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ScienceDirect

Review of Development Finance 4 (2014) 38–49

Review of DEVELOPMENT FINANCE

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Does banking development matter for new firm creation in the informal sector? Evidence from India☆

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Abstract

There is little evidence on the effect of banking development on firm creation in the small firm sector. This paper examines whether differences in banking sector penetration across Indian districts explain the differences in firm start-ups in Indian informal sector. Our empirical strategy lies in examining the effect of the spread of banking facilities at the district level on new firm formation in the informal sector for the period 1994–1995 to 2010–2011. Our results confirm that local bank availability is associated with significant increase in enterprises in the informal sector and the effect is more pronounced for larger enterprises in the sector.

JEL classification: G190; L260; O160

Keywords: Banking development; Firm creation; Informal sector; India

1. Introduction

The regional dimension of entrepreneurship has been a subject of great importance to scholars of regional development (see for example, Acs and Storey, 2004; Acs and Armington, 2004). Small firms are an important source of economic dynamism and particularly job creation, and the formation of such firms can be a crucial determinant of economic growth and employment generation, especially in lagging regions (Fritsch, 1997; Audretsch and Thurik, 2004; Parker, 2004; Audretsch and Keilbach, 2004). Historically, in most countries, whether in the developed or developing world, rates of new firm formation differ significantly across regions within the same country (Keeble and Walker, 1994; Braunerhjelm and Borgman, 2004). Such variation in the rate of new firm formation is often seen as a cause of wide divergence across regions in the same country in economic growth and employment opportunities, and can become a matter of significant policy concern for policy-makers.

Why do we see such wide regional variations in new firm formation? While an emerging literature has attempted to address this question, we still do not know enough on what explains the regional dimension of new firm creation, and what governments can do to promote new firm creation in the more backward regions (O'Farrell, 1986; Armington and Acs, 2002). As Acs and Storey (2004) argue, "the instruments available – such as government assistance programme, local expenditure patterns or even political parties – seemed to exert little or no explanatory power" (p. 872). One crucial determinant of new firm creation is the availability of external finance. The theoretical literature postulates an unambiguous positive relationship between the easing of credit constraints on entrepreneurs and the rate of new firm formation (Evans and Jovanovic, 1989; King and Levine, 1993). While much of the previous literature has studied other determinants of the spatial variations in new firm creation such as agglomeration economies, demographic structure, infrastructure and human capital (see for example, Bartik, 1989; Ellison and Glaeser, 1999; Bonte et al., 2009; Ellison et al., 2010; Doms et al., 2010), there has been less research on the role that banking development can play in explaining why rates of new firm

☆ We acknowledge the support of the British Academy through a small research grant for developing this paper.
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Peer review under responsibility of Africagrowth Institute.

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http://dx.doi.org/10.1016/j.rdf.2014.03.003

creation differ so starkly across regions in a single country.[1] This is a crucial omission – the empirical literature on banking development finds a strong positive effect of the latter on business start-ups (Parker, 2002; Cassar, 2004) and at the same time, levels of banking development differ greatly within countries, providing a clear reason why banking development may matter for regional variations in new firm creation (Guiso et al., 2004). In this paper, we attempt to rectify this omission in the literature by examining whether banking development exerts a positive effect on new firm creation.

Another significant omission in the literature on the regional dimension of new firm creation, especially in the developing country context, has been the relative neglect of the informal sector in the analysis of new firm creation. This is a surprising omission, given the large presence of the informal sector in developing countries. For instance, the ILO (2002) estimates that 48 per cent of workers in North Africa, 72 per cent in Sub-Saharan Africa, 51 per cent in Latin America and 65 per cent in Asia, are employed in the informal economy. De Soto (2000) argues that many entrepreneurs in developing economies prefer to be in the informal sector, as the bureaucratic procedures involved in permission to set up a business in the formal sector discourages nascent entrepreneurs. The informal sector is the preferred site where many entrepreneurs would like to start their operations, and it is often the sector where the most dynamism and creativity among small firms can be found in developing economies (Prahalad, 2005; Maiti and Sen, 2010). Yet it is usually the entrepreneurs in the informal sector who are most likely to be credit constrained and dependent on external finance, as these entrepreneurs generally tend to be low-wealth, and therefore, not having the necessary savings to start an operation on their own funds (Blanchflower and Oswald, 1998; Parker, 2002; Hurst and Lusardi, 2004). Since entrepreneurs in the informal sector would not be able to borrow from bond or stock markets that are not geographically confined, they would have to rely on local financial intermediaries for their sources of funds for investment. In this case, greater outreach of banking facilities would certainly be expected to have a significant role to play in explaining variation in new firm creation across regions in the same country.

In this paper, we examine the role of banking development in explaining new firm formation in the informal manufacturing sector of a developing country. The country we study is India, where about 80 per cent of manufacturing employment and 17 per cent of manufacturing output is in the informal sector (NCEUS, 2007). India provides an ideal context to study the relationship between banking development and new firm creation in the informal sector for four reasons. Firstly, regional development is very uneven in India, with more prosperous Indian states having per capita incomes that are close to five times that of the poorest states, and there has been an increase in regional growth divergence since the economic reforms of 1991 (Ramaswamy, 2007; Nayyar, 2008). The location of informal manufacturing enterprises also shows a highly uneven regional distribution (Ghani et al., 2011). Secondly, while the Indian government actively promoted an equitable spread of financial institutions till 1991 under a system of branch licensing policy for nationalised commercial banks which made it mandatory for these banks to open branches in rural and semi-urban areas and remote regions of the country, this policy has been considerably weakened since the financial liberalisation enacted as part of the 1991 economic reforms. This may have led to greater inequality in banking development in more recent years (Burgess and Pande, 2005; Cole, 2009). Thirdly, the analysis of the determinants of new firm creation across regions within a country allows for institutional, legal and cultural factors to be more adequately controlled for, since there are fewer differences among regions than among countries (de Guevara and Maudos, 2009). Finally, the country has witnessed an increase in the number of enterprises in the informal sector during the period 1994–2011. The country has also witnessed significant financial deepening as the number of bank branches have went up considerably during the same period.[2] This permits us to investigate whether spread of banking facilities can be a factor responsible for the increase in number of small firms in India.

In this paper, we use district level data for India to examine whether the differences in banking sector penetration can explain variation in rates of firm start-ups in Indian districts. We use number of enterprises in the informal sector as a proxy to capture new firm creation at the district level. Our period of analysis is 1994–2011. One innovative feature of our analysis is that we also test for the relationship between banking sector outreach and firm entry among firms that employ both family and hired workers. Analysing the effects of banking development separately for these firms allows us to assess whether finance constraints are more binding among some organisational forms in the informal sector than others (that employ only family labour).

We use a rich data-set of large representative surveys of informal firms for the period 1994–1995 to 2010–2011. We find that banking development promotes new firm creation and aids firm growth in the informal sector in India. The effect is more pronounced among larger firms employing both family and hired labour.

The rest of the paper is in five sections. In the next section, we summarise related literature on the credit-start-ups linkage and on the regional dimension of new firm creation in India. In Section 3 we provide a brief discussion of financial policies in India. Section 4 discusses the empirical strategy employed in the study, and provides a description on the data and the variables used in the analysis. Section 5 presents the results of the empirical analysis. Section 6 concludes.

[1] An exception is de Guevara and Maudos (2009), who investigated the role of regional financial development on firm growth in Spanish provinces and found that firms in industries with a greater dependence on external finance grew faster in more financially developed provinces.

[2] The data indicates that the number of enterprises in the informal sector which were 12 million in 1994-1995 increased to 17.2 million in 2010-2011. The same period also witnessed an increase in number of bank branches, from 63,817 in 1995–1992, 117 in 2011.