Journal of Business Venturing 30 (2015) 526–545

Contents lists available at ScienceDirect

Journal of Business Venturing

Economic informality and the venture funding impact of migrant remittances to developing countries[1]

Candace Martinez [a,2], Michael E. Cummings [b,3], Paul M. Vaaler [c,d,*]

[a] IE Business School, Calle María de Molina, 11, 28006 Madrid, Spain
[b] Lee Business School, University of Nevada, Las Vegas, 4505 S. Maryland Parkway, Las Vegas, NV 89154, USA
[c] Law School, University of Minnesota, 412 Mondale Hall, 229 19th Avenue South, Minneapolis, MN 55455, USA
[d] Carlson School of Management, University of Minnesota, 3-424 CarlSMgmt, 321 19th Avenue South, Minneapolis, MN 55455, USA

ARTICLE INFO

Article history:
Received 31 March 2014
Received in revised form 25 August 2014
Accepted 26 October 2014
Available online 12 December 2014

Field Editor: Jeffrey McMullen

JEL classifications:
L26
O16
O43

Keywords:
Informal economy
Entrepreneurship
Venture funding availability
Remittances
Migrants

ABSTRACT

In developing countries, weak institutional capacity to observe and regulate the economy discourages foreign capital inflows vital to venture investment. This informality effect may differ for migrant remittances, inflows less reliant on formal arrangements. We use institutional and transaction cost theories to propose that informality shifts migrant remittances toward venture funding. Analyses in 48 developing countries observed from 2001 to 2009 support our proposition. When the informal sector exceeds approximately 46% of GDP, remittances increase venture funding availability. Migrants and their remittances are vital to funding new businesses and entrepreneurially-led economic growth in developing countries where substantial informality deters other foreign investors.

1. Executive summary

Many recent studies in entrepreneurship (Kiss et al., 2012; Webb et al., 2012), business, and economic development (Bruton et al., 2012. McGahan, 2012; Webb et al., 2009; Yang, 2011) have highlighted the importance of informal sector entrepreneurship and called for new theoretical models and empirical evidence to guide our understanding of how entrepreneurs and their firms emerge and

* Corresponding author. Tel.: +1 612 625 4951.
E-mail addresses: cjmartnz@gmail.com (C. Martinez), michael.cummings@unlv.edu (M.E. Cummings), vaal0001@umn.edu (P.M. Vaaler).
[1] Please contact Paul M. Vaaler regarding this paper. This research benefitted from a presentation at the Instituto de Empresa, Madrid, Spain, Simon Fraser University's Beedie School of Business, Tufts University's Fletcher School of Law & Diplomacy, the University of Illinois at Urbana-Champaign's College of Business, and the meetings of the Great Lakes Entrepreneurship Network and the Strategic Management Society. Paul M. Vaaler acknowledges financial support for this research from the Carlson School of Management's Dean's Office. He also thanks Mari Sako and Chris Flegg of Oxford University's Saïd Business School, the late Mark Janes of Oxford University's Bodleian Library for time and resources helpful to the development of this research. He is also grateful to Sebastian Plubins, Iñigo Moré Martinez and colleagues at Ria Financial for helpful comments and survey information on recent remittance industry trends. All errors are ours.
[2] Tel.: +34 91 568 9600.
[3] Tel.: +1 702 623 1749.

http://dx.doi.org/10.1016/j.jbusvent.2014.10.004
0883-9026/

grow in the informal sector. In response, we develop and test a theoretical framework based on institutional theory and transaction cost economics to describe how entrepreneurs in developing countries with substantial informal sectors might find venture funding abroad through remittances. Remittances are individual-to-individual or household-to-household money transfers from host to home countries. We propose that an increase in informality shifts the allocation of these remittances away from their default use of financing household consumption toward venture investment.

We find support for this proposition in empirical analyses of remittances to and informality in 48 developing countries observed from 2001 to 2009. Although informality has a negative direct effect on venture funding availability, it has a positive moderating effect; remittances increase venture funding availability when informal transactions exceed approximately 46% of gross domestic product (GDP). That basic finding proves robust to reasonable variations in data sampling and empirical model specification, including a dynamic panel estimation strategy that addresses the possibility of omitted variable bias and reverse causation between remittances and venture funding availability.

Despite the importance of our study for understanding entrepreneurship in the informal economy, it is important to point out that informality is most productively thought of as an institutional condition to be studied and understood, rather than a development goal to be sought after. Our empirical findings (negative direct effect, positive moderation effect) suggest that the combination of high remittance contributions and high informality is more of a consolation prize than a fast track to a robust entrepreneurial economy.

Our theory-based explanation complements other recent research focusing on the venture-funding role of large multinational corporations ("MNCs") in developing countries. Their approach emphasizes that large-scale foreign direct investment ("FDI") from MNCs can generate indirect venture funding spin-off effects (Kim and Li, 2012; Webb et al., 2010). In contrast, our approach emphasizes how small-scale transfers from individuals and households abroad can generate direct venture funding effects, contingent on the level of informality.

Our study also contributes to current debates in development research (e.g., Yang, 2011), practice (e.g., Moneygram, 2010), and in public policy (e.g., Ratha, 2003) circles. These researchers share an interest in understanding the conditions under which remittances to developing countries are more likely to shift toward financing commercial transactions such as new business creation. Development economists typically explain this shift based on occasional disruptions in other venture funding resources (i.e. resulting from natural disasters), or to the location of would-be entrepreneurs in more remote, rural areas (Yang, 2011). Our study suggests informality as an alternative driver of shifts in remittance uses; one that is linked to differences in a developing country's institutional rather than natural environment.

Lastly, our findings regarding institutional shifts in remittance uses will permit foreign development professionals (e.g., Ratha, 2003) to better calibrate policies designed to decrease the transaction costs of remitting for household versus business uses. Similarly, important remittance industry players such as banks and money transfer organizations (e.g., Moneygram) can better anticipate customer needs and offer services better-tailored to household or business uses. More generally, firms and development professionals can better serve remitters abroad and recipients in developing countries trying to fund, found and grow new, often-unregistered microenterprises serving very low-income populations.

2. Introduction

Economic activity in many developing countries is still substantially located in the so-called "informal" sector where local public authorities lack adequate resources to observe and regulate business transactions. Maloney (2004), for example, estimates that from 30 to 70% of Latin American workers operated outside the purview of tax authorities during the early 2000s, while Friedman et al. (2000) estimate that from 14 to 63% of economic output in developing countries during the 1990s came from entrepreneurs and businesses gone underground. Informal economies are not merely transitory phenomena; they seem to persist and even grow in many developing countries. Indeed, during the 1990s and early 2000s several countries in Sub-Saharan Africa and Latin America saw faster economic growth in informal sectors than in the formal economy (Maloney, 2004).

Recent research in entrepreneurship (Kiss et al., 2012; Webb et al., 2012) and other fields in business and economic development academies (Bruton et al., 2012. McGahan, 2012; Webb et al., 2009; Yang, 2011) highlights the importance of informal sector entrepreneurship and calls for new theoretical models and empirical evidence to guide our understanding of how entrepreneurs and their firms emerge and grow in the informal sector. In response, we develop and test a theoretical framework explaining how entrepreneurs in developing countries with substantial informal sectors find venture funding abroad. We use institutional theory (North, 1990; Ramamurti, 2003) and transaction cost economics ("TCE") theory (Coase, 1937; Williamson, 1975, 1985) to propose that migrant remittances from abroad ("remittances") increase venture funding for local entrepreneurs when economic informality ("informality") is substantial. An increase in informality shifts these small individual-to-individual or household-to-household transfers away from their "default" use of financing household consumption toward venture investment. We find support for this proposition in empirical analyses of remittances to and informality in 48 developing countries observed from 2001 to 2009. Remittances increase venture funding availability when informal transactions exceed approximately 46% of gross domestic product (GDP).

Our study contributes to entrepreneurship theory, practice and public policy. We answer a call in academic research in entrepreneurship (Dau and Cuervo-Cazurra, 2014; Webb et al., 2012) and elsewhere in the business academy (Webb et al., 2009) to develop and test models that explain entrepreneurial processes in informal economies typical of many developing countries. Our theory-based explanation complements other recent research focusing on the venture-funding role of large multinational corporations ("MNCs") acting alone (Kim and Li, 2012) or in concert with others such as non-governmental organizations (Webb et al., 2010) in developing countries. Their approach emphasizes that large-scale foreign direct investment ("FDI") from MNCs can generate *indirect* venture funding spin-off effects. In contrast, our approach emphasizes that small-scale transfers from individuals and households abroad