

NOTES ON POLICIES FOR THE FORMALIZATION OF MICRO AND SMALL ENTERPRISES

Policies for the formalization of micro and small enterprises

Informal employment in micro and small enterprises in Latin America and the Caribbean represents 60% of the total, a situation that is of great concern to governments, workers and employers in the region. The majority of these enterprises are also not registered with tax and other relevant authorities. In countries with better track records in this area, one in two micro and small enterprises is registered, a proportion that is far from being reached in most countries in the region. Several countries have designed policies and programmes to deal with this complex situation, but clearly the challenge remains sizable.

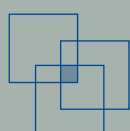


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Foreword

One of the major challenges in reducing informal employment in Latin America and the Caribbean is to facilitate the transition to formality of micro and small enterprises, which are the main generators of employment in our region.

This is a complex challenge as informality is a multidimensional phenomenon and as the reality of MSEs is highly heterogeneous. Available data indicate that informality in micro and small enterprises constitutes a major obstacle for countries in the region to advance in their social and economic development, which is why it is crucial to find solutions.

Over the last decade, Latin American and the Caribbean registered a period of sustained growth that even resisted reasonably well the international financial crisis. Urban open unemployment fell to 6.2% in 2013, the lowest figure since ILO started recording. Informality, although it was reduced over time, is persistent and still affected 47.7% of urban employment in 2012. According to ILO estimations, 60% of the workers in MSEs are informally employed.

The majority of the region's informal workers belong to the 20% poorest segment of the population, which presents an informality rate of 72%, more than double the rate registered for the richest 20% of the population where informality is around 31%. These figures show a clear link between informality and income inequality.

How to address informality in MSEs? There is no standard recipe and that is precisely why this new series of ILO FORLAC Focus Notes seeks to encourage debate on this topic and generate discussion on different policy options to reduce informality.

The design of MSE policies needs to take into account that there is a difference between formalizing small enterprises and formalizing employment in these firms. The reality is that undeclared work also exists in an important share of registered MSEs. Therefore special attention should be paid to strategies for the creation of formal jobs in this segment of enterprises.

In order to advance towards MSE formalization, integrated and long term strategies are required that simultaneously address the multiple causes of informality, incorporating issues related to administrative, tax and labour regulations, access to social security and private sector development strategies. Policies to promote the formalization of MSEs should include strategies to increase productivity, improve norms and regulations, generate incentives for formalization and enhance government's capacity to enforce compliance.

Key aspects include the simplification of administrative procedures for business registration, the development of adequate taxation regulations, the creation of incentives related to social security and the strengthening of information and inspection systems. For enterprises, it is important that the transition to formality makes good business sense. And for countries it is critical to take advantage of the potential of the MSE sector and its workers in order to boost sustainable economic growth.

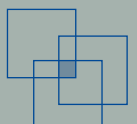
This series of focus notes reveal that notwithstanding the complexity of the issue, positive experiences exist in several countries in Latin America and the Caribbean, which are worth reviewing and sharing with policy makers. The experiences presented in this series of focus notes also show that countries are concerned about the fact that youth and women are overrepresented in informal MSEs, either as workers or entrepreneurs.

The dissemination of these focus notes form part of the Programme for the Promotion of Formalization in Latin America and the Caribbean (FORLAC), launched by this Office in 2013. We hope that this series of notes helps in the design of policies that can give a new impulse to a topic that needs to be at the centre of the Latin American and Caribbean policy agenda.

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Micro and small enterprises and informality

According to ILO estimations in 2009 there were about 59 million economic enterprises in Latin America and the Caribbean, of which about 48 million were entities operated by own-account workers and about 7 million were businesses with up to 5 business workers. This implies that the greater part of employment in the region is generated either through self-employment or in small companies.

Unfortunately, a high proportion of employment generated in this segment is informal: the informal employment rate among own-account workers is 84%, while the share of informal employment in micro and small enterprises (MSEs) amounts to 60% of the total. According to ILO (2013), own-account and businesses with up to 10 employees account for almost 70% of total informal employment in the region.

Table 1: Informal employment by occupational category in Latin America and the Caribbean (2012)

	Informality rate
Public sector	15.4%
Private sector (employers and employees)	33.1%
Enterprises with 1 - 10 workers	59.9%
Enterprises with more than 10 workers	14.6%
Own-account workers	83.5%
Domestic workers	78.9%
Contributing family workers	100.0%
Total	47.7%

Note: (*) These figures include public and private sector employers and employees in urban areas, but exclude agricultural employment.

Source: ILO SIALC, based on household surveys.

People working in micro and small enterprises face worse working conditions compared to those working in larger companies. According to ILO data, in Latin America and the Caribbean in the year 2012 only 48.4% of urban employees in enterprises with five or fewer workers were covered by health and/or pension schemes, compared with 87.6% of workers in firms with six or more workers¹.

Apart from the impact of informality on working conditions, a central concern for the ILO, informality in micro and small enterprises poses a range of other challenges, both from the perspective of society, workers and companies. Operating informally as a business implies low productivity, limited market access, reduced access to credit and little opportunity for developing human capital, amongst others. For society, a narrow tax base and reduced coverage of social security systems are only some of the challenges posed by informality.

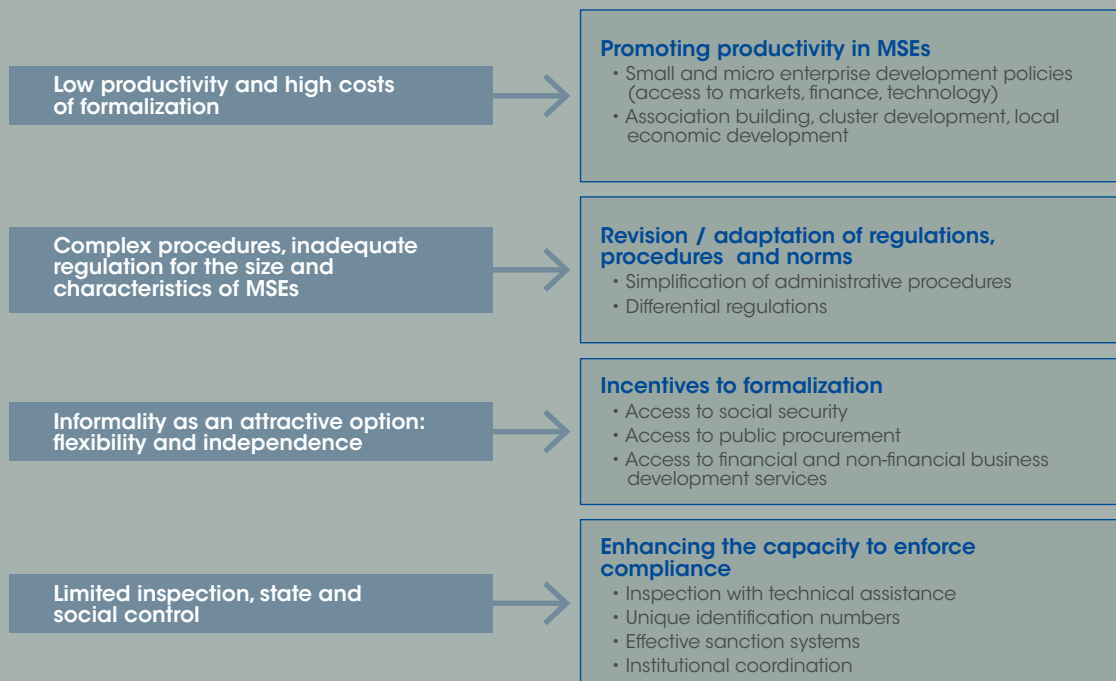
Much has been said about the possible causes of this reality. It is important to point out that the levels of informality in a given economy are determined by a range of economic, structural, institutional and even political factors. Globalization, outsourcing and subcontracting processes also define the levels of informal employment in the economy. At a more micro level, the determinants that influence the decision of small company owners to operate informally are:

- Low productivity as compared to the costs of operating formally

¹ ILO, 2013 Labour Overview Latin America and the Caribbean. Lima: ILO, 2013.

- Complex procedures and inadequate regulation for micro and small enterprises
- Informality as an attractive option in terms of flexibility and independence
- Poor inspection and social control

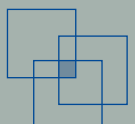
Figure 1: Causes of informality and strategies for the formalization of micro and small enterprises



Policies for the formalization of micro and small enterprises

When designing policies for the formalization of micro and small enterprises it is important to make a distinction between the goal of formalizing business entities and formalizing employment in these companies. Although strong correlations exist between the two objectives, the results of certain policies on one variable or the other may be uneven. In other words, policies to promote business registration do not necessarily generate the desired results in terms of formal employment and compliance with labour regulation. Clearly policies that address both aspects are required.

This series of focus notes reviews some of the policies and programmes implemented in four different countries in the region in order to promote the formalization of MSEs. Special attention is given to policies that help to reduce the administrative burden related to formalization, to schemes that create incentives to formalization and to policies that address challenges related to inspection and compliance in small and micro enterprises.



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Table 2: Policies and programmes for the formalization of MSEs reviewed in selected countries (Brazil, Chile, Colombia and Costa Rica)

	Streamlining of administrative procedures	Taxation	Social security	Inspection and compliance
Brazil	<ul style="list-style-type: none"> • SIMPLES Nacional • Law on individual microentrepreneurs • REDESIM 	<ul style="list-style-type: none"> • SIMPLES Nacional • Law on individual microentrepreneurs 	<ul style="list-style-type: none"> • SIMPLES Nacional • Law on individual microentrepreneurs 	<ul style="list-style-type: none"> • SEBRAE
Chile	<ul style="list-style-type: none"> • Law 20.494 on administrative streamlining • Law 20.659: "Your business in a day" • Law 19.740 on family-owned microenterprises 	<ul style="list-style-type: none"> • Simplified tax regime 	<ul style="list-style-type: none"> • PREVIDED • Law on subcontracting 	<ul style="list-style-type: none"> • Substitution of labour inspection fines with training • MSME good labour practices programme
Colombia	<ul style="list-style-type: none"> • Business support centres (CAE) • Law 1429 of 2010 • Anti-Red tape decree (N° 19 of 2012) • Web portal for enterprise creation • Integrated social security contribution form (PILA) 	<ul style="list-style-type: none"> • Law 590 MSME Statute • Law 1429 of 2010 • Tax Reform 2013 (Law 1607 of 2012) 	<ul style="list-style-type: none"> • Tax Reform 2013 (Law 1607 of 2012) 	<ul style="list-style-type: none"> • Colombia Goes Formal: Formalization workshops and brigades • Integrated social security contribution form (PILA)
Costa Rica	<ul style="list-style-type: none"> • Law 8220 on protecting citizens against excessive red tape • Centralized tax collection system (SICERE) 	<ul style="list-style-type: none"> • Law 9024 on tax exemptions for MSEs • Law 7092 on preferential profit tax rates • Law on corporations 	<ul style="list-style-type: none"> • Centralized tax collection system (SICERE) 	

Note: The focus notes also review policies to improve productivity, which are omitted in this table.

Source: Authors, based on focus notes reviewing policies in 4 countries.

Streamlining of administrative procedures

The need to streamline the procedures for business registration and licencing has lately received much attention in Latin American and the Caribbean countries. Different governments have implemented reforms to make it easier and less costly to establish a business formally. Legislative changes that translate into shorter and cheaper procedures for registering companies with the different administrative entities and for obtaining the necessary licences and operating permits, should be an important cornerstone of any agenda to formalize micro and small enterprises.

The most common strategies to simplify business start-up are 1) one-stop-shops 2) business licensing reform, 3) administrative deadlines and positive administrative silence, 4) reduction or elimination of minimum capital requirements, 5) simplified legal formats for micro businesses, 6) simplification of administrative processes, 7) electronic services, and 8) information and technical support.

The most effective way to carry out a process of streamlining procedures for business start-up depends on the complexity of present regulations, existing political commitment, the level of centralization in decision-making and to what extent regulations are similar between different jurisdictions. Multiple efforts have been undertaken in the region. In Chile, for instance, company registration procedures were simplified in different steps, starting with a law that created a special legal format for family-owned microenterprises (Law 19.740), followed by laws that eliminated red tape in businesses start-up and simplified the creation (Law 20.659), modification and dissolution of companies, among other initiatives.

In Colombia, on the other hand, the 2012 anti-red tape decree attempted to streamline a series of procedures in one go. At the same time Law 1.429 removed the obligation for companies to

undertake certain administrative procedures with the Ministry of Social Protection. Colombia's network of business support centres (*Centros de Atención Empresarial*) provides information services and supports entrepreneurs in establishing their companies in one day at low cost. In Costa Rica, Law No. 8220 was promulgated to protect citizens from excessive red tape and to allowed better access to information regarding different administrative procedures, amongst them procedures for registering a business.

Reform processes typically involve a wide range of stakeholders that should be involved in the process from the beginning. This is how it was understood in Brazil when the government created the National Network for the Simplification of Registration and Legalization of Businesses (REDESIM), led by the Federal Government with the participation of state and local authorities as well as the private sector.

Taxation

An important area to look into if we want to promote the formalization of micro and small enterprises, are tax laws and regulations. The fiscal obligations that come along with business formalization are undoubtedly taken into consideration by small business owners when deciding to register or not. Many countries in the region offer a differential tax rate for smaller companies. However, for MSEs it's not only rates that matter. The complexity of procedures, multiplicity of taxes and the lack of information and support also play against business formalization.

Possible strategies in the area of taxation that could have a positive impact on formalization include: 1) Special tax regimes for micro and small enterprises, 2) simplification of accounting standards, reporting requirements and payment facilities within the general tax regime, 3) information and technical assistance, and 4) improved inspection to reduce tax evasion.

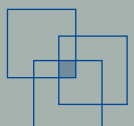
Several countries in the region have created special tax regimes for small and micro enterprises in order to promote formalization, support small enterprise development and allow greater administrative efficiency in tax collection. These schemes usually combine one or more of the following characteristics: 1) lower tax rates as compared to the general regime, 2) presumptive taxation methods, and 3) integration of different taxes into one single tax payment.

In Brazil, the "SIMPLES Nacional" scheme allows small businesses to combine several federal, state and municipal taxes into one single annual payment, of which the amount varies according to gross income and the type of economic activity exercised. By 2012 more than 4 million micro and small enterprises had opted for the scheme, boosting formalization in this segment of enterprises. Similarly, Brazil's Law on Individual Microentrepreneurs allows own-account workers with annual sales amounts up to a certain ceiling to pay a fixed monthly amount which replaces social security contributions and certain taxes, while exempting them from paying another range of taxes.

Chile's simplified tax regime, introduced in 2007, makes it easier and cheaper for micro, small and medium entrepreneurs to comply with tax regulations. In Colombia, the MSME Law reduced parafiscal contributions of businesses during their first three years of operation. Colombia's Law 1429 of 2010 further reduced enterprises' administrative burden, introducing exemptions to income tax, parafiscal contributions, company registration fees and other contributions for companies with up to 50 workers.² Finally, the Colombian 2012 tax reform definitely eliminated parafiscal contributions and decreased employers' social security contributions in the case of employees whose salary does not exceed ten minimum wages. Through this measure payroll deductions for these workers were reduced by 13.5%.

In Costa Rica small companies benefit from a preferential income tax rate and an exemption from a corporate tax established in 2012. To take advantage of this latter exemption, the company

² These reductions decreasing over time until the sixth year of operation. The provisions on taxation have an indefinite character, while lower payroll taxes and reductions in the fee for commercial registration may only be used by companies benefiting from the Law until 31/12/2014.



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must be inscribed in the SME register of the Ministry of Economy. This register only issues certificates to companies that are up-to-date with their different fiscal and labour obligations, thus reinforcing formalization.

The central challenge in this area is to design a tax system that is appropriate for different types of small firms. For microenterprises operating at subsistence level it is generally considered inappropriate to establish tax obligations beyond a single patent or fee payable at the municipal level. Microfirms above subsistence level, however, should be required to pay taxes but could benefit from special schemes. More established small companies, on their turn, should be incorporated into the general tax regime, where they could possibly benefit from certain tax simplifications. The transition from one regime to the other should be as smooth as possible.

In general terms, international experience validates the notion of differential tax regimes for certain types of enterprises. However, special tax regimes can also produce negative consequences. The most obvious problem is that they create an incentive for firms to remain small, be it in reality or on paper. Experiences also show that in practice it is not so easy to establish simple and verifiable parameters for presumptive taxation.

Social security

Another set of obligations that micro and small enterprises often fail to comply with are those that have to do with the social security coverage of the people working in the firm. Micro enterprises especially, tend to compensate their low productivity with informal employment arrangements, thereby saving between 25% and 45% of gross payroll. For these enterprises, the transaction costs related to declaring and paying to different social security administrators are an additional obstacle to formalization. An indicator of the magnitude of this problem is that by 2012, 60% of employees in microenterprises in Latin America and the Caribbean were considered informal workers for not being covered by health insurance.

Whether workers are contracted formally or informally and whether social contributions are declared and paid or not, however, does not just depend on the capacity of the micro or small enterprise to administer and pay these obligations. Often the workers in these companies feel that social security contributions do not necessarily generate the benefits they would aspire to enjoy.

Another disincentive to formalization is the lack of continuity in social security payments, caused by seasonal or intermittent employment in micro and small enterprises. At the same time, for a lot of workers in this segment of enterprises, accepting a formal employment contract means losing certain subsidies and benefits. Limited knowledge among employers and employees about the real benefits of social security, constitutes another obstacle.

Given the difficulties faced by micro and small businesses in complying with social security payment schedules, it is important that the benefits of these systems are considered valuable by the different stakeholders. A key factor here is the quality of the services provided by the different kind of social security schemes. The quality of the benefits in the areas of health, maternity and unemployment determine whether or not the systems respond to the needs of their (potential) affiliates. People's confidence in their pension systems, generated through clear and respected rules, transparent criteria and stable indexing systems, are equally important. Adequate insurance coverage for accidents at work and occupational diseases in micro and small enterprises also acts as an incentive to labour formalization.

There is no single, ideal format for promoting formalization and social protection coverage in micro and small enterprises. However, the way in which social security schemes are designed and administered certainly has an impact on the level of formalization in this segment of firms. Some of the characteristics that would favour formalization are: 1) progressive social security contributions, 2) subsidies for social security contributions on low-income wages, 3) the existence of a solidarity pillar 4) reduction of the administration costs of social security schemes.

Similar to what is observed in the area of taxation, some countries in Latin America and the Caribbean have established special social security schemes for certain segments of workers, companies or sectors. In most cases these schemes target the own-account workers, contributing family workers, micro and small businesses, subcontractors and temporary or part-time workers. The most common characteristics of these schemes are 1) lower contribution rates, 2) integrated contributions into one single payment 3) simplified calculation methods for social security contributions, 4) adapted payment schedules 5) exemptions, 6) gradual contribution rates and, 7) social security subsidies in times of economic crisis.

The design of special social security schemes for certain types of workers or employers requires a lot of caution as in some instances these schemes negatively affect workers' rights. These undesirable situations occur in regimes where the exemption, reduction or gradual application of social security contributions for employers is not compensated by subsidies or solidarity pillars. They also occur where workers employed in small firms, for being registered under a special scheme, are entitled to benefit packages of lower quality or intensity of coverage than those of the general scheme. This type of special regimes rather than improving job quality, exacerbate inequality between workers in different sectors and segments of the economy. There are, however, differential regimes that reduce the administrative burden of micro and small business without negative implications on workers' rights. Regimes that replace certain social contributions with subsidies, that unify contributions and taxes into a smaller number of payments and that adjust payments schedules to seasonality do not adversely affect the quality of employment. These regimes deserve to be studied and, where appropriate, replicated or adapted to other contexts.

The Colombian 2013 tax reform (Law 1.607) is an example of an attempt to bring down the cost of formal labour and increase the share of social security financed thru general taxes. This reform eliminated certain payroll taxes and employers' contributions to social security in the case of employees with salaries of less than ten minimum wages. To offset the drop in social security revenues, the Government created a new equity tax, known as CREE, levied on firm profits. Shifting part of social security costs from payroll to profit tax is supposed to be beneficial for micro and small enterprises, which are generally labour intensive.

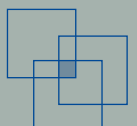
A pending task in many countries is a better streamlining of administrative processes related to social security registration, declaration and payments. This task is especially urgent where employers and workers can choose between multiple private entities either operating at the national or local level. Some countries have advanced towards unified and digitalized systems for registration, declaration and payment of contributions. The PreviRed platform, used by 450,000 Chilean companies, is a good example.

Inspection and compliance

An important obstacle for the formalization of micro and small enterprises is the limited control that labour and tax authorities exert over this segment of firms. Experiences in the region, however, show that there is a range of methodologies to improve inspection through better information management and analysis, education and support by these inspectorates. Some countries have also created more effective inspection mechanisms in subcontracting processes.

Experience in the region shows that it is absolutely essential to complement legislative reform with information campaigns and capacity building efforts. It is necessary, first of all, to train officials of the administrative entities that interact with employers so that they are able to transmit the correct information, provide efficient services and process requests in accordance with regulations. SEBRAE's training program for municipal officials in Brazil, for example, was key to the successful implementation of laws like "SIMPLES" and "Individual Microentrepreneurs".

At the same time, it is necessary to organize training programs and information campaigns for employers and employees of micro and small enterprises. The role of business associations and trade unions in these efforts is very important and positively evaluated in the region. The business



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support centres and the formalization workshops and brigades in Colombia constitute interesting examples in this regard.

Chile's Labour Code (2001), allows microentrepreneurs that have violated labour regulations to participate in a course on labour legislation, instead of paying a fine. This scheme was established in response to high levels of informality in microenterprises combined with a generalized lack of knowledge about labour legislation. The programme reduces the risk for recently formalized microentrepreneurs to incur costs due to unfamiliarity with labour regulations, thus offsetting an existing disincentive for formalization. Another programme implemented by the Chilean labour inspection to encourage the formalization of micro and small enterprises is the good labour practice program for micro, small and medium enterprises, which provides technical assistance to employers and workers in complying with labour regulations, social security provisions and occupational safety and health standards in companies.

Finally, Colombia's Integrated Social Security Contribution Form (*Planilla Integrada de Liquidación de Aportes*) is an example of an improved information flow between public agencies. Before its creation, employers had to separately pay the different social contributions, payroll taxes and other taxes separately. With the integration of payments, inspection of formal employment was strengthened as companies could only access the certain tax benefits when complying with labour regulations.

Concluding remarks

As stated in the 2014 International Labour Conference, promoting formalization in micro and small enterprises requires a comprehensive approach. Necessarily, this approach needs to attend to the different economic and institutional determinants of informality. It also requires a combination of strategies geared to increase business registration with policies to promote formal employment in this segment of enterprises.

This series of focus notes reviews some experiences with policies in different countries in Latin America that aim to promote the formalization of MSEs. Figures from the region show that this is not necessarily an easy task. Progress over the past decade has been modest compared to the efforts put into promoting formalization.

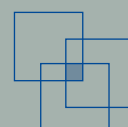
The experiences reviewed in this series of focus notes offer some interesting conclusions. Reducing the administrative burden for small firms is not effective if it is not combined with continuous efforts to improve competitiveness in small enterprises through effective enterprises development policies and programmes. At the same time it is necessary to create the right incentives for formalization, taking into account the needs and interests of small companies and their workers. These efforts need to be further complemented by policies to improve inspection and raise awareness amongst employers and workers on the obligations and benefits of formalization.

In addressing informality it is necessary to find a balance between incentives and sanctions. The optimal balance, however, is not necessarily the same for countries with different levels of economic development. In countries with large segments of informal micro enterprises which do not even generate enough income to cover the basic needs of the people working in these firms, poorly designed sanctions only increase vulnerability and inequality. The challenge for policymakers is to find the right mix of instruments for each context, ensuring that formalization is an attractive option both for companies and their employees.

The mushrooming of special tax and social security schemes for small enterprises, leads to a more fundamental question as to what extent it is desirable to establish more favourable regulation for certain segments of businesses than for others. The existence of differentiated regulation can create a situation where companies are better off staying small, be it in reality or on paper.

This problem again points to the need for a holistic approach and interagency coordination to ensure that policy design encourages the formalization of micro and small enterprises without discouraging their growth.

Experiences in Latin America and the Caribbean show that some reforms require long periods - up to a decade- before they start to show results in the levels of formalization. Ultimately, what these policies need to promote is a culture of compliance and to strengthen the social contract, issues that do not change overnight but require long-term efforts. On the positive side, the wide range of policy initiatives described in this series of focus notes show that a wealth of policy responses already exists in the region, worth to be studied and, where appropriate, adapted to new contexts.

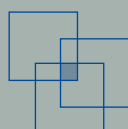




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