Formal and Informal Firm Dynamics

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Abstract

Firm dynamics differs greatly across developed and developing countries. Firms in developing countries grow less, unproductive and stagnant firms survive longer and firm size distribution is highly concentrated among tiny firms. Moreover, these countries also have very high levels of informality among firms and workers. I develop a tractable framework that is able to rationalize these facts. The model features burdensome regulations and taxes, imperfect enforcement and heterogeneous firms that can exploit two margins of informality: (i) the extensive margin – to register or not their business; and (ii) the intensive margin – whether registered firms hire informal workers to evade labor costs. I estimate the model using matched employer-employee data on both formal and informal firms in Brazil. I use the structural model to analyze two counterfactual scenarios where I separately increase the costs of both margins of informality. I assess the effects on firm size distribution, firm growth, TFP, total output, among other outcomes.