Title: Financial constraints and institutional quality

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Abstract

Considering a population of manufacturing SMEs located in a common socio-cultural environment and divided by an institutional border, this work investigates the potential consequences of being sited on the "wrong" side of that border (i.e., the area with a longer delay in enforcing credit rights). According to our results, we cannot reject the hypothesis that locations affect the financing of SMEs, providing a contribution to the current debate on whether institutions are a source of comparative advantage (or disadvantage) in regional growth. Indeed, crossing that institutional border and assuming we detect a 10% higher inefficiency, we expect to observe a lower financial debt ratio (-0.03) and a lower trade credit ratio (-0.06), as well as a higher shareholders' loan ratio (+0.08) and lower investments in tangible fixed assets (-2,733 TEUR). Policy implications concern the opportunity for a structural reform of the national institutional system, as well as the adoption of specific policies to support the SMEs located on the "wrong" side of the border, supporting their access to the capital market.

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**Extended abstract**

Geographical location affects business dynamics and being on the “right” or the “wrong” side of a border can make a difference. If your firm is located on the “right” side of that border, there may be better opportunities for your business than in the neighboring area. Several pieces of evidence highlight how proximity can mitigate agency problems between lenders and borrowers, thanks to better monitoring (e.g., Boubakri et al., 2016; Huang and Fan, 2022) and reduced information asymmetries (e.g., Bernile et al., 2015; Uysal et al., 2008), supporting access to external financial resources raised from these local investors (e.g., Loughran, 2008; Kuchler et al., 2022). Obviously, the possibility of reducing firms’ difficulties in raising external financial resources is fundamental to support investments and to foster local development and, for this reason, there is an ongoing need to further investigate which types of financing present geographically inconsistent availability (Pollard, 2003; Sokol, 2013; Zhao and Jones-Evans, 2017). To the best of our knowledge, there is no evidence of the role of institutional barriers in shaping these geographical locations or the decision making of lenders, amplifying or reducing their risks according to the institutional efficiency of these areas. Is it admissible to hypothesize that courts can affect access to local capital markets according to their ability to enforce credit rights? In other words, if firms are located on the “wrong” side of the border (i.e., where courts are more inefficient), can we expect them to have less access to the local capital market than their neighboring firms sited on the “right” side of the border? And finally, can we interpret underinvestment levels across neighboring areas in terms of institutional inefficiency? These are the questions addressed by this paper, and, considering the current literature, the expected contributions of our findings are threefold. First, we expect to verify whether the financing of firms is affected by their legal environment. In detail, we test whether firms have less access to external financial resources than their neighbors merely because they are located on the “wrong” side of the institutional border, i.e., in an area where the time to enforce credit rights is longer. Second, focusing on corporate financing, we expect to verify whether firms under financial constraints substitute their access to external resources (i.e., financial debt and trade credit) with alternative funds (i.e., shareholders’ loans). Third, we expect to test whether higher underinvestment levels can be explained by the performance of the legal environment in which firms are located, corroborating our expectations on the relationship between institutional barriers and local development, and providing a contribution to the current debate on whether institutions are a source of comparative advantage (or disadvantage) in regional growth. According to the evidence gathered, several policy implications can be formulated, supporting both the central and the local government in their interventions to foster cohesion among neighboring territories.

To illustrate our expectations, consider two hypothetical municipalities (i.e., municipalities A and B) each with a population of manufacturing SMEs and presenting the same socio-cultural environment. These municipalities have a different court that is competent in cases of insolvency, so the institutional border between these locations might affect their SMEs' access to the capital market according to their ability to enforce credit rights in these areas. Indeed, assuming the population of SMEs cannot refer to alternative courts in the event of insolvency, we conjecture that investors internalize these risks by restricting access to their financial resources. To test these expectations empirically, this work focuses on a specific case study, i.e., the Italian manufacturing industry between 2015 and 2019. Specifically, we investigate the differences between populations of SMEs located in two municipalities not more than 10 kilometers apart and in the same region (i.e., the administrative unit responsible for local interventions and cohesion polices), but with a different court that is competent for the enforcement of credit rights in the event of insolvency. The competence of these courts perfectly represents our idea of an institutional border among locations, which can affect the dynamics under investigation.

According to our results, we cannot reject the hypothesis that institutional locations affect the financing of SMEs. Indeed, crossing that institutional border and assuming we detect a 10% higher inefficiency, we expect to observe a lower financial debt ratio (-0.03) and a lower trade credit ratio (-0.06), as well as a higher shareholders' loan ratio (+0.08) and lower investments in tangible fixed assets (-2,733 TEUR). These results are robust to several controls, confirming the causality effect between the dynamics under investigation (FE regression model) and verifying the presence of potential endogeneity (GMM regression model).

Italy is an optimal case study to conduct this empirical investigation. On the one hand, the country is characterized by one of the highest densities of SMEs in the European Union (EU), which are commonly under financial constraints due to their size and maturity (Bakhtiari et al., 2020). On the other hand, the country is one of the most inefficient in the EU, although there is significant heterogeneity across the country (Ippoliti and Tria, 2022). Finally, it is fragmented into 8,000 municipalities and, according to the administrative and judicial geography, we can identify more than 3,000 pairs of municipalities with the same socio-cultural environment but within a different jurisdiction. Note that, even this is a single-country study, we expect to transfer our insights to an international context, leading corporate governance across boundaries.

The rest of the paper is organized as follows. The second section presents the current literature and the proposed hypotheses. The third section illustrates the data and methodology, while the fourth section shows the results obtained. Finally, the fifth section presents the conclusions and practical implications.