FINANCIAL LITERACY AND FIRM PERFORMANCE IN INFORMAL ECONOMY FIRMS IN ECUADOR (SUMMARY)

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SUMMARY

FINANCIAL LITERACY AND FIRM PERFORMANCE IN INFORMAL ECONOMY FIRMS IN ECUADOR

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Principal Topic

In many developing countries, the majority of economic activity takes place in microenterprises operating out of sight of government regulations and established institutions. These ‘shadow’ firms are oftentimes described as operating in the informal economy and are often the modus operandi of individuals seeking to exit poverty. However, empirical research on informal economy firms has remained relatively scant. We examine fundamental but often overlooked factors in explaining firm performance - financial literacy and role models. These factors help guide decisions about the attractiveness of a perceived opportunity and illustrate the basic skills needed to make business decisions. Generally, entrepreneurship research focuses on the right tail of human capital (i.e., high levels of education or expertise) and ignores the left tail (i.e., individuals lacking fundamental knowledge). Financial literacy and role models fit into the left tail. Our study adds needed empirical work on the performance of entrepreneurial firms and extends discussions of human capital in the informal economy.

Method

We collaborate with one of the leading microfinance institutions, Banco D-Miro, who provided client data and assisted in conducting a survey. Our unique dataset consists of 750 microenterprises in Ecuador. Acquiring reliable and valid data in these firms is difficult. We capture three types of financial performance – ROA, profitability, and growth. Our main independent variables are financial literacy and usage of role models. We also control for factors such as founder education, age, firm size, leverage, geographic location, and industry factors.

Results and Implications

Our empirical results reveal that both financial literacy and roles models are important predictors for some, but not all, types of performance. Specifically, both are important for understanding ROA but not sales growth. We argue that the outcomes of these variables is due to the specific nature of the informal economy context. Overall, our empirical results add needed detail concerning the effect of human capital on firm performance, including the stronger predictive power compared to traditional measures of human capital such as education level and previous entrepreneurial experience. Consequently, our findings suggest that, at least in the informal economy, an emphasis on basic financial literacy skills and offering role models have a substantive impact on subsequent firm performance.

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