

Evaluating the Role of Microfinance in Addressing Economic Vulnerability Among Women in India's Informal Economy

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ABSTRACT

Informal employment remains a defining feature of India's labour market, accounting for close to 90% of the workforce, though estimates vary by definition and period. Women engaged in informal employment face particular economic vulnerabilities arising from unstable incomes, limited social protection and restricted access to formal financial services. This paper uses a structured secondary-source literature review to evaluate the extent to which microfinance can reduce these vulnerabilities. It distinguishes between short-term financial inclusion, including improved credit access, liquidity and income-generating opportunities, and long-term economic transformation, reflected in sustained income growth, enterprise expansion, asset accumulation and greater economic agency. The evidence suggests that microfinance can meaningfully improve financial access and short-term economic resilience. However, these benefits do not consistently translate into long-term transformation because of repayment pressures, limited enterprise growth and persistent structural and gender-based constraints. The paper therefore concludes that microfinance is more effective as a mechanism of financial inclusion than as an independent solution to long-term economic vulnerability.

Keywords: Microfinance Institutions (MFIs), Credit Constraints, Gender Inequality, Informal Labour, India, Poverty Alleviation

INTRODUCTION

Informal employment accounts for nearly 90% of India's workforce, although estimates vary by definition and time period (ILO, 2020). Although the informal sector forms the backbone of the country, contributing nearly 50% of its GDP (Ahlawat, 2022), these enterprises operate on a small scale, without the oversight or advantages afforded to registered businesses, making them highly vulnerable in an emerging economy.

Within this already precarious workforce, gender often plays a vital role in the disproportional presentation of workers in the informal sector. The disparity between men's and women's wages is striking. While men, on average, earn Rs. 48 per hour, women earn only Rs. 24 per hour (Harza, 2024). Indian women are routinely engaged in low-paid, low-skilled work with negligible social protection - working as domestic labourers, home-based workers, or other insecure forms of work - often making them susceptible to hardships such as exploitation, arbitrary dismissals, or perilous working conditions. Furthermore, this intensifies women's economic vulnerability as they are less visible and less likely to be legally recognised as workers.

Compounded by low income, limited access to formal credit, and low financial literacy, informal workers are often trapped in a cycle of financial fragility. This creates a dependence on alternative sources of finance such as moneylenders, personal networks, or informal savings groups. While these sources may seem accessible and convenient, they often come with exploitative conditions, including high interest rates, limited borrower protection, and coercive recovery practices. This raises a fundamental question: do financial interventions targeted at vulnerable communities meaningfully address economic instability, or do they merely provide short-term relief from a deeper structural problem?

In response to these challenges, microfinance has emerged as a potential intermediary, offering an alternative pathway for financially excluded groups, particularly women within the informal economy. Microfinance refers to financial services provided to individuals from lower socioeconomic backgrounds or those who lack access to traditional banking systems (CFI, 2020). By improving access to credit, microfinance is often positioned as a tool for promoting entrepreneurship, income generation, and financial independence. However, questions remain regarding its true effectiveness in enabling long-term economic mobility, particularly whether access to small-scale credit alone can overcome the broader structural barriers that keep vulnerable communities trapped in cycles of poverty. In light of this, this paper asks: To what extent can microfinance help workers in India's informal economy overcome cycles of economic vulnerability, with a particular focus on women, a disproportionately affected group?

Through a systematic review of secondary-source material, this paper evaluates the extent of microfinance's contribution to reduced economic vulnerability among women in India's informal economy. Rather than demonstrating an independent causal effect, it synthesises available theoretical and empirical work and distinguishes between short-term financial inclusion and long-term transformation. Outcomes such as access to formal or semi-formal credit, liquidity, income diversification and participation in income-generating activities together indicate short-term financial inclusion. Long-term economic transformation is evaluated through evidence of lasting income growth, enterprise expansion, asset accumulation, greater control over financial resources, and durable reductions in economic vulnerability. Improvement in the former with no benefits on the latter supports the conclusion that microfinance eases immediate financial constraints without effecting a systemic difference in women's long-term economic situation.

The study suggests that microfinance could enhance financial inclusion and economic resilience among women facing credit constraints in the short run. However, this does not guarantee a change in their long-run economic outcomes. By linking evidence on financial access, enterprise outcomes and women's economic agency, it builds a case for empowerment rather than treating access to credit itself as such. The paper assesses not only whether microfinance generates benefits but whether these are sustained and substantial enough for women to overcome the broader cycles of economic vulnerability associated with informal work through this distinction

RESEARCH METHODOLOGY

This study systematically reviews secondary literature on the role of microfinance in alleviating economic vulnerability among women in India's informal economy. Combining search terms such as “microfinance India”, women self-help groups India”, “microfinance women empowerment”, etc., with India means our search results focused mainly on India and not on global literature.

We included sources focused on microfinance, self-help groups, or financial inclusion for low-income/financially excluded populations, with women-related evidence and India-specific evidence preferred. To evaluate outcomes, the review prioritised peer-reviewed empirical studies over government or institutional reports, while using well-established theoretical literature to develop the conceptual framework. Sources were excluded from the core empirical assessment when their geographical setting, population or outcome was insufficiently relevant to the research question.

Because the included studies differ in geographical setting, sample size, research design and outcome measures, their findings are not treated as directly equivalent estimates of impact. Instead, the evidence is comparatively synthesised according to two analytical categories established in this paper: short-term financial inclusion and long-term economic transformation. Particular attention is given to whether findings are consistent across studies, whether contradictory or limited effects are reported and whether methodological limitations restrict their generalisability. This approach allows the review to evaluate the strength and consistency of the available evidence rather than relying on any single study as representative of women across India's informal economy.

LITERATURE REVIEW

As mentioned previously, the informal economy refers to all economic activities undertaken by workers and enterprises that are, by law or in practice, not fully covered by formal arrangements, including labour legislation, social security, income taxation, and commercial regulations. More often than not, it is found in the context of unemployment, underemployment, gender inequality, exploitation, and poverty.

The informal economy has been interpreted through several theoretical perspectives rather than through a single unified explanation. Chen (2012) distinguishes between major schools of thought including dualist, structuralist, legalist and voluntarist approaches, each of which attributes informality to different economic and institutional mechanisms. The dualist perspective broadly views informal activity as providing income and employment opportunities for populations excluded from sufficient formal employment, particularly where economic growth does not generate enough formal jobs. This perspective should be distinguished from the more specific concept of dual labour market theory, which examines segmentation between relatively secure, well-remunerated primary employment and lower-paid, insecure secondary employment.

The structuralist perspective, by contrast, treats informal and formal economic activity as interconnected rather than independent. Informal workers and enterprises may be incorporated into wider production systems under conditions that allow formal firms to reduce labour and production costs (Chen, 2012). This interpretation is particularly relevant to economic vulnerability because it suggests that low incomes and weak labour protection cannot necessarily be overcome through individual access to finance if workers remain positioned within unequal productive relationships. Other perspectives, including legalist and voluntarist explanations, place greater emphasis on regulatory incentives and economic choice. For this paper, however, the dualist and structuralist perspectives are particularly useful because they show why financial exclusion may be both a consequence of limited formal economic opportunities and one component of broader structural disadvantage.

Chen (2012) also discusses perspectives that view informality as a condition associated with incomplete economic development and limited formal employment opportunities. Under this interpretation, informal employment may decline as economies modernise, productivity rises, and workers gain access to more formal forms of employment. Tokman (2007), for example, links informality partly to labour-market conditions in which lower-skilled workers are concentrated in smaller, lower-productivity activities. However, the persistence of informal employment in rapidly growing economies such as India challenges the assumption that economic growth alone will necessarily lead to its disappearance. This is important for the present study because it suggests that interventions such as microfinance operate within a broader structural context and may improve financial access without independently resolving the underlying causes of informality.

Although the informal sector contributes significantly to many countries' GDP, workers face severe, pervasive constraints because of financial exclusion. This exclusion, however, is not merely a lack of access to bank accounts but a deeper, systemic issue rooted in the perilous nature of their employment. In this context, credit market theory explains how borrowers and lenders interact to determine loan volumes and interest rates. This theory explains credit rationing, which arises from asymmetric information between the two economic agents.

Asymmetric information helps explain why financially vulnerable borrowers may remain excluded from formal credit markets even when they are willing to pay higher interest rates. Akerlof's (1970) analysis of

adverse selection provides the broader theoretical foundation for understanding markets in which one party possesses information that the other cannot readily observe. In credit markets, however, the problem is more directly reflected in credit rationing, whereby lenders may restrict loan availability rather than continually raising interest rates in response to borrower risk.

Adverse selection arises before lending because banks cannot perfectly distinguish between borrowers with different risk levels. Higher interest rates do not necessarily compensate for this uncertainty because they may disproportionately discourage relatively safer borrowers while remaining acceptable to borrowers pursuing riskier projects. Moral hazard may subsequently arise after lending because the lender cannot perfectly observe how borrowed funds are used or how much risk the borrower assumes. If a borrower undertakes a riskier activity that subsequently fails, the lender bears part of the resulting loss through non-repayment. These information problems can therefore make lenders reluctant to extend conventional credit to borrowers who lack formal income records, established credit histories or collateral, contributing to the financial exclusion experienced by many low-income and informal workers.

Because banks ration credit, many informal workers, even those able to repay loans, lack access to it. This leads to lower productivity and a self-reinforcing cycle of poverty, as shown in Figure 1, that requires significant capital to break. Capital constraints, such as the inability to invest in education, health, or business due to low income and lack of credit, make it nearly impossible to escape these poverty traps without significant intervention.

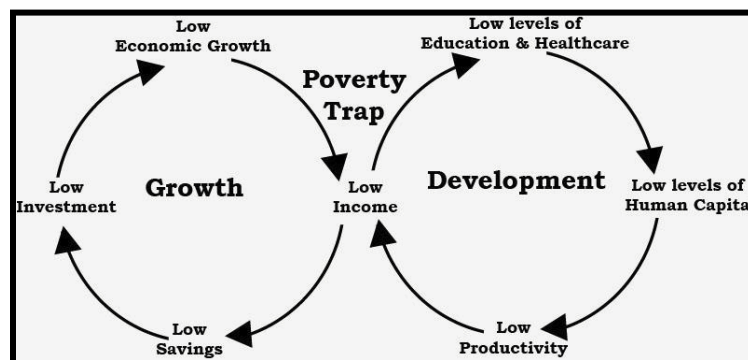


Figure 1: The Poverty Trap

Furthermore, extreme exposure to external shocks without financial back-ups creates a vicious cycle for informal workers that constrains asset accumulation and investment in human capital. This further leads to intergenerational economic vulnerability, where children inherit their parents' unstable working conditions and low productivity. This vicious cycle stems from inadequate investment in health and education, compounded by informal workers' inability to build a financial buffer. Thus, interventions that ease liquidity constraints can help disrupt these cycles. By increasing access to microfinance, individuals can invest in productivity-enhancing activities, thereby increasing income and breaking the self-reinforcing nature of poverty traps.

Microfinance, which originated as microcredit, was initially designed to provide small-scale financial support to individuals excluded from formal banking systems. It emerged as a mechanism to support informal workers by providing access to credit that could improve business margins, stabilise income, and enable more sustainable profits. By easing liquidity constraints, this financial access allows individuals to invest in productive activities, helping break persistent poverty cycles and sustain their livelihoods. A landmark developed in this field was the establishment of the Grameen Bank by Muhammad Yunus in 1983 (Yunus, 1999). Yunus pioneered collateral-free loans for low-income workers, particularly women, through a group lending model. Through social accountability, this model helped reduce the risk of default. This bank inspired other microfinance institutions by showing that the poor are also creditworthy and capable of entrepreneurship with the right financial guidance. Microfinance was therefore designed not as charity, but as a sustainable, market-based solution that helps workers build financial resilience to cover large, unforeseen expenses. In line with this, microfinance operates on a commercial basis to integrate those shut out of conventional financial institutions into the mainstream economy, serving as a crucial bridge between small businesses and the organised economy by facilitating last-mile connectivity.

By operating through several key mechanisms, microfinance can help address the underlying failures of the credit market, primarily stemming from asymmetric information. Joint liability lending (JLL) is one such mechanism to address adverse selection and moral hazard, thereby facilitating credit access for individuals who lack traditional collateral. Joint liability lending occurs when two or more parties are jointly responsible for paying a debt or fulfilling a legal obligation (Kenton, 2025). Joint liability thus shifts the lending dynamic from a one-on-one bank-borrower relationship to a group-based structure, directly mitigating information gaps. When borrowers self-select into lending groups, they leverage localised information about each other's creditworthiness that external lenders, such as banks, cannot directly observe. As each person has an incentive in mind not to suffer the consequences of the other person's default risk, they tend to associate with people they perceive as being trustworthy. This creates assortative matching, whereby people with lower risk tend to cluster together and those with higher risk cluster together. This way, banks can indirectly identify borrowers' risk profiles through the groups they form, thereby mitigating adverse selection. (Guttman, 2006)

Furthermore, joint liability structures provide a strong incentive to monitor investment decisions and members' effort levels, helping alleviate informational frictions. Because group members are jointly liable, borrowers are discouraged from undertaking risky projects that promise high returns, thereby mitigating moral hazard. In this context, social capital- including trust, community, and reputation- is used in lieu of physical collateral, which is generally absent in the case of poor people (Pang and Yang, 2018). Threats of social sanctions and exclusion from future credit further reduce default risk, thus increasing repayment rates. By reducing information asymmetry and perceived risk, these factors facilitate lending to previously excluded individuals and relax liquidity constraints. By providing access to credit for productive investment, microfinance allows informal sector workers to expand their businesses and incomes, and even break out of poverty traps, correcting structural inefficiencies in traditional credit markets.

Joint liability should not, however, be interpreted as a complete solution to information asymmetry. Peer selection and monitoring can improve lenders' information and repayment incentives, but the same mechanisms may generate costs for borrowers. Collective responsibility for repayment can create social pressure when individual members experience financial difficulty, while risk-sharing arrangements may discourage borrowers from undertaking uncertain but potentially higher-return investments. Group formation may also exclude individuals other members perceive as comparatively risky. Joint liability therefore changes how lending risk is managed rather than eliminating adverse selection or moral hazard altogether. This qualification matters when assessing whether microfinance promotes long-term economic transformation, since mechanisms that improve repayment performance from the lender's perspective do not necessarily maximise entrepreneurial growth or borrower welfare.

ASSESSING MICROFINANCE AS A PATHWAY TO FINANCIAL INCLUSION FOR WOMEN IN INDIA'S INFORMAL ECONOMY

As mentioned previously, women are an integral part of the informal economy, yet face a lack of social protection, unstable income, and limited access to formal financial resources. These structural limitations create persistent financial vulnerability, leading to liquidity constraints that limit women's ability to invest in productive activities or overcome financial hardships. Within this context, microfinance programs have emerged as a policy and development effort to promote financial inclusion among marginalised groups, especially women. By focusing on women in informal economies, microfinance aims to alleviate their liquidity problems and provide access to capital to support entrepreneurial or income-generating activities.

From a theoretical perspective, microfinance programs are largely effective because of institutional mechanisms such as joint liability lending, peer monitoring, social collateral, and trust-based lending. Together, these techniques aim to mitigate information asymmetries and reduce risks such as moral hazard, which often restrict lending to people without formal collateral (Goddard, 2009). Microfinance organisations can thus provide loans to borrowers who would otherwise be financially excluded by replacing traditional collateral requirements with social and group-based incentives. Because women in the informal sector often lack land titles or assets in their own names, social collateral substitutes for the physical collateral they are currently denied (Calderone et al., 2018). Through this framework, access to microfinance can enable women to expand their economic activities, invest in microenterprises, and manage income volatility more effectively.

Microfinance programs targeting women in India's informal sectors have grown tremendously through self-help groups (SHGs) and NGO-driven financial assistance initiatives. Such microfinance schemes typically involve financing arrangements that make relatively small loans, savings schemes, and financial assistance available to financially excluded women in the informal sector (Gaiha and Nandhi, 2008). These schemes aim to address some of the problems that hinder women's involvement in economic

activities in the informal sector. The impact of these programs can be examined across several dimensions, including their effects on economic outcomes, women's empowerment and decision-making power, and the structural barriers that shape how far microfinance can improve long-term economic opportunities.

First, regarding economic outcomes, microfinance is theoretically expected to alleviate liquidity constraints and allow women to invest in more productive, income-generating activities. Field research on SHGs in rural India suggested that small-loan provisions enable women to engage in micro-enterprises such as sewing, running small retail stores, dairy farming, producing processed foods, and livestock rearing. A study by Pandhare, Bellampalli, and Yadava (2024) among SHG members in Maharashtra found that women could launch new small enterprises and earn supplementary income through microfinance loans. Women used the loans to buy equipment, livestock, or raw materials needed for production, which helped diversify household income sources. This finding partly aligns with the theoretical expectation that access to credit will enable productive investment.

However, evidence also suggests that microfinance benefits are limited in certain contexts. Although SHGs are considered more supportive than traditional moneylenders, many microfinance institutions in India still charge relatively high interest rates of 20%-26%. These high repayment obligations absorb a large share of the supplementary income, which can result in a trapped cycle of borrowing - taking new loans to repay others rather than accumulating savings or growing their enterprise. Further, the capital provided by microfinance institutions is usually small, thereby hindering women from investing in large projects. These risks were especially evident during the 2010 Andhra Pradesh microfinance crisis, when widespread over-indebtedness and aggressive loan-recovery practices led to severe financial and social distress among many female borrowers (CGAP, 2010). This episode clearly shows how microfinance, without adequate regulation or support systems, can reinforce financial vulnerability rather than alleviate it.

Taken together, the available evidence therefore provides stronger support for microfinance as a mechanism of financial inclusion than as an immediate pathway out of poverty. While access to small amounts of capital can relax liquidity constraints and facilitate income-generating activity, evidence of supplementary income or enterprise creation alone does not establish sustained economic transformation. This distinction matters where repayment pressures, limited loan sizes, or repeated borrowing prevent initial financial gains from developing into asset accumulation or enterprise expansion.

Beyond income and enterprise outcomes, microfinance's long-term impact also depends on whether access to credit translates into greater economic agency. Importantly, access to a loan should not itself be treated as evidence of empowerment; the stronger test is whether women gain greater control over financial resources and economic decision-making. In line with this, microfinance programs are often associated with improvements in women's empowerment and agency. By joining SHGs, women regularly interact with other women and banking institutions as well as attend meetings. Studies among women in SHGs have shown that, through these programs, women gain financial freedom and increasingly

participate in household decision-making as they build confidence to interact in market settings (Basak and Roy Chowdhury, 2024). Women involved in microfinance programs have reported greater participation in decisions related to household spending, children's education, and business investments. Social capital also becomes an important determinant in facilitating these changes. Group-based lending models thus serve as a platform for teamwork and information exchange, strengthening the local economic network. Furthermore, SHGs may offer informal training to members on market conditions, supply sources, or production methods. These interactions can expand women's economic awareness and increase their participation in community activities.

However, the joint liability structure that facilitates microfinance lending may also put pressure on borrowing groups. Social ties may suffer if one member struggles to repay because repayment is the group's communal responsibility. Peer pressure within organisations can often restrict risk-taking and deter women from investing in more creative but unproven entrepreneurial ventures. Therefore, methods intended to lower loan risk may also limit borrowers' ability to explore entrepreneurial opportunities.

Broader societal and structural barriers also substantially affect microfinance outcomes (Sahu and Behera, 2025). Certain societies have cultural norms that prevent women from accessing markets, travelling freely, and managing their financial resources. In many parts of India, women still depend on their male counterparts to obtain supplies, transport goods, or engage in specific economic activities, even while obtaining financing from microfinance companies. More often than not, male family members also control how the loan is used, further weakening women's economic agency. Furthermore, a lack of time for domestic duties such as childcare and housework also restricts women's participation in economic activity. While microfinance loans help women start their businesses, they are still expected to perform most, if not all, domestic chores. This often limits their business growth to a subsistence level, as they cannot dedicate entire workdays to the enterprise.

It is still important to highlight that microenterprises established with SHG loans operate in comparable industries, such as small retail stores, food preparation, and tailoring, across many rural locations. However, market saturation from this concentration may limit profits, make it harder for companies to expand beyond subsistence levels, and create intra-group competition. Further, SHGs also have disadvantageous effects that work in relation to the societal structures and leave women in unfortunate situations (Pratiksha and Kulkarni, 2025). Despite SHGs' transformative potential, many female members still have limited financial literacy, business training, or access to wider markets, which can reduce loan effectiveness and keep enterprises small and low-profit. Additionally, SHGs often rely on external support from NGOs or government programs, suggesting they may struggle to function effectively once that support decreases. These challenges suggest that while SHGs improve women's access to finance, this access does not always translate into sustained economic independence or significant poverty reduction.

Overall, the data indicate that microfinance can offer significant advantages to many women in India's informal sector, particularly by expanding access to finance and encouraging small-scale business ventures. SHG membership can improve women's participation in household financial decisions, boost

confidence, and fortify social networks. That said, the intervention does not fully remove the structural obstacles that limit women's economic potential. Microfinance's capacity to produce significant income gains or long-term economic transformation remains constrained, even though it can enhance income stability and provide avenues for small enterprise development. Evaluation thus reveals that although microfinance is an essential instrument for providing women in India's informal economy with liquidity, its impact is typically more horizontal than vertical.

CONCLUSION

The informal sector is an integral part of India's development, serving as the backbone of the economy and generating almost half of its GDP. However, despite its importance, more than 90% of informal workers operate in an unstable system, without formal financing. Such enterprises operate on a very small scale without the institutional oversight available to formally established organisations, leaving these employees highly vulnerable in an emerging economy. Moreover, a striking disparity persists in the informal labour market, where women earn less than half of the average male wage. This negligible social protection is further compounded by the fact that Indian women are routinely engaged in low-paid, low-skilled work, such as domestic labour, which deems them less visible and less likely to be legally recognised as workers.

As discussed in the literature review, the analysis underscores that India's informal economy is not just a transitory phase but a structural sub-part of the formal economic system, characterised by weak value-added production and a lack of institutional protection. This study highlights how asymmetric information drives formal banks to ration credit, leaving informal workers trapped in a self-reinforcing cycle of poverty. As a solution, microfinance can disrupt these poverty traps by easing liquidity constraints through the joint liability lending model, which addresses the twin problems of adverse selection and moral hazard by using social accountability and group-based monitoring. Ultimately, by providing a sustainable, market-based bridge to the mainstream economy, microfinance facilitates capital accumulation, enabling women engaged in informal work in India to enhance productivity and achieve long-term financial resilience.

That said, a persistent pattern emerges: microfinance promotes a survivalist perspective rather than a transformative one. The limitations are simply rooted in the rigid nature of the loans, which ultimately force women to prioritise low-risk, low-reward activities such as basic tailoring - this creates a trap where high market saturation limits profitability. Furthermore, societal pressures of male relatives controlling the capital while women bear the compulsion of repayment highlight that monetary input on its own is insufficient to challenge the patriarchal order within the family. The solution lies in microfinance schemes beyond simple interventions.

Several limitations should be considered when interpreting this review's conclusions. First, as a secondary-source review, the paper synthesises existing evidence rather than independently estimating the

causal effect of microfinance on economic vulnerability. Associations between participation in microfinance programmes and improved economic outcomes may therefore reflect other borrower or community characteristics unless the underlying studies use credible causal identification strategies.

Second, much of the available Indian evidence concerns women participating in rural Self-Help Groups. Findings from these populations cannot automatically be generalised to all women engaged in informal employment, particularly urban informal workers or women operating outside organised group-lending structures. Women borrowers are highly heterogeneous in income, occupation, household circumstances, geographical location, and control over financial resources, so the effects of microfinance are unlikely to be uniform.

Finally, the studies reviewed differ in sample size, methodology, geographical coverage, outcome measurement and follow-up period. Evidence of short-term changes in borrowing, income or enterprise participation may not capture whether these improvements persist over time. A more confident assessment of microfinance as a pathway to long-term economic transformation would therefore require longitudinal evidence, credible comparison or control groups, and simultaneous measurement of financial outcomes such as income and asset accumulation alongside non-financial outcomes such as decision-making authority and control over economic resources.

Overall, microfinance is a powerful instrument for immediate economic stability and can help workers in India's informal economy overcome cycles of economic vulnerability to a certain extent. However, it remains a tool for poverty reduction rather than eradication, which would require broader structural reforms in labour rights and gender-neutral asset ownership for informal workers in India.

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