

FORLAC

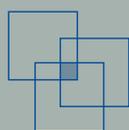
PROGRAMME FOR THE PROMOTION OF FORMALIZATION
IN LATIN AMERICA AND THE CARIBBEAN



International
Labour
Organization

NOTES ON POLICIES FOR THE FORMALIZATION OF MICRO AND SMALL ENTERPRISES

Policies for the formalization of micro and small enterprises in Costa Rica



Regional Office for Latin America and the Caribbean

TABLE OF CONTENTS

Foreword	3
1. Introduction	4
2. Recent trends in informality in Costa Rica	4
3. Policies to formalize small and microenterprises	5
4. Conclusions	12

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.

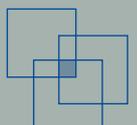
This series of focus notes reveal that notwithstanding the complexity of the issue, positive experiences exist in several countries in Latin America and the Caribbean, which are worth reviewing and sharing with policy makers. The experiences presented in this series of focus notes also show that countries 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.

Elizabeth Tinoco
ADG

Regional Director of the ILO Office for Latin America and the Caribbean

Regional Office
for Latin America
and the Caribbean



NOTES ON POLICIES FOR THE FORMALIZATION OF MICRO AND SMALL ENTERPRISES

1. Introduction

The need to facilitate the transition of informal micro and small enterprises (MSEs) to formality has been recognized as a priority by the different countries in Latin America and the Caribbean. Many countries are undertaking significant efforts to generate the institutional frameworks and approaches required to address informality in MSEs and improve the quality of work and life of people working in this segment of firms.

Costa Rica is no exception. Different studies have indicated that this country has established policy approaches that have allowed it to reduce informality to a level below that of many other countries in the region. Its policy approach involves strategies to improve the competitiveness of small and microenterprises, incentivize formalization, reduce the costs of formality, inform entrepreneurs of the different administrative procedures involved and help them meet their obligations. This focus note describes the laws, policies and programmes that have had the biggest impact on formalization, along with the challenges that remain.

2. Recent trends in informality in Costa Rica

According to data from the Ministry of Economy, Industry and Trade (*Ministerio de Economía, Industria y Comercio, MEIC*)¹ in the year 2012, micro, small and medium-sized enterprises (MSMEs)² accounted for 95% of businesses in Costa Rica, 46% of total employment, and 30% of Gross Domestic Product. That same year, 70% of Costa Rican firms were classified as microenterprises.

Detailed information on the characteristics and trends in informality in Costa Rica are unavailable, but several studies taken together provide insight into the level of informality in the overall economy, and in the micro and small enterprise sector.

According to the ILO,³ in 2012, 66.5% of urban wage earners in firms with up to five employees were covered by health and/or pension provisions, substantially more than the weighted average for Latin American countries. Over the past decade, however, figures have improved less. In 2000, 65.4% of urban wage earners in firms with up to five employees were covered by health and/or pension provisions.

A FUNDES study found that in the Metropolitan Area of San José, where almost 50% of the country's small and microenterprises are located, 78% of these entities were not operating formally. According to Ramírez (2010),⁴ the main reason for remaining informal was the high cost both in terms of time and money involved in formalization.

The first National Report on Micro, Small and Medium-sized Enterprises (*Primer Diagnóstico Nacional de MIPYMEs, 2008*)⁵ found that around 60% of the total number of enterprises included in public registries were actually "semi-formal", as they did not meet some of their obligations related to social contributions, labour or tax obligations. Formality was lower in Limón (17.49%) and higher in San José (47.26%).

The ILO Regional Office for Latin America and the Caribbean would like to thank Lucía Alfaro, Ileana Ávalos and Hugo Chavarría, who prepared the document that formed the basis for this Focus Note, and Linda Deelen, for her technical coordination.

1 Based on the Inventory of Institutional Units and Establishments of the National Office for Statistics and Census (*Directorio de Unidades Institucionales y Establecimientos, Instituto Nacional de Estadística y Censos*)

2 The classification is based on the number of employees as defined in Ministry of Economy, Industry and Trade, *Estado de Situación de las PYMEs en Costa Rica, 2013*. A microenterprise has fewer than 15 employees, a small enterprise 15-30, and a medium-sized enterprise 30-100 employees. This classification reflects official definitions, Executive Decree 37,121, Law 8,262.

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

4 Ramírez, *La informalidad y semiformalidad empresarial en Costa Rica: un acercamiento desde la mirada de personas expertas*. Observatorio de PYMES series. San Jose: UNED, 2010.

5 UNED, *Hacia el estado de las MIPYMEs: Primer diagnóstico nacional de MIPYMEs*. Observatorio de MIPYMEs series. San José: UNED, 2008.

Earlier ILO data from the year 2000⁶ show that in that year 45.6% of micro and small enterprises failed on one or more of their obligations in order to be considered formal enterprises.⁷ Amongst these informal or semi-formal enterprises 7.3% did not meet initial registration requirements, 18% did not pay income tax, 76.6% did not pay occupational safety and health insurance and 76.3% did not contribute to social security.

3. Policies to formalize small and microenterprises

The next section presents the main policy initiatives in Costa Rica that supported the transition of micro and small enterprises to formality. Although none of these policies were specifically designed to formalize small and microenterprises, they included mechanisms and incentives favouring formalization. This set of policies helped the country to advance towards a situation in which small and microenterprises are informed, encouraged and capable to comply with administrative, labour and tax obligations.

Law 8,262 On Small and Medium Enterprise Promotion

In 2002, Costa Rica promulgated Law 8,262 on Small and Medium Enterprise Promotion (*Fortalecimiento de las Pequeñas y Medianas Empresas*). The main objective of this Law was to develop the small and medium enterprise sector as a means to favour economic development and job creation. When the operational regulations for the implementation of the Law took effect in 2012, several mechanisms were created that have facilitated formalization. Important initiatives in this regard were the creation of an MSME Registry in the Ministry of Economy, Industry and Trade, the creation of credit and guarantees schemes, technical assistance and business support programmes as well as mechanisms to improve the participation of small and microenterprises in public procurement.

Within the framework of Law 8,262 the Ministry of Economy, Industry and Trade, established a network of universities, technical and technological institutions mandated to develop educational and technical assistance programmes to improve the productivity and competitiveness of micro, small and medium enterprises. The law also created a small and medium enterprise (SME) advisory council (*Consejo Asesor Mixto de la Pequeña y Mediana Empresa*), led by the Ministry of Economy, Industry and Trade with the participation of a broad range of public and private sector entities, among them COMEX,⁸ MICIT,⁹ INA,¹⁰ PROCOMER,¹¹ CONARE,¹² Banco Popular, Unión de Cámaras¹³ and business representatives.

With the objective to facilitate access to credit to viable, job-creating MSMEs, Law 8,262 created a Special Fund for the Development of Micro, Small and Medium Enterprises (*Fondo Especial para el Desarrollo de las Micro, Pequeñas y Medianas Empresas, FODEMIPYME*), within the Banco Popular y de Desarrollo Comunal.¹⁴ The fund is capitalized through the 0.25% employers' contribution to the *Banco Popular y de Desarrollo Comunal*, extraordinary contributions from other state banks, and public and private donations.

One of the most innovative strategies included in Law 8,262 was the creation of the SME Support Programme (Programa de Apoyo a la Pequeña y Mediana Empresa, PROPYME) that

⁶ ILO, El sector informal de la economía: Características de la micro y pequeña empresa en Costa Rica. PRONAMYPE/MTSS, Proyecto PROMICRO. San José: ILO, 2001.

⁷ According to ILO (2001), formal enterprises have a municipal operating license and comply with social security contributions, tax regulations and labour standards.

⁸ Ministry of Trade

⁹ Ministry of Science and Technology

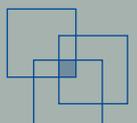
¹⁰ National Learning Institute

¹¹ Costa Rica's Export Promotion Agency

¹² National Commission of University Deans

¹³ Association of Chambers of Commerce

¹⁴ Costa Rica's worker-owned development bank



NOTES ON POLICIES FOR THE FORMALIZATION OF MICRO AND SMALL ENTERPRISES

co-finances SME's projects in the area of technology development and innovation. Its purpose is to finance projects that aim to improve SME's management capacities and competitiveness through technological development. Funding comes from the national budget and the Ministry of Finance. The programme provides grants that cover up to 80% of total project costs, according to the technical circulars issued by CONICIT.¹⁵

Law 8,262 also created mechanisms to increase MSME participation in public procurement, internal trade promotion programmes, sectorial training and technical assistance programs, as well as a business portal for SMEs, created within the framework of the Costa Rican Business Information System (*Sistema de Información Empresarial Costarricense, SIEC*).

Law 8,262 clearly defines the criteria to be met by MSMEs in order to benefit from the different services created: compliance with social security contributions, tax regulations and labour standards. In this sense, the Law does not only support business development but also business formalization.

One fundamental weakness in the implementation of the Small and Medium Enterprise Promotion Law has been the limited participation of microenterprises. Currently, the main beneficiaries are small and medium enterprises. The Law also doesn't support small agricultural producers, as it only covers the manufacturing, trade, service and agro-business sectors. It is equally important to improve the dissemination of the different aspects of the Law, as promotion only really began in 2010, with the launch of the Costa Rica Entrepreneurship Programme (*Costa Rica Emprende*).

The Costa Rica Development Banking System

One of the key policies that has helped small enterprises to start and improve their businesses is Costa Rica's Development Banking System (*Sistema Banca para el Desarrollo, DBS*), created under Law 8,634. Operational since 2008, the purpose of this scheme is to finance technically and financially viable productive activities in accordance with the country's development model. The Law establishes certain priorities, among them, women, ethnic minorities, the disabled, young entrepreneurs, development associations, cooperatives, and enterprises located in underdeveloped regions, along with projects that promote clean production.

The entities that take part in the system are the Office of the Superintendent of Financial Institutions (*Superintendencia General de Entidades Financieras, SUGEF*), all public financial and non-financial service providers, the National Cooperative Development Institute (*Instituto Nacional de Fomento Cooperativo, INFOCOOP*), as well as other public entities that channel funds to productive investments, with the exception of the housing mortgage bank (*Banco Hipotecarios de la Vivienda*).

The system was created in 2008 and currently has three sources of funding: i) the National Trust Fund for Development (*Fideicomiso Nacional para el Desarrollo*), whose funds come from the public budget and other trust funds; ii) the Credit Fund for Development (*Fondo de Crédito para el Desarrollo*), financed through 17% of private bank deposits; and iii) the Development Finance Fund (*Fondo de Financiamiento para el Desarrollo*), financed through 5% of net annual profits generated by state banks, which are administrated by each bank. This way, the Development Banking System manages its own equity.

The Development Banking System offers services to micro, small and medium enterprises that range from loans to implement certain projects, guarantees and collaterals as well as technical assistance in the elaboration of business plans and investment projects. The ceiling for any of its products is CRC 65 million per client.

The financial service providers that form part of the system can be categorized in two groups. One group includes formal financial institutions, such as the *Banco de Costa Rica, Bancrédito, Banco Popular and Banco Nacional*. The other group includes non-financial institutions such

¹⁵ National Council for Scientific and Technological Research (*Consejo Nacional para Investigaciones Científicas y Tecnológicas*).

as the National Rice Corporation (*Corporación Arrocera Nacional*), the Centre for Cooperative Studies and Training (*Centro de Estudios y Capacitación Cooperativa*), the University of Costa Rica's Research Foundation (*Fundación de la Universidad de Costa Rica para la Investigación*), the Foundation for Academic Development (*Fundación para el Desarrollo Académico*), the Costa Rica Foundation for Technology (*Fundación Tecnológica de Costa Rica*), the Costa Rican Association of Development Organizations (*Asociación Costarricense para Organizaciones de Desarrollo*), the Sustainable Development Foundation (*Fundación para el Desarrollo Sustentable*), the Costa Rica Chamber of Industries (*Cámara de Industrias de Costa Rica*), the Strategic and Business Consultancy Group (*Consultora de Estrategia y Negocios*) and Parquetec. Under Law 8,634, all financial operators must periodically evaluate their operations and reinforce weaknesses in their service provision.

The beneficiaries of the Development Banking System do not necessarily have to have legal personality as they may also be sole proprietorships operating under the name of their owners. Business entities that are not formally registered can still become clients. From the moment they enter the system, however, they are given a deadline by which they have to comply with business regulations. This way the system incentivizes gradual formalization.

According to Costa Rica's Central Bank,¹⁶ the Development Banking System has improved small enterprises' access to finance. Between 2008 and 2011, the number of new clients increased by 27%, while the number of operations augmented by 50%. Costa Rica's state banks contributed most to this expansion as they were responsible for 93% of the total number of new clients served by the system.

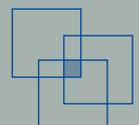
Although the Development Banking System has had a positive impact on access to finance in the country, there is also significant scope for improvement. Some pending tasks relate to reducing red tape, incorporating entities that represent the different productive sectors, improved mechanisms for allocating resources, and the reinforcement of guarantees.

National Policy For SME Development And Entrepreneurship

Costa Rica's 2010-2014 National Development Plan (*Plan Nacional de Desarrollo 2010-2014 María Teresa Obregón Zamora*), recognizes the crucial role of micro, small and medium enterprises in regional and national development. Given the sector's economic importance, the Government in 2010 launched its National Policy for SME Development and Entrepreneurship (*Política Pública de Fomento a la PYME y al Emprendedurismo 2010-2014*). The main purpose of this policy is to enhance the competitiveness of micro, small and medium enterprises through regional strategies that improve their productivity and support these entities in taking advantage of business opportunities both in local, national and international markets. In 2010 the Government assigned the task of promoting SMEs and entrepreneurship to the Ministry of Economy, Industry and Trade, defining eight strategic areas (encouraging legal compliance, entrepreneurship, association building, market access, access to finance, business development services, regionalization, technological development and innovation).

The National Policy for SME Development and Entrepreneurship envisages the registration of micro, small and medium enterprises in the Costa Rican Business Information System (*Sistema de Información Empresarial Costarricense*), administered by the Ministry of Economy, Industry and Trade. It also provides for certain tax incentives as described later in this focus note. By 2012, over 10,000 micro, small and medium-sized enterprises had registered with SIEC in order to be eligible for fiscal and other benefits.

As part of the same policy, in December 2010 the Ministry of Economy, Industry and Trade launched its national entrepreneurship policy "*Costa Rica Emprende*", proposing the creation of a set of solid support instruments as well as improved coordination between public and



¹⁶ Central Bank of Costa Rica, Acceso de las MIPYMEs a los servicios financieros a partir de la implementación de la ley 8634 del Sistema de Banca de Desarrollo, 2013.

NOTES ON POLICIES FOR THE FORMALIZATION OF MICRO AND SMALL ENTERPRISES

private efforts in this area. Executive Decree No. 36,343 passed in 2011, which establishes the operational regulations of *Costa Rica Emprende*, creates a National Entrepreneurship Council (*Consejo Nacional de Emprendimiento*) as well as a National Network of Business Incubators (*Red Nacional de Incubadoras y Aceleradoras*).

Within the framework of the National Policy for SME Development and Entrepreneurship, the Government of Costa Rica promotes the development of new financial products tailored to SME needs. Commercial banks are incentivized to expand SME finance, either through existing financial instruments or by designing new instruments, such as seed capital, venture capital and factoring.

Complementary to these initiatives, the National Technical Assistance Program (*Programa Nacional de Asistencia Técnica*) provides personalized assistance to SMEs in different areas, and offers information about the different kind of training opportunities that exist in the country.

Costa Rica also promotes a better integration of SMEs in the different value chains, through its National Association Building Program (*Programa Nacional de Fomento de la Asociatividad*). This programme seeks to strengthen SME's ability to work together and to become reliable suppliers to bigger companies. At the same time a strategy on regionalization has implied the subdivision of the country into smaller areas with common characteristics for the purpose of enterprise development policy implementation, which enables better planning and evaluation on the basis of specific indicators.

Through an agreement between the Ministry of Economy, Industry and Trade and the Ministry of Education, and using the ILO's Know About Business tool (*Conozca de Empresa*), the country intends to promote an entrepreneurial culture in vocational schools, training almost 300 teachers countrywide. By the end of 2014, more than 20,000 students are expected to have participated in the process.

In terms of export promotion, the government intends to make the most of its existing foreign trade platform, reinforcing and diversifying existing businesses and encouraging new export-oriented enterprises. This has required the strengthening of the national suppliers development programme (*Costa Rica Provee*) within Costa Rica's national export promotion agency, in order to encourage new initiatives that can respond to the needs of foreign investors, local and international value chains.

Thanks to the elaboration of a document that identifies the different institutions providing assistance to entrepreneurs (*Mapa Institucional de Atención a Emprendedores*), it has become easier for enterprise promotion agencies to identify not only their beneficiaries but also other public institutions, international cooperation agencies and donors operating in this area. This has facilitated the creation of national and international cooperation networks working together to achieve their strategic goals.

Notwithstanding the enormous achievements of the Government in implementing its policy for SME development and entrepreneurship, certain challenges have emerged that relate, for instance, to the limited support received by microenterprises and small agricultural producers. At the same time increased efforts are required in the development of indicators and data collection methods that would allow the Ministry of Economy, Industry and Trade to properly monitor and evaluate its efforts in implementing its policies.

Protecting Citizens from Excessive Red Tape

Law 8,220 on protecting citizens from excessive red tape (*Protección al Ciudadano del Exceso de Requisitos y Trámites Administrativos, 2002*), its amendments (2011) and operational regulations (2012) establish the obligation of public entities to provide citizens with the relevant information on their procedures, requirements and processes, in order to facilitate compliance.

The goal of this Law is to protect citizens from administrative inefficiency and corruption, encourage coordination among public entities, foster the efficient use of state resources and, in

general, provide citizens with legal certainty. The Law protects citizens from excessive bureaucracy and red tape, recognizing the right of the administered party to information and fair treatment.

Under the law, public agencies cannot require applicants to resubmit information already provided, whether for the same or additional procedures. Moreover, regardless of its normative origin, any legal procedure or obligation required of a business owner must be based on either on law, executive decree or regulation, and be published in the Official Gazette, along with the procedure to be followed. The law also promotes inter-agency coordination, establishing that any public agency requiring information issued or held by another public agency cannot request it from the person, but rather must coordinate with the other public agency.

In line with the above, business owners are assigned a code which enables the different administrative entities to access and monitor their files, in order to complete the administrative processes within the legally defined period. If this does not occur, the principle of positive administrative silence is applied and the user can even sue the public administrative entity, the public official and her or his superior, for noncompliance.

Law 8,220 is applicable to the entire public administration, whether central or decentralized, including autonomous and semi-autonomous bodies with legal personality, non-state public bodies, municipalities and public enterprises. To promote compliance, the Ministry of Economy, Industry and Trade and the national planning ministry (MIDEPLAN) have organized a series of awareness-raising and training programmes in public agencies, and have reinforced the comptroller functions within these institutions.

Whereas implementation is not yet completed and institutions have advanced at different speeds, both central and decentralized bodies have advanced in the simplification and streamlining of their procedures. In the area of construction permits, for instance, all municipalities have committed to digitalizing their procedures no later than 2014, and more than 30 municipalities have joined a proposal to simplify building regulations as per Law 8,220.

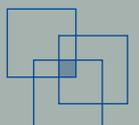
Although the impact of the excessive red tape law on enterprise formalization has not been measured, streamlined procedures reduce not only the costs of initial business registration, but also the cost of staying in the formal economy. The time and resources that firms dedicate to meeting the different administrative requirements are among the most significant barriers to formalization.

Propyme Fund

Created in 2002, the SME Support Fund (*Programa de Apoyo a la Pequeña y Mediana Empresa, PROPYME*) provides co-financing to SME's projects in the area of technology development and innovation. Support for SMEs takes the form of grants allocated by the Incentives Commission (*Comisión de Incentivos*) of the Ministry of Science and Technology (MICIT). Initially the programme was conceived as a competitive grant programme, which later turned into the PROPYME SME Support Fund, with its own specific set of operating rules.

The importance of PROPYME lies not only in the financial support it provides to small and medium enterprises. The fund also encourages the formalization of these businesses since, to be eligible, they must be registered with the MEIC and be up to date in their contributions to the national social security system (*Caja Costarricense de Seguro Social, CCSS*) and the Family Welfare Fund (*Fondo de Desarrollo Social y Asignaciones Familiares, FODESAF*). This creates significant incentives for businesses to formalize their operations, register their company with the MEIC and obtain the MSME certificate.

In order to apply for a grant from the PROPYME SME Support Fund, companies first of all have to develop a project idea, identify in CONICIT's scientific and technical registry (*Registro Científico Tecnológico*) the unit that would technically support the design and implementation of the project, and then complete the on-line forms to present the project. Upon reception of the proposal the Ministry of Science and Technology (*Ministerio de Ciencia y Tecnología, MICIT*) prepares an initial



NOTES ON POLICIES FOR THE FORMALIZATION OF MICRO AND SMALL ENTERPRISES

evaluation that it forwards to the technical secretariat of the incentives commission (*Secretaría Técnica de la Comisión de Incentivos*). Selected proposals then go on to CONICIT, which issues a technical report, recommending whether or not the proposal should be approved. Based on the technical report from CONICIT and the initial evaluation provided by the Directorate for Innovation (*Dirección de Innovación*) of the Ministry of Science and Technology, the Incentives Commission then makes a final decision.

Once approval from the Incentives Commission is received, the interested party must complete certain formalities with CONICIT and MICIT. The Ministry annually disburses some CRC 500 million for technological development and innovation projects. Funding can cover up to 60% of total project costs, which means that the SME must contribute at least the remaining 40%, either in cash or in kind.

A significant percentage of the companies benefitting from PROPYME funding are microenterprises. Although the abovementioned evaluation procedures focus on aspects related to technological development and innovation, areas in which microenterprises are generally weak, the fund helps many small companies to fund the early phases of projects, for which it is often difficult to obtain bank credit. By supporting microbusinesses in this area, Costa Rica is fostering a shift away from the logic of subsistence and towards innovation and accumulation, thereby encouraging formalization.

National Network of Business Incubators and Accelerators

The National Network of Business Incubators and Accelerators (*Red Nacional de Incubadoras y Aceleradoras, RNIA*) was conceived as a platform to support entrepreneurs in strengthening their businesses, along with creating and encouraging opportunities for new business creation. The network provides advice, support and tools to business owners seeking to create the necessary conditions to start, develop and consolidate their business activities. To join the network, companies must be registered with the Business Information System (*Sistema de Información Empresarial Costarricense*).

The mandate of the incubators is to create new companies by providing the necessary support during their early stages and ensuring they have the necessary infrastructure and legal documents to carry out their productive and commercial activities. Accelerators, on their turn, support existing companies with potential to innovate, so they can access international markets or expand into a larger share of the domestic market.

In 2012, network members included ParqueTec, Parque LA Libertad Costa Rica, the Costa Rican Chamber of Commerce (*Cámara de Comercio de Costa Rica*), CIE-TEC (*Centro de Incubación de Empresas*), UNA INCUBA, GS1 Costa Rica, Auge, the University of Costa Rica Research Foundation, and Caro Ventures. The network is expected to grow stronger as new academic, government and private sector incubators and accelerators, currently in development, join and bring with them their areas of specialization.

Like the PROPYME Fund, this network has become an important incentive for small and microenterprises to formalize. The incubators and accelerators use clear eligibility criteria for the different types of potential clients and only accept businesses that have fully formalized their operations.

The operational regulations of the National Network of Business Incubators and Accelerators also contribute to streamlining procedures, as it is established that incubators cannot ask MSMEs for documents already presented to the Ministry of Economy, Industry and Trade. Similarly, the incubators have a maximum of 15 working days to analyse proposals and notify interested parties. Performance reviews of incubators and accelerators include questions regarding the number of jobs created, together with audited financial statements, and documentation of success cases.

Tax exemptions for registered small and microenterprises

Law 9,024 (2012) establishes an annual tax equivalent to 50% of a monthly minimum wage to be paid by all corporations and limited liability companies. The same Law exempts small and microenterprises from paying this tax, provided they are registered with the Ministry of Economy, Industry and Trade and with the internal revenue service (*Dirección General de Tributación*).

Law 9,024 reinforces formalization, since the Business Information System of the Ministry of Economy, Industry and Trade (*Sistema de Información Empresarial Costarricense*) does not issue MSE certificates to companies that are behind on their tax or social security payments. Non-payment of this tax for three consecutive periods is grounds for dissolving the firm. The Business Information System maintains a publicly available, electronic data base which allows the public to see whether taxpayers are up to date with their obligations.

Several challenges, however, remain in fully realizing the potential of Law 9,024 as an incentive to the formalization of small and microenterprises. These challenges relate to the need to better disseminate information on the provisions of the Law and ensure that the Ministry of Economy, Industry and Trade has sufficient capacity to administer the Business Information System.

Preferential income tax rates

Law 7,092 (1988) establishes preferential profit tax rates, of either 10% or 20% of gross revenue, for small companies that register revenues up to certain ceilings that vary from year to year, compared to 30% for larger firms.

The same Law also establishes suitable mechanisms for small and microenterprises experiencing losses. Companies that register losses during a certain fiscal period, can deduct these amounts from taxable income over the three following periods (five in the case of agricultural firms). Cooperatives that have been legally constituted in accordance with Law 6,756, and business organizations that bring together small and medium producers of agricultural goods and services are exempt from this tax.

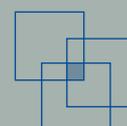
Along with the Law on Corporations, Law 9,024 and Law 7,092 have consolidated a regulatory environment that assuages business owners' fears that the formalization of their business may lead to a heavy tax burden. At the same time, the regulatory framework encourages formalization, as business registration is necessary in order to be eligible for the exemptions provided for in Law 9,024.

Like any preferential tax regime, Costa Rica's scheme involves a risk of "fiscal dwarfism". At the one hand the regime facilitates the formalization of small and microenterprises, substantially reducing their costs of compliance. Exemptions and preferential rates, however, may encourage companies to remain small, either on paper or in reality.

Support for MSME to formalize

In Costa Rica a wide range of services exist that provide business owners with information on formalization procedures and on the different support programmes offered by public and private entities. These services respond to an enormous need identified by several studies, which revealed the importance of business owners knowing about and genuinely understanding procedures involved in formalization.

The website PYME.go.cr is a joint project of the Ministry of Economy, Industry and Trade, and the National Training Institute (*Instituto Nacional de Aprendizaje*), that benefits from the support of the institutions that form part of the SME Support Network (*Red de Apoyo PYME*). The website facilitates access to programmes, services and tools that can help entrepreneurs that start and improve their business. It also provides the information that business owners need in order to meet their administrative, labour and tax obligations. The website provides information on the steps to



NOTES ON POLICIES FOR THE FORMALIZATION OF MICRO AND SMALL ENTERPRISES

register a business, obtain an SME certificate, get the necessary sanitary permits and register with the national social security scheme (*Caja Costarricense de Seguridad Social*) and the internal revenue service.

The website costarica.eregulations.org provides details on the procedures involved in formalizing a company according to the different legal formats recognized in the country. This website also provides information on how to register as a supplier to the public sector, importer or exporter.

CREAPYME is a network of specialized business service centres supporting the development of MSMEs, offering information and advisory services, business linkages and support with certain administrative procedures. CREAPYME has branches in the Central, Brunca, Chorotega, Huetar Atlantic, North and Central Pacific regions, with some 25 service points for business owners. Aside from supporting entrepreneurs as they go through formalization procedures, these centres provide information on access to finance, markets, exporting, importing, production-related associations, along with technological, innovation and business development services.

4. Conclusions

Costa Rica has developed a set of policies and approaches that encourage the formalization of small and microenterprises as well as the formalization of employment in this segment of firms. While many of the policies described in this chapter do not define formalization as their central objective, encouraging formalization has always been an integral part of their design features.

Costa Rica's Government recognizes small and microenterprises as a fundamental pillar of economic development and has generated a range of financial and non-financial services to support this segment of firms. The establishment of the "Costa Rica Emprende" programme has been a milestone in ensuring that the necessary resources for the promotion of small enterprise growth and formalization are available.

Costa Rica has established a series of incentives to formalization in both the fiscal and production spheres. The National Business Information System (*Sistema de Información Empresarial Costarricense*) organizes these incentives, since only companies registered as MSMEs are eligible for exemptions, lines of credit and business development services. In order to have real access to these different programmes, companies must be up to date with their labour and tax obligations. Although little used during its initial phase, over the long haul this system should promote a culture of formalization and compliance with the law.

The virtues of this integrated model are reflected in the figures. According to the ILO,¹⁷ in 2012, 66.5% of urban wage workers in establishments with up to five employees were covered by health and/or pension programmes, well above the weighted average of 48.4% for Latin America and the Caribbean.

As is the case in other countries in the region, challenges remain. In terms of fostering productivity and competitiveness, there is a perception that microentrepreneurs who most need support in innovation and market access, are generally not the main users of public programmes. One exception is the microenterprise support programme (*Programa de Apoyo a la Microempresa, PRONAMYPE*) of the Ministry of Labour and Social Security. This programme, the national entrepreneurship policy formulated and implemented by the Ministry of the Economy, Industry and Trade and the network of business incubators, are all valuable efforts to ensure that microenterprises achieve the necessary capacities to meet their administrative, fiscal and labour obligations.

Law 8,220, which protects citizens from excessive red tape, was a significant step forward in reducing the administrative burden related to the formalization of small and microenterprises.

¹⁷ ILO, Labour Overview 2013 Latin America and the Caribbean. Lima: ILO, 2013.

Similarly, the Costa Rican public administration has made great progress in providing information, digital support and advice on how to complete business procedures. The country, however, still ranks rather low on the World Bank's index measuring the ease of business creation (102). One important bottleneck is the process for obtaining a municipal operating license. There are major differences in the protocols from one municipality to another, and the perception that the process is complicated and expensive persists among entrepreneurs.

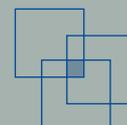
Another procedure that tends to discourage the formalization of small and microenterprises is obtaining the sanitary permit required of all companies, regardless of sector or size. An important step forward was the establishment of a one-month time limit, defined by law, for the health authorities' response to applications, after which the procedure receives tacit approval. The decree issued by the Ministry of Health establishing tariffs for sanitary registration and operation is presently under review, to ensure that this provision does not discourage the formalization of small firms.

Several studies have shown that the greatest fear among business owners with regard to formalization is becoming unable to comply with their social obligations as employers. In Costa Rica, social contributions add up to 34% of pay-roll, composed of a 25% employers' contribution and a 9% employees' contributions.¹⁸ Low revenues, particularly in microenterprises, have led a situation where many business owners opt to remain informal or semi-formal, saving scarce resources at the expense of job quality and labour rights. The Government of Costa Rica doesn't provide any subsidies on the social contributions to be made by small enterprises.

It is important to mention that since 2001, the declaration and payment of social security contributions has been simplified, through a centralized system (*Sistema Centralizado de Recaudación, SICERE*) that allows employers to pay their social security contributions on-line. Procedures to obtain occupational health and safety insurance, however, require a separate procedure administered by the National Insurance Institute (*Instituto Nacional de Seguros*).

Business associations' crucial role in promoting formalization should be highlighted. While not all business associations require their members to formalize their businesses, the Costa Rica Chamber of Industries (*Cámara de Industrias*) does. In general terms, the private sector has the challenge to encourage small and microenterprises to formalize. It is vital to move toward greater synergies between the different private and public efforts in this area, thereby increasing the impact of the different programs, and making more efficient use of existing capacities and resources.

¹⁸ These contributions include insurance for disability, old age and death, maternity and health insurance, family allowances, payments to the Banco Popular, contributions to the social assistance institute (Instituto Mixto de Ayuda Social), the vocational training fund (Fondo de Capacitación Laboral), the complementary pension fund (Fondo de Pensiones Complementarias) and the national insurance institute (Instituto Nacional de Seguros).

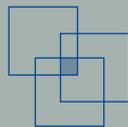




International
Labour
Organization

FORLAC

PROGRAMME FOR THE PROMOTION OF FORMALIZATION
IN LATIN AMERICA AND THE CARIBBEAN



**NOTES ON POLICIES FOR THE FORMALIZATION
OF MICRO AND SMALL ENTERPRISES**

Regional Office for Latin America and the Caribbean