Intervention, Financial Development and Inclusive Growth: A Study on Indian States

Dr. A G Hareesh Kumar
Former Research Scholar
Research Department of Commerce
St Thomas' College (Autonomous)
Thrissur, Kerala, 680001
hareeshkumarag@gmail.com
Phone: 91-7902844035

Dr. Thomas Paul Kattookaran
Associate Professor and Head
Research Department of Commerce
St Thomas' College (Autonomous)
Thrissur, Kerala, 680001
thomascommerce@gmail.com
Phone: 91- 9446622342

Febina K
Research Scholar
Research Department of Commerce
St Thomas' College (Autonomous)
Thrissur, Kerala, 680001
febinakmf@gmail.com
Phone: 91-7558046896

Abstract

Heterogenous nature of states in India pose a challenge to inclusive growth. Although targeted interventions are there, spending of governments sometimes may not be effective without an apt financial framework. This means that to ensure inclusive growth, the fundamental operating structure of financial institutions itself to be modified. We are interested in the reverse causality. The output of financial institutions, presumably, is flexible. Thus, one of the premises on which the paper forward is that the *intervention and heterogeniety have a bearing on financial development*. The conventional proposition-*financial development on inclusive growth* is also verified with statewise data. Our data set shows that state interventions and heterogeneity have a strong bearing on financial development of Indian states. Further, it was found that, savings significantly affects inclusive growth in these regions. The adverse association between financial development and inclusive growth attracts urgent scrutiny. Government must take a stock of the volume of credit that are channelised solely for productive purposes.

Key Words: Intervention, Heterogeneity, Financial Development, Inclusive Growth

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1. Introduction

The nature of relationship between financial development and economic growth, for long, is a controversial topic. In the case of India, there exists a noticeable disagreement on the causality of the relationship. This paper describes state specific as well as institutional determinants of financial development of India. Further, this study explores the institutional determinants of inclusive growth in India. For this, nine years' data, starting from 2008-09 is studied. Our results shows that, people have to resort financial institutions for their basic amenities whereas surplus income (tax revenue) have a strong bearing on the output of such institutions. It means that, taxable income of affluent section might be channelised through the financial institutions for facilitating social well being. Further, it was found that, savings significantly affects the inclusive growth in sample regions.

2. Foundations

Inquiries on inequality in the distribution of income and economic growth dates back to early nineties such as of Kuznets(1955). Disparate income distribution, it was experienced that, slows interventions processes. A large inequality in income distribution,otherwise heterogeneity in the population, delays stabilisation process (Alesina & Drazen, 1989). In this respect, in the context of Indian states, this heterogeneity poses a very serious issue. This fact triggers an explanatory debate on region- wise analysis of inequality and causes.

Based on the data of 44 developing countries, Adelman & Morris(1971) examined income distribution and its relationship to various economic and non- economic forces. It was found that the most important variables affecting income distribution are ecological, socio-economic and political. Their examination further reveals that, the rate of improvement of human resources is the most important variable that affects the differences in patterns of income distribution. Thus, by using a selective spending on social expenditure, this rate may be enhanced.

In 2016, Khan*et al.*developed a unified measure to inclusive growth. It integrates growth, inequality, accessibility and governance into one single measure. Their results shows satisfactory performance level with respect to its performance in growth inclusiveness. Further, it was found that, macroeconomic stability and social financial deepening are important determinants to enhance the inclusiveness, and reduce poverty and inequality. Reforms in trade, as per their empiriacl results, are required to increase their efficiency in terms of inclusiveness. In India, Bhalla (2011) criticised Government policy since it was ineffective in generating the inclusive growth outcomes. In contrast, it was observed that, favourable redistribution has an important role in the decline in the depth and severity of poverty during 1951 to 1994(Datt, 1998). The finding was then empirically supported by the results of Datt &Ravallion (2002) who found that the incidence of poverty has been falling at a little less than one percentage point per year over the main post-reform period.

Data on the evolution of top incomes and wages for 1922-2000 in India, presented by Banerjee & Piketty(2005), shows that the shares of the top 01.01 percent, 0.1 percent, and 1 percent in the total income shranked substantially from the 1950s to the early to mid-1980s but then rose again. This means that, these shares are only slightly below what they were in the 1920s and 1930s. This U- shaped pattern was broadly consistent with the evolution of economic policy in India.It suggests a more ambitious restatement of the pro-poor goals of

economic policy as opined by Filho (2010). It is possible that the policy shall be, as opined by World Economic Forum (2015), pro-equity and pro-growth at the same time.

Urata & Narjoko (2017) surveyed the empirical findings on the impact of International trade on inequalities from various perspectives. It revealed that the impacts of increased trade or trade liberalisation on within-country inequalities are mixed. These mixed findings, according to the authors, are consistent with the mixed theoretical predictions. Impact of other factors affecting inequalities such as labour market conditions, inflow of capital and policy reforms are one reason for the mixed findings. In Indian context, although Deaton & Kozel (2005) criticised the too optimistic official poverty estimates particularly for rural India, they admited that in the 1990s, there was good evidence for a fell in poverty.

According to Ali & Son(2007),growth is defined as inclusive if it increases the social opportunity function. It depends on two factors: (i) average opportunies available to the population, and (ii) how opportunities are shared among the population. The quantum of average opportunity, whether it is social or economic, is largely explained by the revenue of region. More specifically, it is determined by the amount of tax revenue per person. The opportunities are fairly distributed by a well entrusted financial system.

Singh, Das, & Agrawal(2013) used employment and unemployment surveys to examine the inclusiveness of Indian economic growth. Their findings revealed that socio-economic inequalities in regular employment increased minutely during 1993-1994 to 2009-2010.

The hypothesis that poverty is inversely related to agricultural performance was well founded by Ahluwalia(1978), Tafesse (2005), Godoy & Dewbre (2010) and Janvry & Sadoulet (2010). In Indian context, Chand *et al* (2011) portrayed the weak performance of small farm in India in terms of generating adequate income and sustaining livelihood. Changes in distribution are roughly uncorrelated with economic growth (Bruno, Ravallion, &Squire (1996) and Tripathi (2013)). The following table describe some of the findings of contemporary authors on inequality, financial development and inclusive growth.

Table I
Inequality and growth- Major Findings

SL No	Authors	Region	Finding
1	Bourguignon & Morrisson (1990)	Developing Countries	Endowments in mineral resources, land concentration in agricultural exports, trade protection and secondary schooling are major determinants in income inequality.
2	Pelaez & Diaz (2005)	U.S	Evolution of inequality is very sensitive to the length of the transition path.
3	Siddiqui & Nawaz Saleem (2010)	Pakistan	Services-led growth without an integrated and competitive industrial sector can lead tosevere external accounts deficits and unemployment.
4	Mukherjee, Chakraborty, & Sikdar(2014)	India	Importance of State-specific Human Development path and presence of high rural-urban disparity.
5	Berg & Ostry (2011)	Theoretical Finding	Longer growth spells[1] are robustly associated with more equality in the income distribution.
6	Estrada, Park,	125 Asian	Financial development has a significant

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[1]Time interval starting with a growth upbreak and ending with a downbreak.

		Countries	positive effect on growth, especially in developing countries
7	Brei, Ferri, & Gambacorta (2018)	Panel of 97 economies	Deeper financial systems help reduce poverty and inequality in developing countries
8	Rehman, Khan, & Ahmed (2008)	Panel of 51 countries	Inequality first increases with financial development but then decreases.
9	Sahoo & Dash(2009)	India	Infrastructure plays an important role in economic growth.

Financial development involves improvements in the production of information, investment decisions, trading, mobilization and pooling of savings and exchange of goods and services (Levine, 2005). In general, all these aspects will be reflected in the financial sector's GDP. Banks and insurance providers are the facilitators of financial services in a standard financial system. Apart from the facilitation of financial services, banks and insurance providers serve as a source of reliable information regarding the time points to save/spend[2],wiser consolidation of savings/spendings and intra bank alternative deposit plans/advances. Here, the role of bank, independently and collectively, is praiseworthy since the informative content of the bank is largely helpful in the addition of productive assets in the economy.

The conventional role of banks and insurers recently shifted from a maker of saver to the maker of investment. Here important decisions are taken by the people with the help of these intermediaries. In one sense, this investment decisions are also a function of improved information. Improvement in trading taking place when the lags of movements minimised by the timely intervention of financial intermediaries. Digital platforms largely helped in the accumulation of savings of people with financial intermediaries. Here, savings takes place initially and the surplus is expendend later. According to the data of Reserve Bank of India (RBI)[3], during the period of 2011 to 2018, total value of transactions through ATMs became more than 2.5 times. During the same period, total value of transactions became more than ten times[4].

The issues related with inclusive growth are discussed above. It can briefly summarises as follows. Heterogenous nature of states in India pose a challenge to inclusive growth. Although targeted interventions are there, spending of governments sometimes may not be effective without an apt financial framework. This means that to ensure inclusive growth, the fundamental operating structure of financial institutions itself to be modified. We are interested in the reverse causality. The output of financial institutions, presumably, is flexible. Thus, one of the premises on which the paper forward is that the *intervention and heterogeniety have a bearing on financial development*. The conventional proposition-*financial development on inclusive growth* is also verified with statewise data.

3. Data and Results

To explore the determinants of financial development and inclusive growth, panel data of 15 major states (Annexure 1) for the period of 2009-2017 is used in this study. Data gathered

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[2] We used the term 'spend' rather than advance. Because, recent banking practices promote spending with the backing of banks. Apart from the two extreme purposes of bank advance- accumulation of a productive asset or achievement of some 'economically irrational likes'- recent bank advance cover whole day to day individual needs through innovative schemes.

[3] Bankwise ATM/POS/Cards Statistics- https://rbi.org.in/scripts/ATMView.aspx

[4] Comparing the period of 2011 December and 2018 December.

from *The Handbook of Statistics on Indian States, RBI*, for various years. The specified period, a combination of two different governments, witnessed a slow growth in per capita net state domestic product in India (Refer Table IV). The remaining part of this paper focus on two regression models; determinants of *sectoral GDP*- banking and insurance- and *per capita net state domestic product on tax revenue*.The former, sectoral GDP, represents the volume of financial development whereas the latter is a proxy of inclusive growth. In second model, sectoral GDP and insfrastructure are independent variables.Total number of observations for the two models are 135 and 120 respectively.

a. An Overview of Disparity

This section briefly diuscusses dimensions of disparity. Difference between gross income and per capita income is outlined in Figure I while inefficient part of products and services that cannot ensure adequate factor income to the people is presented in Figure II.

Figure I
Difference Between GNI Growth and GNI Per Capita Growth in India
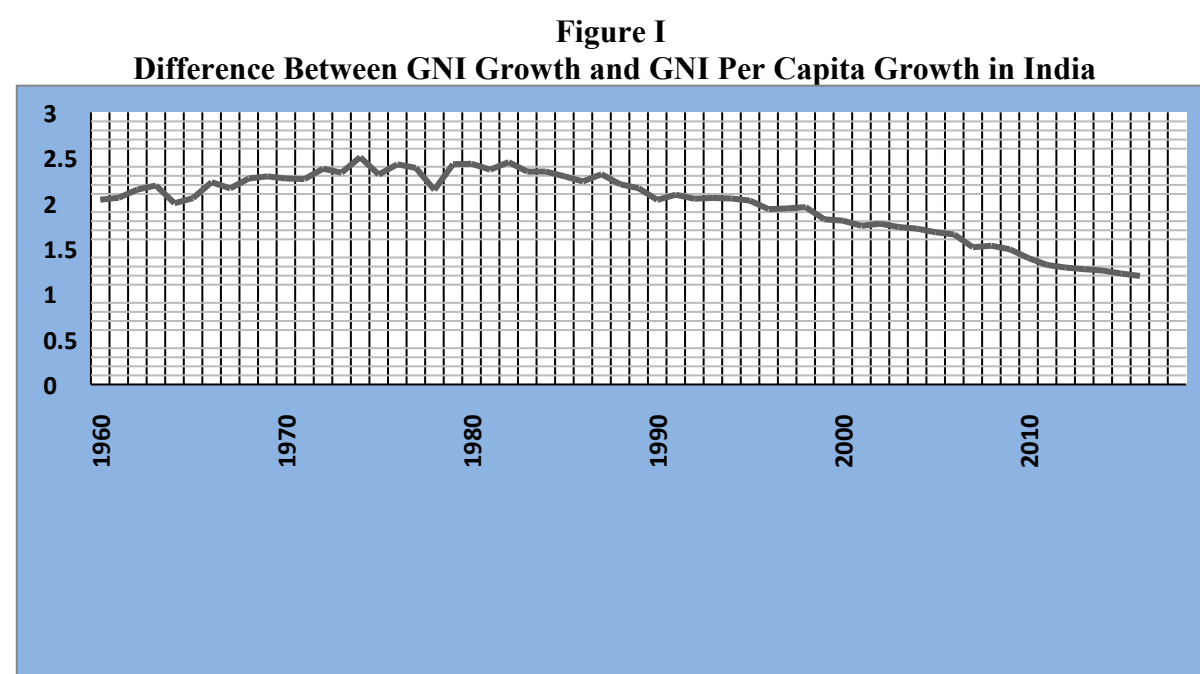
Source: World Development Indicators, World Bank. Note: Figures in Percentage

Although the difference between growths fell recently, the difference continues to pose a challenge on redistributive transfers. Average GNI per capita growth (annual percent) was 4.9 percent after 1990 whereas GNI growth (annual percent) shows an average 6.6 percent. However, the post liberalised era witnessed a remarkable decrease in the difference between GNI growth and GNI per capita growth. The existing difference between these growth might be due to the non participation of whole individual in production. Figure II shows the recent widening gap between per capita national income and per capita GDP. It is to be noted that the volume of GDP significantly increased after 1990s.

Figure II
Individual Income and GDP in India[5]
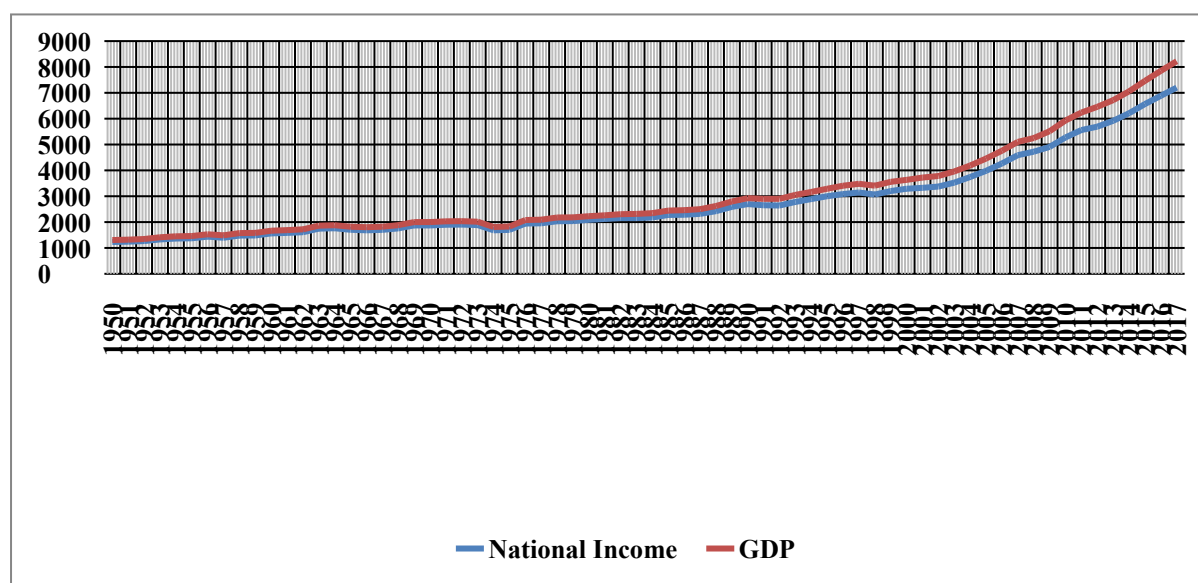
Source: World Inequality Data Base.
https://wid.world/data/#countrytimeseries/anninc_pall_992_i;agdpro_pall_992_i/IN/1922/2017/eu/k/p/yearly/a
Note: Figures in Rupees.

During the period of 2010-2017, on average, Maharashtra (38.6 percent), Karnataka (9.1 percent), Tamil Nadu (6.6 percent), Andhra Pradesh (4.97 percent) and Uttar Pradesh (4.11 percent) are the major states which contribute towards the total tax revenue (Apendix 2). Apart from Uttar Pradesh, all these states are bestowed with a good amount of Foreign Direct Investment (FDI).In Uttar Pradesh, the share of tax revenue is reflecting the proportion of population.

Per capita national income (individual) does not shows a proportionate increase (Figure II). In other words, the nature of incremental product largely shows inefficiency in distributing the factor incomes. Financial sector plays an important role in effcient redistribution of factors of production. The following section discusses the determinants of financial sector development in the major fifteen states in India.

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[5]Average National income within a given percentile group. National income aims to measure the total income available to the residents of a given country. It is equal to the gross domestic product (the total value of goods and services produced on the territory of a given country during a given year), minus fixed capital used in production processes (e.g. replacement of obsolete machines or maintenance of roads) plus the net foreign income earned by residents in the rest of the world.// National income has many limitations, however it is the only income concept that has an internationally agreed definition (established by the United Nations System of National Accounts, see SNA 2008). We thus use it as our reference concept (after corrections to include income hidden in tax havens). // The national economy - in the national accounts sense - includes all domestic sectors, i.e. all entities that are resident of a given country (in the sense of their economic activity), whether they belong to the private sector, the corporate sector, the governement sector. The population is comprised of individuals over age 20. The base unit is the individual (rather than the household). This is equivalent to assuming no sharing of resources within couples.[National income]=[Net domestic product]+[Net foreign income]

Average Gross domestic product within a given percentile group. Gross domestic product is the total value of goods and services produced by the national economy.The national economy - in the national accounts sense - includes all domestic sectors, i.e. all entities that are resident of a given country (in the sense of their economic activity), whether they belong to the private sector, the corporate sector, the governement sector. The population is comprised of individuals over age 20. The base unit is the individual (rather than the household). This is equivalent to assuming no sharing of resources within couples.

b. Determinants of Financial Development

Table II presents panel data regression results for sectoral GDP. The development in the financial sector would be definitely reflected in the sectoral GDP. The financial intermediaries such as banks and insurers act as vehicles for social welfare. The intervention of states is materialised largely through these establishments. Here, the association between the intervention and sectoral GDP is comprehended. The income, roughly the part above an average figure, taxed unevenly to stabilise the content of disposable income of people. Our model incorporate both the tax and share of tax on total revenue to understant the association with the sectoral GDP. Some region specific elements such as Credit Deposit Ratio, Bank Deposit and Per Capita availability of power are also included in the model. Unlike other variables which are framed by state authority, these three features are largely determined by the heterogenic nature of specific state. Table II shows regression results.

Table II
Regression for Sectoral GDP- Banking and Insurance

Independent Variable	Coefficient	t-ratio
constant	-4.46	-11.63***
Social Sector Expenditure/Tax Revenue	-0.72	-8.54***
Tax Revenue/Total Revenue	0.63	2.87***
Credit Deposit Ratio	0.42	5.74***
Tax Revenue	-0.71	-14.86***
Per Capita Availability of Power	-0.19	-4.39***
Bank Deposit	0.66	14.30***
R-squared		0.821
F(6,128)		98.02***
No of Observations		135

Notes: *** denotes significance at 1 percentage level. Dependent and Independent variables are measured in natural logarithms.

Social sector expenditure as share of tax revenue has a significant implication on the banking and insurance GDP of the selected states. The social sector spending by the governments caused a remarkeble curtailmentof the advances of banks. This means that, in these regions, apart from acting as an intermediary for redistribution, a large part of social sector expenditures were being advanced by scheduled commercial banks. In other words, productive advances are significantly shortened to that extent by which such social sector expenditures are advanced. Further, per- capita availability of power, one of the major proxies of social welfare, shows a negative association with sectoral GDP. Tax revenue as percentage of total revenue is positively and significantly associated with the banking and insurance GDP of Indian states. Since the generated tax revenue is a terminal outcome of income generating activities of individuals/firms, it would be better to infer that the income generating activities of these states have a fair reflection on the output of financial institutions. If these income generating activities are supported by an improved credit delivery system, via extended deposit as well as an improved credit deposit ratio, the states shall enjoy additional GDP in the financial sector. Our data shows that an improvement in both the deposit and CDR will significantly helps in the formation of sectoral GDP. Thus, an enhancement in demand with the help of confident banking practices will definitely augment financial sector GDP. Savings still act as one of the important determinants of sectoral GDP. Absolute value of tax revenue shows a high negative association with this sectoral GDP. This

means that, generation of banking and insurance GDP was significantly taking place without using the share of taxable income.

Regression results points out that, people have to resort financial institutions for their basic amenities whereas surplus income (tax revenue) have a strong bearing on the output of such institutions. It means that taxable income of affluent section might be channelised through the financial institutions for facilitating social well being. Here, the state intervention through social sector spending is a powerful mechanism which helps in the formation of GDP in banking and insurance sector.To add more GDP in banking and insurance sector, our data set further points out that tax revenue shall be reduced to some extent and the share of tax revenue must be higher than that of non-tax revenue. Table III presents average growth of tax and non-tax revenue of 15 major states in India for the period of 2008-2009 to 2016-2017.

Table III
Average Growth of Revenue of Major States

SL No	Name of State	Tax Revenue	Non- Tax Revenue
1	Maharashtra	12.6	-1.2
2	NCT Delhi	11.6	0.2
3	Tamil Nadu	12.9	15.7
4	Karnataka	13.9	6.6
5	Gujarat	13.2	13.3
6	Andhra Pradesh	6.4	2.1
7	West Bengal	15.1	27.0
8	Rajasthan	14.5	14.2
9	Madhya Pradesh	15.8	17.8
10	Kerala	13.5	26.9
11	Goa	13.8	13.1
12	Uttar Pradesh	14.9	23.0
13	Odisha	14.5	14.5
14	Assam	15.6	10.2
15	Bihar	19.3	25.1

Source: Handbook of Statistics on Indian States, RBI. Note: Period 2008-09 to 2016-17

Bihar (19.3 percent) and Madhya Pradesh (15.8 percent) shows highest growths in tax revenue. These states are also characterised with comparatively higher growth in non-tax revenue- 25.1 percent and 17.8 percent respectively. Highest magnitude of difference between tax and non-tax revenue is visible in the case of Kerala and West Bengal. Political ideology generally plays a dominant role in determining the share of non-tax revenue in states. Thus, as per our data, political ideology also determines the share of financial sector GDP on total GDP of states.

Table IV
Average Growth of Per Capita NSDP

Period	Average Growth (%)
1996-97 to 1998-99	4.28
1999-00 to 2003-04	16.14
2004-05 to 2008-09	11.87
2009-10 to 2013-14	5.93

Source: Handbook of Statistics on Indian States, RBI

Table IV presents average growth of per capita NSDP of Indian states. A double digit growth was experienced during two closest terms of different political parties. By how much per capita net state domestic product is generated out of the tax revenue is very relevant in the selected states. This generation would represent a meaningful implication of reforms. Because, more per capita net state domestic product is expected from the private revenue than from government expenditure.

c. Determinants of Inclusive Growth

Theoretical foundations propose a positive association between financial development and inclusive growth. Data of Caporale *et al* (2009) show that a more efficient banking sector accelerate growth. The present section deals with the role of financial development on inclusive growth. Financial sector GDP represents financial development. Three state centric variables such as per capita availability of power, bank deposit and number of offices of scheduled commercial banks are included in the model. Table V presents regression results for per capita net state domestic product by tax revenue.

Table V
Regression for PCNSDPTXREV

Independent Variable	Coefficient	t-ratio
const	−7.96	−14.21***
Per Capita Availability of Power	0.30	6.61***
Sectoral GDP- Banking and Insurance	−0.56	−5.36***
Bank Deposit	0.58	6.86***
No of Offices of Scheduled Commercial Banks	−1.83	−20.17***
R-squared		0.928
F (4, 115)		368.62***
No of Observations	120	

Notes: *** denotes significance at 1 percentage level. Dependent variable is Per Capita Net State Domestic Product/Tax Revenue. Dependent and Independent variables are measured in natural logarithms. Independent variables are lagged by one year.

Per capita net state domestic product on tax revenue represents the share of tax revenue that contributes towards individual GDP. It, in other words, represents the volume of income that might be channelised towards the individuals for production. Basic infrastructure, proxied by per capita availability of power, shows a significant positive association with inclusion. Development of financial institutions through sectoral GDP and expansion of offices does not contribute towards the inclusive growth. However, one important component of financial infrastructure, provision of savings by way of bank deposit, shows positive association with the inclusive growth. This indicate that, savings significantly affects the inclusive growth in these regions.

Conclusion

People have to resort financial institutions for their basic amenities whereas surplus income (tax revenue) have a strong bearing on the output of such institutions. It means that taxable income of affluent section might be channelised through the financial institutions for facilitating a social well being. Our data set shows that state interventions and heterogeneity have a strong bearing on financial development of Indian states. Further, it was found that, savings significantly affects inclusive growth in these regions. In India, financial institutions largely act as amechanism for passing welfare benefits. The role helped in the improvements of the financial sector. But the adverse association between financial development and inclusive growth attracts urgent scrutiny. In this regard, we recommend an improved modelling. Government must take a stock of the volume of credit that are channelised solely for productive purposes. In this respect, some reforms made in various policies after 1990. But the characterestics of financial institutions, still, unnecessarily exhibit a social fabric.

Appendix-1

Sample States/UT with Average Growth in Per Capita NSDP (Period: 2009-10 to 2016-17)

SL No	Name of State/UT	Average Growth
1	Karnataka	20.89
2	Goa	18.30
3	Rajasthan	18.29
4	Odisha	17.83
5	Kerala	16.95
6	Gujarat	16.55
7	Andhra Pradesh	16.41
8	Assam	16.23
9	Delhi	15.44
10	Tamil Nadu	14.92
11	Madhya Pradesh	14.65
12	Maharashtra	14.33
13	Uttar Pradesh	14.08
14	Bihar	13.02
15	West Bengal	11.15

Source: Handbook of Statistics on Indian States, RBI

Appendix-2　　　　　　**Statistical Characteretsics of Percentage Share of Tax Revenue of States to Total Revenue**

SL No	Name of State	Average	Minimum	Maximum	Median	Kurtosis	Skewness	Std. Deviation	Variance
1	Andhra Pradesh	4.97	4.36	5.46	5.11	-1.53	-0.54	0.44	0.19
2	Arunachal Pradesh	0.02	0.00	0.02	0.02	5.82	-2.27	0.01	0.00
3	Assam	0.67	0.54	0.83	0.68	-1.45	0.14	0.11	0.01
4	Bihar	0.67	0.54	0.79	0.67	-0.58	-0.27	0.08	0.01
5	Jharkhand	0.43	0.20	0.56	0.44	1.58	-1.08	0.12	0.01
6	Goa	0.60	0.22	1.11	0.44	-1.94	0.52	0.36	0.13
7	Gujarat	4.53	3.88	5.26	4.59	0.77	0.06	0.42	0.17
8	Haryana	2.25	1.72	2.68	2.34	-0.88	-0.55	0.33	0.11
9	Himachal Pradesh	0.25	0.20	0.30	0.24	-2.11	0.10	0.04	0.00
10	Jammu Kashmir	0.19	0.13	0.23	0.19	0.90	-0.31	0.03	0.00
11	Karnataka	9.06	7.92	10.38	8.90	-0.82	0.26	0.84	0.71
12	Kerala	1.49	1.25	1.74	1.50	-1.39	-0.17	0.18	0.03
13	Madhya Pradesh	1.84	1.46	2.15	1.88	-1.39	-0.38	0.26	0.07
14	Chhatisgarh	0.40	0.19	0.49	0.43	6.48	-2.40	0.09	0.01
15	Maharashtra	38.58	36.62	40.64	38.67	-1.57	-0.08	1.48	2.19
16	Manipur	0.01	0.01	0.02	0.01	1.09	1.24	0.00	0.00
17	Meghalaya	0.08	0.04	0.10	0.09	4.76	-2.06	0.02	0.00
18	Mizoram	0.00	0.00	0.01	0.00	2.95	1.74	0.00	0.00
19	Nagaland	0.01	0.00	0.02	0.00	7.69	2.76	0.01	0.00
20	Delhi	14.30	13.15	16.15	14.24	1.79	0.97	0.93	0.86
21	Odisha	1.37	1.00	1.57	1.43	0.34	-1.20	0.20	0.04
22	Punjab	1.18	1.02	1.32	1.19	-1.40	-0.33	0.11	0.01
23	Rajasthan	1.78	1.33	2.44	1.80	1.84	0.84	0.33	0.11
24	Sikkim	0.03	0.01	0.05	0.03	-1.05	0.15	0.01	0.00
25	Tamil Nadu	6.59	6.02	7.26	6.56	-0.56	0.06	0.42	0.18
26	Tripura	0.03	0.02	0.03	0.03	-1.22	-0.25	0.01	0.00
27	Uttar Pradesh	4.11	3.44	4.69	4.21	-0.84	-0.48	0.44	0.20
28	Uttrakhand	0.29	0.25	0.33	0.29	-1.29	-0.15	0.03	0.00
29	West Bengal	4.29	4.07	4.46	4.29	-1.03	-0.46	0.15	0.02

Source: Handbook of Statistics on Indian States, RBI

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