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Do Informal Businesses Gain From Registration and How? Panel Data Evidence from Vietnam

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Summary. — This paper evaluates the impact of Household Businesses' decision to leave the informal sector on their performance and mode of operation. It capitalizes on a unique panel dataset, result of a five-year project.

Using dynamic specifications, we find a significant impact of formalization on annual value added of 20% on average. More importantly, we show that this improvement is not valid for the smallest units, and that it is made possible for the others by changing their operating conditions. Released from the constraints of informality, they can access better equipment, increase their scale of operation, and operate in a more competitive environment.

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1. INTRODUCTION: WHY IS IT WORTH MEASURING THE IMPACT OF FORMALIZATION ON THE BUSINESSES THEMSELVES?

Should we hope that each of the Informal Household Businesses (IHB)¹ that constitute a predominant share of developing economies will formalize in the medium run? Even if the question is rarely asked directly, the answer makes no doubt considering the long-standing negative connotation of informality and the loss of revenue for the State. However, the extent to which micro-firms themselves would benefit from formalization remains unclear.

The question is yet a first-plan research topic. First, it is closely related to the micro-determinants of informality: a large segment of literature defends the view of chosen informality, which implies that the overall size of the informal sector would depend on the perceived costs and benefits of each legal status. Furthermore, estimating the causal impact of registration is a necessary condition to the promotion of policies addressing informality. It is of particular interest in the case of Vietnam since encouraging formalization is one of the national priorities for the country's employment policy pointed out by the Ministry of Labor and Social Affairs. Despite the rapid growth that started after the 1986 liberalization (Đổi mới), and the new status of middle-income country according to the World Bank's classification, the informal sector is still a leading job provider, accounting for almost half of non-agricultural jobs.

If costs associated with formality have been extensively described (De Soto, 1989; Djankov, La Porta, Lopez-De-Silanes, & Shleifer, 2002), measuring the gains of registration is not straightforward and raises two major problems: the data requirements and the potential endogeneity.

Given the very nature of the informal sector, quantitative data are everything but easy to produce (ILO, 1993; Razafindrakoto, Roubaud, & Torelli, 2009). The original sin of IHB -being unregistered- keeps them inherently away from statistical systems. They often operate without fixed premises, outdoor or at home, which makes classical enterprises surveys (often census-type) inefficient in capturing this phenomenon. This paper capitalizes on the panel data produced during the

five-year IRD/GSO research project² led by its authors to address the question. Large-scale representative surveys have been conducted in 2007 and 2009 in the two major cities, Hanoi and Ho Chi Minh City (HCMC). Both are based on the mixed-survey methodology, principle of which is to identify the IHB heads in a first-phase Labor Force Survey, and to build a sampling frame of IHBs that will be surveyed in a second phase. This methodology allows capturing outdoor unregistered businesses (at least all of those whose heads are included in the population census), and to be representative of the informal sector (ILO, 2013, chap. 6; Roubaud & Séruzier, 1991). Our data include a total of 1,464 Household Businesses (HB) that were informal in 2007, of which 147 formalized before the second wave of the survey in 2009, allowing us to identify the impact of registration on a rich set of intermediate and final outcome variables.

Even when reliable survey data exist, evaluating a plausible causal impact of formalization required addressing three key issues. First, businesses that chose to formalize were not comparable with the ones that remained informal: the potential outcomes of the formalized HBs would probably have been different from the non-formalized one, whatever their trajectory. This selection issue might be explained by *observed* differences that might be fixed in time or not, such as education level, time in business, industry, and location. Second, *unobserved* factors might affect the formalization decision and the outcomes. Some of these factors can be considered as being fixed in time: it is the case of the two major ones, namely the entrepreneur's ability, and her degree of

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compliance with regulations. They can also be changing over time, in particular if a specific effort is made by local authorities to enforce registration regulations in some locations only.

These two forms of endogeneity have been largely documented and need to be accounted for. We make use of the panel nature of our data to address them by estimating Difference-in-Difference (DiD) models in an OLS and Fixed-Effect (FE) settings, and finally by using DiD Matching Estimators (ME). We can fully control for selection on observables as well as unobserved time-invariant characteristics. Some unobserved time-variant sources of heterogeneity might remain in theory, which our DiD specification cannot exclude. To the best of the data's possibilities, we checked the (non-) existence of what appeared to be the main potential source: differentiated changes in local policies.

The third concern is that registration might be partly determined by performance, resulting in a simultaneity bias. This can be true if, for instance, higher profits lead to more visibility and therefore a higher probability to register. We checked for a potential impact of profit growth on the probability to formalize by applying similar dynamic models than in the core analysis. The lack of significant effects ruled out the reversed causality concerns.

Although the core of the paper relies on this quantitative approach, it also includes the results of two complementary qualitative surveys. The first one was undertaken in 2009 to investigate further the characteristics of IHBs, the motivations of the businesses' heads and their attitude toward registration. In-depth semi-structured interviews were conducted with 60 HBs in the two cities (Cling *et al.*, 2010; Cling, Razafindrakoto, & Roubaud, 2012). The second survey consists in 10 semi-structured additional interviews conducted in Ho Chi Minh City in 2013 with businesses operators selected from the observations of the panel that had formalized or informalized their activity. The results of both qualitative surveys, in addition to their role in structuring the quantitative approach, are used throughout the paper under the form of quotations.

The ambition of the paper is threefold: (1) to determine what types of already existing informal businesses to choose to formalize, (2) to measure the impact of formalization on performance, and (3) to identify the channels through which this effect occurs by evaluating the impact of registration on their conditions of operation.

We find that (1) Businesses that formalized belonged to the upper tier of the informal sector, save a few self-employed workers. (2) By formalizing, IHBs increase their annual value added by 20% on average. (3) This is made possible by the release of many of the constraints associated to informality. Joining the formal sector is found to be associated with an improved access to electricity and Internet, to allow increasing size, improving premises, and widening the use of written accounts. Furthermore, micro-enterprises that decided to register operate in a more competitive environment, reporting more problems with competitors. These results however only hold for the biggest IHB. Originally self-employed businesses do not benefit from registration, suggesting the existence of a threshold below which there is no gain in formalizing.

The rest of the paper is organized as follows. Section 2 reviews the literature on formalization and its benefits. Section 3 presents the data, and a descriptive analysis of the formalized HBs' characteristics. Section 4 presents the identification strategy and the estimation results. Section 5 provides further robustness checks. Section 6 concludes and suggests some policy implications.

2. LITERATURE: WHAT ARE THE EXPECTED EFFECTS OF FORMALIZATION?

The literature handled the question in three manners. The first strand of literature aims at identifying the correlates of informality at the firm level. Although informative, this approach does not allow isolating the effect of informality on outcomes: given the selection issue, a direct comparison is required between (otherwise similar) formal and informal businesses. The second strand of literature, to which contributed several recent papers, compares HBs that *are currently* formal and units that *are currently* informal. An additional question handled in the third strand, to which this paper contributes, is the effect of formalization for *already existing* informal businesses. This dynamic vision -comparing units that remained informal and units that formalized- is closer to the actual question for policy makers caused by the existence of a predominant informal sector.

(a) *The correlates of informality at the HB's level*

Enlightening the characteristics associated with informality at the HBs level is one of the more documented strands of literature about developing countries. Informality has been shown to imply a number of correlates that are associated with inferior production conditions and subsequently with reduced performance.

First, IHB are generally small. Not only are they largely made of self-employed workers (Maloney, 2004) and subsistence businesses, but also their expansion can be inhibited by the fear of attracting the attention of the authorities. They often operate in a fuzzy legal framework with which neither informal workers nor the police is really acquainted, and often prefer remaining unnoticed. In Vietnam as in several other countries, registration is compulsory only above a certain threshold of size and/or activity that just a tiny minority of workers knows. Most of them believe that they are illegal, whether they actually are or not, which may prevent small IHB from growing when they have the opportunity to do so.

This point is reflected in many answers obtained in the qualitative survey (Cling *et al.*, 2010, 2012):

– “*I did not register my activity because nobody asked me to register. The same goes for all the HBs operating in this street. I think it is a traditional street activity. That's why the State does not ask for registration*” (a metal door manufacturer);

– “*My business is not registered because I work at home. Local authorities consider that my house is a normal house; they do not ask any questions about my activity. It is not like shops in a big street*” (a dressmaker);

– “*It is a small business. I do not know much about the law. Administrative procedures are normally very complicated. Nobody asked me to register*” (a tea and tobacco seller);

– “*I don't know the legislation. All I know is that when I see the police officers, I have to run away. If not, I will be harassed or pay some money*” (a fruit seller–street vendor);

– “*I do not know the law, but nobody asked me to register. Too bad for the State, good for me because if I had to register, I would have to pay taxes, buy specific protection equipment, it is complicated*” (a plastic tube manufacturer).

The uncomfortable environment, in which IHBs operate, with the risk of being victim of arbitrary decision, is also

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