



International
Labour
Office
Geneva

The Regulatory Framework and the Informal Economy

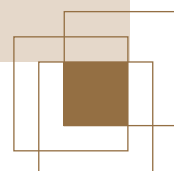


Women tea pickers, Bangladesh.

International Labour Standards

4.a1 THE REGULATORY ENVIRONMENT AND THE INFORMAL ECONOMY: SETTING A SOCIAL FLOOR FOR ALL WHO WORK

■ This brief provides an introduction for the technical briefs which follow on the regulatory framework. It provides an overview of not only the challenges in providing legal protection and recognition to those in the informal economy but also discusses the policy debates regarding regulation and de-regulation. Within a Decent Work framework all those who work have rights at work irrespective of whether it is in the informal or formal economy. This brief argues that creating a minimum social floor through rights, and regulation of those rights, can have major economic and social benefits including the more efficient functioning of markets. It is therefore a crucial aspect of the transition to formality and forms a central plank in addressing poverty and social exclusion. There is no section on Emerging approaches within this brief since the different aspects of labour regulation are discussed in all the briefs in this section and throughout the Guide.



- Labour regulation and informality
- Problems with legislation
- The conflicting theoretical views on the effect of labour regulation – a brief overview
 - Does labour legislation increase the size of the informal economy?
 - The ILO's position

■ **Labour regulation and informality.** As the 2002 Resolution on Decent Work and the Informal Economy established, informality is primarily an issue of governance - including weak legal and institutional frameworks and fragmentary and ineffective implementation of laws and policies.¹ Bringing the multitude of workers and enterprises within the informal economy under the protection of the law would be a major step in the direction of Decent Work.

Yet regulation is at the centre of many debates concerning the origins and means of tackling the informal economy. In particular, the impact of labour legislation, and more broadly, labour regulation, on the informal economy is a highly contested issue which is embedded in the complex debates regarding the benefits of regulation and deregulation. Within economics, for example, some argue that regulation impedes economic efficiency by generating extra costs, and indeed may even be a driver of informality, while others believe that regulation is an essential way to correct market imperfections and achieve redistribution.² (see also brief on Key Conceptual issues).

The ILO offers the most comprehensive international framework for unifying economic growth with social justice for all. It is devoted to promoting social justice through internationally recognised human and labour rights, pursuing its founding mission that social justice is essential to peace and prosperity. Furthermore, its mission is firmly grounded in the international legal order which has respect for human rights as one of its essential elements. From this point of view, many rights that the ILO promotes, such as fundamental rights at work, are considered non-negotiable and warrant no discussion about their intrinsic validity or desirability (see brief on International Labour Standards). The ILO's main aims, as defined in its Decent Work agenda, are to promote rights at work, encourage decent employment opportunities, enhance social protection and strengthen dialogue on work-related issues. Normative action is an indispensable tool to make decent work a reality.³

● Regulation is seen by the ILO as an essential way to correct market imperfections, achieve redistribution and set a minimum social floor for all those who work

What is labour regulation?

“Labour regulation” is understood here as including all legislations, institutions and policies in the labour field. “Labour law” is understood as all legislation, collective agreements and case law concerned with all labour issues.

1 ILO, 2002b, para.14.

2 One reason for such divergent views is that they are underpinned by fundamentally different premises concerning the nature of society, as well as the desirability of regulation in the labour sphere. For a review of various neo-classical and neo-institutional positions, see for example, Sengenberger, 2005; Freeman, 2005.

3 See ILO, 2001.

The social case for labour regulation

The social case for labour regulation originates from the fundamental principle, underlining the work of the ILO, that labour is not a commodity. Unlike, steel or machines, labour has a humane aspect; workers' behaviour is highly affected by the environment and the various incentives they are confronted with. Work, which is an essential part of human condition, cannot be treated on the basis of market relationships.

See Resources section to access: Stiglitz, 2002, 'Employment, social justice and societal well-being' p.10.

● An influential strand of thinking, influenced by neoclassical economics, sees labour regulation as a market externality which increases informality

■ **Problems with legislation.** There exist however several issues concerning the informal economy and labour regulation that need attention. These will be touched upon in the next sections. One significant general problem is that legislation is often not implemented, whether in the formal or informal economy, or may not serve its initial purpose. Legislation can also be out-of-sync with its environment and in need of amendments. Legislation is not always good – badly drafted and badly implemented laws can clearly have negative effects.⁴ More generally, labour regulation needs to be adapted to the context it is applied in, which is why it is important to evaluate legal practices in the environment they are operating in. National good practices in labour regulation are therefore not necessarily replicable in different national contexts – a good legal practice adopted in one country may not have the same results if it is transplanted in another environment. This comment is valid for all aspects of the question of national regulation of workers in the informal economy.⁵ Nonetheless, while there is not always a “one size fits all” solution to the regulation of labour, carefully crafted regulation is an essential means of enabling the enjoyment of rights for all those who work.

■ **The conflicting theoretical views on the effect of labour regulation – a brief overview.** As mentioned above, there are broadly speaking two major views within economics of the potential relationship between labour regulation and informal economic activity.

● **Does labour legislation increase the size of the informal economy?**

A currently influential strand of economic thinking, heavily influenced by mainstream neoclassical economics, believes that labour regulation is a market externality that is detrimental to economic efficiency, and therefore counter-productive. According to the neoclassical theory, wage and employment are set by supply and demand, and informality stems from a structural imbalance between too many job seekers and not enough jobs. Labour regulation is seen to lead to the growth of the informal economy by increasing the cost of formal employment, therefore acting as a barrier to entering the formal economy. Within this view of things, informality is often seen as a voluntary choice for workers.

Such a perspective is quite influential amongst some experts and international development agencies,⁶ including by some within the World Bank. The latter, for example, stated in its World Development Report of 1990 that labour market policies such as minimum wages, job security regulations and social security, which are usually intended to raise welfare or reduce exploitation, actually work to raise the cost of labour in the formal sector and reduce labour demand. This, according to the report, increases the supply of labour to the rural and urban informal sectors.⁷

4 Kucera and Roncolato, 2008, give the example of minimum wage legislation in Colombia (pp.338-339).

5 There is of course a continuum between the successful transfer of laws and its failure: some initiatives may be directly transposed, others clearly not (on the problems and possibilities of transplanting laws, see Kahn-Freund, 1974).

6 Sengenberger, 2005, pp.45-46.

7 World Bank, 1990, p.63. This argument was repeated subsequently in other World Development Reports.

Another more recent strand of empirical research has also pointed in the same direction,⁸ and has fed into the World Bank's construction of the very influential, Employing Worker Indicator of its *Doing Business* report.⁹ This essentially aims to capture the possible costs to businesses of employing workers, without regards to the social and economic benefits of regulation. There has been widespread criticism of this indicator and the theory behind it, however.¹⁰ In particular, it has been noted that the fact that the starting premise of the research underlying the index is the notion that excessive regulation prevents formality, almost inevitably leads to very drastic and influential policy recommendations that explicitly call for a weakening of labour regulation.¹¹ After consultations involving, amongst others, the ILO, International Trade Union Confederation (ITUC) and the International Organization of Employers (IOE), the use of this indicator has been suspended and is under review.

Furthermore, as many have argued, the view that labour regulation makes the informal economy grow is not based on sound empirical evidence. The data used or the way it is gathered is questioned, and the results, based on weakly constructed indicators are said to be not only misleading but also lead to simplistic policy conclusions.¹² It is often noted, for example, that there are critical problems relating to the measurement of the informal economy itself and of labour legislation, its enforcement and its efficiency. There is no doubt that measuring these is not an easy task. However, some indicators are clearly not satisfactory,¹³ and focus, for example, on the strictness of employment protection using only indicators such as the number of month's notice required for individual dismissals.¹⁴ Labour regulation concerns much more than hiring and firing laws. A further problem concerns the fact that most studies on the impact of regulation do not take into consideration the fact that the operation of legal rules is often incomplete or imperfect (legal rules do not always have a clear scope of application and they do not produce results automatically – they are not “self-executing”, in the sense that further action is needed for them to lead to a specific outcome), and claim to measure the effect of legislation regardless of whether it is applied in practice.¹⁵ Finally, many studies do not have a clear cause and effect linkage.¹⁶

A different point of view starts from the premise that there is a lack of appreciation of the positive functions of labour regulation for economic activity. Rather than a driver of informality, labour regulation can act as positive influence on economic activity. Indeed, regulation is essential to correct

8 See for example, Perry et al., 2007, who state that “excessive labor costs, whether arising through labor legislation—exaggerated minimum wages, severance costs, labor taxes, or unrealistic union demands—depress the number of jobs in the formal sector” (p. 125). See also Feldmann, 2009, who included 73 industrial, developing and transition countries in his study. He concluded from his regression results that tight labour regulations increase unemployment all over the world. Similarly, Almeida and Carneiro, 2009, found that stricter enforcement of labour regulation constrains firm size and leads to higher unemployment. For a recent overview of this literature, see Kucera and Roncolato, 2008 and Lee, McCann and Torm, 2008.

9 This indicator is based on several assumptions about the worker and the business. The rigidity of employment index is the average of three subindices (difficulty of hiring, rigidity of hours and difficulty of redundancy) – see World Bank, *Employing Workers Methodology*, <http://www.doingbusiness.org/MethodologySurveys/EmployingWorkers.aspx>.

10 Most importantly by the World Bank's Independent Evaluation Group (IEG, 2008); See also, Berg and Cazes, 2008; Lee, McCann, and Torm, 2008; Deakin, 2009.

11 IEG, 2008, p.6.

12 For a thorough overview, see Kucera and Roncolato, pp.340-341. See also Berg and Cazes, 2008 and Deakin, 2009.

13 For example, labour law enforcement has been measured rather simplistically by the number of registration fines by Almeida and Carneiro, 2005.

14 Deakin, op.cit, p.1.

15 Deakin, op.cit, p.1.

16 *ibid*, p.9. As Deakin states, the fact that “a study shows that more stringent employment protection legislation is correlated with higher levels of unemployment, may not be evidence of the economic impact of that particular legal institution, but evidence instead of a change in the macro-economic environment (higher unemployment) triggering a certain policy response (stricter controls over dismissals)”.

market imperfections and the absence of labour regulation creates a context where persistent inequality, unemployment and economic inefficiency prevail.¹⁷ There are a number of studies, including from the ILO, the OECD and the World Bank, which support this view.¹⁸

It is clear that the effects of the law will vary across industry, region, country, and that the implementation of the law will necessarily be affected by social norms and practice. It is therefore of crucial importance to know the specific context in which the law is applied as well as the wider political and economic context in order to evaluate its real impact.¹⁹ According to some empirical research which evaluates the impact of particular labour legislation by collecting and analysing data on a range of legal and institutional features over a long period, employment protection legislation may, for example, have positive impacts on productivity because it encourages training and innovation at firm level.²⁰

Despite decades of theoretical and empirical research however, the debate on the effects of labour regulation on economic and labour market outcomes continues²¹ and the specific question of whether it is possible to capture the effects of labour legislation on economic performance and on the informal economy remains current.²²

● While it is true that simplifying laws and procedures are often warranted to open up avenues into the formal economy, it is important not to erase what has been achieved in basic rights and principles governing the world of work

- **The ILO's position.** The tripartite consensus established through the 2002 ILC Resolution on Decent Work and the Informal Economy affirmed that a defining characteristic of the informal economy is that workers and enterprises are not recognised, regulated or protected by law. While it is true that simplifying laws and procedures are often warranted to open up avenues into the formal economy, it is important not to erase what has been achieved in basic rights and principles governing the world of work. This includes fundamental rights at work but other matters as well such as conditions of work, safety and health and income security, as well as basic rules for fair treatment, for example with regard to job security and vulnerable groups.²³

The informal economy and the law

'Even if the precarious situation of the informal economy makes the immediate application of some of the national standards impossible, and even if certain aspects of national legislation would gain from being simplified, there can be no question of going back on these social gains simply in order to allow the informal economy to become legalized.'

Source: ILO, 1991, Reply of the Director-General to the discussion of his Report, Provisional Record, ILC, 78th Session, Geneva, p. 27/7.

Labour regulation has, as one of its fundamental objectives, to redress the inherent inequality between employers and workers while promoting enterprises, thereby aiming to bring about social justice. While the costs of labour regulation are immediately visible, their benefits are more indirect, and therefore more difficult to measure. They are also conditioned by the effective implementation of the law, which in turn depends on a range of non-legal factors, such as the moment in the economic cycle at which the law was introduced, or the existence of social norms or self-regulatory practices.²⁴

17 Deakin, op.cit, p.1.

18 Deakin and Wilkinson, 2000, p.61. See also Sengenberger, 2005.

19 Supporting the view that employment protection legislation in particular is positive, see for example, OECD, 2003, pp.89-90.

20 Deakin and Sarkar, 2008 (the results showed a positive correlation between regulation and growth in employment and productivity in France and Germany). See a Deakin, 2009, p.5-8 – he is describing indexes developed by the Cambridge Centre for Business Research.

21 Berg and Cazes, 2008; See also Freeman, 1994, p.80.

22 See Deakin, op.cit.2009.

23 For more details see Resources section to access: ILO, 2002a, Decent work and the informal economy, p.44.

24 Deakin, 2009, op.cit. p.4.

The social and economic justifications of international labour standards (ILS), when reflected in national legislation, are very significant and important to take into account because they counter the “partly wrong and partly exaggerated” view that they engender higher costs:²⁵ ILS, when enforced at the national level through domestic law, generally lead to higher productivity, innovation and other improvements in economic performance.²⁶

The benefits to workers are clear: compliance with labour standards usually implies, for example, more certainty and financial stability, better training, less work-related accidents, better health, better education (for children who do not work, for example), all of which have positive spill-over effects on the economy and the society. Many view improved labour standards as self-financing for employers. Indeed, complying with legislation on minimum working hours, for example, and rest leads to better productivity, less absenteeism, fewer accidents and mistakes.²⁷ If competition based on wages and minimum employment costs is eliminated for instance, a competition based on productivity, improved management, work organisation and worker competence is likely to emerge and will squeeze out inefficient firms leading to an overall more efficient economy. Worker participation brings mutual trust and cooperation, for example.²⁸

The following briefs in this thematic section will look at the various ways in which law and law-related initiative can make a difference in the way we tackle the informal economy. More specifically, they will look at law, informality and: ILS, the employment relationship, MSEs, domestic workers, homeworkers, street vendors, and undeclared work in the European Union. These technical briefs acknowledge the important role that law plays, together with other initiatives, in moving out of informality.

The World Commission on the Social Dimensions of Globalization

‘The rule of law and the effective administration of justice is the foundation. An equitable legal framework, applied consistently to everyone, defends people from abuse of power by the State or by non-State actors. It empowers people to assert their rights – to property, education, decent work, freedom of speech and other “springboards” for human growth and advancement. Meanwhile, efforts are needed at both national and local level to ensure that the law is respected and applied, and that all citizens, rich and poor, have the access, knowledge and resources to use it.’

Source: World Commission on the Social Dimension of Globalization ILO, 2004, pp.55-56

● While the costs of labour regulation are immediately visible, their benefits are more indirect, and are therefore more difficult to measure

25 Sengenberger, 2006, p.336.

26 Sengenberger, 2005, pp.63-66.

27 Ibid., and Dorman, 2000.

28 In general, see Sengenberger, 2005 and 2006. See as well CLEP, 2008, pp.157-165.



Cooking falafel in a street in Bethlehem, Occupied Palestinian Territories.



Child street vendor, Moldova.

RESOURCES

This section provides a list of resources which can enable the reader to delve deeper into the issue. 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

Conventions

<http://www.ilo.org/ilolex/english/convdisp1.htm>

Recommendations

<http://www.ilo.org/ilolex/english/recdisp1.htm>

Declaration on Fundamental Principles and Rights at Work, 1998

<http://www.ilo.org/declaration/thedeclaration/textdeclaration/lang--en/index.htm>

Declaration on Social Justice for a Fair Globalization, 2008

http://www.ilo.org/wcmsp5/groups/public/---dgreports/---cabinet/documents/publication/wcms_099766.pdf

ILO, 2002, Resolution concerning decent work and the informal economy, Provisional Record 25, ILC, 90th Session, Geneva: ILO

<http://www.ilo.org/public/english/standards/relm/ilc/ilc90/pdf/pr-25res.pdf>

Relevant Publications

Deakin, S., 2009, The Evidence-Based Case for Labour Regulation, Paper prepared for the Regulating Decent Work Conference, ILO, Geneva, July 2009.

http://www.ilo.org/legacy/english/protection/travail/pdf/rdwpaper_pl1a.pdf

Dorman, P., 2000, "The Economics of Safety, Health, and Well-Being at Work: An Overview", working paper, Geneva: ILO.

http://www.ilo.org/wcmsp5/groups/public/---ed_protect/---protrav/---safework/documents/publication/wcms_110382.pdf

ILO, 2002, Report VI, Decent work and the informal economy, ILC, 90th Session (Geneva

<http://www.ilo.org/public/english/standards/relm/ilc/ilc90/pdf/rep-vi.pdf>

ILO, 2009, Rules of the Game: A brief introduction to International Labour Standards, Geneva: ILO.

http://www.ilo.org/wcmsp5/groups/public/---ed_norm/---normes/documents/publication/wcms_108393.pdf

Kucera, D. and L.Roncalto 'Informal Employment: Two contested policy issues', International Labour Review, Vol 147 (2008) No.4

http://www.ilo.int/public/english/revue/download/pdf/s2_kucera_roncolato.pdf

Lee, S., and D. McCann (editors) 2011, Regulating for Decent Work: New Directions in labour market regulation

http://www.ilo.org/global/publications/ilo-bookstore/order-online/books/WCMS_157549/lang--en/index.htm

Sengenberger, W., 2005, Globalization and Social Progress: The Role and Impact of International Labour Standards, Bonn: Friedrich Ebert Stiftung.

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http://www.wider.unu.edu/publications/working-papers/discussion-papers/2005/en_GB/dp2005-04/_files/78091750491424025/default/dp2005%2004%20Trebilcock.pdf

World Commission on the Social Dimensions of Globalization, 2004 "A fair globalization – Creating opportunities for all" ILO Geneva, available in seven languages

<http://www.ilo.org/fairglobalization/report/lang--en/index.htm>

Tools

ILO 2002 Decent Work and the Informal Economy: CD Rom with 2002 Background papers.

http://www.ilo.org/dyn/infoecon/iebrowse.page?p_lang=en&ieresource_id=807

ILO 2009. Rules of the Game: A brief introduction to International Labour Standards, (Geneva).

http://www.ilo.org/wcmsp5/groups/public/---ed_norm/---normes/documents/publication/wcms_108393.pdf

ILO 2010 Extending the scope of application of labour laws to the informal economy: A digest of comments of ILO's supervisory bodies related to the informal economy. ILO: Geneva

http://www.ilo.org/wcmsp5/groups/public/@ed_norm/@normes/documents/publication/wcms_125855.pdf

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