal financial system can play a positive role in reducing poverty, the analysis highlights the undeniable contribution of informal financial systems to poverty reduction in developing countries. It is a compelling fact that 68% of respondents reported utilizing both formal and informal financial services, indicating the prominent role these systems play in the financial lives of individuals. Also, 56% of respondents found it easier to access informal financial services, highlighting the accessibility and convenience these systems offer to the unbanked and underbanked populations.

Furthermore, the study revealed the deep mechanisms through which informal financial systems influence poverty reduction of which access to credit emerged as a key mechanism, with 46% of respondents agreeing that informal lending practices provide better opportunities for impoverished individuals. Moreover, savings mobilization and informal insurance practices were indicated by 34% of respondents as significant factors in their financial resilience, contributing to poverty alleviation.

The study noted that perceptions can be a driving force behind the continued utilization and growth of these systems and the research found that 52% of respondents held a very positive perception of the role of informal financial systems in providing access to credit for small-scale entrepreneurs. With an overwhelming 90% of respondents acknowledging the very significant role of these systems in reducing poverty, there is very clear that the informal system can help in poverty reduction in the economy. Based on the findings of this study, here are the recommendations:

(a) Given the significant role of informal system in poverty reduction and 56% of respondents found it easier to access informal financial services, emphasizing their accessibility and convenience. Governments should consider regulatory frameworks that recognize and support these systems.
(b) 52% of respondents held a very positive perception of the role of informal financial systems in providing access to credit for small-scale entrepreneurs, highlighting their potential. Policymakers should prioritize financial literacy programs targeted at populations with limited understanding of formal financial services. This education can empower individuals to make informed financial decisions.
(c) Investment in expanding the reach and accessibility of formal financial services, particularly in underserved areas, can bridge gaps in financial inclusion. This is crucial given that 68% of respondents utilized both formal and informal financial services.
(d) Implementing mechanisms to assess policy effectiveness regularly ensures that policies remain aligned with changing dynamics and desired outcomes. This is especially relevant given that 90% of respondents acknowledged the very significant role of informal financial systems in reducing poverty.
(e) Allocate resources to support microfinance institutions and community savings groups. Allocating resources to support these initiatives can strengthen their impact. These institutions provide access to

credit, savings, and insurance, empowering individuals to invest in income-generating activities and build financial resilience. Microfinance and savings mobilization were identified by 34% of respondents as significant factors contributing to their financial resilience.

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