Cost of Size-dependent Regulations:
The Role of Informality and Firm Heterogeneity

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Abstract

We study the effects of size-dependent regulations in a dynamic model where heterogeneous firms spend resources to grow by improving their productivity and can rely on informality in the labor market. We use the model to study firms in Turkey, where labor market regulations make the operation more costly for firms with over 50 employees. We find that firms rely more on informality to avoid the burden of the size-dependent regulations: the overall share of informality would be lower by 5.9% in the absence of the regulation. Additionally, size-dependent policies takes a higher toll on firms with high growth potential. In a counterfactual economy with no distortion, the share of those firms would increase by 2.5% and the share of firms with over 50 employees would increase by 78%. Finally, under no regulation, economic growth and welfare would increase by 1.9% and 0.6% respectively.

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