Institutional theory of financial inclusion

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Abstract

This article advocates a new addition to the theories of financial inclusion which is the institutional theory of financial inclusion. The case for a new theory arises from the role of institutions or non-market structures in influencing the level of financial inclusion. Postulating an institutional theory of financial inclusion is important due to the need to understand financial inclusion from the context of institutions and non-market structures that people have a great deal of trust in. The institutional theory of financial inclusion has the capacity to generate a wide range of testable hypotheses, and can provide the social scientist with tools that are relevant for understanding the broad spectrum of financial inclusion in society.

Keywords: financial inclusion, institutions, institutional theory, access to finance, non-market structure, culture, unbanked adults, financial exclusion.

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Introduction

The purpose of this paper is to develop a new theory of financial inclusion known as the institutional theory of financial inclusion.

This study is an extension of prior theoretical developments in the financial inclusion literature, notably the "theories of financial inclusion" developed in Ozili (2020). Since the theories of financial inclusion were first developed in 2020, efforts have been made to refine the theories and increase its application in different scenarios. The benefit of refining the theories of financial inclusion is that it leaves the field open for the introduction of new ideas. Therefore, as I observe my own work, the research of others and the new developments in the financial inclusion space, I am convinced that a new theory needs to be formed to ensure that the theories of financial inclusion can cope with more complex external phenomena.

There are institutional theories in many disciplines. These institutional theories explain how organizational or social structures and processes acquire meaning and continuity beyond their technical goals. (Suddaby, 2010). In this paper, I extend the application of institutional theory to financial inclusion. Institutional theory itself is concerned about the processes by which formal and informal structures, including schemes, rules, norms and routines, become established as authoritative guidelines for social behavior (Suddaby, 2010; Munir, 2015; Willmott, 2015; Peters, 2022). Institutional theory explains how structures are created, diffused, adopted, adapted, and how they fall into decline and disuse over time (Scott, 2005). Understanding financial inclusion in the context of formal and informal institutions is important because institutional factors such as enduring rules, practices, law and structures can influence people's decision making and also influence how they engage with formal financial services. It can influence people's decision on how to access formal financial services, and it can have positive or negative implications for the level of financial inclusion in society.

In the literature, there has been much emphasis on the effect of institutional quality on the level of financial inclusion (e.g. Ali et al, 2021; Xu, 2020; Evans, 2018; Lashitew et al, 2019; Nguyen and Ha, 2021; Anthony-Orji et al, 2019; Nkoa and Song, 2020; Ouechtati, 2022; Kebede et al, 2021; Kwenda and Chinoda, 2019; Aracil et al, 2022; and Eldomiaty et al, 2020). These studies control for the effect of institutional quality on the level of financial inclusion. The emphasis on institutional quality as a control variable in financial inclusion empirical research reflects the need for independent formal institutions that can enforce rules without fear, and carry out their duties fairly and with appropriate legal powers to sanction rule-breakers, in promoting financial inclusion. Other studies such as Muriu (2020) show that institutions such as rule of law is crucial in enhancing financial inclusion in sub-Sahara Africa (SSA). Berk Saydaliyev, Chin and Oskenbayev (2020) found that remittances that increase financial inclusion are associated with better institutional quality, and the effect of remittances on financial inclusion is conditional upon individuals' perception of the institutions. Lachebeb et al (2021) show that better quality of political institutions leads to a higher degree of financial inclusion. Ajide et al (2022) show that institutional governance indicators complement financial inclusion in reducing the constraints to financial access for the poor.

There is also the informal dimension of institutions. This includes the informal institutions and non-market structures, e.g. enduring social norms, local rules and culture, that people trust and interact with on a daily basis. There is not much literature on how informal institutions affect financial inclusion (Farazi, 2014). This makes it difficult to draw a meaningful conclusion about how informal institutions affect financial inclusion based on the findings of existing empirical studies. This vacuum gives theorists an opportunity to develop propositions that explain how formal and informal institutions affect the level of financial inclusion. Although I do not offer empirical tests or summarize empirical literature to illustrate the role of informal institutions in explaining financial inclusion, I hope that the ideas and propositions in this paper will stimulate empirical work by others, and encourage the search for new data that can accurately test the effect of institutions on the level of financial inclusion.

This paper contributes to the financial inclusion literature. It contributes to this literature by identifying formal and informal institutions as potential factors that influence access to formal financial services and the level of financial inclusion. The paper also contributes to the financial inclusion literature by providing an alternative paradigm that is useful in explaining the changes in the level of financial inclusion from time to time.

The rest of the paper is structured as follows. Section 2 presents the literature review. Section 3 develops the theory. Section 4 highlights the implication of the theory. Section 5 presents the applications of the institutional theory of financial inclusion. Section 6 evaluates the theory. Section 7 presents the conclusion.

2. Literature review

Some theories of financial inclusion have been formulated. They include the public good theory of financial inclusion, the dissatisfaction theory of financial inclusion, the vulnerable group theory of financial inclusion, the systems theory of financial inclusion, the community echelon theory of financial inclusion, the public service theory of financial inclusion, the special agent theory of financial inclusion, the collaborative intervention theory of financial inclusion, the financial literacy theory of financial inclusion, the private money theory of financial inclusion, the public money theory of financial inclusion and the intervention fund theory of financial inclusion (see., Ozili, 2020). The vulnerable group of financial inclusion and the public good theory of financial inclusion have been used by several studies to explain the dynamics of financial inclusion in several contexts such as Mhlanga (2021) and Odei-Appiah, Wiredu and Adjei (2021), etc.

In the literature, there have been much emphasis on the effect of institutional quality on the level of financial inclusion in the literature. Several empirical studies examine the direct effect of institutional quality on financial inclusion while other studies control for the effect of institutional quality while investigating the determinants of financial inclusion (e.g. Ali et al (2021), Xu (2020), Evans (2018), Lashitew et al (2019), Nguyen and Ha (2021), Anthony-Orji et al (2019), Nkoa and Song (2020), Ouechtati (2022), Kebede et al (2021), Kwenda and Chinoda (2019), Aracil et al (2022), Berk Saydaliyev et al (2020) and Eldomiaty et al (2020). For instance, Ali et al (2021) investigate whether institutional quality moderates the relationship between financial inclusion and financial development in 45 countries from 2000 to 2016. They find a significant positive relationship between institutional quality, financial inclusion and financial development. They also find that institutional quality moderates financial inclusion and has a significant positive impact on financial development. Xu (2020) examines the role of social trust in financial inclusion after controlling for individual characteristics, and country level differences in institutions and financial markets. Xu (2020) finds that social trust is a significant and positive determinant of financial inclusion and that social trust supplements weak formal institutions and low educational levels.

Evans (2018) examines the relationship and causality between internet, mobile phones and financial inclusion in Africa and controlling for the effect of institutional quality. They find that internet and mobile phones have a significant positive relationship with financial inclusion, and that macroeconomic factors and institutional factors such as regulatory quality are important determinants of financial inclusion in Africa. Lashitew et al (2019) find that economic factors and institutional factors affect the adoption and usage of mobile money innovations. They observe that the quality of the regulatory environment has a strong effect on the adoption of mobile money innovation. Nguyen and Ha (2021) investigate the empirical linkages between ASEAN countries' institutional quality and financial inclusion using country data from 2008 to 2019. They find that institutional quality has a positive impact on financial inclusion. Anthony-Orji et al (2019) investigate the empirical linkages among financial stability, institutional quality and financial inclusion in Nigeria using quarterly data from 1998 to 2013. They find that financial stability has a significant impact on financial inclusion in the long run while institutional quality has a significant impact on financial inclusion both in the long run and in the short run. Nkoa and Song (2020) investigate the impact of institutional quality on financial inclusion in 51 African countries from 2004 to 2018. They show that institutional quality increases financial inclusion as well as the penetration, accessibility, and use of financial services in Africa. Ouechtati (2022) investigates the role of economic and political institutions in moderating the effect of financial inclusion on inequality. They use data from 110 countries from 2004 to 2018. They find a significant interaction between financial inclusion and institutions in determining the level of income inequality.

Kebede et al (2021) examine the effect of foreign bank presence on the various dimensions of financial inclusion using panel data for 17 African countries from 2004 to 2018. They find that foreign banks reduce financial inclusion, and the effect of foreign bank presence on financial inclusion depends on institutional quality, with its impact turning from negative to positive when institutional quality increases to a higher level. Kwenda and Chinoda (2019) investigate the impact of institutional quality and governance on financial inclusion in 49 African countries from 2004 to 2016. The results obtained suggest a positive impact of institutional quality and governance on financial inclusion within the region. Aracil et al (2022) examine the positive moderating effect of institutional quality on the relationship between financial inclusion and poverty alleviation for 75 developing and developed countries from 2004 to 2017. They find that institutional quality intensifies the beneficial effects of financial inclusion on poverty rates. This effect is more pronounced in poorer economies than in wealthier economies. Berk Saydaliyev et al (2020) investigate the effect of remittance inflow on financial inclusion in developing countries between 2011 and 2018 while controlling for institutional quality. They find that remittances that increase financial inclusion are associated with better institutional quality, and the effect of remittances on financial inclusion is conditional upon individuals' perception of the institutions. Eldomiaty et al (2020) examine the impact of the world governance indicators (WGIs) on the level of financial inclusion in world economies from 2011, 2014 and 2017. The empirical results reveal that institutional factors such as control of corruption, government effectiveness, political stability and voice and accountability are significant factors influencing the level of financial inclusion.

3. Developing the theory

The institutional theory of financial inclusion states that people constantly interact with formal institutions and informal institutions in society, and their constant interaction with these institutions shape their views on whether they need to join the formal financial sector, remain in the formal financial sector, exit the formal financial sector after joining, or never join the formal financial sector.

The institutional theory of financial inclusion assumes that:

(i) some individuals and firms have incomplete information about how to access formal financial services (Ozili, 2020);

(ii) some individuals and firms have incomplete information about the conditions they must meet in order to access formal financial services (Claessens and Tzioumis, 2006);

(iii) some individuals and firms have incomplete information about the constraints and risks they might face when they join the formal financial sector. These constraints or risks include income and ethnic discrimination, the possible loss of one's deposit when a bank fails, high or multiple transaction costs, etc.

Knowing that they have incomplete information about how to access formal finance, this will motivate them to interact with the informal or formal institutions they have trust in, in order to obtain more information which will form the basis of their decision making. Their frequent interaction with these institutions will shape their views on whether they need access to formal financial services and how to access formal financial services. It will shape their views on the benefits and disadvantages of formal financial services, and shape their views on how to overcome the obstacles to accessing formal financial services. Such views will influence their decision on whether to join the formal financial sector or to remain outside the formal financial sector, and this will affect the level of financial inclusion. These institutions may be formal institutions such as constitutions, local laws, community rules, regulations, contracts, etc. The institutions may also be informal institutions such as unwritten rules, ethical codes, local culture, attitudes, values, tradition, norms of behavior, etc.

3.1. Informal institutions

Informal institutions are enduring and unwritten rules, norms or codes of behavior that are created, communicated, shared and enforced by members of society. Often, informal institutions are widely known, they become tradition and tend to be more persistent than formal rules (North, 2005).

Enduring informal institutions are multiple shared standards of acceptable behavior or informal understanding among members of society and which have lasted over many years. Enduring informal institutions are powerful drivers of people's attitude towards formal financial institutions. Informal institutions can reinforce distrust in formal financial institutions, and discourage members from trusting formal financial institutions with their money or savings. Another factor that contributes to this is when there is a strong belief in society that formal financial institutions are self-serving and do not pursue the interest of customers based on past experiences. This can make some societal members feel their money is never safe in banks. It can also make them to avoid formal financial institutions, or make them believe that it will be difficult to obtain basic financial services from formal financial institutions to meet their emergency needs. They will communicate such belief to other members of society, and also pass the information to the future generation. This will lead to mistrust in formal financial institutions, and decrease trust in the formal financial system, thereby making members of society unwilling to join the formal financial sector. This will decrease the level of financial inclusion.

Informal institutions can also reinforce trust in formal financial institutions, and encourage members to trust formal financial institutions with their money or savings. A factor that contributes to this is when there is a strong belief in society that formal financial institutions bring great benefit to members of society based on past experiences. This can make some societal members feel their money is safe in banks. It can make them patronize formal financial institutions, or make them believe that they can obtain basic financial services from formal financial institutions to meet their emergency needs. They will communicate such belief to other members of society, and also pass the information to the future generation. This will lead to trust in formal financial institutions, and increase trust in the formal financial system, thereby making members of society willing to join the formal financial sector. This will lead to greater financial inclusion.

3.2. Formal institutions

Formal institutions are institutions which are created by law with the intention to control human behavior in specific economic activity (Holmes Jr et al, 2013). There are three factors that determine how formal institutions influence financial inclusion: (i) the presence of institutions that protect banked adults from exploitation, (ii) people's awareness that these institutions exist to protect banked adults in the formal financial sector, and (iii) people's judgment or perception about whether these institutions are effective or ineffective in protecting the welfare of banked adults in the formal financial sector. These factors play a significant role in determining whether the presence of formal institutions can encourage people to join the formal financial sector or discourage them from joining the formal financial sector, thereby influencing the level of financial inclusion.

When people become aware that formal institutions exist, they will interact with these institutions by reporting complaints of exploitation to formal institutions that have the legal authority to take action to address the complaints of exploitation. Over time, the action of formal institutions in response to reported complaints of exploitation tend to shape people's perception about whether formal institutions are effective or ineffective in resolving complaints of exploitation. The action or inaction of formal institutions will shape people's perception about whether they will be protected. This perception will play a significant role in helping them reach a decision on whether to join the formal financial sector or to remain outside the formal financial sector.

4. Implication

The implication of the institutional theory of financial inclusion is that institutions or non-market structures can play an important role in influencing people to join the formal financial sector, thereby increasing the level of financial inclusion. The institutional theory of financial inclusion emphasizes the importance of institutions in influencing the level of financial inclusion in society. Some institutions or non-market structures reinforce trust in formal financial institutions, and this will make it easier to persuade unbanked adults to engage with formal financial institutions to get the money they need to meet their financial needs. On the other hand, other institutions or non-market structures reinforce mistrust in financial institutions, especially when there has been frequent incidence of high transaction costs, high bank charges, fear of bank failure, exposure to fraud, etc. These institutions can reinforce negative perceptions about formal financial institutions, and discourage unbanked adults from joining formal financial sector.

5. Applications of the institutional theory of financial inclusion

One application of the institutional theory of financial inclusion pertains to situations where culture and traditions have a significant influence on how people engage with financial services. Culture and traditions can influence how people save money, how people obtain credit, and how they spend and invest money. For instance, some culture and traditions require community members to keep a large portion of their money in their houses rather than keeping the money in the bank so that community members can easily donate money towards building the community. Other culture and traditions do not dictate how members engage with financial services. Members can choose to keep their money in a bank or elsewhere. In the first scenario, community cultural codes prevent people from joining the formal financial system. But this is not the case in the second scenario. These two scenarios show that changes in the level of financial inclusion in communities can be explained by non-market or institutional factors such as culture, and communal codes which are based on institutional theory of financial inclusion.

Another application of institutional theory of financial inclusion relates to the presence of incomplete information. This pertains to situations where unbanked adults have little or no information (i.e. incomplete information) about how to access financial services. When faced with incomplete information, individuals will rely on institutions to gain knowledge and shared meanings about the best way to access financial services to improve their welfare. This means that people with incomplete information will rely on the institutions they trust to gain additional information on how to access financial services to improve their welfare. The institutions may be the informal groups, family members, local institutions, conventions, constitution, ethics, etc.

Another application of institutional theory of financial inclusion pertains to its role in explaining the determinants of financial inclusion and the determinants of financial exclusion. The theory shows that institutions and non-market structures that reinforce the usefulness of formal financial institutions can play a significant role in increasing the level of financial inclusion while institutions and non-market structures that reinforce the importance of informal financial services can play a crucial role in increasing the level of financial exclusion, thereby making institutional (or non-market) factors an important determinants of the level of financial inclusion.

6. An Evaluation of the theory

Although the institutional theory of financial inclusion is new and its implications are unexplored yet, the applications indicated above suggest the diverse application of the institutional theory of financial inclusion. The institutional theory of financial inclusion is not in conflict with the existing theories of financial inclusion. An important advantage of the institutional theory of financial inclusion is its greater emphasis on how trusted norms, values, rules and enduring behavior play a role in influencing people's decision to access and use formal financial services. This shift in emphasis toward the role of institutions or non-market structures in influencing the level of financial inclusion may appear to be hiding individual independent decision-making under the pretext of shared meanings in society. But if individual independent decision-making were to be more paramount, individuals that are concerned about their lack of complete information about how to access financial will eventually seek to gain new knowledge from institutions or non-market structures that convey shared meanings in society. For this reason, the institutional theory of financial inclusion provides new insights in explaining the changes in the level of financial inclusion from time to time. As institutions and non-market structures are refined to support the use of formal finance services, it can encourage more people to use formal financial services to improve their welfare, and this will have a positive effect on the level of financial inclusion.

7. Conclusion

This paper suggests that the institutional theory of financial inclusion is an important framework that explain the state of financial inclusion in communities, countries and regions. It identifies institutions and non-market structures as determinants of the level of financial inclusion. The institutional theory of financial inclusion expands the applicability of the theories of financial inclusion into institutional contexts, thereby making the theory more useful in analyzing how enduring norms, behavior, codes, shared meanings, laws and conventions affect the level of financial inclusion. The final evaluation of this theory depends on its usefulness and its ability to indicate the kind of new data that would be useful to researchers investigating the institutional determinants of financial inclusion. Future research can extend this study by examining the application of institutional theory in explaining financial inclusion in developing countries. Future studies can test the propositions of the theory using empirical data.

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