RESEARCH BRIEF • MARCH 2023

Access to Credit in Informal Economies: Does Financial Information Matter?

Based on BFI Working Paper No. 2023-12, "Access to Credit in Informal Economies: Does Financial Information Matter?", by Rimmy E. Tomy, Chicago Booth; and Regina Wittenberg-Moerman, University of Southern California

KEY TAKEAWAYS

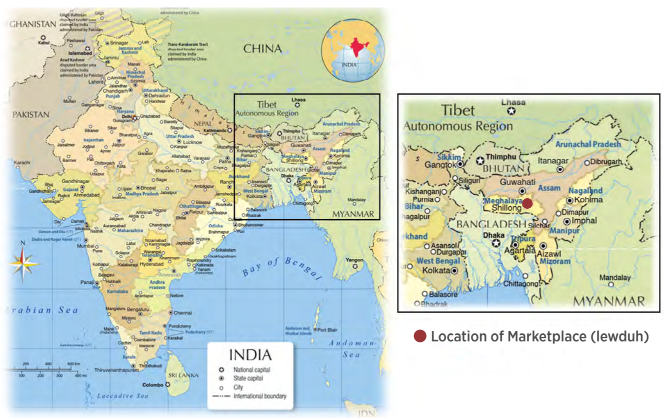
- ✓ The informal economy accounts for roughly 30 percent of the world's GDP and 70 percent of employment.
- ✓ Efficient credit allocation spurs productivity and growth, but such allocation is hampered within informal markets by a lack of financial information between wholesalers (suppliers of credit) and retailers.
- ✓ This research finds that the lack of reliable information prevents the use of financial information in credit allocation decisions.
- ✓ Trustworthiness is key to expanding the use of financial information in credit allocation decisions within informal markets, that is, wholesalers do not believe that retailers would report truthfully, and retailers are concerned that wholesalers may misuse their information.

Travelers to North Africa, the Middle East, India, the Balkans, and countries throughout Asia have likely encountered a bazaar, where sellers gather to form an often large, tightly grouped assortment of small shops and stalls that offer food, clothing, household wares, and other items for sale. For tourists, these shopping experiences, with their vibrant display of local products, offer a unique method of experiencing a local culture, while also allowing for the purchase of souvenirs.

However, bazaars are much more than bucket-list tourist stops. These informal shopping malls and other similar markets are economic engines that are part of the informal economy, which accounts for roughly 30 percent of the world's GDP and 70 percent of employment. In other words, these are profitable businesses for those who sell goods, and also for those who supply the goods to those retailers.

In a formal economy, shopkeepers and other business owners can benefit from a banking or lending system that allows businesses—however small—to finance growth and otherwise benefit from relationships with lenders who understand their business. Within informal economies, though, businesses tend not to access bank loans for a variety of reasons. Instead, financing within bazaars usually occurs when a supplier offers credit to a shopkeeper, and usually without very much financial information about that shopkeeper.

Figure 1 · Location of Marketplace Where Study Was Conducted in Northeast India



Note: This map shows the geographical location of the marketplace (lewduh). The map is sourced from Nations Online Project (nationsonline.org).

Why does this matter? Research has shown that information aids efficient credit allocation, spurring productivity and growth. If you are a supplier of garments to shopkeepers in regional bazaars, for example, and you treat all of your clients the same, you will likely extend credit at a rate that protects you against the worst-case borrower. That is, all shopkeepers will likely pay an inefficiently high rate of interest to protect you against one possibly bad loan, rather than you providing credit to clients at rates that reflect their likelihood to successfully sell your product and pay you back. More information would better allocate credit and, by extension, would result in a more efficient distribution and sale of your product. Good for you, the sellers, and their customers.

There are other advantages to a formal economy, including better labor protections, all of which have led multinational agencies and governments to advocate for a shift to formality. The use of financial information in credit allocation in informal markets can accelerate this shift. But that is easier said than done. In this paper, the authors explore the issues (or frictions, in economic parlance) that prevent the widespread use of financial information in credit allocation in informal economies. Understanding these frictions is the first step in resolving them.

Reducing frictions, improving outcomes

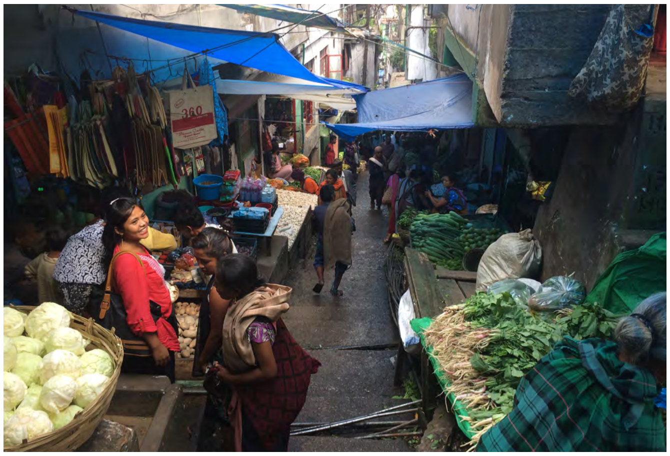
Why isn't this problem solved by merely introducing financial information into these informal credit markets? What are those frictions that make the transition to formal lending so difficult? There are many, and they include low levels of financial literacy among micro-entrepreneurs and households in developing countries, a lack of trustworthy data and information, and a tendency for wholesalers to rely on informal lending mechanisms (like those based on community membership) even when other information is available.

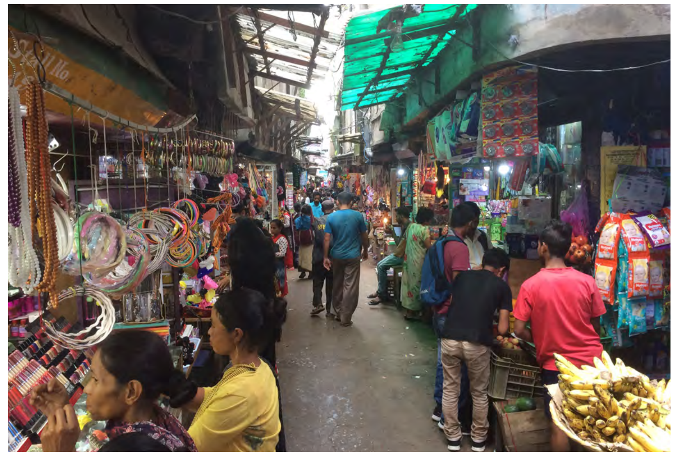
To address these and related issues, the authors study economic activity within the lewduh bazaar, a large historical market and a regional center of trade in northeast India, where wholesalers and retailers co-locate and trade in products ranging from groceries and tobacco to textiles and household appliances.[1] While retailers in this bazaar are often credit-constrained, they tend not to access bank financing for various reasons, including a lack of trust in formal institutions, an insufficient understanding of loan applications, and an inability to provide collateral. This means that wholesalers are the primary source of credit. Interestingly, in contrast to trade credit arrangements in developed economies, wholesalers in the bazaar do not charge interest for delayed payments or offer early payment discounts, and do not offer discounts if retailers pay in cash vs. credit. Thus, the variation in trade credit terms is primarily across the amount and repayment time.

To examine wholesaler preference for retailers' information, the authors employ a combination of survey questions and a hypothetical choice experiment. Offering hypothetical choices to the suppliers of credit is a key feature of this project because wholesalers' preferences may be constrained by the types of information available in the bazaar. In other words, although wholesalers do not currently use retailers' financial information in credit allocation, if wholesalers had access to such information about retailers, and if those wholesalers were able to adequately analyze that information, they may change their behavior.

Those hypothetical choices for wholesalers include retailers' financial information (sales and profits), which reflects business size, growth, and efficiency of retailers' businesses; and nonfinancial information (relationship length and community membership). Also, to ensure that they can draw valid inferences from their study, the authors ask wholesalers to assume that retailers are similar in all other aspects. For example, wholesalers

[1] See BFI Research Brief, "Community Membership and Reciprocity and Lending: Evidence from Informal Markets," based on related work by Tomy and Wittenberg-Moerman.





Iewduh bazaar is a large historical market and a regional center of trade in northeast India.

may offer more credit if they can sell more goods. However, under the above assumption, the amount of goods sold is held constant across retailers, who are evaluated only based on the information that the authors provide. The authors further ask wholesalers to assume that all information presented in the experiment is accurate and reliable.

The authors' results offer a rich description of the real and hypothetical financial relationship between wholesalers and retailers, including, for example, whether women (who are presumed to depend more on relational aspects of business) place a higher value on informal information, and to what degree wholesalers trust retailers' financial numbers. The authors find the following:

- Wholesalers *do* value retailers' financial information in making credit decisions. All else equal, wholesalers are willing to provide 11% more trade credit (as a percentage of sales) to a retailer with sales higher than those of a typical retailer than to one with no sales information.

> While retailers in this bazaar are often credit-constrained, they tend not to access bank financing for various reasons, including a lack of trust in formal institutions, an insufficient understanding of loan applications, and an inability to provide collateral.

- Wholesalers are also willing to provide 2% (0.7%) more (less) trade credit to a retailer with sales equal to (less than) that of a typical retailer than to one with no sales information.

- Wholesalers are willing to provide 6.2% and 3.4% more trade credit to retailers with profits higher than or equal to that of a typical retailer, respectively, while providing 2.9% less credit to retailers with profits lower than that of a typical retailer.

- While these results allow the authors to conclude that wholesalers find retailers' financial information worthwhile in allocating credit, wholesalers continue to rely on informal information sources: wholesalers provide 9.5% more trade credit to same-community retailers relative to retailers from outside communities, and provide 9%–29% more credit to retailers with whom they have a longer relationship.

- Although wholesalers who are women, and those who rely more on their networks, value informal information more, they still value financial information as much as others. Even wholesalers who have strong priors about the low usefulness of retailers' financial information value it in their decision-making when presented with it.

- Surprisingly, wholesalers who are more financially sophisticated do not value retailers' sales and profits information more in making credit decisions.

- Lack of reliable information is a key friction that prevents the use of financial information in credit allocation decisions. For example, while 75% of

CLOSING TAKEAWAY

Although wholesalers value informal information such as retailers' community membership and relationship length, they also overwhelmingly value retailers' sales and profits in making credit decisions. Traders use financial information sparsely not because of financial illiteracy, but because they perceive such information to be unreliable.

wholesalers believe that less than 10% of retailers would report their sales and profits truthfully, in a hypothetical world where financial information is always accurate and reliable, even wholesalers who hold these beliefs use financial information when presented with it.

What about retailers, or those who receive credit from their suppliers/wholesalers? The authors also survey retailers to find the following:

- Although a majority of retailers agree that providing financial information to wholesalers could improve their access to credit, they are reluctant to share such information, fearing that such information would not remain confidential.
- Consistent with results for wholesalers, the authors find no association between retailers' financial sophistication and their willingness to provide financial information to wholesalers.

Conclusion

This work reveals that trustworthiness is key to expanding the use of financial information in credit allocation decisions within informal markets. To the point: Wholesalers do not believe that retailers would report truthfully, and retailers are concerned that wholesalers may misuse their information. For policymakers and others who advocate expenditures for financial literacy programs, these findings are salient. This research suggests that increased financial literacy is unlikely to substantially increase the use of financial information within informal credit markets. An alternative would be to improve reporting reliability by, for example, designing a verification mechanism that constrains retailers' ability to lie, or wholesaler's ability to misuse, information. By enhancing the efficiency of lending decisions, such a mechanism could consequently increase access to credit in informal markets.

READ THE WORKING PAPER

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