RESEARCH INSIGHTS

How Does the Enforcement of Labor Market Regulations Affect Informality and Firms?

N.° 146 | December 2024

Author: Cezar Santos.

- **Labor inspections reduce informality but slow firm growth: inspections mandate formalization and impose fines, causing immediate compliance but long-term stagnation in growth for audited firms in Brazil.**
- **Informality is pervasive: both large and small firms hire informal workers, and informal workers are similar to formal employees in age, education, and gender but earn slightly less.**
- **Inspections dampen innovation and dynamism: firms subjected to audits innovate less, with declines in trademark registrations and organizational complexity.**

CONTEXT

Informal employment is a defining feature of labor markets in many developing countries, including Brazil. Workers in the informal sector lack social protections, while informal firms avoid costly regulations. Governments enforce labor laws to curb informality, but these efforts have broader implications for businesses and the economy. Brazil's Ministry of Labor audits formal firms for non-compliance, focusing on unregistered workers. These audits impose fines and mandate worker formalization. Understanding the economic consequences of these inspections is critical, as they influence firm behavior, growth, and overall labor market dynamics.

PROJECT

This research examines the impact of Brazil's labor inspections on formal firms caught employing informal workers. Using a detailed dataset spanning over a decade, the study tracks how inspections affect firm dynamics, worker composition, and long-term growth. By linking inspection data to comprehensive employment records, the analysis reveals patterns of informality across firms of different sizes and explores the aftermath of enforcement actions. The findings focus on the consequences of regulatory enforcement, shedding light on policy trade-offs in tackling informality.

RESULTS

The findings reveal three important patterns: inspections slow firm growth, informality is pervasive across businesses of all sizes, and informal workers resemble formal employees in most observable characteristics.

Labor inspections mandate that firms caught employing informal workers formalize their entire workforce and pay significant fines. This enforcement causes a mechanical increase in the number of formal employees immediately after an inspection. However, over time, audited firms experience a notable slowdown in growth. This can be seen in Figure 1, which reports three lines. Each line represents the average firm size, measured as number of employees, for a group of firms that were caught with informal workers in an audit for a particular year: 2002, 2005, and 2008. It is easy to see that, as soon as a firm is caught by these inspections, its firm size stalls. While not-yet-caught firms keep growing, the size of a firm that is caught essentially remains constant for many years in the future.

This stagnation is consistent across firms of all sizes, suggesting that informality is not solely a characteristic of smaller enterprises. Large firms, despite being better resourced, also employ informal workers, albeit at lower rates.

Key Concept

INFORMAL EMPLOYMENT

Jobs where workers lack formal contracts, making them ineligible for benefits like social security or unemployment insurance.

The data also show that informal workers are similar to their formal counterparts in terms of age, education, and gender, but they earn slightly lower wages. This similarity underscores that informality stems from firms' cost-saving strategies rather than differences in worker characteristics.

Proximity to labor inspection offices plays a role in enforcement intensity. Firms closer to these offices face higher audit risks, leading to greater reductions in size and slower recovery post-inspection. Beyond employment, inspections have broader effects on business behavior. Firms audited for informal practices are less likely to innovate, as evidenced by declines in trademark registrations and patents. They also reduce their organizational complexity, becoming less dynamic.

POLICY IMPLICATIONS

Labor inspections effectively reduce informality in Brazil's formal sector, but they come with trade-offs. Policymakers face a delicate balance: too much enforcement can stifle firm growth and innovation, while lax oversight allows informality to persist. Targeted inspections, focusing on high-risk firms, may enhance enforcement efficiency without overburdening compliant businesses. Additionally, reducing payroll taxes or simplifying firing costs could encourage formalization organically, making compliance less onerous for firms.

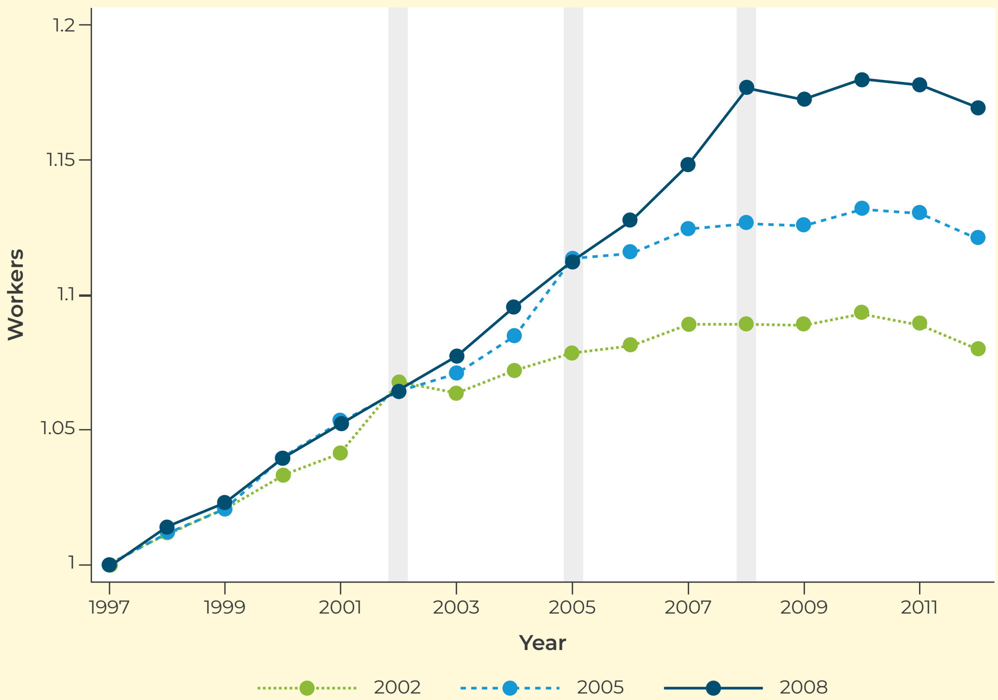
Key Concept

LABOR INSPECTIONS

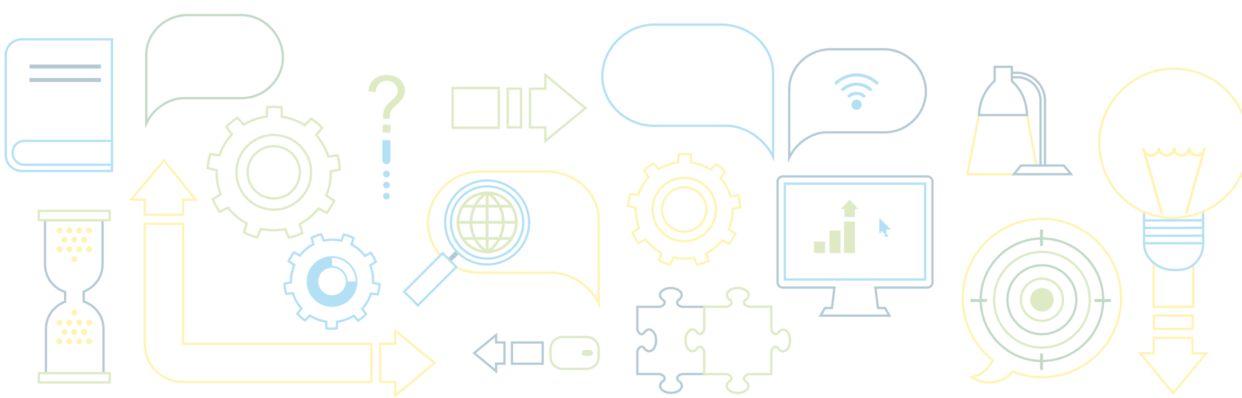
Government audits aimed at ensuring firms comply with labor laws, such as employing workers formally, which may involve surprise visits and penalties for violations.

Brazil's experience highlights a broader lesson for developing economies: enforcement strategies must align with economic realities. Policymakers should combine inspections with reforms that promote flexibility and reduce the regulatory burdens driving informality. Balancing these objectives is key to fostering a vibrant, inclusive labor market.

FIGURE 1. Number of Workers and Inspections



Note: This graph shows the relative increase in firm size, measured as number of employees. Each curve shows the average size of firms that were caught employing informal workers in different years.

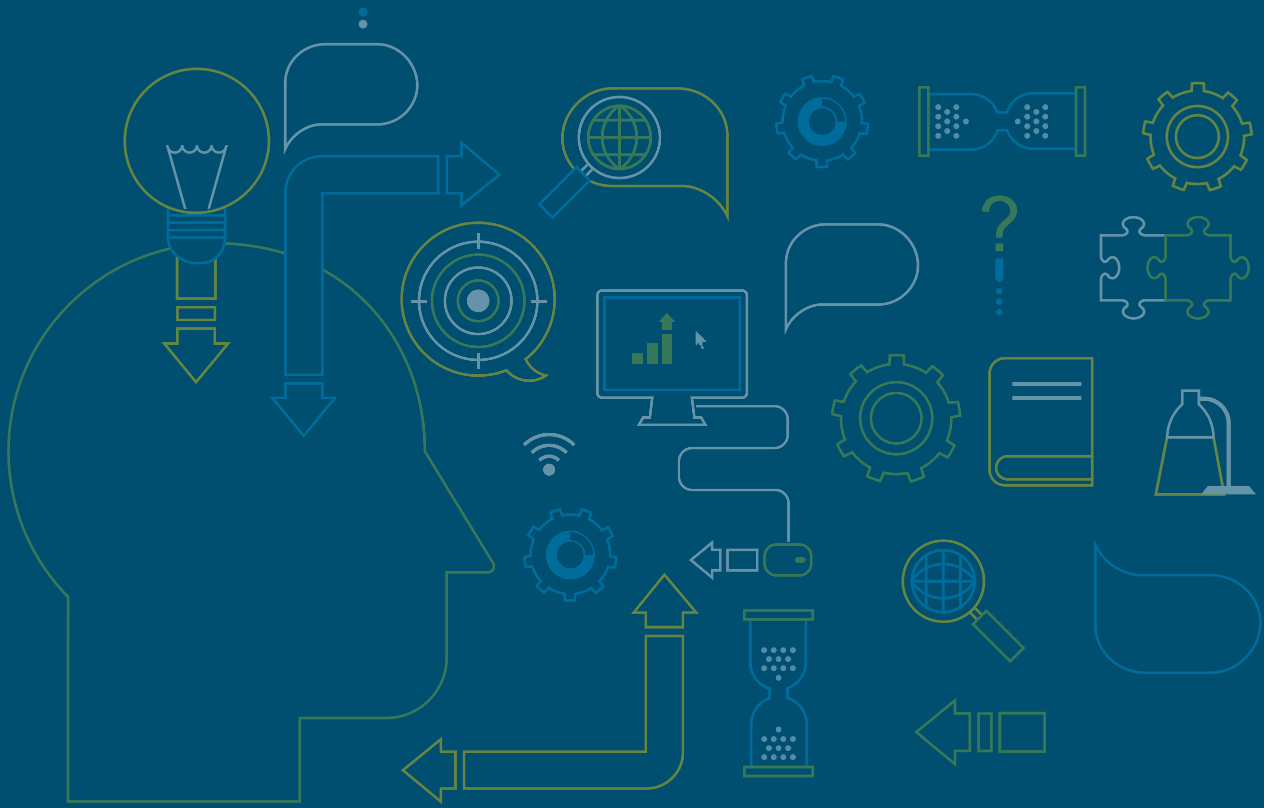


FULL STUDY

Brotherhood, Luiz, Daniel Da Mata, Cezar Santos, Nezih Guner, and Philipp Kircher. 2024. "Labor Market Regulation and Informality." IDB Working Paper No. 1646. Washington, DC: Inter-American Development Bank. https://publications.iadb.org/en/labor-market-regulation-and-informality.

Department of Research and Chief Economist

The Department of Research and Chief Economist generates new ideas to enrich the knowledge base that supports the policy agenda of the Inter-American Development Bank (IDB) and its member countries for achieving sustainable and equitable development in the region. To maximize the impact of its research, the Research Department carries out activities that serve as inputs to other IDB departments, governments, the academic community and public opinion in the region.



BY

www.iadb.org/res

IDB