Formal labour regulations as a cause of informal employment: Judging the evidence

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Overview of Presentation

- Evidence for developed countries: “Lawyer’s case empiricism”

- Evidence for developing countries: Re-reading the WB’s *Informality: Exit and Exclusion*

- Conclusions: Trial lawyers vs. judges
Evidence for developed countries


☐ Contrary evidence for cross-country versus within-country (over time) variation

☐ IMF study emphasizes with cross-country evidence: stronger regulations associated with higher unemployment
Evidence for developed countries

- Freeman refers to “blinders,” “prior-driven analysis” and “lawyer’s case empiricism”

- His proposed solution? Different research methods

- Less reliance on cross-country analysis, more on micro-analysis of workers and firms and on experimental methods
Evidence for developing countries


- “A substantial body of literature sees the size of the informal sector to be determined substantially by regulatory distortions or corruption…. Documenting the impact of legislation on formal sector demand in Latin America has been the subject of several major efforts in the region. Of particular importance, the National Bureau of Economic Research volume edited by Heckman and Pages (2004) collected some of the most serious attempts made to that date to quantify the impacts of various regulatory changes…. For the region and several countries, a credible case can be built that labor legislation had a substantial impact on the size of the formal sector” (p. 121).

Consider the empirical results of several studies that address impacts of labour regulations…
Evidence for developing countries


**Description:** Seven country studies use micro datasets to estimate the effects of “job security costs” on formal employment in Argentina, Barbados, Brazil, Chile, Jamaica, Peru and Trinidad and Tobago.

**Results:**
Statistically significant results only for Argentina and Peru, with lower job security costs associated with higher formal employment.

But what are the implications of job security costs for *informal* employment?...
Evidence for developing countries

...consider the case of Peru


- Job security costs fell while formal employment increased in Peru in the 1990s.

- However, informal employment increased even more rapidly, with the result that falling job security costs occurred alongside a rising share of informal employment.

Results for Peru are typical for the region...
Evidence for developing countries


Description: Cross-country panel data analysis of OECD and LAC countries, 1990-1999

Model of: Share of self-employment

Key explanatory variable: Job security index

Results:

<table>
<thead>
<tr>
<th></th>
<th>OLS</th>
<th>Fixed effects</th>
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<tbody>
<tr>
<td>OECD plus LAC</td>
<td>1.37 (5%)</td>
<td>-8.43 (1%)</td>
</tr>
<tr>
<td>LAC</td>
<td>1.09 (10%)</td>
<td>-8.34 (1%)</td>
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**Description:** Cross-industry panel data analysis, 1983-2002

**Models of:** share of formal employment, formal job creation and destruction

**Key explanatory variables:** % of unionized workers, labour costs

**Results:**
- Greater unionization is associated with higher shares of formal employment
- Estimated positive and negative effects on formal job creation and destruction cancel each other over time
The authors conclude that the increase in informal employment in Brazil in the 1990s resulted from “increases in union power” and “rising labor costs.”

Description: Cross-country panel data analysis of developed and developing countries, mid-1980s-2004

Model of: share of self-employment

Key explanatory variable: Regulation of Credit, Labor and Business

Results:
- Full sample of countries: -0.017 (10%)
- Developing countries: 0.005
- LAC: 0.004

1. (%, urban and rural)
2. Fraser Institute index (0-10, 0 = strongest regulation, 10 = weakest regulation)
3. OLS
“Dodging the Grabbing Hand” – J. Friedman et al. (2000)

Description: Cross-country analysis of 69 developed and developing countries

Model of: “Unofficial” activity as a share of GDP

Key explanatory variables: Tax rates and index of corruption

Results: Higher taxes and less corruption are associated with less “unofficial” activity

Contrary to WB, stronger regulations may be associated with a smaller informal economy insofar as associated costs of LM regulations are paid for from taxes.
Evidence for developed & developing

“The Regulation of Entry” – Djankov et al. (2002).

Description: Cross-country analysis of 85 developed and developing countries

Model of: “Unofficial” activity as a share of GDP and share of labour force

Key explanatory variable: Number of procedures required to start a company, including for labour and social security-related procedures

Results: Greater number of procedures are associated with more “unofficial” activity

The results are more about how a state regulates labour than strength of de jure or de facto labour regulations. E.g., China requires 5 labour and social security-related procedures whereas Canada requires 0

E.g., evidence for careful policy design rather than de-regulation
Conclusions

- Given what is at stake for workers in developing countries, those arguing that labour regulations exclude informal workers from formal employment ought to hold themselves to a high standard regarding the strength of empirical evidence. This standard has not been met.

- Some of the statistically strongest results show a positive association between shares of formal employment and the strength of labour regulations.

- Other studies could be cited to show a positive association between shares of formal employment and the strength of labour regulations and labour standards (e.g., R. Galli and D. Kucera (2004)).

- In short, recent empirical evidence does not support the view that weakening labour regulations is an effective policy to reduce informal employment.
Conclusions

- Re Freeman, micro-analysis is surely helpful, but micro results can be just as readily mis-represented as macro results

- Researchers need to act as fair-minded judges rather than adversarial trial lawyers

- Particularly important that policy-makers can trust literature surveys as well as authors’ conclusions of their own work, as policy-makers may not have time or expertise to scrutinize these studies

- Acting as fair-minded judges facilitates shifting debate to a discussion of optimal design and implementation of labour regulations in country- and time-specific contexts