“INFORMALITY AND ACCESS TO FINANCE: EVIDENCE FROM INDIA”

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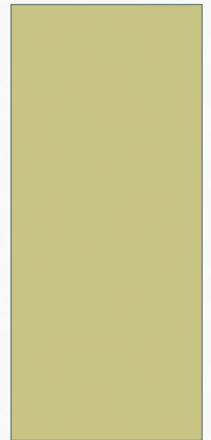
DISCUSSION BY IFTEKHAR HASAN



RESEARCH QUESTION

- What is the effect of finance access in reducing the informality? Increase transparency or enhance productivity?

SUMMARY

- **Financial outreach** helps to reduce formality barriers, increases the number of formal firms, especially for smaller firms, and diminish opportunistic informality.

- **Financial depth** mainly affects informality by increasing productivity of industries dependent on external finance; it has no significant impact on informal sector firms.

WHAT I LIKE

- **Interesting data set, although intermittent and covers a wide spread of period, but make the hypothesis testable**

- **Literature review that brings the two different channels through which financial development impacts the informality**

- **Authors’ efforts to bridge different literature to tell a consistent story.**

COMMENT (1)

- **Gap between concept and implementation.**
- "firms's decision between formality and informality" and "threshold size of a company indifferent between formality and informality"
- The paper claims contribution in several literature: "informality", "Real effect of financial deepening", and "economic development in India".
  - Evidence is more consistent with the real effect of financial deepening, a contribution to the "finance-growth" nexus literature, consistent with RZ, Ceterolli, Black and Strahan papers where "formal-informal" represents the real effect.

COMMENT (2)

- How does the story fit into the choice between stay formal and informal?
  - Shadow economy exists everywhere across nations.
    - e.g. A large part of economy in China chooses to stay informal for tax and regulation benefit.
  - Is the choice homogenous across India?
    - Geographic variation in economy, industry, regulation, etc.
    - Controlled state level indictors are only for formal economy

COMMENT (3)

The selection bias is a big concern to me. The sample is apparently biased towards the small firm side, as only around 10% of the firms are registered under any act, and around 2% are registered under tax (table 2A). and these small firms only comprise a small portions of the economy, therefore the measure of tax enforcement expenditure per firm is debatable.

COMMENT (4)

- Diff-in-diff should be conducted with exogenous event, so far the diff-in-diff test in the paper involves only an interaction term between RZ and financial development variables. I do not think it is the best measure one can have. Authors need to specify the exogenous event adopted.

- Examples of Jharkand and Kerala simply report differences in financial environment across states but not changes. A model where actual changes in finance within a given state effecting the changes in formal/informal sectors may be more appealing.

COMMENT (5)

- Even if the diff-in-diff setting is econometrically valid, the model (equation 2 of page 18) should also include RZ, FD, X, and Y independently, to see the standalone effect of these variables.

- the econometric concern also brings in the reverse causality or omitted variable concerns. The way it is resolved in the paper may not be adequate!

- economic significance (Page 20) seems very limited.

COMMENT (6)

- RZ Index of Financial Dependence

- Measure based on US firms used to identify Indian industries' need of external financing. Computed for a group of large listed enterprises in the U.S. over 1980s. I am not sure if it is valid measure applying to India sample. (Page 15), both firm size and country factor could be very different.

- But sample period for this study spans the 1990s and 2000s.
- Modified RZ Index of de Serres, Kobayakawa, Slok and Vartia (2006) may be a better measure.
  - Calculated over a more relevant period (1994-2003).
  - Data derived from Worldscope instead of Compustat.
  - Uses different industry classification and covers services sector.
  - Used by Hiroko Oura (2008).
    - Financial Development and Growth in India: A Growing Tiger in a Cage?

COMMENT (7)

- How to interpret/generalize the results?
  - Any Legal, cultural, demographic, industrial difference?
  - Does the form of financial development matter?
  - Does organizational types matter? Government versus Private Banks?

COMMENT (8)

- **There is a dramatic decline in the sample size from 2000 for ASI and from 2005 for NSS**
  - **What happened? Is it economic related?**
  - **Does it affect the results?**

- **In figure 4-6, it seems that a few outliers can affect the linear relationship**

- **Does the Appendix A4 truly eliminate the concerns for reverse causality?**

COMMENT (9)

- Trends in the value-added and employment share of formal and informal firms are similar to number of firms.
  - First dropping and then increasing.
  - Is it related to the political regimes in India?
    - High periods seems to be correlated with Congress regime and low periods with non-Congress regimes such as BJP and Janata Dal.

COMMENT (10)

- Is there a different underlying story? DEMOCRATIC ENVIRONMENT (CENTRAL VERSUS STATE; CONGRESS VERSUS OPPOSITION RULING THE CENTER-STATE?)
- TRUST? CULTURE? INFORMAL INSTITUTIONS.

COMMENT (11)

- **Two dimensions of financial sector development is captured.**
  - **Financial depth and financial outreach.**
  - **World Bank defines financial sector development along four dimensions: Depth, Access, Stability and Efficiency.**
  - **Are the results generalizable across other dimensions such as stability of financial institutions and markets (stability) and efficiency of financial intermediaries and markets in intermediating resources and facilitating financial transactions (efficiency)?**

COMMENT (12)

- **Business groups dominates in India even for smaller level groups. It is a tax decision where in good economic environment, a profitable company will have multiple smaller firms registered, increase operational expenses towards owners/management pockets and lower tax burdens.**

COMMENT (13)

- Why SDPC (local GDP) has a negative (or zero) significance?
- Correlations coefficient between enforcement expenditure and credit to GDP (0.61***) and Branch/10K (0.58***) are too high! Is this a channel of "increased transparency"?

CONCLUSIONS

- Pioneering piece in describing and understanding formal and informal business sectors in India. Despite my constructive criticism, the paper stands on its own to tell a compelling story.
- With appropriate changes and further fine tuning, it has a bright prospect to make a significant contribution.
- I appreciate the opportunity to read and discuss this paper.