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CREDIT CONSTRAINTS, SECTOR INFORMALITY AND FIRM INVESTMENTS: EVIDENCE FROM A PANEL OF URUGUAYAN FIRMS

Néstor Gandelman*
Universidad ORT Uruguay

Alejandro Rasteletti
Inter-American Development Bank

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Using data on Uruguayan firms (1997-2008) this paper explores whether the extent of informality in a sector affects a firm's investment decision either directly or indirectly through a credit availability channel. The results suggest that financial restrictions affect investment decisions: a one percentage point increase in overall credit growth translates into a one half percentage point increase in investment rates. It is also found that, although there is no direct effect of informality on the firm investment decision, there is an indirect effect through the borrowing channel.

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I. Introduction

Catão, Pagés and Rosales (2009) argue that the link between financial development and firms' informality has been much overlooked. They suggest that the incentives

* Néstor Gandelman (corresponding author): Universidad ORT Uruguay, Bulevar España 2633, Montevideo 11.300, Uruguay; tel: (598)27071806, email: gandelman@ort.edu.uy. Alejandro Rasteletti: BID, Avenida Paseo de la Reforma 222 Piso 11, Colonia Juárez, Delegación Cuauhtémoc, Ciudad de México, 06600, México, email: arasteletti@iadb.org. We would like to thank Eduardo Cavallo, Verónica Frisancho, Hernán Moscoso and seminar participants at the IDB workshop for helpful comments. We also thank Diego Lamé and Fiorella Pizzolon for their research assistance. All errors and omissions are the authors' sole responsibility. The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of the Inter-American Development Bank or its Board of Directors, or the countries they represent.

for firms to become formal increase as financial markets deepen, as they experience a higher likelihood of accessing the credit market. Using data on Brazilian firms, they find evidence that financial deepening led to higher employment formalization rates in sectors where firms are typically more dependent on external finance. In this paper, we focus on a different firm decision that might be affected in the presence of financial restrictions. Using data on Uruguayan firms, we test whether financial restrictions affect firms' investment decisions and whether the extent of informality in a given sector exacerbates this effect.

The role of informal firms in the economic development process is not very well understood by economists. This is in part due to the different views in the profession on the nature of informal firms. La Porta and Shleifer (2008) divide these views into three groups, which they label the romantic view, the parasite view, and the dual view. According to the romantic view, informal firms are productive firms that are unable to reach their full potential due to excessive government regulation and taxation.[1] The other two views have a more negative perspective on the nature of informal firms. According to the parasite view, informal firms are unproductive firms that choose to gain competitiveness through the avoidance of government taxes and regulations.[2] This view considers informal firms to be actual competitors of formal firms, and their existence therefore hampers growth and productivity of formal firms. The dual view also portrays informal firms as unproductive firms but not as competitors of formal firms. According to the dual view, formal and informal firms operate in different markets, addressing the needs of a different customer bases.[3]

The dual view seems to be the one that has gained the most acceptance among economists. In fact, the very thorough and widely cited work of La Porta and Shleifer (2008) suggests that the empirical evidence is mostly consistent with the dual view. They find very large differences in productivity between formal and informal firms, which are unlikely to be merely due to government regulation. Therefore, they argue that the data are not consistent with the romantic view. They also affirm that surveys results indicate that formal firms do not view competition from informal firms as a serious problem, which is inconsistent with the parasite view.

Even though formal firms might not view competition from informal firms as a serious problem, their presence might still influence the actions taken by formal

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[1] La Porta and Schleifer (2008) associate the romantic view with the work of De Soto (1989, 2000).

[2] La Porta and Schleifer (2008) mention the work of McKinsey Global Institute as an example of this view. See, for example, Farrell (2004).

[3] This view relates to the work of Harris and Todaro (1970).