Does it pay firms to register for taxes? The Impact of formality on firm profitability

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Abstract
This paper estimates the impact of registering for taxes on firm profits in Bolivia, the country with the highest levels of informality in Latin America. A new survey of micro and small firms enables us to control for a rich set of measures of owner ability and business motivations that can affect both profits and the decision to formalize. We identify the impact of tax registration on business profitability using the distance of a firm from the tax office where registration occurs, conditional on the distance to the city center, as an instrument for registration. Proximity to the tax office provides firms with more information about registration, but is argued to not directly affect profits. We find tax registration leads to significantly higher profits for the firms that the instrument affects. However, we also find some evidence of heterogeneous effects of tax formality on profits. Tax registration appears to increase profits for the mid-sized firms in our sample, but to lower profits for both the marginal smaller and larger firms, in contrast to the standard view that formality increases profits. We show that owners of large firms who have managed to stay informal are of higher entrepreneurial ability than formal firm owners, in contrast to the standard view (correct among smaller firms) that informal firm owners are low ability.

Gender Connection
Gender Informed Analysis
Gender disaggregated productivity

IE Design
Instrumental Variable
The study investigates the impact of firm formalization. In order to formalize, the owner must register with the municipal government to obtain a municipal business license, register with the tax authorities to get a tax ID number, and register in the registry of congress.

Intervention Period
Firms could have formalized at any time before the survey.

Sample population
There are 469 firms included in the sample. The median firm has been in business for 9 years. Half of the firm owners are female.

Comparison conditions
Firms that are formalized are compared to firms that are not formally registered. The study also uses distance to the registration office as an instrument to capture probability to register.

Unit of analysis
Firm level

Evaluation Period
The survey was conducted in August 2005

Results
Registering to pay taxes leads to significantly higher profits. Firms which obtain a tax ID number earn 88% greater profits. Male and female owners do not have significantly different profitability. There are heterogeneous effects. Registering has a
positive impact for firms with 2-5 workers, but registering leads to lower profits for firms that are larger than 5 employees and smaller than 2 employees.

The distance to the tax office may be correlated with other interactions with the government which also affect profitability. There also may be agglomeration effects or information externalities that are not captured.

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