

**FOR DEBATE AND GUIDANCE**

FIRST ITEM ON THE AGENDA

**Business environment, labour law
and micro- and small enterprises****Introduction**

1. This paper responds to the decision by the Officers of the Committee on Employment and Social Policy (ESP) to include an item for discussion on the agenda of its November 2006 session on the topic of business environment, labour law, and micro- and small enterprises. The paper sets out to address the dilemma of striking a balance in terms of minimizing the cost of the regulatory burden on micro- and small enterprises and thus enhancing the prospects for competitiveness and growth, without compromising the protection of those who work in MSEs. This is an issue of growing international debate and the Office is increasingly being asked to provide guidance to constituents and other agencies. The topic was discussed by the ESP Committee during the 289th Session of the Governing Body, when Core Component 5 of the Global Employment Agenda was on the agenda. It was also discussed during the 90th Session of the International Labour Conference in 2002 on decent work and the informal economy. A number of tentative recommendations are provided in this paper and the Committee is requested to provide guidance to the Office on how to further this area of work.

**I. Advancing decent work among micro-
and small enterprises (MSEs)**

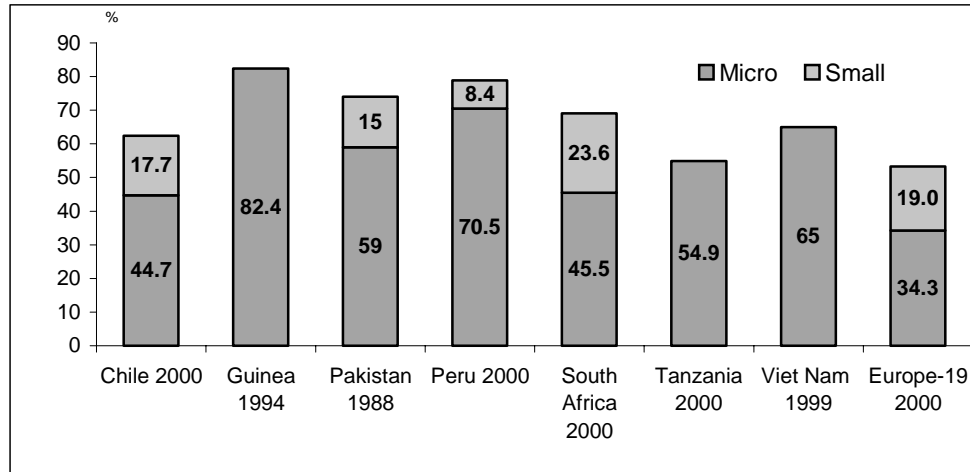
2. Micro- and small enterprises (MSEs)¹ have a crucial role in employment creation. In most countries, the major part of employment can be found in MSEs (figure 1 below).² These

¹ There is no single definition of micro-, small and medium enterprises, and employee numbers may not be the sole defining criterion. However, SMEs are generally considered to be non-subsidary, independent firms which employ less than a given number of employees. This number varies across countries. The most frequent upper limit is 250 employees, as in the European Union. However, some countries set the limit at 200. Small firms are considered to be firms with fewer than 50 employees, while micro-enterprises have at most ten, or in some country cases, five. Financial assets and turnover are sometimes also used to define SMEs. OECD, 2002: *Small and medium enterprise outlook*.

² ILO: *Panorama laboral '99*. Lima; ECLAC, *A decade of social development in Latin America, 1990-1999*. Santiago, 2004; G. Reinecke and S. White, *Policies for small enterprises. Creating the right environment for good jobs*, ILO, Geneva, 2004; ILO: *Panorama laboral 2005 (Avance primer*

enterprises are also important in unlocking the capacity of entrepreneurship and providing for dynamism in an economy. They are extremely heterogeneous, including survivalist operations with very low profit margins to high-tech enterprises in emerging service sectors.

Figure 1. Employment share of micro- and small enterprises in non-agricultural employment



Note: MSEs include self-employed persons.

Source: G. Reinecke and S. White: *Policies for small enterprises. Creating the right environment for good jobs*, ILO, Geneva, 2004.

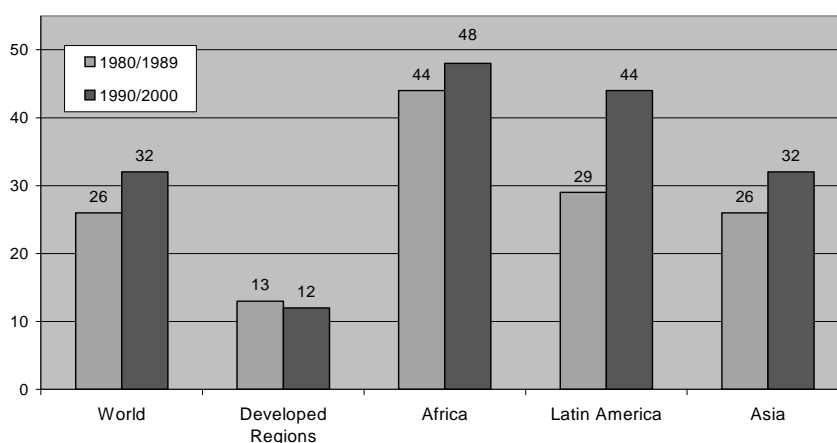
3. Many MSEs, mostly but not exclusively at the lower end of the size spectrum, are part of the informal economy, which is growing in most regions (figure 2 below)³ and also generally characterized by economic precariousness. In most countries, the share of women workers and employers in micro-enterprises is much higher than their share among larger enterprises (47 per cent women in micro-enterprises in Peru and 60 per cent in Nepal).⁴ Due to lack of sufficient growth in formal employment, many governments attach much importance to the development of MSEs for their potential for job creation and poverty reduction. In this connection, there has been an increasing recognition of the importance of an enabling business environment for growth of enterprises and the generation of quality jobs.

semestre), Lima; C. Fenwick, J. Howe et al.: "Labour and labour-related laws in micro- and small enterprises: Innovative regulatory approaches", a paper prepared for ILO, Geneva, 2006.

³ "The term 'informal economy' refers to all economic activities that are – in law or in practice – not covered or insufficiently covered by formal arrangements. Their activities are not included in the law, which means that they are operating outside the formal reach of the law; or they are not covered in practice, which means that – although they are operating within the formal reach of the law – the law is not applied or not enforced; or the law discourages compliance because it is inappropriate, burdensome, or imposes excessive costs." ILO, Conclusions concerning decent work and the informal economy, International Labour Conference, 90th Session, Geneva, June 2002.

⁴ G. Reinecke and S. White, op. cit.; and Pushkar Bajracharya, Binaya Maharjan and Bimal Raman Parajuli: "Assessment of the MSE sector", a paper prepared for ILO Kathmandu as a part of its work on MSE policy review, 2003.

Figure 2. Non-agricultural self-employment, 1980-89 and 1990-2000
(in per cent of total non-agricultural employment)



Note: Self-employment is used as a proxy for employment in the informal economy.

Source: ILO: *Women and Men in the Informal Economy – A Statistical Picture*, Geneva, 2002, p. 22.

4. There is some evidence to indicate that reforms to the business environment have a positive impact on growth and the nature of employment. Countries which improve their regulation to correspond to good practice standards can increase growth by as much as 2.3 per cent a year.⁵ Better performance on the ease of doing business is associated with more jobs and conversely, where regulations are costly and burdensome, businesses are more likely to operate in the informal economy, remaining very small and creating few decent jobs. There are examples where, in aggregate, successful regulatory reforms demonstrate significant pay-offs for job creation. For example, some studies purport to show that if the investment climate for firms in Dhaka matched that of Shanghai, Dhaka would reduce, hypothetically, its productivity gap by 40 per cent and wages could rise by 18 per cent whilst for Calcutta the effect would be twice as strong, with wages rising by 38 per cent.⁶ Research in Slovakia suggests that reforms have helped cut the number of unemployed by 43,000 since 2002, whilst in Colombia it is suggested that reforms of employment and business start-up regulations have created 300,000 jobs in the formal economy.⁷ It is clear, however, that further research is required on the relationship between reforms to the business environment and the growth and nature of employment.

II. Business environment for enterprise development and job creation

5. Basic components of a conducive business environment for growth of enterprises include sound macroeconomic policies (including monetary, fiscal and trade policies), aggregate demand, the structure of and access to markets, access to inputs and credit, availability of infrastructure such as transport and communications, responsive enterprise promotion policies as well as a supportive regulatory environment. The rapidly growing economies of

⁵ S. Djankov, C. McLeish and C. Ramlho: *Regulation and Growth* (Washington, World Bank, 2005).

⁶ World Bank: *World Development Report 2005 – A Better Investment Climate for Everyone* (Washington, World Bank, 2004), p. 31.

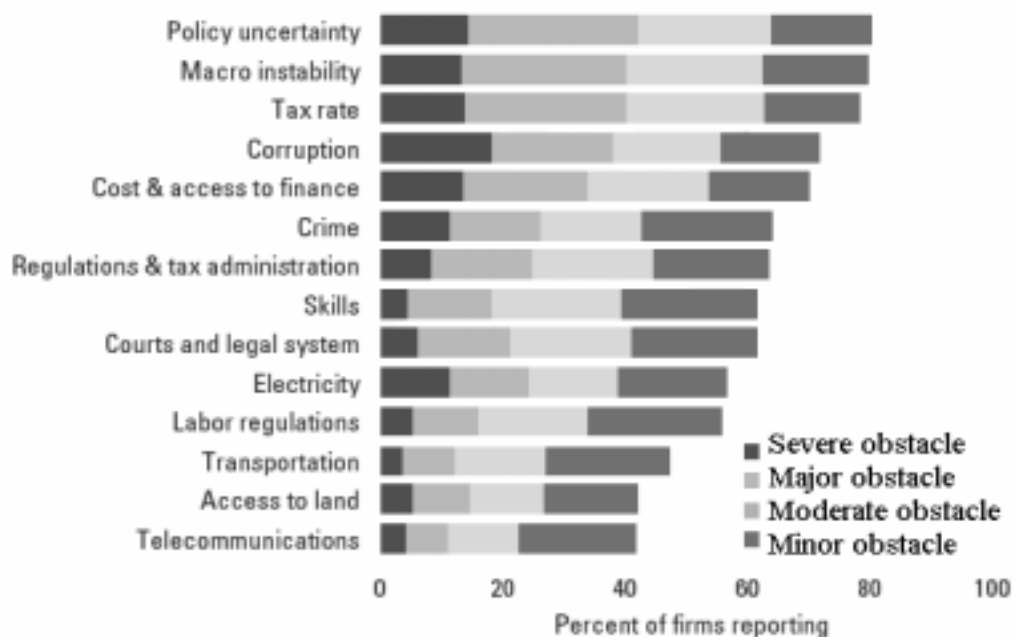
⁷ World Bank: *Doing Business in 2006 – Creating Jobs* (Washington, World Bank, 2006), p. 6.

Asia and Latin America are testimonies of how such an enabling environment has proved to be key for expanding business opportunities and scope for generating productive jobs.

6. Although these factors affect enterprises of all size classes, MSEs tend to be disproportionately affected as they have fewer resources to overcome obstacles in the business environment.⁸ In many cases, they operate in economic sectors with low barriers to entry, fierce competition and low profit margins. Informality and precariousness are key reasons for both workers and owners in MSEs to operate under poor conditions that are very distant from the ILO's objective of decent work for all and often imply poverty and lack of social protection. A favourable business environment increases the potential for MSEs to develop and create more and better employment opportunities.
7. The ILO carries out various activities of research, advocacy and technical cooperation to contribute to improvements in the business environment for MSEs. ILO support to member States includes assessments of the policy and regulatory environment for MSEs to enable representative organizations to advocate for improved policies. Training by ITCILO on how to create an enabling business environment is an example of capacity building of constituents and other relevant stakeholders. Technical cooperation in the areas of business development services, microfinance, value chain analysis and sector upgrading, local economic development, women's entrepreneurship and gender mainstreaming and youth entrepreneurship aim at overcoming constraints in MSEs' ability to cope with the business environment. The ILO is also an active member of the Donor Committee for Enterprise Development and chairs its Business Environment Working Group, which provides opportunities to influence how other agencies operate in this field.
8. The World Bank's investment climate surveys – covering more than 26,000 firms in 53 countries – show that while priority constraints can vary widely across and within countries, in the aggregate, it is policy uncertainty and macroeconomic instability which are most consistently highlighted as principal obstacles to their operation and expansion (figure 3). Across all firms surveyed, close to 60 per cent of respondents reported that labour market regulations represented an obstacle (minor, moderate, major). Around 16 per cent report that these regulations are a major obstacle to the operation and growth of their business. However, not all firms are affected in the same way by labour regulations; medium-sized firms (20-100 employees) are the ones most severely affected, while MSEs tend to be less concerned. This divergence may be related to the lack of enforcement of labour legislation in MSEs, either because of legal exemptions or widespread informality.

⁸ G. Reinecke and S. White, *op. cit.*

Figure 3. Most frequently reported obstacles to firm operation in developing countries



Note: Firms were asked to rank the list of issues as to whether they were an obstacle to the growth and operation of their business on a 5 point scale, from "no obstacle" to "severe obstacle."

Source: World Bank investment climate surveys.

9. For the purpose of the discussion in this paper, labour and labour-related regulations will include the following areas:⁹

- collective bargaining and freedom of association
- anti-discrimination/equal employment opportunity
- prohibitions on forced labour/child labour
- minimum wage
- overtime/working time limits
- paid time off
- social security (retirement, disability, death, sickness and health benefits)
- unemployment insurance
- workers' compensation
- protection against unjust dismissal
- occupational health and safety standards
- advance notice and consultation (for large-scale lay-offs) placement after dismissal

⁹ Broadly based on the ILO's classification of international labour standards.

- parental/family leave
 - employee consultation
 - protection of rights and entitlements on transfer of undertaking
10. The Office's work to date on promoting the creation of an enabling business environment, including the debates in the Donor Committee, has led to the recognition that application of, and compliance with, labour legislation by MSEs is a significant and often controversial part of the business environment. At the same time, the ILO has a particularly important role to play with regard to informing the debate and promoting well-designed laws that can be realistically applied with wide coverage of MSEs since such legislation can help improve job quality and therefore have a direct impact on decent work.

III. Coverage of labour and labour-related laws of MSEs

Low labour law coverage of MSEs

11. Despite the call for appropriate legal coverage in key policy documents such as the ILO's Job Creation in Small and Medium-Sized Enterprises Recommendation, 1998 (No. 189),¹⁰ a substantial portion of workers and owners of MSEs across the world do not enjoy protection under the coverage of labour and labour-related laws. The low levels of coverage of labour and labour-related laws are an important part of the problem of the decent work deficit in MSEs as they are related directly to shortcomings in levels of income (minimum wages), social protection (affiliation to social security schemes), and job security (employment contracts). Formal work contracts are less common than in enterprises of larger size and infringements of labour law and basic occupational safety and health regulations are frequent.¹¹
12. Some of the key reasons for the low coverage among MSEs will be reviewed in the following paragraphs under the following three major headings:
- (a) exemptions, partial exclusions and parallel labour law regimes;
 - (b) low compliance arising out of various reasons; and
 - (c) insufficient representation of MSEs.

¹⁰ Recommendation No. 189, Paragraph 5, reads: "In order to create an environment conducive to the growth and development of small and medium-sized enterprises, Members should: (a) adopt and pursue appropriate fiscal, monetary and employment policies to promote an optimal economic environment (as regards, in particular, inflation, interest and exchange rates, taxation, employment and social stability); (b) 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; (c) improve the attractiveness of entrepreneurship by avoiding policy and legal measures which disadvantage those who wish to become entrepreneurs."

¹¹ L. Gasparini: *Protección social y empleo en América Latina: Estudio sobre la base de encuestas de hogares*, Estudio para Panorama Laboral 2002, Lima, ILO, 2003.

Exclusions and parallel labour regimes

13. In response to the difficulties in applying labour and labour-related laws in MSEs, countries have taken different approaches:
- (a) *Exemption of the MSEs from the labour and labour-related laws:* In some countries (e.g. in South Asia), all enterprises below a certain threshold size (generally ten workers) are excluded from the scope of application of all labour laws. This approach corresponds to a small share of ILO member States only.¹² In other countries, some categories of workers are excluded due to narrow definitions of the employment relationship concerning for example “daily workers”.¹³
 - (b) *Partial exemption from certain specific statutes:* In some countries, labour legislation covers all workers but exempts MSEs from certain specific sections of the general statute, for example requirements to establish an occupational safety and health committee in the enterprise or the regulations concerning collective dismissal.
 - (c) *Parallel labour law regimes:* A NATLEX search reveals that 18 countries (including some Latin American countries such as Brazil, Ecuador and Peru) have adopted specific MSE laws in the last decade, usually as stand-alone texts separate from the principal labour laws, but not always. Countries have created parallel labour regimes for MSEs with lower standards regarding matters such as hiring and firing, paid vacations, working hours and social security as well as in some cases simplified administrative procedures.
14. Generally speaking, generic or partial exclusions of enterprises below a certain threshold size from complying with legislation have severe disadvantages. They leave workers unprotected and imply the risk of “growth traps” whereby enterprises would stop growing (or disguise their growth by remaining/turning informal) in order to avoid passing the threshold level.¹⁴ Such exclusions also give incentives for enterprises above the threshold to split up into multiple units and can result in unfair competition between enterprises within and outside the scope of the law. On the other hand, parallel labour law regimes with lower labour standards keep MSEs segregated from the mainstream economy, thereby reducing opportunity for integration in supply chains.

Reasons for the compliance gap

15. Figure 4 illustrates the compliance gap between micro- and small enterprises on the one hand, and larger enterprises on the other, for the case of Peru. While in large enterprises, more than 70 per cent of salaried workers are protected by the health insurance and pension scheme they are legally entitled to, this share drops to less than 40 per cent in small enterprises and less than 20 per cent in micro-enterprises. Compliance with the legally binding minimum wage also varies with enterprise size. In micro-enterprises, more

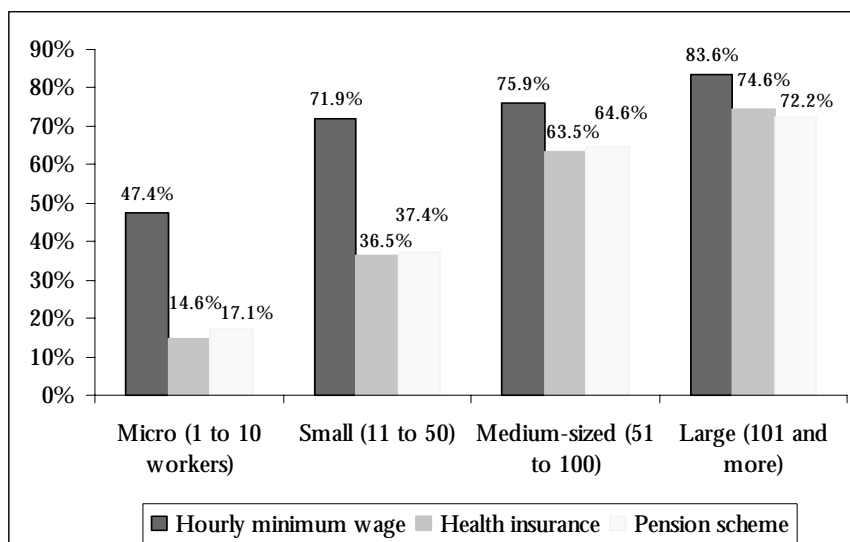
¹² J.L. Daza: *Informal economy, undeclared work and labour administration*, Dialogue Paper 9, ILO, Geneva, 2005.

¹³ Fenwick et al., 2006, op. cit.

¹⁴ Unfortunately, beyond anecdotal evidence of enterprises attempting to maintain their size below the threshold, there are few systematic studies exploring this issue. A recent study on the German legislation of protection against dismissal finds only weak statistical evidence for the threshold effect and points out the need for further research. See S. Verick: *Threshold effects of dismissal protection legislation in Germany*. IZA DP 991. Institute for the Study of Labor, Bonn, 2004.

than half of salaried workers earn less than the hourly minimum wage. Indications are that figures similar to Peru are applicable to many other developing countries.

Figure 4. Peru: Compliance with labour and social security law by enterprise size, salaried private sector workers, urban areas, 2005



Source: J. Chacaltana (2006): *Economic implications of labor and labor-related laws for SMEs: A quick review*. A paper prepared for the ILO, Geneva.

- 16.** The **economic precariousness** of many MSEs is a major barrier to compliance. Many survivalist enterprises hardly generate the resources for the enterprise workers and owners to survive; for this type of enterprise, even costs of compliance that appear low in absolute terms can be too high. Cut-throat competition and frequent moving in and out of economic activities is a major factor in such precariousness.
- 17.** The **design of legislation** in many cases does not appear well-adapted to its application to MSEs. While there is no widely accepted formula for assessing labour legislation (see box 1), it is clear that in many countries, labour laws are not tailored to MSEs' needs. As a result MSEs are constrained by the cost of compliance and workers are left unprotected. In Pakistan, for small enterprises with ten or more workers, the Factories Act (1934) establishes a long and extremely detailed list of steps for compliance in the area of occupational safety and health, including the periodicity for painting walls and the requirements to document this in a register.¹⁵ Recognizing the complexity of this and other laws that cover enterprises, the Government is currently engaged in a process of consolidating the laws affecting enterprises.

¹⁵ ILO: *Creating a conducive policy environment for micro-, small and medium-sized enterprises in Pakistan*, SEED Working Paper No. 29, Geneva, 2002.

Box 1
Assessing and comparing labour regulations

What methods are appropriate to measure and compare the quality of labour law and the optimal level of regulation?

The widely cited *Doing Business* initiative of the World Bank has made an important contribution to the international debate with respect to what generally constitutes an enabling business environment. Its assessment of 175 countries covers ten regulatory areas: starting a business, dealing with licences, employing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and closing a business. In the area of labour regulations, however, the findings have been the subject of substantial debate, and the limitations of its methodology in this area and the possible misinterpretation of the data illustrate the complexities and pitfalls of the issue.

What the *Doing Business* indicators measure in the labour sphere is basically the rigidity of employment regulations for quite large enterprises (201 or more employees) in the country's most populous city, mainly in relation to hiring, hours of work and firing workers. It is also limited to full-time male workers employed by the same company for over 20 years and earning at least the national average salary. Only incorporated domestically owned manufacturing enterprises are included in the survey which is conducted by local experts from a standard questionnaire.¹⁶ The scope is therefore limited in terms of the businesses and workers covered, the labour regulatory domain reviewed, and the assessment criteria used.

The scoring, which simply assigns a higher ranking to countries with a lower level of regulation implies a serious risk of misinterpreting the data. Many readers are likely to draw the conclusion that no regulation is the optimal level of regulation, although this interpretation is not supported by the World Bank¹⁷ itself, which recognizes that a higher ranking does not necessarily mean better regulation. More broad-based measures, better able to capture the need to balance flexibility with protection for both workers and employers, would help inform policy-making and assist governments, employers' organizations and trade unions in designing improved rules and institutions to govern the labour market.

- 18.** In many cases, **high transaction costs**, such as the costs (including time and absences from the workplace) associated with accessing information, legal and bureaucratic procedures and labour inspection have created barriers for compliance in many countries. Given that transaction costs usually have a strong element of fixed costs that hardly varies with the size of the enterprise, the cost of compliance per employee or as a share of turnover is much higher for MSEs than is the case for larger enterprises. The costs for OECD countries as shown in figure 5 below illustrate the disproportionate burden of such costs to smaller enterprises.
- 19.** A **high tax wedge on labour**¹⁸ may negatively impact formal employment and stimulate informality. For instance, a 10 per cent rise in payroll taxes in Colombia reduced manufacturing wages by between 1.4 per cent and 2.3 per cent and formal employment by 4 per cent to 5 per cent.¹⁹ Also in the EU-8 (Czech Republic, Hungary, Poland, Slovakia,

¹⁶ The methodology for the employing workers part of the survey can be viewed on: <http://www.doingbusiness.org/MethodologySurveys/EmployingWorkers.aspx>.

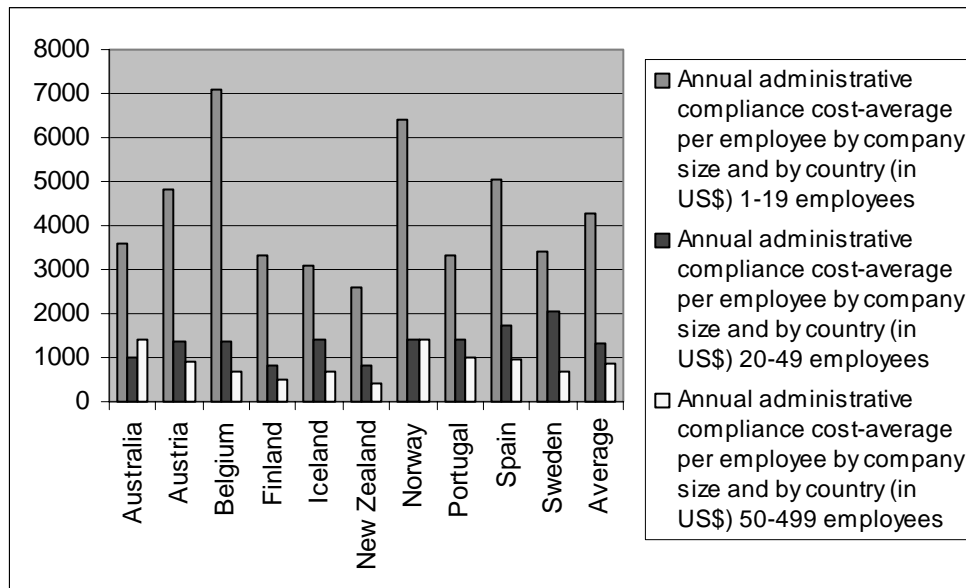
¹⁷ World Bank, op. cit, 2006. Washington, DC, 2005.

¹⁸ The tax wedge is a measure of the difference between the total labour cost to an employer and the corresponding disposable income of an employee. It is the sum of personal income tax, social security contributions and payroll taxes minus any cash benefits.

¹⁹ A. Kugler and M. Kugler: *The Labor Market Effects of Payroll Taxes in a Middle-Income Country: Evidence from Colombia*. IZA Discussion Paper No. 852. Institute for the Study of Labor, Bonn, 2003.

Slovenia, Latvia, Lithuania and Estonia) each percentage point difference in the tax wedge is associated with a decrease in employment growth by 0.5-0.8 percentage points.²⁰

Figure 5. Annual administrative compliance cost per employee, by country and enterprise size



Note: Administrative costs include taxation, environmental and employment regulation.

Source: OECD: *Businesses' Views on Red Tape: Administrative and Regulatory Burdens on Small and Medium-sized Enterprises* (Paris, OECD, 2001).

20. The **outreach of authorities** to enforce labour and labour-related laws in MSEs is very uneven across countries and often insufficient. This is partly linked to limited resources allocated to labour administration resulting in the limited capacity and strength of labour inspections. Such a situation has often given rise to the issues of corruption and low levels of compliance.
21. Exclusive reliance on the **traditional enforcement approach** with a strong focus on sanctions has not necessarily resulted in widespread compliance while at the same time boosting circumstances for higher corruption. Research shows that sanctions combined with positive measures of providing information and incentives for compliance have generally had better results.²¹
22. There are also frequently **procedural weaknesses** that hinder compliance. For example, while the content of labour legislation in South Africa is generally considered to be sound, there are some procedural aspects that create difficulties particularly for MSEs. In relation to procedures for dismissal, one recent study states “[...] employers, consultants, lawyers, arbitrators and judges have continued to overemphasize pre-dismissal procedures and in

²⁰ World Bank, *Quarterly Economic Report, Special topic: Labor taxes and employment in the EU-8*, Washington, DC, 2005.

²¹ Fenwick, 2006, op. cit.

doing so have imposed an unnecessary burden on employers without advancing the protection of workers.”²²

23. Yet another issue that affects compliance is the frequent **lack of information** about legislation among MSE employers and workers. According to studies in various countries, such as China, Nepal and the United Republic of Tanzania, many employers are simply not aware of their legal obligations.²³ Likewise, many MSEs are not aware of the benefits they are entitled to under small enterprise promotion policies or similar schemes.²⁴ In many cases, this is aggravated by frequent changes in regulations, causing additional stress for enterprise owners and managers.²⁵

Insufficient representation of MSEs

24. A way of ensuring that labour and labour-related laws are adapted to the requirements of the MSEs is their involvement in the process of designing the law. While government has the primary responsibility for the design of the policy and legal framework, the role of improving and reforming this environment should not be left to government alone. The ILO’s methodology of participatory labour law reform exemplifies that common sense approach.²⁶
25. Research by the ILO²⁷ and others²⁸ clearly indicates that there is generally insufficient representation of the MSE sector in policy-making processes, and that this is one reason for the large enterprise bias in the policy environment in many countries. MSEs are seldom organized in such a way as to have much involvement or influence on public policy-making. Both MSE employers and workers often face difficulties in representation. On average, MSE employers are less prone to affiliate to employers’ organizations. MSE workers are less likely to affiliate to trade unions than their counterparts in larger

²² H. Cheadle: “Concept paper: Regulated flexibility and small business. Revisiting the LRA & the BCEA,” a paper prepared for the Department of Labour, Pretoria, 2006.

²³ P. Tibandebage, S. Wangwe et al.: *Creating a conducive policy environment for employment creation in micro- and small enterprises in Tanzania*, SEED Working Paper No. 55. Geneva, ILO, 2003; P.M. Shakya, “Labour law reforms and growth trap among micro- and small enterprises (MSEs) in Nepal”, a paper prepared for ILO Kathmandu, 2004; and F. Cooke, “Employment relations in small commercial businesses in China”, in *Industrial Relations Journal*, Vol. 36, No. 1, pp. 19-37, 2005.

²⁴ R. Meier and M. Pilgrim: “Policy-induced constraints on small enterprise development in Asian developing countries” in *Small Enterprise Development* 5(2), 1994, pp. 32-38; and A.K. Singh, A. Joshi et al.: “Review of policy and regulatory environment for micro- and small enterprises in Uttar Pradesh”, a paper prepared for SRO ILO New Delhi, ILO, 2005.

²⁵ Tayo Fashoyin, Emily Sims et al.: *Labour-management cooperation in SMEs – Forms and factors*, Geneva, ILO, 2006.

²⁶ See ILO DIALOGUE’s labour law web site, which stresses participatory labour law reform: <http://www.ilo.org/public/english/dialogue/ifpdial/areas/legislation/index.htm>.

²⁷ Reinecke and White, 2004, op. cit.

²⁸ A. Berry: *Creating an enabling policy environment for promotion of small enterprises: Traditional and innovative approaches*. Focal/CIS discussion papers, FC1995-10. Toronto, Center for International Studies, 1995, p. 1.

enterprises, partly as a result of legal restrictions which establish a minimum number of workers to form a trade union and partly because of the precarious situation of enterprises.

26. In virtually all countries with available data, unionization rates are much lower in MSEs than is the case for larger enterprises. For example, in Tanzania the percentage of unionized enterprises jumps from 12 per cent for micro-enterprises and 33 per cent for small enterprises to 96 per cent for large enterprises. A similar tendency is reflected in the data for South Africa and several Latin American countries.²⁹
27. In many countries, unionization and collective bargaining are legally linked to a certain minimum size of the enterprise, such as in several Latin American countries with labour relations systems based on enterprise unions, excluding workers in the smallest enterprises from the possibility of organizing themselves into unions. Uruguay, however, does not establish any restriction or minimum size for the establishment of a trade union.³⁰ Workers in enterprises below this minimum size can only be covered by virtue of sectoral or national unions and collective agreements. This limitation on unionization would appear to be problematic in the context of the ILO Freedom of Association and Protection of the Right to Organise Convention, 1948 (No. 87).³¹ For example, in Ecuador, the establishment of worker organizations requires a minimum of 30 workers.³²

IV. Orientations for change: Reducing precariousness of MSEs and advancing compliance

28. The complexity and diversity of the issues outlined above suggests that there is no single quick fix to the challenge of increasing the coverage of MSE owners and workers in the area of labour and labour-related laws; rather, what is needed are reforms and measures across a range of interrelated areas. This section will identify key issues which need to be addressed.

Reduce precariousness and promote formalization of the MSE sector

29. General measures to improve the business environment, such as macro policies to promote aggregate demand, access to markets and inputs such as infrastructure, credit and business development services and a system of affordable legal redress, can all help reduce the precariousness of MSEs and thus enhance their ability to comply with laws and regulations. Reducing the time and cost of registering a new business and ensuring adequate property rights have been shown to be important measures to facilitate the

²⁹ Reinecke and White, 2004, op. cit.

³⁰ J. Dieste (2005). *La aplicación de la legislación en las micro y pequeñas empresas. El caso de Uruguay*, Santiago, ILO.

³¹ C. Schlyter: *International labour standards and the informal sector: Developments and dilemmas*. Working paper on the informal economy, No. 3, ILO, Geneva, 2002.

³² ILO: *Organizing for social justice. Global Report under the Follow-up to the ILO Declaration on Fundamental Principles and Rights at Work*, International Labour Conference, 92nd Session, Report I(B), Geneva, 2004.

formalization of MSEs,³³ particularly if complemented by positive incentives such as access to credit, government contracts, training, low-cost health insurance and other services. Some countries have successfully supported such measures through special MSE departments and one-stop-shops for information, paper work, etc. (e.g., Peru and the Philippines).

30. Examples of such incentives include the training, insurance and credit opportunities provided by the Shanghai municipal government to the self-employed in exchange for increased levels of formalization, or the tax allowances offered to MSEs in Viet Nam and Hungary for a certain period after registration. Research from Peru also indicates that incentives, such as access to credit or to markets, are essential in inducing enterprises to join the formal sector.³⁴ While only 5,000 enterprises decided to register under a special labour regime, 300,000 enterprises registered under a regime that provides tax incentives for micro-enterprises.
31. Specific measures may be required to enable women entrepreneurs to start, expand, and formalize their businesses. Lack of legal title to land and discrimination in access to formal credit mechanisms often work specifically against women entrepreneurs. Legal mechanisms need to be introduced and/or made more robust in order to eliminate such discrimination.
32. Employers' organizations can play a key role in improving the competitiveness of MSEs and promoting their formalization. They are uniquely positioned to support small enterprises since they enjoy privileged access to policy-makers and can provide or facilitate access to services and markets.³⁵ To tap this potential, the ILO in collaboration with the International Organisation of Employers has developed a capacity-building tool known as "Reaching out to SMEs" which is being used in South Asia, Eastern Europe, Central America and Southern Africa.

Reduce the tax wedge on labour when feasible

33. Reductions in labour taxes, particularly for lower-skilled workers, can, in some cases, contribute to enhance competitiveness and formal employment. Where the informal economy is large, and the revenue base is too small, alternative instruments to labour taxation could be considered in order to advance the twin objectives of social progress and economic development. For instance, social security spending could be partially financed from general taxes as in the case of several countries in Europe and other parts of the world, reducing the burden for employers and workers.³⁶

³³ H. de Soto (1989): *The other path. The invisible revolution in the Third World*, New York, Harper & Row.

³⁴ V. Zuin, "Business strategies of informal micro-entrepreneurs in Lima, Peru", Decent Work Research Programme, International Institute for Labour Studies, Geneva, 2005 and J. Chacaltana, op. cit., ILO, Geneva, 2006.

³⁵ ILO: *Employers' organizations and the promotion of small and medium-sized enterprises – Practical experiences from seven countries*, Geneva, 2004.

³⁶ For an in-depth analysis on the implications of alternative sources of financing social protection, see: M. Cichon, S. Wolfgang et al., *Financing social protection. Quantitative Methods in Social Protection Series*, ILO/ISSA, Geneva, 2004.

Simplify and streamline laws and regulations, taking account of MSE impact

- 34.** Reducing the costs of complying with labour law is an important task, especially where the costs incurred do not contribute to workers' welfare. The degree to which legal requirements are adapted to the situation of MSEs should be reviewed, preferably with the involvement of the concerned employers and workers, leading to, among other things, differentiations in application by enterprise size in specific cases.
- 35.** There are some areas where international labour Conventions recognize the need for enterprises to adopt special provisions for small enterprises, particularly in the areas of employment, social security and collective bargaining.³⁷ However, while governments need to be realistic as to the capacity of MSEs to comply with labour legislation, there should be no general exemptions from labour standards.³⁸ Instead, the focus should be on simplifying and lowering the cost of compliance.
- 36.** In some cases, the legislation may be simplified by merging legal texts (which, in some jurisdictions, are often numerous) and eliminating contradictory prescriptions and legal obligations. For example, Pakistan is engaged in a process of labour law reform to reduce the number of labour laws from 27 to six.³⁹ A multiplicity of parallel legislative frameworks can create ambiguity and confusion; for instance, in India there are 38 central laws with many more state laws applicable to enterprises with different thresholds of number of workers (Factories Act not applicable to enterprises with less than ten workers, Industrial Disputes Act not applicable to less than 50 workers).⁴⁰ Many laws may be less relevant for modern times, since some were from the colonial era.
- 37.** While the content of the law may be problematic for MSEs in some cases, it is very common that complicated administrative procedures for compliance are more of a burden than the law itself. It is therefore important to simplify the application of labour and labour-related laws by eliminating unnecessary fees, reducing the number and complexity or simplifying the content of forms, removing the need for legal verifications and advice, reviewing the periodicity of cyclical reporting and data collection and strengthening the capacities and transparency of law enforcement agencies, including the elimination of corrupt practices.

Raise awareness of laws and regulations

- 38.** The widespread lack of awareness of laws and regulations among MSEs is a major barrier to compliance. It can be addressed through information campaigns by governments,

³⁷ G. von Potobsky: "Small and medium-sized enterprises and labour law", in *International Labour Review* 131(6), 1992.

³⁸ Fenwick, 2006, op. cit.

³⁹ Reinecke and White, 2004, op. cit. and information provided by ILO Islamabad, June 2006.

⁴⁰ Navin Chandra and Vandana Parashar: "Labour law reforms and MSE growth trap", a paper prepared for ILO New Delhi, 2005.

constituents and other groups (see box 2). Wide dissemination of the rules in force can help too.⁴¹ Award schemes and other initiatives can also be effective at raising awareness.

Box 2

Awareness campaign by the ILO

Several ILO technical cooperation projects have run public awareness programmes about labour laws and their application through its constituents. Principal media providers, like radio, TV and print, even street theatre entertainers - in project countries (Indonesia, Kenya, Uganda, United Republic of Tanzania) were trained for the production of programmes, responding to call-in messages and drafting articles focused on the labour laws and related services. The projects have also organized a number of high visibility thematic events and encounters with select organizations as part of the media campaigns.

Source: ILO.

39. The language used in legal documents is often difficult to understand for lay persons. The “plain language movement” in South Africa, for example, tries to ensure that all laws are understandable by involving non-legal specialists in the drafting of texts. Such measures can be particularly effective for MSEs where literacy levels are often low.

Promote positive link between enterprise performance and labour standards

40. Labour standards have a crucial role in ensuring that market integration and economic development proceed in such a way as to ensure long-run, dynamic competitiveness of economies.⁴² Providing examples of benefits that enterprises receive from compliance with labour law can be a more persuasive means of further expanding compliance. There are numerous examples relating to the benefits from compliance. For instance, start-up firms which apply good workplace practices have been shown to experience faster employment growth,⁴³ and small and medium enterprises that use progressive management practices built on good working conditions have also been shown to be more likely to grow.⁴⁴ Studies show that working excessive hours may increase production in the short term, but cause health problems that decrease productivity in the longer term.⁴⁵

⁴¹ For some examples of the ILO’s efforts to share simple descriptions see: the “Labour Law Profiles” at: <http://www.ilo.org/public/english/dialogue/ifpdial/info/national/index.htm> and the “Termination of Employment Digest” (English only) at: <http://www.ilo.org/public/english/dialogue/ifpdial/info/termination/>.

⁴² Simon Deakin and Frank Wilkinson: “Rights vs. Efficiency? The Economic Case for Transnational Labour Standards”, in *Industrial Law Journal*, Vol. 23, No. 4, December 1994, pp. 289-310.

⁴³ P. Doeringer, C. Evans-Klock and D. Terkla: *Start-Up Factories: High-Performance Management, Job Quality, and Regional Advantage*, Oxford University Press, Oxford, 2002.

⁴⁴ A. Cosh, A. Hughes and M. Weeks: *The Relationship Between Training and Employment Growth in Small and Medium-Sized Enterprises*, DfEE Publications, Nottingham, 2000.

⁴⁵ Lee and McCann, forthcoming and see: http://www.ilo.org/public/english/bureau/inf/features/06/asrm_hanoi.htm.

Likewise, a study on the links between health variables and productivity in Nicaragua found that poor health could reduce productivity by up to 58 per cent.⁴⁶

41. Some other examples of benefits of compliance could be from the ILO's technical programmes, such as, Work Improvements in Small Enterprises (WISE) and Improving Work Environment and Business (I-WEB), linking improvement in productivity with compliance with safety and health-related rules. For instance, good labour practices have resulted in increased productivity and competitiveness in the brassware cluster in Moradabad, India.⁴⁷ The ILO's *Better factories Cambodia* project monitors application of labour law and ILO standards by involving workers and management and has reported improved working conditions and productivity.⁴⁸

Involve MSE owners and workers in legal and regulatory reform through social dialogue

42. Closing the "representational gap"⁴⁹ and increasing the role of MSE owners and workers in social dialogue is a key ingredient in any strategy to improve the design and application of labour and labour-related law in MSEs. An important objective of both employers and workers organizations is therefore to extend their outreach among the smallest enterprises and the informal economy. The Confederation of Mexican Workers (CTM) in Mexico, for example, incorporates a broad range of organizations, including agrarian communities and small enterprises. In El Salvador, the national employers' organization helped women market vendors in micro-enterprises in their dealings with the authorities, and some of these women became members as a result.⁵⁰
43. On their side, governments should establish mechanisms to involve representatives of the MSE sector in the design of new legislation, and to carry out regular monitoring of the effectiveness, impact and problems with legislation and regulations. The United Kingdom, Ireland, Canada and Australia, for example, have established various participatory mechanisms to review the impact of new and existing legislation on small businesses in order to make it better suited to the conditions of these enterprises and to promote successful compliance.

Introduce innovative strategies for enforcement

44. Many labour law regimes depend mainly on a traditional enforcement approach largely relying on sanctions. In other words, they establish mandatory labour rights and standards empower one or more regulatory agencies at the national and sub-national levels to oversee

⁴⁶ J. Espinosa, C. Hernández et al.: "Productivity and health status in Nicaragua", in W. Savedoff and T.P. Schultz (ed.): *Wealth from health. Linking social investments to earnings in Latin America*. Washington, DC, IADB, 2000.

⁴⁷ ILO: *Casting a new die*, a CD on Moradabad programme, ILO New Delhi, 2005.

⁴⁸ <http://www.betterfactories.org>.

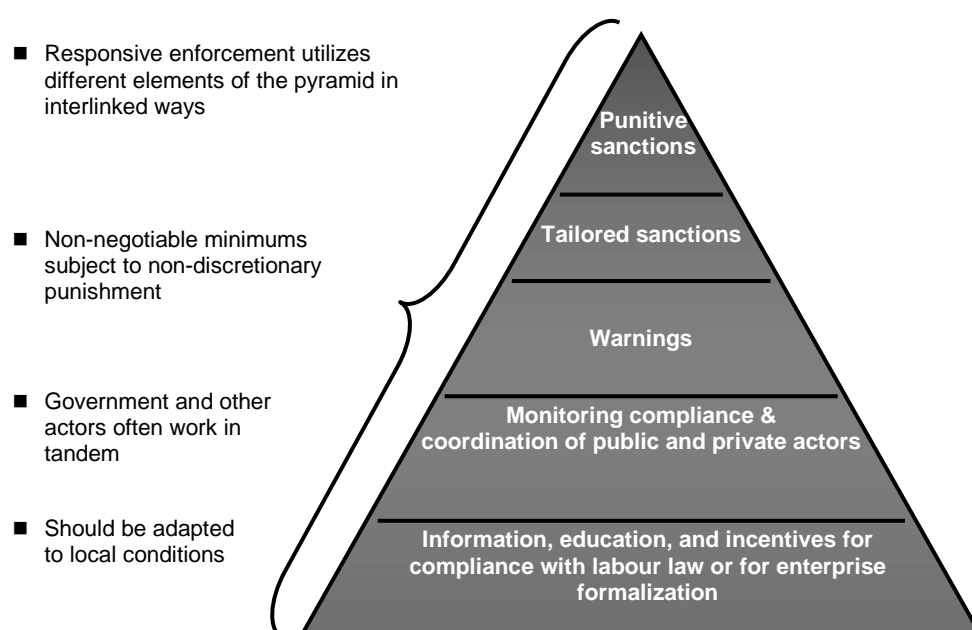
⁴⁹ ILO: *Decent work and the informal economy*, Report VI, International Labour Conference, 90th Session, 2002, Geneva.

⁵⁰ ILO: *Organizing for social justice. Global Report under the Follow-up to the ILO Declaration on Fundamental Principles and Rights at Work*, International Labour Conference, 92nd Session, Report I(B), Geneva, 2004.

the monitoring and enforcement of the standards, and provide for sanctions in the event of failure to comply. However, a growing body of evidence indicates that a more holistic and innovative strategy is likely to lead to higher levels of compliance in MSEs.⁵¹

45. Figure 6 presents such a more holistic approach in the form of a “pyramid of enforcement strategies”. A key aspect of the pyramid is that it assumes that regulation is likely to be more effective when regulators have a number of different options available to them in strengthening compliance with labour laws. The existence of legal rules and norms enshrining labour rights and standards as non-negotiable behavioural minimums, with non-compliance subject to non-discretionary punishment, are at the apex of the pyramid. However, sanctions and fines are only one of several means to ensure compliance. Other regulatory strategies may be used, often in collaboration with other regulatory actors, to achieve the desired change in a manner that is responsive to the circumstances of MSEs.

Figure 6. Pyramid of enforcement strategies



Source: C. Fenwick, J. Howe et al.: “Labour and labour-related laws in micro- and small enterprises: Innovative regulatory approaches”, a paper prepared for the ILO, Geneva, 2006, based on I. Ayres and J. Braithwaite: *Responsive regulation. Transcending the deregulation debate*, New York, Oxford University Press, 1992.

46. Providing advice or education to MSEs about labour rights and standards, together with incentives for MSEs to formalize and recognize their obligations under labour law, can form the first stage in an overall enforcement strategy, or the base of the pyramid. Other strategies at this level include information campaigns, training courses, and “small employer of the year” awards. Employers’ organizations are important players in this regard; many of them already provide industrial relations-related services to assist entrepreneurs in observing labour law and improving employee management practices.
47. The pyramid recognizes the need for regulatory authorities to monitor the extent to which MSEs comply with labour laws. This level of the enforcement pyramid can incorporate cooperation between state labour administrations and representative organizations such as

⁵¹ Fenwick, op. cit.

trade unions organizations in monitoring and inspection. An example of such cooperation is the Regional Safety Representative Scheme in Sweden, under which trade unions play a prominent role in monitoring and promoting compliance with occupational health and safety standards in small businesses.

48. Another stage in moving towards the imposition of formal sanctions for non-compliance might be warnings of non-compliance with labour laws, indicating that further non-compliance would lead to the imposition of tailored punitive sanctions. Such an approach is adopted by the Philippines in relation to small enterprises. This strategy would be used in situations where education and monitoring had failed to bring about behavioural change. Such warnings may be linked to assistance to employers to enable them to comply.
49. Tailored sanctions allow state labour administrations to impose sanctions on MSEs for non-compliance with labour law, but to do so in a manner that provides incentive and capability for the enterprises to comply with the legal requirements. An interesting approach to remediation strategies to enforce the law in micro-enterprises was introduced in Chile with the 2001 reform of labour law. An enterprise with less than ten workers that has been found guilty of infringing the labour law for the first time in a year can exchange the monetary fine against the participation in a compulsory training course. This approach is based on the hypothesis that in many cases, non-compliance among MSEs is due to lack of knowledge and information rather than bad faith. A first impact assessment study suggests slightly higher levels of compliance among training participants than among a control group that paid their fine.⁵²
50. Finally, punitive sanctions would most likely involve legal action taken by a state labour administration invoking and seeking the application of sanctions available under labour laws to a non-complying MSE. Although punitive sanctions form the peak of the enforcement pyramid, the fact that they are available to regulators contributes to the effectiveness of other strategies in the pyramid.
51. While such a comprehensive integrated enforcement strategy as outlined above is required for effective coverage of labour law, it is also recognized that such strategy will entail far more commitment of resources than presently allocated in many member States.⁵³

V. Proposed points for discussion

52. The Committee may wish to provide advice and guidance with respect to future priorities and actions of the Office's work on labour and labour-related law and MSEs as outlined in this paper. The Committee's guidance could address the following areas:
 - Orientations of the Office's work to support constituents' efforts in the area of closing the representational gap which currently prevents or reduces the ability of MSE owners and workers in many member States to influence the policy-making process in general, and in the labour law area in particular, as well as strengthening constituents' capacity to engage in policy debates in the area of labour legislation for MSEs.

⁵² This probably reflects the fact that the impact assessment included many sample enterprises which underwent the training during the very first months of the programme, when training content was still less consolidated than is the case now. See L. Montero, G. Reinecke et al.: *Sustitución de multas por capacitación: Evaluación de una experiencia innovadora de aplicación de la legislación laboral en micro empresas*, ILO, Santiago, 2006.

⁵³ GB.297/ESP/3.

- Indications of how the Office can most effectively draw upon the experience of constituents in the area of labour law and MSEs, including strategies for innovative and effective enforcement policies which might include integrated work across the Office.
- Specific priorities for the Office's work with respect to enhancing its knowledge, advocacy and tools in this area, including methodologies for assessing compliance costs and benefits of labour legislation and, in particular, the impact on employment of reforms in the business environment.
- Partners with whom the Office might usefully strengthen collaboration in this area of work, including possible collaboration with the World Bank on assessing and comparing labour regulation.

Geneva, 3 October 2006.

Submitted for debate and guidance.