Reducing Formalization Costs for Small Businesses in Colombia

Researchers:

Camila Navajas Ahumada

Sebastian Galiani

Marcela Meléndez

Sector(s): Finance, Firms, Labor Markets

Location: Bogota, Colombia

Sample: 1927 firms

Target group: Firms

Outcome of interest: Firm formality

Intervention type: Information Subsidies

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Research Papers: On the effect of the costs of operating formally: New experimental evidence

Partner organization(s): Chamber of Commerce of Bogota

Policymakers in low- and middle-income countries are concerned about the widespread prevalence of informality due to lower productivity in local economies. Two commonly thought barriers to formal sector entry are fixed formalization costs and high taxes on profits and labor post-entry. In the context of a recent government policy that reduced costs of formalization, researchers provided information on the formal entry process through workshops and personalized visits to determine the impacts of information on firms' decision to formalize. They found that the personalized visits temporarily increased the likelihood of formal operation, but firms returned to the informal sector after one year.

Policy issue

The widespread informality of firms in low- and middle-income countries can give rise to market inefficiencies, to the extent that formal and informal businesses compete in the same markets but with differing operating costs. Informal firms that are less productive but also have lower operating costs may be incentivized to stay informal. Two barriers to entry into the formal sector are thought to be the fixed costs of formalization, such as registration fees and time and effort, and high taxes on profits and labor associated with formalization. Although studies have been conducted around the costs and benefits of operating formally, there is limited evidence around the impact of reducing fixed entry costs on firms' decisions to formalize.

Context of the evaluation

In Colombia, firm owners must undergo two procedures to formally register their businesses. First, they must register their business with the national tax authority. Second, they must submit an online form to the local chamber of commerce. This process is free and takes one day. Afterwards, they receive a taxpayer identification number and a business license, and their

firms enter the formal sector. Formally registered firms can operate legally, open bank accounts, and obtain contracts from the government, which is a large buyer of goods and services in Colombia. Firm owners must also renew their licenses each year by paying a fee to the local chamber of commerce, which was about US$17 for small businesses in 2013.

In 2010, Colombia enacted the Formalization and Job Creation Act No. 1429, which made the process of first-time business registration free for firms established between 2011 and 2014. Act No. 1429 also exempted small firms from income, payroll, and value added taxes for two years and halved their business license renewal fee for the first year.

The evaluation took place in the low- to middle-income neighborhood of Restrepo and its surrounding areas in Bogotá, the capital city of Colombia. At the time of study, the Chamber of Commerce of Bogotá had not yet begun formalization outreach efforts in Restrepo. A vast majority of the 1927 informal firms that participated in the evaluation were retailers, had two or fewer employees, had total assets valued at less than US$442,000, and reported monthly profits of less than two times the minimum legal monthly wage (COP 515,000 or US$265 in 2011). Most firms did not keep formal accounting records or provide receipts to their customers. When asked about business registration, 33 percent of firm owners said that taxpayer identification numbers were useless. When asked about the benefits of formalizing, the most frequent answers were avoiding penalties, improving the firm's image, having more marketing opportunities, and having more access to financial markets.

Details of the intervention

Researchers partnered with Econ Estudio (EE), a research institute in Colombia and the Chamber of Commerce of Bogota (CCB) test the impact of information that reduced the non-monetary costs of business registration on the decision by firms to enter the formal sector. Participating firm owners were randomly assigned into the following groups:

1. Workshop group (1017 firms): Firm owners in this group attended two-hour workshops run by CCB instructors that provided information about the costs, benefits, and process of formalizing.
2. Personalized visits group (548 firms): Firm owners in this group received visits by CCB agents who gave them the same information as that provided in the workshop.
3. Comparison group (362 firms): Firm owners in this group did not receive any intervention.

In both interventions, firm owners that agreed to formalize would later receive the assistance of CCB agents with the business registration process.

Results and policy lessons

Personalized visits to firm owners by CCB agents were successful in increasing business formalization rates, but these effects did not last past one year. The workshops had no impact on registration. Combined with the national context of waived registration fees and tax exemptions, these findings suggest that the benefits of formalizing in Colombia are so low that firm owners rationally choose to operate informally even after experimenting with formality.

Take-up: Many firm owners who were assigned to either the workshop group or personalized visits group did not take up the intervention, either by choice or possibly because they shut down their businesses, changed their contact information that the researchers collected, or never received invitation letters. Only 136 firms assigned to the workshop group participated in the workshop, while only 95 firms assigned to the personalized visits group received visits from CCB agents. Firm owners that chose to participate ran older businesses on average, but the researchers note that the age of the business itself did not have a significant effect on firm owners' decisions to formalize.

Decision to formalize: Workshops did not affect firm owners' decisions to formalize. Meanwhile, personalized visits increased the likelihood of formalizing by 5.5 percentage points, or a 222 percent increase, on average for those who were assigned to the

personalized visits group, one year after the intervention. Among firm owners who actually received personalized visits, the visits increased the likelihood of formalizing by 32.0 percentage points on average.

Long-run impacts: The increases in formalization rates that the personalized visits gave rise to did not last. Two years after the intervention, these effects completely faded. The researchers note that the reason that these effects faded was not because of increased formalization rates in the comparison group, but instead a result of firm owners that were previously operating formally making the decision to not renew their licenses.