The influence of entry regulation on formal employment

ECON 807 Macroeconomic Theory & Policy Policy Project Draft

Daniel Sánchez Pazmiño

March 2023

Abstract

Lorem ipsum dolor sit amet, consectetuer adipiscing elit. Ut purus elit, vestibulum ut, placerat ac, adipiscing vitae, felis. Curabitur dictum gravida mauris. Nam arcu libero, nonummy eget, consectetuer id, vulputate a, magna. Donec vehicula augue eu neque. Pellentesque habitant morbi tristique senectus et netus et malesuada fames ac turpis egestas. Mauris ut leo. Cras viverra metus rhoncus sem. Nulla et lectus vestibulum urna fringilla ultrices. Phasellus eu tellus sit amet tortor gravida placerat. Integer sapien est, iaculis in, pretium quis, viverra ac, nunc. Praesent eget sem vel leo ultrices bibendum. Aenean faucibus. Morbi dolor nulla, malesuada eu, pulvinar at, mollis ac, nulla. Curabitur auctor semper nulla. Donec varius orci eget risus. Duis nibh mi, congue eu, accumsan eleifend, sagittis quis, diam. Duis eget orci sit amet orci dignissim rutrum.

1 Introduction

It is well known that informal work -legal but informal economic activities which occur outside the government's regulatory capability (Sassen, 1994) - can hinder economic development through several channels. Informal firms reduce the amount of taxes that can be collected by governments and these businesses tend to remain small and inefficient. Additionally, workers in the informal sector usually lack access to social security and other employment benefits and tend to earn lower wages even after controlling for skills. Informality is also related to bigger gender gaps, higher inequality, lower education and several other factors which worsen economic outcomes (Deléchat & Medina, 2020). Further, the informal economy has been characterized with poorly defined work spaces, unsafe and unsanitary working conditions, inconsistent pay, long working hours and a lack of access to markets, financial services, training, and technology (International Labour Organization, n.d.).

While less present in the developed world, informality seems to be very prevalent in developing countries, where it represents a third of low and middle-income countries' economic activity (Deléchat & Medina, 2020). In the world, the informal economy is thought to encompass more than half of the labour force and more than 90% of small and micro businesses. The work of de Soto (2002) has motivated much research about informality in Latin America, being one of the regions with the most prevalent levels of informality, as it often is the only option for several workers on the lower end of the wealth distribution (Oviedo et al., 2009). At the macroeconomic level, informality could be regarded as one consequence of poor institutions, which have been shown to be significant factors for growth (Acemoglu et al., 2001; Glaeser et al., 2004; La Porta et al., 1997). Further, its effect on inequality and its potential to be a channel for the propagation of monetary and fiscal policy Alberola and Urrutia (2020) make informality a significative macroeconomic determinant of underdevelopment.

The desire for the formalization of the economy is well understood, especially considering that the impact on economic activity due to COVID-19 has increased informality worldwide (International Labour Organization, 2022). However, the policy angle to this issue is subtle, given that the causes and consequences of informality are difficult to document and understand. Among others, some policy approaches have focused on the role of governments in providing incentives for formalization. One approach has been to design tax systems that minimize distortions in the market (Bardey & Mejía, 2019) as well as reducing the costs of formalization by reducing entry regulation for firms. As proposed by Prado (2011), firms which are less productive endogenously choose to operate in the informal sector due to entry costs and taxation in the formal sector. While larger firms might be able to overcome the costs of formalization, smaller, less productive firms may not; thus, reducing entry costs can directly affect entrepreneurship.

In this paper, I investigate the relationship between entry regulation and labour market formalization by exploiting an exogenous shock on entry regulation in post-pandemic Ecuador. By using administrative data of various Ecuadorian public institutions, I put [a model by some professors] to practice through a comprehensive event study empirical framework which exploits variation across time at the province level in Ecuador. The reform in question was enacted in May 2020 and allowed for the creation of a new legal form of business, the *Sociedad de Acciones Simplificada*[1] or SAS. The reform seeked to impact reduced monetary and time costs relative to other legal figures in the firm creation process, and has proven to be effective in doing so Camino-Mogro and Armijos Bravo (2022).

I base the empirical analysis under a theoretical framework informed by the work of Branstetter et al. (2014). In a simple model of entrepreneurship, it is predicted that reduced entry costs will positively impact firm entry and employment, however, all increases are at the margin: while new firms will enter the (formal) sector, these firms will be generally smaller and less productive.

2 Literature Review

[1] *Simplified Shares Society*