



International
Labour
Office
Geneva

The Regulatory Framework and the Informal Economy

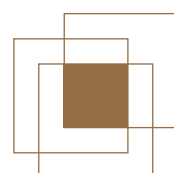


Small workshop making hookahs, Cairo Egypt.

Specific Groups

4.b4 **MICRO AND SMALL ENTERPRISES (MSES), INFORMALITY AND LABOUR LAW: REDUCING GAPS IN PROTECTION**

■ Micro and small enterprises are a strong force for job creation around the world, nonetheless they tend to be in the informal economy for a variety of reasons. Innovative measures need to be put in place to ensure better compliance and regulation. This can not only improve working conditions within MSEs but also result in more efficient business practices and higher productivity. This brief should be read in conjunction with the brief on 'Informal Enterprises: policy supports for encouraging formalization and upgrading'.



KEY CHALLENGES

- **Enterprises and informality**
- **MSE's and the law**
- **Problems related to non-compliance**
- **A multifaceted problem**

■ **Enterprises and informality.** Micro and small enterprises (MSEs) are increasingly responsible for job creation across the globe. They therefore constitute a dynamic asset for development and economic growth.¹ At the same time however, much of this growth takes place in the informal economy. The sheer numbers of economic units involved and the limited capacities of states contribute to the problems of weak compliance and enforcement of labour laws where they exist for MSEs. Labour conditions – or job quality – are, in general, quite unsatisfactory in this sector.²

■ **MSEs and the law.** The ILO's international labour standards (ILS) generally do not contain exceptions or special standards for MSEs so when relevant, they apply to MSEs (see brief on International Labour Standards). The preamble of the *Job creation in Small and Medium-Sized Enterprises Recommendation, 1998 (No. 189)* for example, mentions as particularly relevant ILS concerning freedom of association, forced labour, child labour, discrimination in employment, employment policy, co-operatives, human resources, occupational safety and health. This Recommendation covers "all branches of economic activity and all types of small and medium-sized enterprises, irrespective of the form of ownership (for example, private and public companies, cooperatives, partnerships, family enterprises, and sole proprietorships)" (Para.4). It clearly states that Members should ensure the non-discriminatory application of labour legislation.

The ILS that do contain specific exceptions concern termination of employment, workers' representatives, occupational health and safety, paid educational leave, social security and employment and the rural sector. Some ILS, such as the *Termination of Employment Convention, 1982 (No. 158)* specifically provide that exclusions may be made, after consultation, with regards to "limited categories of employed persons in respect of which special problems of a substantial nature arise in the light of the particular conditions of employment of the workers concerned or the size or nature of the undertaking that employs them".³ *The Minimum Age Convention, 1973 (No. 138)*, for example, authorises the exclusion of family and small-scale holdings producing for local consumption and not regularly employing hired workers (Article 5, Paragraph 3). Similarly, the Convention concerning *Minimum Standards of Social Security, 1952 (No. 102)* provides developing countries with the possibility of excluding, on a temporary basis, MSEs of less than 20 workers (Article 3). Many of the Conventions allowing for exclusions concern family enterprises, however, and are no longer considered up-to-date.

1 For more details see *Job Creation in Small and Medium-Sized Enterprises Recommendation, 1998, No. 189, Preamble.*

2 Reinecke and White, 2004, pp.32-38.

3 Von Potobsky, 1992, pp.605-107. See as well, Faundez, 2009.

What are MSEs?

There is no single definition of micro, small and medium enterprises. A number of criteria can be applied to define micro and small enterprises (MSEs) and small and medium enterprises (SMEs). The most common criterion is the size of the workforce, but the value of fixed assets and of turnover are also used⁴.

A large proportion of informal economic activity around the world takes place within MSEs. This is partly because MSEs more often than not operate in a state of semi-formality. MSEs may be informal not only because they do not comply, whether in part or in full, with the law, but also because the law does not apply, in part or in full, to them, for example. Similarly, workers within MSEs may be informal, even when they are working within a formal MSE, because of the precarious nature or the type of their employment relationship (see brief on the employment relationship in this Policy Resource Guide). Many of the choices specific to the particular nature of MSEs, especially with regard to acquiring labour, as well as broader financial constraints and crisis-induced market shifts, mean that MSEs often offer widespread punctual or short-term employment opportunities, however.⁵ As a result, MSEs have been at the centre of the many debates surrounding the desirability of labour regulation (see briefs on Key Conceptual issues; labour regulation; and on informal enterprises).

4 ILO, 2004, Paras.322-324

5 Fenwick, Howe, Marshall and Landeau, 2007, p.20.

At the level of domestic law, States generally adopt one of four different approaches regarding the extension of labour law to MSEs:⁶

- Some states formally include MSEs within the coverage of all labour laws;
- Some states exclude completely MSEs below a certain threshold (often less than 5 or 10 employees);⁷
- Some states establish a parallel labour law regime (this is a tendency that has been particularly noted in Latin America);⁸
- Some states exclude MSEs from a range of particular requirements of the law.

The latter option is the most common and typically concerns, for example, occupational health and safety (lower standards apply), collective dismissals, the right to enterprise-level trade union representation (a minimum number of workers is often necessary to form an organisation), mandatory social security contributions and employee consultation mechanisms. The reasons behind excluding MSEs could be, for example the desire not to impose excessive costs on MSEs, the very nature of MSEs which would not benefit from certain forms of regulation geared towards larger enterprises (such as regulation concerning consultation), and the fact that it would be impossible for a state to ensure the application in practice of all regulations to MSEs.⁹

● Although partially excluding MSEs from labour legislation may seem to be the only viable solution, it should be noted that MSEs can fall into “growth traps” as a result

Although partially excluding MSEs from labour legislation may seem to be the only viable solution, it should be noted that MSEs can fall into “growth traps” as a result, insofar as this limited enforcement of labour regulations means that they do not have any incentive to grow beyond an established “threshold”.¹⁰ Doing so would force them to deal with labour regulation, and cases have been noted where MSEs stop hiring altogether or start hiring undeclared workers in order to avoid this, for example.¹¹ Alternatively, MSEs that find themselves going above the threshold established by the law may split into two or more enterprises, defeating the purpose of the legislation. Exemptions from labour provisions may be necessary in some domains, but some are clearly not acceptable; others may be acceptable only if they are temporary.

● The highest levels of non compliance with labour law are found in MSEs

■ **Problems related to non-compliance.** At the same time, however, it must be emphasised that when the law does apply formally to MSEs, compliance is often deficient. Indeed, the highest levels of non compliance with labour law and, more generally, human rights law, are found in MSEs (e.g. child labour or forced labour). Non-compliance concerns on the one hand, formalities, such as having to obtain a permit to establish the enterprise and having to declare workers to the social security administration, and on the other, violations of minimum wage laws, non-observance of safety regulations, and failure to make social security contributions.¹² Indeed, compliance with labour law is often seen as a cost, both in terms of the time it takes to understand the applicable legislation and to adhere to it,¹³ as well as the

6 Fenwick, Howe, Marshall and Landau, 2007, p.9.

7 According to Daza, only 10% of the 178 member States of the ILO at the time completely excluded MSEs from their labour codes (Daza, 2005, p.23). The ILO’s Committee of Experts on the application of Conventions and Recommendations has noted, for example, that the Factories Act, 1948, of India, and the Factories Act, 1987, of Nigeria, are applicable only to enterprises with at least ten employees while the Factories and Works Act, 1996, of Zimbabwe is applicable to enterprises with at least five employees (ILO, 2006, Para. 23).

8 Chacaltana, 2009, p.2.

9 Fenwick, Howe, Marshall and Landau, 2007, pp.21-22.

10 Snodgrass and Biggs, 1996, p.203.

11 Reinecke and White, p.98 and Fenwick, Howe, Marshall and Landau, 2007, pp.35-36.

12 Daza, 2005, p. 40

13 IOE, 2008, p.15.

direct costs associated with minimum wage, severance pay, maternity leave, health and safety, holidays, etc. But these are not the only reasons for non-compliance with labour legislation. Other reasons include, for example:

- Inspection – if applicable – is difficult in this sector because of practical reasons: the high number of enterprises and their geographical dispersion;
- The legislation may be difficult to apply or even not formally applicable (freedom of association);
- Entrepreneurs may not be well informed of the content of the law;
- Entrepreneurs may in many cases, make a strategic decision as to the benefits and costs of complying with the law;¹⁴
- There might exist an unfavourable legal climate and distrust of the law and of public authority;¹⁵
- States might overlook or ignore enforcement.¹⁶

■ **A multifaceted problem.** There are a number of general challenges – such as those that apply to the employment relationship, for example – which can be associated with MSEs. There are also a number of more specific challenges, however. General measures geared at increasing compliance with the law are essential – and this could take the form of informing employers and workers of their respective obligations and rights, providing easy access to justice, etc. – but what is fundamentally needed with regards to MSEs is innovative labour regulation to apply and enforce labour law. This includes promoting trade unions, improving knowledge of legal requirements and of ways to comply with them, ensuring that workers who make a complaint to the authorities are protected and drawing on the various corporate social responsibility initiatives.¹⁷ At the same time, however, while MSEs hold great promise for economic growth and employment creation, the jobs created in MSEs are also often of very low quality.¹⁸ Improving compliance with labour legislation will only lead to better job quality if put in a wider context of measures aimed at upgrading MSEs, including for example facilitating their registration, improving their access to credit and to property, submitting them to fair taxation, giving them easy access to dispute settlement, giving them a voice, etc. Application of the law should be promoted but as long as such other conditions are not in place, these measures will likely not be completely successful.

● What is fundamentally needed with regard to MSEs is innovative labour regulation to apply and enforce labour law

● Encouraging compliance with labour legislation needs to be supported by measures aimed at upgrading MSEs, for example facilitating their registration, improving their access to credit and to property, submitting them to fair taxation, giving them easy access to dispute settlement among other factors

14 Reinecke and White, p.53.

15 Faundez, 2008, p.31.

16 Fenwick, Howe, Marshall and Landau, 2007, pp.37-38.

17 Fenwick, Howe, Marshall and Landau, 2007, p.46

18 *ibid*, p.15.



Hearing impaired entrepreneur in her workshop, Ethiopia.



Surgical instrument manufacturing workshop, Pakistan.

- **Guidance in international instruments**
- **Clarifying and simplifying the law**
- **Improving labour inspection**
- **Improving enforcement**
- **Promoting freedom of association**
- **Encouraging compliance**
- **Extending the scope of the law**
- **Organizing**
- **Technical advice instead of fines**
- **Facilitating registration of MSEs**

■ **Guidance in international instruments.** Several ways to promote MSEs and help their development and growth are suggested in the *Job creation in Small and Medium-Sized Enterprises Recommendation, 1998 (No. 189)* mentioned above: Members should adopt and pursue appropriate fiscal, monetary and employment policies, establish and apply appropriate legal provisions as regards, in particular, property rights, including intellectual property, location of establishments, enforcement of contracts, fair competition as well as adequate social and labour legislation, and improve the attractiveness of entrepreneurship.¹⁹ Several policies are suggested to promote efficient and competitive MSEs capable of providing productive and sustainable employment under adequate and equitable social conditions, amongst which, a policy that includes “specific measures and incentives aimed at assisting and upgrading the informal sector to become part of the organised sector” (Para.3.3). It is clear that the problem is multifaceted and certainly cannot be tackled by law alone.

● The law needs to be clear, easily understandable and accessible, with well defined terminology, rights and obligations.

■ **Clarifying and simplifying the law.** There is no doubt as well that the law needs to be clear, easily understandable and accessible, with well defined terminology, rights and obligations. Simplifying the content of the law by identifying unnecessary provisions and obligations which could be replaced by some involving less bureaucracy is also essential.²⁰ For example, this can be achieved through replacing the need for a formal authorisation to start an enterprise with just a declaration to that effect. A country that is often cited as needing reforms in regard to clarifying and simplifying the law is India, where, because each piece of legislation has been drafted independently of others, the labour legislation has proliferated and offers multiple definitions of the same basic terms, such as employer and employee, for example. As stated by the Indian National Commission for Enterprises in the Unorganized Sector, employers and workers of big or small enterprises find it difficult and costly to “find their way through the maze of labour legislation”.²¹ Several attempts have been made to clarify labour law. However, clarifying the form and simplifying the content of the law alone is clearly not enough and does not necessarily lead to increased compliance.

¹⁹ For more details see Resources section to access: Recommendation No. 189, Para.5.

²⁰ ILO, 1986, p.76.

²¹ National Commission for Enterprises in the Unorganized Sector, 2009, p. 174. This is also the case in Bangladesh; a consolidation took place in Nepal (see Sankaran, 2007, p.6).a

Some principles to guide the regulation of MSEs

States clearly face a many dilemmas when designing legislation for MSEs and are often torn between affording rights to workers and reducing the obligations of the employer. Improving the working conditions of workers in MSEs is an essential challenge however and States need to find innovative ways to regulate this field. The three following principles should guide States in this respect:²²

1. Labour regulation should pursue three inter-related and mutually reinforcing objectives: promoting human capabilities, improving job quality, and encouraging formalisation of MSEs.
2. Labour regulation should be underpinned by the basic values of the Decent Work agenda: it should recognise that all those who work have rights at work.
3. Labour regulation should be responsive: it should take into account the various options at hand to apply and enforce it (providing information, education and incentives to comply with regulations, monitoring compliance, giving warnings, imposing tailored sanctions and punitive sanctions); its design, enforcement, and review should be done through a participatory processes; its design and implementation should be targeted specifically at MSEs.

■ **Improving labour inspection.** If an MSE is exempted from the application of labour law, an inspector cannot demand that regulations be complied with, and the only recourse for workers is to turn to civil and criminal courts to redress wrongs. Another strategy is to enlarge the scope of the law in such a way as to allow labour inspection of MSEs. Inspectors can provide advice and promote best practices to non-compliant enterprises, and are as such a valuable tool to encourage compliance with the law.²³ However, this strategy cannot be taken alone as even when MSEs are subject to inspection, there are usually problems locating enterprises and their owner, identifying workers, as well as characterising the employment relationships²⁴ (see briefs on Labour inspection and on the Employment Relationship).

■ **Improving enforcement.** Having too strict regulations and too high penalties will not promote changes in behaviour. A more flexible approach which offers several options to enforce the law is needed. These options can include providing information, education and incentives to comply with regulations, monitoring compliance, giving warnings, imposing tailored sanctions and punitive sanctions.²⁵

■ **Promoting freedom of association.** Another well known aspect of MSEs are the very low unionisation levels. Again, this may be because MSEs are excluded from the law - in some countries, unionisation and collective bargaining are only possible in firms that are above a certain size, or else trade unions need to have a minimum number of members in order to be formally recognised) - or perhaps because they (and their workers) are not registered, are isolated and difficult to access, or because workers fear losing their jobs if they join a trade union, or else are not in stable jobs. Strong

● Inspectors can provide advice and promote best practices to non-compliant enterprises, and are as such a valuable tool to encourage compliance with the law

● Organization of MSEs and their workers is essential to find solutions to their specific problems

²² For more details see Resources section to access: Fenwick, Howe, Marshall and Landau, 2007, p.114.

²³ Schrank, p.41.

²⁴ Daza, 2005, p. 40.

²⁵ See Ayres and Braithwaite, 1992, pp.35-38 and Fenwick, Howe, Marshall and Landau, 2007, pp.105-109.

trade unions and good social dialogue are key elements to securing the best solutions to many of the problems that MSEs face, but information and the involvement of workers is key to ensuring this, as it is often lack of knowledge that protective legislation exists that leads workers to accepting the imposition of poor labour conditions.

● A flexible approach which offers several options to enforce the law including education, incentives for compliance, is needed

■ **Encouraging compliance.** Several avenues can be taken to increase labour law compliance in MSEs, such as:

- Ensuring that workers in MSEs have the same basic rights as other workers, and extending the scope of the law to include them;
- Taking steps to encourage the formalisation of MSEs (see brief on informal enterprises);
- Helping MSEs improve their ability to comply with legislation through education and financial incentives;
- Simplifying the law to make it easily understandable to entrepreneurs and workers;
- Providing advice to MSEs on cheaper ways to comply with the law (with regard to health and safety for example);
- Creating accessible complaint mechanism and improving enforcement mechanisms;
- Providing information to entrepreneurs and workers on their respective rights and obligations;
- Taking steps to promote freedom of association and collective bargaining in MSEs and ensuring that the legislation is enabling in this regard;
- Strengthening social dialogue at the national level.

At the country level there exist a number of examples of successful attempts to tackle the particularities of MSEs. It should be noted that solutions vary depending on whether MSEs are excluded from the law or not, and whether workers are informal within a formal or informal MSE, because they are undeclared or because of the employment relationship with their employer. It should be noted that some examples of initiatives described here have also been covered in the briefs dealing with the employment relationship and labour inspection.

■ **Extending the scope of the law.** In Thailand the social insurance scheme of 1990, which initially covered workers in enterprises with 20 or more employees only, has been progressively extended to cover all enterprises of one or more workers.²⁶

■ **Organising workers in MSEs trade unions' initiatives.** Organising is a key strategy to improve regulation in MSEs. In Kenya the Bakery, Confectionary, Manufacturing and Allied Workers' Union (BCMAU) has been at the forefront of campaigns to protect workers in MSEs, including informal ones. It has lobbied with the Government to reform the labour code and enforce it in the informal economy. It has also been involved in educating MSEs workers on their rights and building strategic alliances with NGOs.²⁷

²⁶ For more details see Resources section to access: Daza, 2005, Informal economy, undeclared work and labour administration, p.47.

²⁷ For more details see Resources section to access: Bekko and Muchai, 2002, pp. 26-27.

■ **Technical advice instead of fines.** Actions that build capacity are often more appropriate than sanctions and penalties. In the Philippines MSEs with less than five workers which are found to have breached labour regulations by a labour inspector are given technical advice and one year to comply with labour standards.²⁸

■ **Facilitating registration of MSEs.** Streamlining and simplifying procedures and reducing transaction costs can result in reducing barriers to move out of informality. In Colombia for example the legislation demands less paperwork for MSEs, provides more credit facilities, and implemented a softer taxation regime from regional authorities. Moreover, it has increased training schemes for MSEs.²⁹

In the Philippines, in MSEs with under five workers, labour inspectors provide technical advice instead of fines and give one year to ensure compliance with labour law where regulations have been breached

A number of countries have streamlined and simplified procedures and reduced transaction costs, in order to encourage registration

Simplified taxation- the case of Brazil

Brazil's Constitution authorises differential treatment regarding MSEs. It has facilitated formalisation of MSEs through the introduction of a simplified tax regime in 1996 (SIMPLES Law, Lei no 9.317 de 05/12/1996, relative to small entrepreneurship), which was supplemented by a Complementary Law no. 123/2006, entitled "General Law for Micro and Small Enterprises". This regime has encouraged MSEs to pay taxes. It consolidated several federal taxes into a flat tax, subdivided enterprises and established a progressive tax rate system with simplified administration procedures. Instead of paying 20% of the payroll bill in federal taxes and social security, firms, depending on their size, spend now between 1.80 and 7.56 % of their annual gross revenue. This has encouraged the formal hiring of employees as this has ceased to be a tax cost.

Source: Fan, Reis, Jarvis, Beath, and Frauscher, 2007. The Investment Climate in Brazil, India, and South Africa: A Comparison of Approaches for Sustaining Economic Growth in Emerging Economies pp.75-76 and 78 <http://wbi.worldbank.org/wbi/topic/governance>

Similarly many countries have adopted laws that require governments to simplify all administrative and other procedures to establish a business (for example, Australia, Austria, Canada, Chile, Estonia, Finland, Honduras, Lithuania, New Zealand, Spain and the United Kingdom).³⁰

28 For more details see Resources section to access: Fenwick, Howe, Marshall and Landau, 2007, p.41. Other examples are cited – drawing from other secondary sources.

29 For more details see Resources section to access: IOE, 2006, p.1.

30 See ILO, 2004, Para.375-377.



Aixin Handicraft Knitting Center of Hedong District. Beneficiary of ILO's SIYB (Start and Improve Your Business) project, China.

This section provides a list of resources which can enable the reader to delve deeper into the issue. Details of the good practices cited above can be accessed here. The section comprises international instruments, International Labour Conference conclusions, relevant publications and training tools. A bibliography of references in the text is further below. There may be some overlap between the two.

ILO and UN Instruments and ILC Conference conclusions

- Labour Inspection Convention, 1947 (No. 81)
- Labour inspection (Agriculture) Convention, 1969 (No. 129)
<http://www.ilo.org/ilolex/english/convdisp1.htm>
- Job Creation in Small and Medium-Sized Enterprises Recommendation, 1998, (No. 189)
- Labour Inspection Recommendation, 1947 (No. 81)
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ILO, 2007, Managing Small Business Associations trainers' manual. ILO Cambodia 2007. http://www.ilo.org/wcmsp5/groups/public/---asia/---ro-bangkok/documents/publication/wcms_108271.pdf

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For further information see the ILO's websites of the International Labour Standards Department
<http://www.ilo.org/global/standards/lang--en/index.htm>
and the Job Creation and Enterprise Department
<http://www.ilo.org/empent/lang--en/index.htm>

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Clay pottery workshop, Cambodia.

Contents:

Acknowledgments / Foreword / Preface / How to use the Guide / Acronyms

PART I: Key concepts

1. Decent Work and the Informal Economy

1.1 Key conceptual issues

2. Measurement of the Informal Economy

2.1 Addressing statistical challenges

PART II: Policies to support transitions to formality

3. Growth Strategies and Quality Employment Generation

3.1 Patterns of economic growth and the informal economy

4. The Regulatory Framework and the Informal Economy

(A) International Labour Standards

4.a1 The Regulatory Environment and the informal economy: setting a social floor for all who work

4.a2 International Labour Standards (ILS): bringing the unprotected under the law

4.a3 Understanding the employment relationship and its impact on informality

(B) Specific Groups

4.b1 Domestic Workers: strategies for overcoming poor regulation

4.b2 Homeworkers: reducing vulnerabilities through extending and applying the law

4.b3 Street vendors: innovations in regulatory support

4.b4 Micro and Small Enterprises (MSEs), informality and labour law: reducing gaps in protection

4.b5 Strategies for transforming undeclared work into regulated work

(C) Labour Administration

4.c1 Labour administration: overcoming challenges in reaching the informal economy

4.c2 Labour inspection and the informal economy: innovations in outreach

5. Organization, Representation and Dialogue

5.1 Social dialogue: promoting good governance in policy making on the informal economy

5.2 The role of Employers' organizations and small business associations

5.3 Trade unions: reaching the marginalized and excluded

5.4 Cooperatives: a stepping stone out of informality

6. Promoting Equality and Addressing Discrimination

6.1 Promoting women's empowerment: a gendered pathway out of informality

6.2 Migrant workers: policy frameworks for regulated and formal migration

6.3 Disability: inclusive approaches for productive work

7. Entrepreneurship, Skills Development, Finance

7.1 Informal enterprises: policy supports for encouraging formalization and upgrading

7.2 Enhancing skills and employability: facilitating access to the formal economy

7.3 Microfinance: targeted strategies to move out of informality

8. Extension of Social Protection

8.1 Extending social security coverage to the informal economy

8.2 HIV/AIDs: overcoming discrimination and economic exclusion

8.3 Extending maternity protection to the informal economy

8.4 Childcare: an essential support for better incomes

9. Local Development Strategies

9.1 Local development: opportunities for integrated strategies for moving out of informality