

# Informality and Access to Finance in Low Income Countries (LICs)

Policy brief DFID/Tilburg University research: *Co-ordinated Country Case Studies - Innovation and Growth, Raising Productivity in Low Income Countries* <http://www.tilburguniversity.edu/dfid-innovation-and-growth/>

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## Introduction

In today's globalising world, economists and business community actors acknowledge the importance of innovation and finance for productivity growth in facilitating economic growth and development. Recently, the promotion of innovation in Low Income Countries (LICs) has entered the agenda of policy-makers and international development agencies. Many agree that innovation is crucial in these countries, because innovation in the private sector, and in particular among small and medium sized enterprises, is fundamental for growth in order to catch up with middle and high income economies.

A large share of private sector activity in LICs takes place in the informal sector, which almost always has negative economic and development consequences. There is among others a large productivity gap between formal and informal firms. The productivity is higher in the formal manufacturing sector due to access to better formal services. However, firms have to pay 'entry costs' to overcome the barrier to formality. This barrier includes registration costs, indivisibility of investment and formal property claims, where the latter enables entrepreneurs to use assets as collateral and thus gain access to formal finance. Informality can indirectly hamper firm growth through the lack of provision of public services and infrastructure caused by deficits in the government revenue.

In the framework of a DFID-funded research project entitled '*Enabling Innovation and Productivity Growth in Low Income Countries (EIP-LIC)*', a team of researchers from the Tilburg University analysed the interplay between informality and access to finance. The research explored financial sector development in the formal and informal manufacturing sector in India. The original working paper<sup>1</sup> is entitled '*Informality and Access to*

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<sup>1</sup> The paper is accessible at the project's website (<http://www.tilburguniversity.edu/dfid-innovation-and-growth>) under 'publications and reports'.

*Finance: Evidence from India*' (2014) by Thorsten Beck and Mohammad Hoseini. This policy brief provides the research approach, main outcomes and policy implications of the paper.

## **Research approach and outcomes**

The informal sector suffers from the lack of access to formal sources of external finance too. One of the important differences between formal and informal enterprises, is that around 44 percent of informal enterprises considers access to financing as the main obstacle of doing business, whereas this number is 21 and 14 percent for small and large formal enterprises. It is not clear, however, whether the lack of access to formal finance discourages entrepreneurs from entering the formal economy, or whether informality prevent them from accessing formal finance.

Better access to financial services is assured through financial sector development, also referred to as financial deepening. This constitutes an increased provision of financial services and institutions with a wider choice of services geared to all levels of society. Beck and co-authors earlier found a positive relationship between financial deepening and economic growth in LICs, a relationship that goes more through productivity growth than capital accumulation.



Other previous research work and theory suggest an impact of financial deepening on pulling more firms into the formal sector as well as increasing total production of the formal sector.

The DFID research of Beck and Hoseini focussed on the effect of financial development on formal and informal manufacturing firms and explores two dimensions of financial development namely outreach (the ease of access to financial services, including credit) and depth (the overall formal credit volume in the economy). The research involves firm-level data between 1989-2010 from different regions in India with different levels of depth and outreach allowing a cross-regional comparison with regard to incidence of informality.

Overall, the empirical findings suggest two positive effects of financial deepening on the incidence of formality in manufacturing: reducing barriers to formality and increasing productivity. The research results show that both depth and outreach are important but in a different way.

Financial outreach - measured in the research as branch penetration - helps to reduce formality barriers and thus increases the number of formal firms. Theory already suggested that one effect of access to finance enables firms to overcome the costs of formality. This is especially the case in industries with a higher demand for external finance. Given the importance of geographic proximity in lending relationships especially of smaller firms, small firms stand to benefit more from financial outreach than large firms. There is no significant effect on productivity for branch penetration.

Financial depth mainly affects informality through increasing productivity of industries dependent on external finance. There is a lesser effect on reduced informality. Thus in conclusion, financial deepening increases the productivity of formal sector and reduces informality.

**Summary research outcomes**

	Outreach	Depth
Reduced informality	++	+
Productivity	0	++

**Policy implications**

The working paper of Beck and Hoseini confirms the policy assumption that promoting the informal manufacturing sector to become formal will raise productivity and economic growth. A formal sector, and entrepreneurs choosing to become formal, implies more commitment to the firm’s survival and consequently a more stable economic sector. Formality also means tax revenue with government can use for developing public services and institutional stability. A formal economy brings benefits for its workforce too. Formal companies usually have an organised system of employment with written rules and has a standardised relationship between the employer and the employee is maintained through a formal contracts.

The research suggest that government policies towards financial deepening can play an important role in reducing informality, though with important differences across industries. A key insights of this paper is that broadening access through outreach plays will have a more important effect on reducing informality than financial depth. In particular, access to bank account makes the operation of firms at least partly observable and reduces the information asymmetry between firm and formal agency. This particularly the case for smaller firms that face high entry barrier to the formal sector. Decentralisation policies of the banking sectors, establishing easy accessible small branches in the more remote areas, is one way forward. Policy of government, but also the policies and strategies within state or private banks, may focus on the ease of access to financial services, including credit.

In terms of promoting raising productivity, a policy implication is to focus on financial depth; increasing the overall formal credit volume in the economy. The working paper demonstrates that financial depth promotes economic growth in LICs via increased productivity of firms.

The working paper is also informative for policy makers with regard to their expected impact of their policies. Policy makers should not expect that policies aimed at outreach will increase productivity. The same holds true for the development of financial depth, such policies will have a modest effect on reducing informality of enterprises.



In addition, the outcomes of the working paper can be further discussed in the context of the different stages of economic development. In factor-driven economies, where informal labour intensive enterprises compete in terms of factor endowments. These informal enterprises process raw materials and have low productivity, while the urgency for efficiency is not so evident. Then outreach oriented policies seems to be the logical way to promote formality.

In the next stage of economic development, efficiency-driven economy, more enterprises are formal while the incomes the skilled labour force have risen. In this stage, price competition by production efficiency and products services quality is critical, so raising productivity becomes important. Policy making within an efficiency-driven economy aiming at raising productivity, developing financial depth is a more effective option than outreach.

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This policy brief is the product of a research project funded by the British Department for International Development (DFID) entitled '*Coordinated Case Studies – Innovation for Productivity Growth in Low Income Countries*'. The project is implemented by Tilburg University (The Netherlands) and explores SME-level innovation in Low Income Countries (LICs) and factors that contribute to or limit its diffusion. Data collection and research collaborations take place in 10 African and Asian countries (Bangladesh, Ethiopia, Ghana, India, Indonesia, Kenya, Tanzania, South Africa, Uganda and Vietnam). The policy implications of research are presented in a series of policy briefs, targeted at a broad audience of policy makers within governments, business and development agencies with a view to quantifying research outcomes and promoting evidence-based policy making.