

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

Sebastian Galiani, Camila Navajas Ahumada, Marcela Meléndez 10 August 2015

Informality is widespread in most developing countries. A challenge for governments is to lure informal firms into the formal economy. This column presents evidence from an experiment designed to induce formalisation in Colombia. Assistance through the bureaucratic process and the removal of the fixed costs of formalising increased the likelihood of formalisation. However, this effect did not persist over time, with many firms returning to the informal sector when minimal fixed costs came back into effect.

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Informality is widespread in most developing countries. Since the work of De Soto (1989), a great deal of emphasis has been placed on the burden represented by fixed formal-sector entry costs. Another major barrier to formality is thought to be the high taxes levied on profits and labour (Galiani and Weinshelbaum 2009). While there is an ample body of literature that evaluates the costs and benefits of formality, there is much less experimental evidence regarding the impact of fixed costs on the decision to operate formally. An exception is the empirical work of De Mel et al. (2008, 2013) evaluating the influence of different interventions on a firm's decision to formalise. One of the approaches that they tested consisted of giving information to potential entrants about the registration process and about the possibility of obtaining reimbursement for direct registration costs. They found that this kind of intervention had no effect on the decisions made by the informal Sri Lankan firms covered in their study, in terms of whether they formalise or not. In contrast, other treatments, in which actual payments were made – in addition to the provision of information and the reimbursement of registration costs – had a significant effect on firms' decisions to operate formally.

New experimental evidence

We present new experimental evidence on formalisation in Galiani et al (2015). ECON ESTUDIO (EE), a research institute in Colombia working together with the Chamber of Commerce of Bogotá (CCB), organised workshops (first intervention) and arranged personalised meetings (second intervention) to inform entrepreneurs about registration procedures and the advantages of operating formally. In both treatment arms of the study, firms interested in starting the process of formalisation would later receive the assistance of CCB agents in conducting all the necessary paperwork. In addition to the assistance of the CCB agents, the Formalisation and Job Creation Act No. 1429 of

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December 2010 establishes that the registration process is to be cost-free for small and micro firms (the population of our study) registering for the first time between 2011 and 2014. In combination with the experiments (workshops and meetings), which eliminated most of the transaction costs of registration, this initiative provided us with an ideal experiment for studying how the elimination of the initial fixed costs of formalisation would influence firms' decision to operate formally. What is more, Act No. 1429 also established that, in the short run, firms are to be exempted from paying all taxes, thus giving them a clean slate for the start-up of their formal-sector operations. This intervention was expected not only to induce firms that were on the verge of entering the formal sector to actually do so, but also to give other firms the opportunity to experiment with formality at no cost for a year. This latter aspect also adds a special feature to our experiment, since it enabled us to analyse the sustainability of the project-induced decision to operate formally once the firms had to renew their licenses (the fee for which, in the first year after registration, was cut by 50% under Act No. 1429).

Thus, we were able to study the effect of the virtual elimination of formalisation costs on the decision to operate formally in a context in which no tax liabilities would be incurred for at least two years. In addition, we were also able to test whether the effects of this intervention would be sustainable once firms had had the opportunity to learn about the advantages or disadvantages of operating formally and had to opt to remain in the formal sector by paying a small fee (which would still be 50% less than it would otherwise have been).

Experimental results

We have two important results to report. First, while the workshop treatment had no effect on the decision regarding formalisation, the CCB agents' visits raised the likelihood of formal operation by 5.5 percentage points for the firms that were randomly invited to participate (the intention-to-treat parameter) and by 32 percentage points for those firms that had been invited and then accepted the invitation (the local average treatment effect). Second, and very interestingly, the effect of the treatment did not persist over time. After a year of formal operation, both effects disappeared. Moreover, this was not the result of businesses in the control group entering the formal sector in order to 'catch up' with the others, but instead reflects the decisions of formalised firms not to renew their licenses. This is a very interesting result, since it suggests that some firms that experiment with formality do not find that it is advantageous for them to continue operating as formal-sector enterprises even when they do not have to pay taxes and only have to pay 50% of the license renewal fee.

These results show that a substantial reduction in the fixed costs of operating formally does not play a key role in a firm's decision whether or not to formalise, since that reduction had no enduring effect on the decision to operate in the formal sector. A considerable number of the firms in the study chose to become formal when it was cost-free, but later, when they would be called upon to pay a relatively small fee, they decided to return to the informal sector.

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