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Incentivizing Gray Market Entrepreneurs in Emerging Markets

Juana Paola Bustamante I. & Kevin J. Fandl*

Abstract: Economic growth and development depends to a large extent on a fair marketplace, whereby all firms play by the same rules. Effective rule of law and strong regulatory enforcement regimes make this possible in most developed countries. Emerging markets are much less successful in regulating firms, leading to extensive informal economies replete with unregulated firms. These unregulated firms undercut the market by evading the costs associated with legitimate firm operations, skirting taxation and discouraging investment in the formal marketplace. Many emerging market governments have responded to this problem with formalization programs aimed at incentivizing the movement of informal firms into the formal economy. In this paper, we assess a recent and comprehensive formalization program to evaluate its strategy and success. We conclude that an incentivization program like this one, aimed at reducing the costs of doing business, misses the underlying structural deficiencies that lead to high levels of informality. We recommend a more nuanced approach that addresses productivity before attempting to formalize micro-enterprises.

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I. INTRODUCTION

The informal economy is a creation of the law.¹ In every economic environment, laws, rules, and regulations shape the nature of business transactions. They set in place the rules of the game for economic activities. But they also create a division between acceptable and unacceptable business practices. The division here is not necessarily between lawful and unlawful activities, but rather between regulated and unregulated activities, the latter forming what has come to be known as the informal economy.²

As a country develops economically, a regulatory structure emerges to protect and sustain that growth.³ Businesses face increased regulations on labor, financial, safety, and health; contracts are subject to more judicial scrutiny; and employees receive more protections under the law. This results in a balanced approach to growth, allowing businesses to succeed within necessary regulatory structures. However, the success of that balance is largely in the hands of enforcement authorities; without effective enforcement of laws and regulations, firms are likely to resort to unconstrained endeavors.

Enforcement in countries such as the United States relies on a combination of regulatory agencies, such as the Securities and Exchange Commission, the Federal Trade Commission, and others, as well as the Congress in its support of governing statutes, and the judiciary in its interpretation of both statutes and regulations enforced by agencies. Aggressive enforcement combined with a general distaste for bad actors in business helps to incentivize compliance. As one example, the Connecticut Secretary of State has fined small businesses that have failed to register their firm with the state, yielding penalties as high as $54,000.⁴ But it takes more than effective enforcement of the law to convince a business that it should operate as part of the regulated economic framework of a country. There must be a clear benefit for the business to do so, or else it would appear more reasonable to operate in the shadows of the law (e.g., running an unlicensed business out of your home). The benefits of registering a business and operating lawfully in a developed country like the United

¹ A firm is considered “informal” if it fails to comply with one or more significant business regulations. See, e.g., Rafael La Porta and Andrei Shleifer, Informality and Development, 28 J. Econ. Perspect. 109 (2014).
² Also known as the gray market, this segment of society refers to unregulated, not illegal, commerce. Illegal commerce is categorized in the black market.
States are numerous. They include access to credit in the form of bank loans; access to seed funding through agencies such as the Small Business Association; tax deductions for business expenses; protection against personal liability (depending on the type of business); enforcement of contracts in courts; the ability to rent or buy commercial space; the ability to legitimately import or export goods; and many more. With these benefits in place, and rigid enforcement of business regulations, operating outside the formal marketplace in the United States creates more risk than reward.

Accordingly, in developed countries, the informal economy is minimal, limited often to home businesses just starting out.

This is not the case in emerging markets. There, a combination of weak law enforcement and lack of incentives to operate formally result in a vast informal marketplace. Small and micro-enterprises face more risk by operating within the formal economy than without, including paying license fees, taxes, and substantial contributions to employee health and pension plans, as well as facing rigid labor laws that limit their ability to hire and fire at will, in exchange for exceedingly few, if any, benefits.

Developing country governments have faced large-scale informal economic activity for decades with little ability to curb it. A number of theories emerged as to how informal firms can be enticed to operate in the regulated marketplace. The most prominent theory, and the one that informs the case study we discuss in this paper, is known as the Legalist Theory. That theory suggests that informal firms are aspiring entrepreneurs held back by an excessive regulatory state. We disagree.

In this article, we argue that removing regulatory barriers to firm registration and operation, while helpful for some types of new firms, fails to address the underlying structural difference between formal and informal firms. We analyzed a prime example of what has come to be called a formalization program, which is an effort by an emerging market state to regulate its informal firms by reducing regulatory barriers. Using data from several governmental sources, we found that programs like this attract a small number of firms into the formal marketplace but have little to no effect on the overall size of the informal economy. We surmise that this lack of impact


on the overall size of the informal marketplace results from gaps created by transitioning firms that are filled by new informal firms.

Informal firm activity exists in every country. We chose Colombia as the emerging market of choice because of its history of high firm informality, increasing exposure to foreign investment, and extensive efforts to mitigate the effects of informality on its growing economy. 10 We will analyze the cornerstone of their formalization program, Law 1429, as an example of the Legalist approach followed by other emerging markets as well as international institutions.

II. UNREGULATED FIRMS HURT ECONOMIC GROWTH

Enterprise informality exists in all parts of the world, making up a small part of developed country markets and a more substantial part of emerging markets. 11 However, in developed country markets, informality is an aberration from the norm—often a temporary or even unintentional act by an otherwise legitimate business. In emerging markets, as many as three-quarters of functioning firms intentionally and permanently operate informally. 12

Many authors have addressed the impact of large informal markets on laborers, who often suffer from unfair wages and working conditions, lack of long-term benefits and stability, and the unpredictable prospect of finding work. 13 In this paper, we are reviewing the impact of informal microenterprises—those consisting of fewer than 11 employees—to better understand their role within the broader economy, as well as their impact on economic growth.

Firm informality is widely criticized as a negative force on an economy. 14 Critiques focus on three principal negative effects on an

emerging market economy: 1) it exacerbates weak rule of law and an inability of the state to mandate compliance with business laws and regulations; 2) it creates unfair competition, dis incentivizing legitimate investments; and 3) it discourages improvements in productivity, reducing overall economic growth and development. Combined, these factors may limit the upward mobility of emerging markets and make them unattractive destinations for foreign capital. We address each of these in turn below.

A. Weak Rule of Law

Rule of law refers to overall compliance with laws and regulations as well as respect for legal authority in a country—the supremacy of law over the sovereign, requiring the state to respect and adhere to the law.\textsuperscript{15} In a more practical sense, rule of law refers to the legitimacy of the state as perceived by its citizens. The existence of laws and regulations does not equate with rule of law.\textsuperscript{16} Accordingly, one of the indicators of weak rule of law is evasion of existing laws through corruption or simple avoidance.

The World Bank estimates that corruption and weak rule of law can reduce annual GDP growth by 0.5 to 1.0\% annually.\textsuperscript{17} A culture of law avoiders substantially weakens rule of law, which scholar Douglass North emphasizes as one of the key elements of economic development.\textsuperscript{18} He argues that long-run economic growth cannot occur in the absence of rule of law.\textsuperscript{19}

Operating a business in a manner that intentionally circumvents laws or regulations or that utilizes back channels to acquire legal benefits reflects a lack of respect for legal rules and a perception of little risk in being caught.\textsuperscript{20} Daniel Ostas has convincingly argued that a firm will tend to avoid complying with procedural laws or regulations that would impact their profit margin if they believe the risk of discovery is low.\textsuperscript{21} In the case of informal firms in emerging markets, they often avoid the foundational requirements of operating a business, such as paying registration fees, taxes, and employee benefits.

Informal economic scholar Hernando de Soto argued that “informal

\textsuperscript{15} BRIAN Z. TAMANHA, ON THE RULE OF LAW: HISTORY, POLITICS, THEORY 30 (2004).
\textsuperscript{16} Id. at 28.
\textsuperscript{19} Id.
activities burgeon when the legal system imposes rules which exceed the socially accepted legal framework – does not honor the expectations, choices, and preferences of those whom it does not admit within its framework – and when the state does not have sufficient coercive authority. In this vein, when more than half of the business community in most emerging markets is operating outside the scope of the law, the exception becomes the rule and the state loses legitimacy for both informal and formal firms.

“On average, firms in Latin America are less confident that their judicial system will enforce contractual and property rights disputes than are firms in other regions of the world.” Distrust in the state has given rise to a culture of law avoiders that find it beneficial, and often lucrative, to operate otherwise legitimate business endeavors outside the regulatory purview of the state.

B. The Deterrent Effect on Foreign Investment

The World Bank issued a major report in 2007 on informality in which they concluded that a large informal enterprise sector has an overall negative impact on the investment climate, which can threaten the ability of that emerging economy to participate in the global economy. Their conclusion is based on the premise that large informal enterprise sectors create unfair competition both on their own account and also as “feeder” firms for larger domestic enterprises. A foreign firm must comply with often costly domestic regulations, whereas an informal firm may evade these costs, allowing them to operate at a lower cost and sell more competitively to consumers and other firms.

In another study, looking at Turkey, the author argued that informality was one of the principal reasons that Turkey maintains low levels of foreign direct investment (FDI) despite its many attractive economic features. In another study, looking at EU accession countries, the author asserted that foreign firms see large informal enterprise sectors as giving domestic firms

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25 Id.
26 See, e.g., Columbia and Mexico Country Management Unit, Report No. 42698-CO, Informality in Colombia: Implications for Worker Welfare and Firm Productivity, WORLD BANK 72 (2010)(explaining the results of World Bank Enterprise surveys in which formal enterprises described informal competition as a severe obstacle to their operations).
27 Aprajit Mahajan, Nicholas Bloom, David McKenzie & John Roberts, Why do Firms in Developing Countries Have Low Productivity?, 100 AM. ECON. REV. 619, 621–22 (2010).
an unfair competitive advantage.\textsuperscript{29}

Entrepreneurs who operate formally are hurt by the implicit subsidies that informal enterprises receive through uneven enforcement and by poor mechanisms for protecting property and contracts, both of which distort competition. Both aspects create an uneven playing field and reduce formal entrepreneurs’ access to inputs and markets, discouraging entrepreneurs who operate formally from making investments to increase productivity.\textsuperscript{30}

Additionally, this uneven playing field disincentivizes formalization by rewarding unlawful behavior.

The U.S. Foreign Commercial Service, part of the Department of Commerce, issued a report on Doing Business in Colombia in 2013 in which they highlight a large informal sector that evades taxes as a risk to investment.\textsuperscript{31} Similarly, the U.S. Small Business Administration funded a study on the U.S.–Colombia Free Trade Agreement, which took effect in 2012, and suggested that new rules under the Agreement may facilitate a reduction in the trade-distorting informal economy in Colombia.\textsuperscript{32}

In addition to serving as a deterrent to potential foreign investors afraid of unfair competition, the permissive unfair competition may be producing a self-reinforcing effect. As more foreign firms invest in emerging markets, competition increases, leading some domestic firms to look for cost-cutting measures. This could incentivize more reliance on inputs from informal firms or informal labor to stay competitive.\textsuperscript{33} This can drive out foreign investors or, at the very least, expand reliance on informal firms. And with little enforcement to prevent reliance on informal firms, the cycle continues unabated.

\textbf{C. Low Productivity}

Domestic economic growth in many emerging markets is hampered by low productivity and weak foreign investment.\textsuperscript{34} Informal firms have limited resources, reduced access to credit, and often little if any training in


\textsuperscript{30} See UNDP, supra note 20, at 21.


\textsuperscript{33} See, e.g., Pablo Acosta, Informal Jobs and Trade Liberalization in Argentina, 50 J. DEV. STUD. 1104 (2014).

\textsuperscript{34} See Bloom, supra note 27.
techniques that might help them become productive. Accordingly, informality is generally associated with low firm productivity. Former World Bank economists Rafael La Porta and Andrei Schleifer call informal firms, “Small, Unproductive, and Stagnant.” In their seminal 2008 study, they found “extreme inefficiencies” in informal business activity across the globe, even after taking into account underreporting and and firm size.

Differences in productivity between informal and formal firms could be related to limited access to financial services as well as access to new markets. Bigger firms usually are more productive and have more capacity to respond to higher market demand. However, the causality could also be the other way around; firms that face greater demand from markets are forced to increase their productivity and grow so to fulfilled the new product orders/demand. “One of the main factors that may lead to a productivity gap between formal and informal firms is the lack of access to markets and services.” In the informal economy, many of the benefits traditionally associated with a formal firm, such as access to credit, enforcement of contracts through the courts, and protection of property rights, are missing or more costly to access, leading to reliance on less efficient outcomes as alternative mechanisms to operate a business. In addition, informal firms tend to be small and, given their need to stay out of the spotlight, they tend to avoid expansion. By constraining their size, they limit their ability to scale their operations.

Studies across the globe have shown that informal firms in general are less productive than formal firms. A study of the Mexican economy by the Inter-American Development Bank found that small firms working with non-salaried contracts (e.g., self-employment) had lower productivity than larger, formal firms. In another study of three African economies, the authors found a significant gap between informal entrepreneurs (opportunists) and informal necessity workers, concluding that the latter group, which worked informally to survive rather than to thrive, was far less productive than the former group.

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35 See, e.g., NANCY BENJAMIN, INFORMAL ECONOMY AND THE WORLD BANK, 7-8 (2014).
37 Rafael la Porta and Andrei Shleifer, Informality and Development, 28 J. ECON. PERSPECTIVES 109, 112 (2014).
38 Id.
39 EROL TAYMAZ, INFORMALITY AND PRODUCTIVITY 4, WORLD BANK BACKGROUND PAPER (2009).
40 See id. at 5.
41 MATIAS BUSSO, MARIA VICTORIA FAZIO & SANTIAGO LEVY, (IN)FORMAL AND (UN)PRODUCTIVE: THE PRODUCTIVITY COSTS OF EXCESSIVE INFORMALITY IN MEXICO, (2012).
The small size of informal firms may also play a role in limiting their productivity. According to Friedrich Schneider, who conducted an extensive analysis of informality around the world, small firm size caused by a desire to avoid detection prevents otherwise productive enterprises from expanding their business and taking advantage of specialization and efficiencies gained by adding employees.\footnote{FRIEDRICH SCHNEIDER, SIZE AND MEASUREMENT OF THE INFORMAL ECONOMY IN 110 COUNTRIES AROUND THE WORLD 159–60 (2002).} Using enterprise survey data, Maloney and Perry suggest that there may be a negative correlation between firm productivity and informality. They assert that as firms become more productive, they are less likely to be informal.\footnote{See PERRY ET AL., supra note 23, at 160.} Of course, as they recognize, this correlation may have little relation to the ability of the state to increase the productivity of existing informal firms and may instead relate to the firm’s ability to shed its informal skin once it finds an avenue toward earning sufficient profit as a formal enterprise. Rather, this merely shows that firms that are formal are more productive than firms that are not, which is logical given the small size, inefficient operation, and limited resources of an informal firm.

Firm productivity has long been linked to economic growth.\footnote{Diana Farrell, The Hidden Dangers of the Informal Economy, 3 MCKINSEY QUART. (2006).} Increases in marginal productivity are generally measured by calculating the change in output gained from one additional unit of input (labor, land, or capital). These changes can come from capital investments, technology, or from specialization and growth, for example. As a firm becomes more productive, it is able to increase its profits without changing the number of hours worked.\footnote{BUSSO, supra note 41.} For an informal firm to increase profits, it must generally operate for longer hours.

In Colombia, firm productivity and formality are high priorities for the state.\footnote{Mauricio Santa Maria & Sandra Rozo, Informalidad Empresarial en Colombia: Alternativas para Impulsar la Productividad, el Empleo y los Ingresos (Firm Informality in Colombia: Alternatives to Stimulate Productivity, Employment, and Investment), INTER-AM. DEVELOP. BANK WORKING PAPER (2008).} As Colombia rapidly integrates into the world economy by negotiating bilateral and regional trade agreements, lowering tariff levels, and changing laws to protect foreign investors, the informal economy has become a barrier to successful economic growth. Thus, significant resources have been funneled into the resolution of this dilemma.\footnote{See, e.g., Gobierno Busca Estrategias para Combatir Informalidad (Government Searches for Strategies to Combat Informality), Portafolio, Sept. 8, 2011; Colombia y OIT Sellan Alianza para Luchar Contra la Informalidad y la Pobreza en el Campo (Colombia and ILO Sign an Alliance to Combat Informality and Poverty in the countryside), Col. Ministry of Labor, June 6, 2015 (announcing an alliance between Colombia and the International Labor Organization to combat informality), http://www.mintrabajo.gov.co/junio-2015/4535-colombia-y-oit-sellan-alianza-para-luchar-contra-la-
Colombian Ministry of Commerce, Industry and Tourism, at the forefront of trade development in Colombia, maintains an office of formalization.49 This office initiated a program known as Colombia se Formaliza (Colombia Formalizes), which is a joint initiative led by the Ministry along with other governmental entities.50 Under the mandate of Law 1429, this office works with firms to help them establish a formal presence in Colombia.

Programs like Colombia se Formaliza attempt to increase economic growth by moving less productive informal firms into the more productive formal economy. And while data suggests that informal firms are less productive than formal firms, the relationship formalization and economic growth appears weak, at best.51 After surveying a number of studies around Latin America, Perry and Maloney conclude that the empirical evidence suggesting a linkage between formalization and growth is quite limited. “The empirical evidence of aggregate negative growth effects of informality is not conclusive, as informality tends to lose significance when other standard growth determinants are controlled for.”52 Yet they encourage states to continue their efforts to reduce regulatory burdens and streamline business development, arguing that these could reduce the size of the informal sector. But they cautiously suggest that this should not be the only, or even the primary approach for states.53

Consider Mexico, which recently implemented its own program focused on disincentivizing informal labor (as opposed to firms).54 The program creates a taxpayer-funded pension and health system for all, rather than one funded by the state (used by informal workers) and one funded through payroll taxes (used by formal workers). The proposal attempts to drive informal workers into formal jobs by taking away the barriers to hiring formal workers.

According to The Economist, “[t]he main reason for Mexico’s mediocre economic performance (annual growth has averaged just 2.3% since 1982) is low productivity. And the most plausible explanation for it is the prevalence of a huge informal economy of unregistered and mainly small businesses, in informalidad-y-la-pobreza-en-el-campo-.html.

50 See Colombia se Formaliza (Colombia Formalizes), Quienes Somos (Who we Are), (Mar. 6, 2017), http://colombiaseformaliza.com/quienes-somos/.
51 SEBASTIAN GALIANI & MARCELA MELENDEZ, LECCIONES A PARTIR DE EXPERIMENTOS DE FORMALIZACION EMPRESARIAL (LESSONS FROM BUSINESS FORMALIZATION EXPERIMENTS), INTER-AMERICAN DEV. BANK (2013).
52 See PERRY ET AL., supra note 23, at 175.
53 See id., at 176.
which three Mexicans in five work." However, their solution addresses only one facet of informality, labor regulations, rather than grappling with the larger determinants of informal economic activity, which we discuss below.

III. SIGNIFICANCE OF THE PROBLEM

Measuring the informal enterprise economy in any emerging market is challenging. The very nature of an informal firm suggests that it would attempt to avoid contact with the government if at all possible. This makes counting the number of informal firms accurately nearly impossible. Additionally, firm informality is not a well-defined concept. A number of characteristics may make a firm more or less informal (using Colombia as an example):

- Failure to register with the proper state agency;
- [In some cases] Failure to register with the Chamber of Commerce;
- Failure to subscribe employees to pension and social security programs;
- Failure to pay annual taxes; and,
- [In cases where required] Failure to pay annual Chamber of Commerce dues.

Most firms comply with some of these requirements. Some firms

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58 Id.
59 These taxes are paid to the DIAN, the Colombia tax agency. See KPMG, Colombia: Thinking Beyond Borders, KPMG: INSIGHTS (Feb. 28, 2017), https://home.kpmg.com/xx/zh/home/insights/2014/04/colombia-thinking-beyond-borders.html.
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37:415 (2017)

comply with all of them. The majority of firms that fail to comply with one or more of these requirements are small firms or micro-enterprises. In Colombia, micro-enterprises are evaluated annually by the Colombian statistics agency, the DANE. Their annual surveys of micro-enterprises give some idea as to the structure of firm informality in Colombia.61

Of the factors listed above, the best measure of compliance in Colombia and the factor used by the DANE to measure overall firm informality is registration with the Colombian Chamber of Commerce.62 The Chamber is a private institution that functions as the single gatekeeper to legitimate business functions in the country.63 Other measures, such as tax identification and registration only show one-time acts and not ongoing compliance (since a firm only needs to apply for state registration once but they must annually renew their Chamber of Commerce membership).

As discussed later in this paper, data collection on micro-enterprise registration in Colombia has proven challenging due to frequent changes in methodology by the DANE.64 According to their micro-enterprise survey, roughly half of all micro-enterprises operated informally through 2008. Following a change in methodology after Law 1429 was implemented in 2010, the same survey found only a quarter of micro-enterprises operating informally.65 This could reflect increased compliance due to the new law, but it could also reflect initiatives started by the national chamber of commerce or simply a new data collection technique.66 We therefore do not find these estimates to be reliable and thus we look to alternative sources for more accurate measurements, as discussed later.

IV. LITERATURE REVIEW: AN ECONOMIC AND LEGAL EXPLANATION FOR INFORMALITY

Since its identification by the International Labor Organization in 1972,67 the informal economy has been a subject of significant interest for economics and political science scholars.68 The World Bank released a

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61 Defined as fewer than ten employees.
64 See also Koos von Elk & Jan de Kok, ENTERPRISE FORMALIZATION: FACT OR FICTION? 70 (Int’l Lab. Org. Report 2014) (discussing the poor data collection done prior to and following implementation of law 1429).
65 L. 1429 Dec. 29, 2010 (Colom.).
66 See, e.g., von Elk & de Kok, supra note 64, at 70 (offering alternate explanations for increased registrations).
68 See, e.g., CHRISTOPHER BAJADA & FRIEDRICH SCHNEIDER, SIZE, CAUSES AND CONSEQUENCES OF
flagship report on the impact of the informal economy on emerging market
growth in 2007, highlighting the critical importance of evaluating
informality alongside statistics such as tax rates and innovation. And authors
such as William Perry, Margaret Chen, and Daniel Cordova continue to find
interest in how the topic relates to business development and investment.

This article examines the rationale behind firm informality among
micro-enterprises using Colombia as the central case study. This literature
review will assess prior works on enterprise informality as it relates to
business development and entrepreneurship. Many theories have been
posited about what the informal economy is, why it is growing, and how to
eliminate it. In our research, none of these theories sufficiently captures the
nature of the informal firm and thus none of the approaches to formalization
seem equipped to regulate those firms. We begin with an examination of the
central theories of informality.

A. The Legalist Approach

The connection between informality and small business development
was drawn most prominently by Peruvian scholar Hernando de Soto. In his
semina work, The Mystery of Capital, de Soto convincingly argues that
overly complicated and expensive regulatory frameworks limit the ability
and willingness of small firms in emerging markets to formally form their
business (i.e., become “formal”). He began mapping the number of steps
and associated costs for registering a business formally in Peru and found it
to be exceedingly expensive and time consuming, deterring the majority of
aspiring entrepreneurs from registering their business with the state.

In de Soto’s view, a wealth of aspiring entrepreneurs are being
subjugated to the informal economy due to the state’s inability to streamline
its regulatory procedures. Would-be small firms have no choice but to
operate in the shadows as gray market firms, substantially limiting their
ability to grow or be successful. He continued this line of argument in his
subsequent book, The Other Path, which argued that regulatory streamlining
would not only improve economic growth, but that it would also reduce the
likelihood of violence from gangs such as the Shining Path.

De Soto’s ideas at the time were trailblazing and opened the door to a

the Underground Economy (2005).
69 See Perry et al., supra note 23.
70 Daniel Cordova, Enhancing Formal and Informal Entrepreneurship in Developing Countries
and-informal-entrepreneurship-developing-countries.
72 Id. at 102.
73 See de Soto, supra note 9.
number of regulatory reform projects around the world. The World Bank,74 the Inter-American Development Bank,75 and the U.S. Agency for International Development,76 among others, quickly engaged with this theory by focusing their projects on regulatory streamlining. In addition, developing countries began implementing “formalization” programs whereby they followed the logic of de Soto in streamlining their regulatory processes for new businesses in an effort to encourage more business registrations, as we have discussed elsewhere.78

Institutions, such as the Center for International Private Enterprise (CIPE), have also followed the Legalist approach. In a background paper written by a CIPE program officer in anticipation of a major informal economy workshop, Kuchta-Helbing argued:

entrepreneurs of modest means without political influence simply do not have the resources or the incentives to comply with costly laws and regulations—including obtaining formal property rights, acquiring a business permit, or maintaining legal accounting records. Locked out of formal, wealth-creating institutions, these entrepreneurs operate informally in small-scale, short-term, low-investment and low surplus-generating activities or they do not engage in business at all. This greatly hinders growth.79

The author went on to suggest that, “poorly designed institutions bar entrepreneurs from or discourage their participation in the political and economic system. Hence, they operate in the informal sector.”80

The World Bank’s Norman Loayza has written extensively on the causes of informality in Latin America.81 In his more recent work at the

74 Yaye Sakho, Increasing Formality and Productivity of Bolivian Firms, WORLD BANK (2009).
75 Entrepreneurial Strengthening and Formalization to 500 Informal Businesses, INTER-AM. DEVLOP. BANK (2008).
77 Note that informality in Peru, where de Soto conducted his study, surpassed other countries in Latin America at the time. See, e.g., NORMAN LOAYZA, CAUSAS Y CONSECUENCIAS DE LA INFORMALIDAD EN EL PERÚ (Causes and Consequences of Informality in Peru) (2008).
80 Id.
81 See Norman Loayza et al., The Impact of Regulation on Growth and Informality: Cross-Country
World Bank, Loayza argued that informality arises when states impose excessive tax burdens without the institutional mechanisms needed to enforce them.\textsuperscript{82} Again following the tenets of the Legalist approach, he maintains the need to focus on regulatory reform to eliminate informal business activity.

Nobel Laureate Douglas North suggests that institutions “form the incentive structure of a society” and that these in turn are the foundation for economic performance.\textsuperscript{83} These institutions consist of formal and informal constraints along with their enforcement characteristics. Their existence determines the transaction costs of starting and operating a business. He argues that only when there are no transaction costs are institutions unnecessary. Because economic markets are imperfect and include high transaction costs, institutions matter.

Ceyhun Elgin and Oguz Oztunali argue that institutions are particularly significant in the context of the informal economy.\textsuperscript{84} Weak institutional environments are more conducive of a more robust and larger informal economy. But there are two sides to the institutional analysis of the informal economy. First, the perception of a weak state by firms gives the impression that the state will be unable to provide adequate and equal benefits for all firms that comply with the law.\textsuperscript{85} This is most obvious with respect to access to the judiciary to enforce contracts, enforcement of property rights, or effective access to legal remedies.

Second, a state that lacks effective enforcement mechanisms may generate a culture of law avoidance, or illegality.\textsuperscript{86} Lack of comprehensive and fair enforcement mechanisms may lead some individuals to bypass the law because the risk of doing so is low. This, in turn, may influence the decision of others to do the same, leading to a growing population functioning outside the law, as argued by the World Bank.\textsuperscript{87} Take compliance with traffic laws as an example. In many countries, red lights are treated as stop signs, especially at night when the risk of being robbed at the stoplight is greater than the risk of being caught for ignoring the law.\textsuperscript{88} With no

\textsuperscript{83} Id.
\textsuperscript{84} See North, supra note 18.
\textsuperscript{85} Ceyhun Elgin & Oguz Oztunali, INSTITUTIONS, INFORMAL ECONOMY, AND ECONOMIC DEVELOPMENT (2013) (using panel data to conclude that developing countries with strong institutions are more effective at reducing informal firm activity during economic growth periods than countries with weak institutions).
\textsuperscript{86} See North, supra note 18.
\textsuperscript{88} See Perry et al., supra note 23.
\textsuperscript{88} Note that in some cities, red light cameras are deactivated at night to allow drivers to pass red lights without fear of infractions. See, e.g., Transit Secretary Resolves New Doubts About the System of Camera
significant sign of being caught, and growing distrust in the state, this practice has become commonplace and has spread to daytime usage.

A culture of law avoiders substantially weakens the rule of law, which North emphasizes as one of the key elements of economic development. He says that long-run economic growth cannot occur in the absence of rule of law.89

De Soto, while a strong advocate of the overbearing regulatory state theory, also recognizes the problem of weak institutions. “We can say that informal activities burgeon when the legal system imposes rules which exceed the socially accepted legal framework – does not honor the expectations, choices, and preferences of those whom it does not admit within its framework – and when the state does not have sufficient coercive authority.”90 However, de Soto perceives the legal barriers to formality as arising from the enforcement of laws that deter firms from operating formally, rather than from a lack of access to good legal institutions and effective enforcement regardless of the state of registration.

Rule of law in Latin America is generally very weak.91 The perception of government enforcement of property rights and of fair and impartial courts is lower than in OECD countries, as well as in many other developing country regions.92 Distrust in the state has given rise to a culture of law avoiders that find it beneficial, and often lucrative, to operate otherwise legitimate business endeavors outside the regulatory purview of the state.

Avoidance of tax and business registration laws is further influenced by the law enforcement environment.93 When the risk of law enforcement is low, and the perceived benefit of paying taxes and regulatory fees is also low, there may be a higher incidence of avoidance.94 Yet rather than simply a matter of weak deterrence, several authors comment that it is the broader exchange of taxes for benefits that leads some countries’ citizens to comply with the law while others do not, despite similar levels of enforcement.95 Perry and Maloney convincingly argue that state taxation can be conceived

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89 See North, supra note 18.
90 See DE SOTO, supra note 9.
92 See PERRY ET AL., supra note 23.
94 See, e.g., Raymond Paternoster, How Much do we Really Know about Criminal Deterrence?, 3 J. OF CRIM. L. AND CRIMINOLOGY 765, 768 (2010) (discussing commentary that there is an increased willingness to avoid compliance in the absence of a strong perceived risk of being caught).
95 See PERRY ET AL., supra note 23.
of as a contract between the state and its citizens, and that when the citizens do not perceive that the state is upholding their performance obligations, there is little desire for the citizen to do so either.96

The role of institutions in sustaining informal economic activity has not been extensively addressed by the literature, yet appears to play a significant, perhaps even a central role. Economic factors no doubt also play an important role in driving firms into and out of informality, but institutions form the framework in which ultimate cost–benefit decisions are made. Within the institutional framework, rule of law may be the most significant factor in facilitating an environment that welcomes, and perhaps even encouraging informality.

Despite widespread support for the Legalist theory that regulatory barriers are holding back aspiring entrepreneurs, other scholars have found that informality is in fact more related to issues such as access to finance and related resources. And in many cases, these “entrepreneurs” are nothing more than survivalists attempting to find income in a limited opportunity job market. This brings us to the Dualist approach.

B. The Dualist Approach

The Dualist approach is largely associated with authors such as Victor Tokman of the International Labor Organization, Dartmouth’s Rafael La Porta, and Harvard’s Andrei Schleifer. This approach contends that the informality firms engage in is not entrepreneurial at all. Rather, informal firms are merely survivalist in nature, getting by on minimal profit margins acquired from their avoidance of regulatory burdens.97 In effect, this approach implies that informality is a choice made in the interest of economic gain, or perhaps because no other viable options remain for gainful employment.

La Porta and Schleifer, well-known for their controversial work on the effects of legal origins on economic development,98 characterize de Soto’s approach to informality as hopeful but unrealistic. In their view, reducing the

96 See PERRY ET AL., supra note 23, at 239–40.
97 Christian M. Rogerson, Emerging from Apartheid’s Shadow: South Africa’s Informal Economy, 53 J. INT’L AFF. (2000)(arguing that informal firms are not micro-enterprises but rather survivalist entities seeking day-to-day sustainability).
98 A highly influential article on legal origins and economic development was published by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, which found that countries employing or deriving from a common law system grow faster than those with a civil law system. “Any inquiry into policy implications has to go beyond regression results to the underlying mechanisms through which the law, the judiciary, and the legal profession influence the economy.” Kenneth W. Dam, Legal Institutions, Legal Origins, and Governance 13 (John M. Olin Law & Economics, Working Paper No. 303, 2006); see also Florencio Lopez-de-Silanes Rafael La Porta, & Andrei Shleifer, The Economic Consequences of Legal Origins, 46 J. ECON. LIT. (2007).
barriers to doing business, while always a productive avenue for economic growth, has little to do with reducing informality. Informal firms are vastly different from formal firms because they operate on a much smaller, less productive scale and are driven by uneducated, less savvy managers.\(^99\) Their approach draws a clear line between formal and informal firms and makes no secret of the contention that programs such as formalization are a waste of resources.\(^100\) In their view, informal firms are not entrepreneurs, nor are they prevented from formalizing by a complex legal regime. Rather, they are survivalist firms in need of basic social services from the state to prevent them from slipping deeper into poverty. In their view, the remedy for informality is expansion of the formal sector through productivity incentives such as improved tax regimes, human capital development, and infrastructure. In other words, job creation should lead to a reduction in the number of individuals resorting to informality.

Moving even further away from the entrepreneurial view, La Porta and Schleifer define the informal economy as a “manifestation of underdevelopment.”\(^101\) The results of their survey analysis show that informality is closely linked with GDP per capita—more poverty leads to more informality. They call this the “dual view” and suggest that the best approach to ridding a country of informality is to develop more formality by focusing resources on micro-enterprise development.

La Porta and Shleifer’s most recent paper on informality contends not only that these firms are small and unproductive, but also that they are disconnected from the formal economy and rarely transition to the formal economy.\(^102\) This view coincides with the idea that capitalism will ultimately open new opportunities in the formal sector for these workers and they will then abandon their posts at informal firms. In their view, economic development will automatically dissolve the informal economy.

Tokman initially identified informality as another name for the “working poor,” surviving on basic trade in the absence of employment opportunities.\(^103\) In his later work, he argued that informality resulted from excessive labor supply and inadequate job opportunities due to the decentralization of productive activities. And in his most recent paper on this topic, he adopted the more Structuralist ideas of Alejandro Portes and others in arguing that globalization has played a role in dividing labor between more and less productive contributing members of the marketplace. In this work, unlike his former colleagues in the Dualist school, Tokman argues that

\(^{99}\) See La Porta & Shleifer, supra note 37.

\(^{100}\) See id., at 118.

\(^{101}\) See La Porta & Shleifer, supra note 12, at 292.

\(^{102}\) See generally La Porta & Shleifer, supra note 37.

\(^{103}\) Victor Tokman, Modernizing the Informal Sector, 1 (Department of Economic and Social Affairs, Working Paper No. 42, 2007).
formalization programs should address productivity through training and access to credit. Tokman argues that “[i]nformal activities are not caused by regulatory inadequacies but rather by the failure of the economic system to create enough productive employment.”

This brings us into the most recent theory attempting to rationalize informality, the Structuralist Approach.

C. The Structuralist Approach

A competing view can be found in the Structuralist school of thought, embraced by Princeton sociologist Alejandro Portes, Friedrich Schneider, and World Bank economists Ian Perry and William Maloney, among others. This view perceives informality as the result of the economic environment rather than the legal environment. For these authors, streamlining the regulatory system will not provide the necessary incentives for most informal firms to transition to formality. An unproductive firm will remain unproductive whether it has easy access to regularization or not.

This approach tends to see capitalist development as the creator of informality, with formal firms subjugating informal workers and small enterprises to maintain competitiveness through low labor and capital costs. In their description of the structuralist school, Alejandro Portes and Richard Schauffler explain how their approach differs from the Legalist approach. They contend that de Soto’s recommendation to remove the regulatory barriers to operating a business would not only have little positive impact on informality, but that it may destroy the capitalist system itself. In the view of Portes and Schauffler, “[i]nstead of the Trojan Horse that will ultimately break down the fortress of ‘mercantilist’ privilege, the informal sector in fact represents part of the routine operation of capitalism as it is presently organized in Latin America.”

Accordingly, their solution focuses on enhancing the relationships between formal and informal enterprise through capital investments in modern industrial and service sectors.

Going even further, Portes challenged the Dualist idea that informality will dissipate with capitalist development. He argued that it was the movement toward rapid industrialization and regulatory liberalization that contributed to a growing informal economy in the first place, as small enterprises were pushed away from participation in an economy geared toward industry and export, while larger enterprises became dependent on

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104 See Tokman, supra note 103, at 4.
105 See Portes, supra note 11.
106 See Schneider, supra note 43.
the inputs of small, informal firms.\textsuperscript{109}

Taking a more nuanced view, World Bank economists Ian Perry and William Maloney authored a major study on informality in 2007 in which they argued that informality is reflective of a larger problem of unproductive firms. Their report suggested that productivity should be at the center of the effort to reduce informality: “formality can be seen as an input in the production process for which small firms have little need.”\textsuperscript{110} At early stages of development, profitability, although not necessarily productivity, requires avoidance of state regulations in order to maintain sustainable income. Complying with the law would require the firm to divulge the majority, if not the totality, of their earnings.

Maloney distinguishes the Structuralist approach from the Dualist approach by arguing that, “we should think of the informal sector as the unregulated, developing country analogue of the voluntary entrepreneurial small firm sector found in advanced countries, rather than as a residual comprised of disadvantaged workers rationed out of good jobs.”\textsuperscript{111} Likewise, in a report by the U.S. Federal Reserve Board of Governors, the authors conclude that informal economic activity is a major contributor to the overall national economy and not distinct from it.\textsuperscript{112}

Perry and Maloney contend that informal firms, while unproductive themselves, also impact the productivity of the broader economy.\textsuperscript{113} In the broader economy, informal firms tend to restrict the operation of the capitalist doctrine of creative destruction, allowing new firms to rise up to seize new market opportunities. Also, high levels of informality may restrict the willingness of formal firms to adopt new technology or innovative techniques that could be improperly requisitioned by informal firms.\textsuperscript{114}

For Perry and Maloney, the informal economy may be standing in the way of the creative destruction process by allowing small, unproductive firms to compete with small, formal firms that face higher operating costs.\textsuperscript{115} But in exchange for those higher operating costs, the formal firms may have the ability to grow into productive, innovative firms. The informal economy, then, holds back potentially innovative formal firms. Of course, this argument fails to take into account the cross-breeding between the formal and informal sectors that may allow small registered firms to take advantage of low cost inputs, marketing, labor, and distribution of their goods or

\hspace{1cm} \textsuperscript{109} \textsc{alejandro portes et al., the informal economy: studies in advanced and less developed countries} (1989).
\hspace{1cm} \textsuperscript{110} See \textsc{perry et al., supra} note 23.
\hspace{1cm} \textsuperscript{111} See Maloney, supra note 107.
\hspace{1cm} \textsuperscript{112} Ihrig & Moe, supra note 56, at 2.
\hspace{1cm} \textsuperscript{113} \textsc{perry et al., supra} note 23 (explaining the effects of informality on productivity).
\hspace{1cm} \textsuperscript{114} \textit{Id.} at 170.
\hspace{1cm} \textsuperscript{115} \textit{Id.} at 173.
services via the informal economy. So, while informal firms may undercut the potential of a formal firm to rapidly accelerate to profitability, they may also facilitate that development through lower cost labor and supplies.

Innovation and technology can help a firm become more productive by increasing efficiency and output without increasing labor input. As informal firms are associated with the theft of technology through piracy and reverse engineering, formal firms are hesitant to engage in extensive innovation or investments in technology.116 This withdrawal from innovative practices can reduce the productivity potential of a formal firm and limit overall economic growth.

Informal firms are also limited in the application of technology and innovation to their own operations. With little capital to invest and little skill to apply, an informal firm often resorts to outdated production techniques and devices to run their business. In many developing countries, this is visible among street traders and marketplaces where even basic goods such as electricity and clean water are lacking.

The structuralist views of Perry, Maloney, and similar authors offer a more expansive view of informality than the Legalist view by focusing on increasing productivity through a variety of means, not simply regulatory streamlining.117 This perspective sees informality as a rational choice by the firm, which is attempting to capitalize on its extralegal operations. In order to incentivize firms from this approach, Perry suggests administrative and tax simplification procedures, eliminating anachronistic or privately motivated laws, and enhancing enforcement. This view perceives barriers to formalization within the formal legal structure of the state and implies that if these barriers are lowered, more firms will be incentivized to become formal.

D. Concluding Remarks on Existing Literature

Enterprise informality is not a homogenous concept. Just as Harvard scholar Martha Chen described labor informality as existing on a sliding scale, firm informality similarly occupies distinct categories based upon the firm’s relationship with the state.118 De Soto’s approach suggests that all firms are interested in formalizing and capable of surviving in the regulated marketplace. Dualism suggests that no informal firms would survive in the formal economy and that they should be largely ignored by the state. The

Structuralist approach falls between the two extremes, positioning informal firms as an essential part of the capitalist value chain but an unproductive one, unlikely to survive the burden of a regulated marketplace.

Many informal firms in Latin America are survivalist firms, operating at or below the poverty line and succeeding because of evasion of the state’s regulatory system. However, a substantial number of firms evidence an interest in growing and becoming productive enterprises. These are the firms that de Soto referred to as being held back by the regulatory system; however, we suggest here that his justification for their informality was misplaced. Rather than regulatory barriers, we contend that these would-be entrepreneurial firms have limited reasons for formalizing because of the lack of benefits offered by the state to these firms.

The process of formalization requires a firm to register with a state body and subject itself to labor, health, safety, and other business-oriented regulations. In exchange, the firm would typically receive valuable benefits, such as access to credit, participation in a network of like-minded businesses, and the ability to participate in formal supply chains occupied by formal enterprises. In addition, these firms would avoid the regulatory enforcement mechanisms of the state that might levy fines or other penalties on non-compliant firms.

In many developing countries, the benefits of formalization and the risk of regulatory enforcement are limited, substantially weakening the incentive to formalize. Nevertheless, developing countries in Latin America, especially those with strong capitalist markets, have sought to bring these informal firms into the regulated marketplace. These efforts are known as formalization programs.

E. The Formalization Incentive

States are motivated to formalize their informal firms for a number of reasons, but principally for those discussed above—increased productivity, compliance with laws and regulations, and the creation of a more attractive investment climate. By luring more firms into the formal marketplace, a state may be able to work toward these goals. This approach has been encouraged by major institutions, including the World Bank in its annual Doing Business reports.120

The negative elements of informality are widely acknowledged by economists. Schneider summarizes the downside of informality as yielding lower tax revenue for the state; distorting economic and social data that could

119 See Fandl, supra note 78.
120 See, e.g., Miguel Jaramillo, Is There Demand for Formality Among Informal Firms 1 (Ger. Dev. Inst., Discussion Paper 2009) (relying on the idea that informal firms have entrepreneurial capabilities).
affect the distribution of state benefits; lowering tax morality, which is highly associated with rule of law; creating unfair competition with the formal economy; increasing dependence on welfare programs; reducing efficiency in production; leading to unregulated business activities that could put consumers at risk; and potentially worsening inequality.121 His global survey yields few observable positive benefits of maintaining a large informal economy, other than basic employment at the subsistence wage. As a result, regularizing these firms through formalization programs has gained widespread acceptance.

But is formalization necessary? Historically, informal firms have provided some economic benefits for emerging markets.122 For instance, these firms are flexible and adaptable enough to quickly meet changing demands for products and services that might not otherwise be possible by highly regulated formal firms. Additionally, informal firm owners might otherwise be unemployed and depend on the state for support through unemployment insurance, healthcare, and pensions.123

Perhaps even more importantly, demand for formalization among many informal firms may be much lower than expected. Consider a recent experiment conducted in Peru, which offered to pay the costs of formalization and guide informal firms through the process.124 Only 25% of the surveyed firms accepted the offer and many of those that did failed to complete the process. After surveying a sample of informal firms about why they did not formalize, the majority complained that the process to do so was too lengthy and expensive.125 When questioned about the benefits of formalization, firms consistently reported that it was beneficial to avoid fines and bribes. Yet when asked about the risks of formalizing, the principal concerns were ongoing costs, such as inspections and taxes.126 The author of the study concluded that most informal firms see few benefits and some serious drawbacks to formalizing, even when the costs of doing so are reduced.127

It appears to have been understood by developing countries that informal business serves a necessary purpose along their economic growth path. Yet as global markets have become more competitive and expanded into the territory of these emerging markets, demand from within and without for more productive and fair business practices has grown.

121 See Bajada, supra note 68.
123 Id. at 11–12.
124 See Jaramillo, supra note 120.
125 See Garcia-Bolivar, supra note 123, at 17.
126 See id. at 9.
127 See id. at 15–16.
Accordingly, many developing states that intend to become integrated into the global marketplace have taken on efforts to address informality.128 Each country approaches the informal economy differently—some focusing more heavily on social programs to protect workers, others adding resources to enforcement of registration laws—but most have begun the process of formalization in one way or another.129

Formalization is viewed by many states and international organizations as a pathway to economic growth. Accordingly, in addition to extensive studies on the benefits of formalization,130 investments by international development organizations to support formalization programs have been prominent. In the past several years, the Inter-American Development Bank has provided several formalization project loans to countries in Latin America.131 Many of these have focused on efforts in Colombia.132 In a 2013 retrospective review of their work in the area of formalization, the Bank concluded that their efforts had little effect on the actual formalization of firms nor their access to credit; however, the projects did result in improved operating income and assets.133

All major formalization programs in Latin America share a common theory—that large informal economies are bad for business and should be formalized. This is evident through the reports and recommendations of the

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128 See id. at 7–8.
130 See, e.g., PERRY ET AL., supra note 23.
World Bank134 and the Inter-American Development Bank.135 In his seminal work, *The Other Path*, de Soto argues that regulatory barriers such as excessive taxation and bureaucratic red tape are the barriers holding back natural formalization.136

In particular, de Soto focused on the state requirements to form a business and register property. He argued that excessive regulation creates costs and time inefficiencies that make it more burdensome to register a business and pay taxes than to remain informal. De Soto’s work formed the basis of the World Bank’s Doing Business report, which surveys countries based upon their regulatory systems, among other things, and categorizes them based on the ease of doing business in the country.137

Despite many critiques of his theory,138 including by authors of World Bank and Inter-American Development Bank Reports,139 de Soto continues to hold sway over development institutions and, through their work, over developing countries. Though his position is not officially adopted by these institutions, his approach to formalization—promoting entrepreneurship by reducing the burdens of doing business—has informed projects throughout the region.140

V. CASE STUDY: COLOMBIA’S FORMALIZATION LAW

According to the 2014 Doing Business Report, Colombia ranks as one of the most streamlined countries to do business in (see Figure 1).141 The 2015 report indicates that Colombia has dramatically improved its business environment. However, it is worth noting that the vast majority of “points”

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134 See Perry et al., supra note 23, at 1.
136 See de Soto, supra note 9; but see Rafael La Porta and Andrei Shleifer, *The Unofficial Economy and Economic Development*, TUCK SCHOOL OF BUSINESS WORKING PAPER (2009) (critiquing de Soto’s approach and suggesting that his view is overly “romantic”).
137 See, e.g., WORLD BANK, DOING BUSINESS (2015).
140 See Report, supra note 131 (identifying numerous projects in the region focuses on formalization with the goal of improving entrepreneurial activity).
141 See WORLD BANK, DOING BUSINESS (2013): Smarter Regulations for Small and Medium-Size Enterprises (dedicating a chapter to discuss Colombia’s success in streamlining business regulations and improving foreign investment).
that Colombia received allowing it to rise in the rankings was due to improvement in access to credit. That factor improved because of Colombia’s efforts to enhance protections for secured creditors by creating a collateral registry and setting forth rules for prioritizing secured creditors in bankruptcy proceedings.\footnote{In particular, the World Bank notes that “Colombia improved access to credit by adopting a new secured transactions law that establishes a functional secured transactions system and a centralized, notice-based collateral registry. The law broadens the range of assets that can be used as collateral, allows a general description of assets granted as collateral, establishes clear priority rules inside bankruptcy for secured creditors, sets out grounds for relief from a stay of enforcement actions by secured creditors during reorganization procedures and allows out-of-court enforcement of collateral.” \textit{World Bank, Business Reforms in Colombia}, http://www.doingbusiness.org/Reforms/Overview/Economy/colombia.}

Figure 1. World Bank Doing Business in Colombia 2015 Report.

\begin{table}
\centering
\begin{tabular}{|c|c|c|c|c|}
\hline
\textbf{REGION} & \textbf{Latin America & Caribbean} & \textbf{DOING BUSINESS} & \textbf{DOING BUSINESS} & \textbf{CHANGE IN RANK} \\
\textbf{INCOME CATEGORY} & \textbf{Upper middle income} & \textbf{2016 RANK} & \textbf{2014 RANK} & \textbf{CHANGE IN DTP** (% POINTS)} \\
\textbf{POPULATION} & \textbf{48,321,405} & \textbf{34} & \textbf{53} & \textbf{\uparrow 19} \\
\textbf{GNI PER CAPITA (US$)} & \textbf{7,560} & \textbf{DOING BUSINESS 2015 DTP** (% POINTS)} & \textbf{68.01} & \textbf{\uparrow 4.28} \\
\textbf{CITY COVERED} & \textbf{Bogotá} & \textbf{72.29} & & \\
\hline
\end{tabular}
\caption{Registering a business in Bogotá.}
\end{table}


Firm informality remains exceedingly high in Colombia, despite compliance with the recommendations of de Soto and the World Bank, making it an excellent choice for a case study on the success of formalization programs.\footnote{See \textit{Int’l Lab. Org.}, supra note at 4.} Despite the apparent disconnect between reducing regulatory burdens and increasing formalization, countries continue down this path to improve business. Through our analysis of the latest efforts to do so in one emerging economy, we hope to highlight the fault in this approach.

The World Bank ranks Colombia 34th in ease of doing business, well above other Latin American countries and similarly situated developing countries.\footnote{See \textit{World Bank}, supra note 143.} In addition, opening a business in the country’s capital city, Bogotá, is a relatively straightforward process, requiring only four steps.\footnote{See \textit{id}.} The steps for doing so are listed in Figure 2 below.

Figure 2. Registering a business in Bogotá.
Colombia has not always offered a friendly business environment. The costs associated with starting a business in Colombia hovered around 25% of an individual’s annual income only ten years ago.\textsuperscript{146} Today, the costs are below 10%, as noted in Figure 3 below.

Figure 3. Cost to start a business in Colombia. Source: Author’s calculations based upon data from the World Bank.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{Figure3.png}
\caption{Cost (% of income) to start a business in Colombia (2004-2015)}
\end{figure}

\textsuperscript{146} Id., at 16.
A. Legislative History

When the Colombian government promulgated Law 1429, Colombia was facing high levels of unemployment and informality. In 2009 the average official unemployment rate in Colombia was 12% at the national level (slightly higher in some cities). However, about 61% of the working population was excluded from the social security system according to the PILA\textsuperscript{147} and RUA\textsuperscript{148} indicating that more than half of the population were working in unregulated businesses as sole proprietors.\textsuperscript{149} And despite high and sustained economic growth since that time, these rates had not declined.

Over half of the population works without job security, without reasonable living wages, and is likely on the road to worsening poverty. And nearly every small firm lacks access to protection from the state, including reasonable access to the courts, property right protection, and state finance. According to some authors, this fact represents one of the greatest challenges to the development of the country.\textsuperscript{150}

The growth of the informal sector in Colombia may be partially linked to the rapid growth of the nation’s urban areas, a result of mass migration and displacement of workers in rural areas by rebel fighters (guerillas).\textsuperscript{151} Conditions which contribute to increased migration “ha[ve] a large impact on the probability of being employed in the informal sector.”\textsuperscript{152} A significant contingent of informal workers in Colombian cities were displaced by guerilla activity in their hometowns. Additionally, the informal economy grew due to a decline in the demand for labor during the economic downturn of the 1990s, with workers turning to independent firms to generate survival income.\textsuperscript{153}

B. Law 1429: The Formalization Law

Colombia passed Law 1429 in December of 2010.\textsuperscript{154} Also known as the Law of Formalization and Employment Generation, the law attempts to promote business and employment formalization throughout the cycle of

\textsuperscript{147} Comprehensive Form of Liquidation of Contributions, Ministry of Social Protection.

\textsuperscript{148} Register of Contributors, Ministry of Finance.

\textsuperscript{149} See also, Sebastian Galiani & Marcela Melendez, Lecciones a Partir de Experimentos de Formalizacion Empresarial (Lessons from Business Formalization Experiments) (2013) (finding that 59% of informal firms in Colombia were operated as sole proprietorships).


\textsuperscript{151} Carmen Elisa Flórez, Migration and the Urban Informal Sector in Colombia, Paper prepared for Conference on African Migration in Comparative Perspective, Johannesburg, South Africa (June 2003).

\textsuperscript{152} Id. at 2.

\textsuperscript{153} Id. at 6.

\textsuperscript{154} L. 1429 Dec. 29, 2010 (Colom.).
existence of firms. The law takes an incremental approach to formalization by easing new small businesses that might otherwise operate in the informal sector into the formal registration process and providing them with tax incentives for generating new formal employment, among other things.

Micro-enterprise promotion is an important goal of the formalization process. Micro-enterprises constitute the bulk of economic activity in most developing countries. And for a micro-enterprise to succeed, it must be able to operate productively, generating net profits while complying with the law. However, most of the micro-enterprises in the informal economy are unable to generate profits if they comply with the law. As a result, they choose to operate outside the law.

Law 1429 was intended to motivate these small businesses to formalize and generate productive employment, since 67% of dependent employment or wage income in Colombia is generated by these businesses. Additionally, informality is heavily concentrated in these smaller, less detectable businesses. At the time the law passed in 2010, business informality (defined as either failure to obtain commercial registration or failure to pay taxes) was around 36% in companies with ten or fewer employees while this percentage is around 7% for companies with more than ten employees.

The formalization law targets three main causes of informality: 1) firm informality resulting from registration burdens; 2) firm informality resulting from tax burdens; and 3) labor informality. The law is thus structured to provide incentives intended to overcome each of these. Each of these is outlined below.

C. TARGET 1: Formalization of Newly Registered Firms: Registration and Taxes

1. Registration Incentives

Law 1429 offers incentives for the creation of new small formal enterprises, defining formality as registration with the Chamber of Commerce, by reducing the cost of registration. The aim is to reduce the administrative costs of formalizing new and existing enterprises. The law creates a progressive payment scheme for commercial registration and renewals (until December 31, 2014) for new enterprises with fewer than 50 employees and less than 5,000 minimum salaries in assets (approximately

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156 See INT’L LAB. ORG., supra note 61 at 5–6.
157 Departamento Nacional de Planeación (Colombia) [Colombian National Department of Planning].
Incentivizing Gray Market Entrepreneurs
37:415 (2017)

US$1,635,000).\textsuperscript{158}

Figure 4. Progressive New Firm Registration Fees with the Chamber of Commerce.

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>50%</td>
<td>75%</td>
<td>100%</td>
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</tbody>
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Figure 5. Progressive Existing Firm Registration Fees with the Chamber of Commerce.

<table>
<thead>
<tr>
<th>Years before 2008</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>50%</td>
<td>50%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

This incentivizes re-registration for firms that registered and then dropped their renewals because they did not need it. Existing firms that were formerly out of compliance receive a discount on back fees for registrations.\textsuperscript{159} These firms accounted for the majority of those taking advantage of registration under Law 1429.\textsuperscript{160}

2. Simplification of Formalization Procedures

In order to encourage formal registration of a firm, the law substantially simplifies existing registration procedures. It establishes a set of rules and amendments to the Labor Code, Law 1116 of 2006 (Corporate Insolvency Regime) and other regulations, in order to simplify and reduce labor, commercial, and administrative procedures, including:\textsuperscript{161}

- Simplification of business procedures in the substantive Labor Code
- Simplification of commercial procedures

\textsuperscript{158} The Colombian minimum monthly wage in 2014 is COL$616,000 = US$327.

\textsuperscript{159} See von Elk & Kok, supra note 64, at 70 (finding that 87,043 existing firms re-registered under Law 1429).


\textsuperscript{161} L. 1116 of 2006 [Colombia].
• Control mechanisms and other provisions

The law also created the National Information System, which consists of representatives from several Ministries and has the aim of consolidating and processing information found on job applications, including features and specifications of occupations in both the public and private sectors at national and local levels. It creates the Bulletin of Unsatisfied Labor Demand, which is an informational document containing a detailed list of jobs that have high levels of unsatisfied demand in particular regions of the country.

3. Income Tax Incentives for New Firms

The law is intended to promote fiscal formalization of new small businesses by offering progressive reductions in the payment of income tax.\textsuperscript{162} This contributes to the reduction in initial operating costs for the firm’s initial period of existence. Progressive increases in income tax rates are applied to new firms with fewer than 50 employees and less than five thousand minimum salaries.\textsuperscript{163}

Figure 6. Progressive Income Tax Payment Schedule for New Firms.

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>0%</td>
<td>25%</td>
<td>50%</td>
<td>75%</td>
<td>100%</td>
</tr>
</tbody>
</table>

D. TARGET 2: Formalization of the Labor Market

Both formal and informal firms may employ unreported labor.\textsuperscript{164} These workers face significant risks when they function informally, including lack of pension accrual, lack of health care, and lack of predictable employment. Thus, the Formalization Law also seeks to reduce the risks associated with informal labor.\textsuperscript{165}

To do so, the law works to encourage more formal labor contracts for new small businesses by reducing the costs of payroll contributions for all formal employees. The aim is to help in a progressive way to reduce the costs associated with formal employment (until December 31, 2014). The law

\textsuperscript{162} See, e.g., \textit{id.}, at Art. 85 (explaining the intent to establish a tax base and reduce red tape to encourage the registration of informal enterprises).

\textsuperscript{163} Not applicable to withholding tax or presumptive income system (until December 31, 2014).

\textsuperscript{164} See World Bank, \textit{supra} note 26, at 69.

\textsuperscript{165} See \textit{INT’L LAB. ORG.}, \textit{supra} note 61 at 8–9.
Implements a progressive system whereby social security payments will increase incrementally for new enterprises with fewer than 50 employees and less than 5,000 minimum salaries in asset value.

Figure 7 shows the type of social security contributions subject to the progressive reduction established by the law. Each of these refers to a distinct social program implemented by the state to protect workers and their families.

Figure 7. Social Security Contributions Required from all Firms.\textsuperscript{166}

<table>
<thead>
<tr>
<th></th>
<th>CCF</th>
<th>ICBF</th>
<th>SENA</th>
<th>FOSYGA</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>4%</td>
<td>3%</td>
<td>2%</td>
<td>1.5%</td>
</tr>
</tbody>
</table>

Figure 8 shows the progressive increases for the payment of social security contributions.

Figure 8. Progressive Discount on Social Security Payments for New Firms.

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>0%</td>
<td>0%</td>
<td>25%</td>
<td>50%</td>
<td>75%</td>
<td>100%</td>
</tr>
</tbody>
</table>

E. TARGET 3: Youth and female employment.

The formalization law targets not only new small firms, but also young entrepreneurs.\textsuperscript{167} Unemployment rates for workers under the age of 30 in 2009 were around 20%, while the rate for those over 30 was around 10%. This is why it is important to implement policies aimed at increasing formal employment, with social security and economic benefits, for the young population.

\textsuperscript{166} These abbreviations are explained as follows. CCF: Caja de Compensación Familiar. ICBF: Instituto Colombiano de Bienestar Familiar. SENA: Servicio Nacional de Aprendizaje. FOSYGA: Fondo de Solidaridad y Garantía del Sistema General de Seguridad en Salud de Colombia.

1. Young Entrepreneur Incentives

In order to incentivize the creation of new formal enterprises, the provisions of this regulation are aimed at directing the efforts of the programs of the Ministry of Commerce, Industry, and Tourism to target beneficiaries referred to by Law 1429, especially those under 28 years old.168

- Design and promote programs of micro credit oriented to businesses created by people under age 28;
- Programs or technical and financial support to formalize the rural sector and business, employment generation;
- Strengthen relationships between enterprises, State and University: joint committee on labor and business formalization; and,
- Improve youth employability through the design of programs that offer tools to people in exclusion situation.169

To encourage more formal hiring of young workers and women over 40 years of age, the law provides employers with a discount on the income tax paid for social security contributions for these employees.170 The goal of this element of the law is to encourage the creation of new formal jobs in established companies that hire people from targeted populations. To be eligible, the new jobs must be given to members of these vulnerable groups—youth and women over 40 who earn less than 1.5 minimum wages (approximately US$490.).

VI. IS THE LAW WORKING?

Our analysis of Law 1429 suggests that it has not successfully achieved its goal of substantially reducing firm informality in Colombia. The goal of any enterprise formalization program is to increase firm compliance with the legal and regulatory structure of the state. Accordingly, the best measure of whether a formalization law is working is to assess the number of firms in compliance before and after the law was passed.171 This includes compliance

168 L. 1429 Dec. 29, 2010 (Colom.).
170 See INT’L LAB. ORG., supra note 61 at 10.
171 See, e.g., Externado, supra note 160, at 27 (explaining that the best measure of the effects of the law would be to examine the number of firms that registered directly as a result of the law and stayed
with tax laws, business registration laws, and general labor laws. And though elimination of the informal enterprise economy would not be a feasible (or necessary) goal, a formalization program should produce both a substantial decrease in informal business activity and a substantial increase in formal firm operation.

In our research, we set out to collect as much of this data as possible; however, we discovered that the Colombian statistics agency that collects this data applied different methods for data collection before and after the law was passed.\textsuperscript{172} Prior to passage, a substantial survey of all firms was conducted that captured extensive firm information, including compliance with registration and tax laws. After passage, the agency shifted its approach to using only a sample of small firms to extrapolate general conclusions. The data reflect very different results, as shown below.

Figure 9. Percentage of Colombian Firms Not Registered with the Chamber of Commerce.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure9.png}
\caption{Percentage of Firms with no Registro Mercantil.}
\end{figure}

Though promising at first blush, the data presented in Figure 9, which comes from the DANE’s national micro-enterprise survey, do not accurately reflect the degree of firm informality in Colombia nor the effects of Law 1429.\textsuperscript{173} Rather, it reflects the change in methodology from a survey of over

\textsuperscript{172} See also von Elk & de Kok, supra note 64, at 70 (noting the uncertain correlation between data sets on informality in Colombia post-passage of Law 1429).

one million firms to a sample of less than 40,000. In fact, the DANE itself issued a report entitled “Prosperity for All” in 2014 as part of their National Development Plan, noting that over the previous five years, the rate of firm informality in Colombia based upon the number of firms that have registered or renewed their registration with the Chamber of Commerce averages 55%.176

Another source that we examined to assess levels of firm informality is the DANE household survey. This survey, similar to a census, asks questions about the lives of individuals, including their employment status. One of the questions posed on more recent surveys was whether the individual operated a business and, if so, how that business was formed. In the most recent iteration of that survey, individuals claiming to operate a business without registration with the Chamber of Commerce exceeded 71% (see Figure 10).

Figure 10. Colombian Micro-enterprises by Registration Status (2014).


Finally, as a third comparative source of data, we examined data from the Chamber of Commerce itself. This data is presented with the caveat that the Chamber has a vested interest in encouraging firm registration as they retain the registration fees paid by formal firms. The information in the

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176 *Id.* at 128 (noting that the percentage of informal micro-enterprises in Colombia grew from 53.7% in 2006 to 55.4% in 2008).

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RUES\textsuperscript{178} Confecamaras database reflects the number of firms that registered or renewed their registration under the formalization law. The law did not differentiate by firm size, which means that it would count not only micro-enterprises (more likely to be informal), but also medium and large enterprises that may have terminated their prior registration and re-registered as new entities to receive benefits under the law.

The database shows that between the entry into force of the law on December 29, 2010 and December 2013, 622,226\textsuperscript{179} firms took advantage of the law’s favorable tax and registration regime (Articles 5 and 7), generating about 595,381 jobs.\textsuperscript{180} Additionally, 91,131 firms formed before 2010 benefited from the formal registration discount offered by the law by re-registering after the law’s passage. As noted above, a substantial number of these firms were renewing their registration under the law rather than registering as previously informal firms.\textsuperscript{181}

Figure 11. Enterprises Receiving Discounted Registration Fees.

<table>
<thead>
<tr>
<th></th>
<th>New small enterprises formalized (registered)</th>
<th>Enterprises that renewed their registration as formal firms</th>
<th>Total number of firms that benefited</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>200,721</td>
<td>89,771</td>
<td>290,703</td>
</tr>
<tr>
<td>2012</td>
<td>425,193</td>
<td>91,131</td>
<td>507,023</td>
</tr>
<tr>
<td>2013</td>
<td>622,226</td>
<td>91,131</td>
<td>712,357</td>
</tr>
</tbody>
</table>

Source: Colombian Ministry of Commerce, Industry and Tourism.

The data in Figure 11 was not broken down to reflect the number of micro-enterprises (fewer than ten employees) that comprise the total of newly registered firms. However, using data from the DANE covering the year 2013, we can extrapolate the percentage of newly formed micro-enterprises that registered under the law. The percentages shown in Figure 12 (below) indicate that micro-enterprises were much less likely to take advantage of the new law. The DANE further breaks down the data by the three largest sectors

\textsuperscript{178} Registro Unico Empresarial (Single Business Registry).

\textsuperscript{179} This value takes into account the changes in GDP and growth of business in order to try to isolate the natural growth of businesses.

\textsuperscript{180} Informe de Rendición de Cuentas (Accountability Report), Ministerio del Trabajo (2013) (Planilla Integrada de Liquidación de Aportes (PILA) y Confecamaras - Cálculos Ministerio del Trabajo).

\textsuperscript{181} See, e.g., Externado, supra note 160, at 27–28.
of registered firms: retail, services, and industry. Only 3.6% of the small enterprises with 6 to 9 employees in the industrial sector benefited from the law. This was 3.6% in the service sector and 4.2% in the retail sector. When looking at small enterprises with one to five employees, this percentage drops to less than 1.4%. The size of the business usually is related to its level of formality, and this data supports this theory.

Figure 12. Percentage of Micro-enterprises Registering after 2010.

The data that we analyzed indicate that Law 1429 did not significantly reduce the level of informality among firms in Colombia. However, given the change in methodology by the agency that collects this precise data, we cannot assert this conclusion with a high level of confidence. We were informed by the Ministry of Commerce that they are aware of this issue and are working with the DANE to implement a consistent data collection approach to monitor firm informality in Colombia.182 However, we can draw important lessons from Colombia’s implementation of its enterprise formalization program that can be applied in a number of other contexts. We discuss these below.

182 Notes from author’s discussion with the Office of Formalization Programs of the Colombian Ministry of Commerce, Industry, and Tourism.
VII. CONCLUSIONS

Law 1429 set out to reduce informality in the Colombian marketplace by incentivizing formal business registration through temporarily reduced taxes and other government payments. Though the law succeeded in formalizing a number of existing firms that were attracted these benefits, only a very small percentage of those firms were micro-enterprises, where firm informality is by far most prevalent. In addition, a substantial number of firms registered for the initial year to take advantage of the benefits of the law, but then failed to register the following year either due to insufficient resources or lack of will.

The law has failed to achieve its goal of substantially reducing the size of the informal enterprise sector. One of the principal reasons for this failure is the law’s basic theoretical premise that regulatory costs are the most significant barrier to formalization. And while this appears to be an important factor, it is not the underlying reason a business will choose to avoid regulatory compliance.

As discussed earlier in this study, many informal firms operate below or at a baseline productivity level, making success as a formal firm with its associated costs of doing business an often insurmountable task. And “formalization per se may not address the fundamental determinants of productivity.” Even with the temporary reprieve in some of these costs, partial formalization implies operating openly, facing scrutiny from both the public and private sectors. The benefits available in return for taking this risk appear limited, at best, and firms are acutely aware of this limited tradeoff.

Policies aimed at addressing the problem of informality should contain the key elements that influence informality, including both the institutional factors that encourage business and labor formalization as well as the policies necessary to enhance individual and enterprise performance, in order to facilitate and encourage transition into the formal economy. As we discussed earlier in this paper, theories on how to reduce informality suggest establishing both policies that foster formalization of firms through

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183 L. 1429, Dec. 29, 2010 (Colom.) (describing the goal of formalizing small enterprises).
184 See, e.g., supra Figure 12.
188 See Melendez, supra note 149, at 10 (conducting a survey of informal firms and finding that a majority do not find registration useful or worthwhile).
incentives that lower the costs of doing business legitimately and also increasing the benefits of being formal. Law 1429 fails to address these structural factors comprehensively.

The law provides some of the benefits recommended by the theories discussed earlier—principally, lower costs for doing formal business. Nevertheless, the law appears to have overlooked several key structural factors: i) effective marketing of the law to the informal business community—many informal firms were unaware of the law and thus could not take advantage of its benefits; ii) fear of exposure—many informal small businesses (survivalist firms) don’t want to grow because of the probability of being detected by the government and being subjected to additional costs, disincentivizing a registration process that emphasizes benefits for larger firms; and, iii) limited benefits—the law provides few if any benefits that a micro-enterprise would be interested in receiving, such as access to credit, business development guidance, and protection of their investment through loan guarantees, bankruptcy protection, and access to courts.

In addition, there is a significant problem with enforcement of laws regulating the operation of businesses in most emerging markets. We have said that inclusion of workers and firms in the legal and regulatory state structure began with the development of regulatory mechanisms for business operations and labor formality. But there are few incentives to avoid informality for most micro-enterprises. Few penalties exist or are enforced against informal firms that would discourage them from remaining informal. With little enforcement of the law, and little benefit in compliance with the law, informal firms often prefer to remain informal.

The Formalization Office of the Ministry of Commerce in Colombia is working aggressively to find rational solutions to the problem of firm informality. They have thus far launched three pilot programs aimed at providing informal firms exhibiting a minimal degree of productivity with

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189 See De Soto, supra note 71, at 102.
190 See Fandl, supra note 78 (describing survivalist firms as those which would fail but for the benefits offered by non-compliant firm operation).
191 See generally, Louise Kantrow, Enabling Environment for Rule-based Business and Investment, Remarks to the UN Intergovernmental Committee of Experts on Sustainable Development Financing (Mar. 3, 2014); Doing business in high-risk countries, Basel Institute on Governance advises, WORLD FIN., Mar. 10, 2015.
193 See Codigo de Comercio, art. 37 [Colombia] (levying a fine up to 10,000 pesos for persons operating a business without registration).
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the means to improve their operation. These programs include: 1) providing expert evaluations of small retail firms operating as part of larger supply chains to identify mechanisms for process improvements; 2) providing consultants to service firms for a period of time to share management and productivity techniques with small firm owners; and, 3) establishing partnerships between less productive firm owners and offering resources to facilitate a small business growth model. Preliminary results of these pilot programs are promising, though the scale is quite small as the ministry has limited resources to invest in firm formalization.

VIII. RECOMMENDATIONS

Along the lines of what the pilot programs in Colombia have been doing, we recommend that a developing country interested in reducing its informal enterprise sector carefully consider the benefits that compliance with regulatory formalities will provide to different types of firms. A one-size-fits-all solution to informal business activity is destined to fail. Some small firms require management training, access to credit, networking opportunities, and other incentives that can be provided either by government or the private sector. Others require capital infusions to purchase inventory, space, and perhaps to hire staff. And still others in the “survivalist” sphere require more direct government assistance through education and linkages with other firms to facilitate some degree of growth in productivity. In some cases, firms in the last category may simply need to be eliminated in exchange for employment opportunities within more productive firms.

The incentives provided by formalization programs such as the one discussed in this paper encouraged already productive firms to test the waters of formality and may have encouraged unproductive firms to expose themselves to the formal marketplace temporarily. Yet this is a short-term and short-sighted solution. The root cause of firm informality is likely structural—high unemployment is creating “forced entrepreneurs” who have no choice but to open an unregulated business in order to generate income. Some of these firms are no doubt operated by potentially successful entrepreneurs. Yet many serve a more limited and more immediate need—economic survival. These firms do not benefit and might even be harmed by formalization programs that bring them into the light with promises of productivity and legality only to see them flounder and fail under the pressure

195 Based on author’s interviews with Ministry representatives.
196 Id.
197 Id.
198 See, e.g., WORLD BANK, supra note 26, at 66.
of competition.\textsuperscript{199} The goal of a successful formalization program must be improvements in business productivity.\textsuperscript{200} A firm that can compete with regulated firms is a firm that will seek out formality because those firms will benefit from opportunities to expand, hire workers, access credit, and market their enterprise. Those very firms will create job opportunities that might be filled by survivalist “forced entrepreneurs,” ultimately reducing the size of the informal sector.\textsuperscript{201}

Until the government is able to get the incentives right by focusing on improvements in firm productivity, the informal firm sector will continue to grow. And while the informal marketplace thrives, foreign investors will be discouraged from developing a presence in these emerging markets, feeding a cycle of low economic growth. Finding the right path to inclusive firm regulation is the surest way forward in boosting domestic economic growth and creating an attractive investment environment.

\textsuperscript{199} \textit{Id.} at 73 (explaining that many firms self-select into informality due to their low-productivity endeavors and would not improve productivity if formalized).

\textsuperscript{200} See \textsc{Perry et al.}, \textit{supra} note 23, at 15.

\textsuperscript{201} See, \textit{e.g.}, \textit{Doing Business 2013: Smarter Regulations for Small and Medium-Size Enterprises}, \textsc{World Bank} (2013) (indicating that improvements in the regulatory regime will likely lead to more firm registration by true entrepreneurs and more wage-based employment by “forced entrepreneurs” in the survivalist cycle).