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Laws or luck? Understanding rising formality in Brazil in the 2000s

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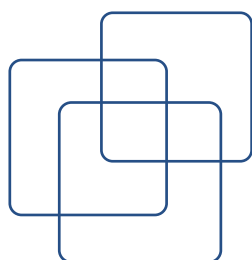
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Janine Berg

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Understanding rising formality in Brazil in the 2000s

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Janine Berg

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1 Introduction

Until the debt crisis of the 1980s and the lost development decades of the 1980s and 1990s, it was a widely held belief within development circles that developing countries would industrialize over time and that with industrialization, the living standards of the population would rise. Productivity increases would lead to increases in real wages and labour protections, typically restricted to a select few, would be extended to the newly industrialized workforce.

But the experience of the 1980s and 1990s, particularly in Latin America, led policymakers to consider otherwise. A series of economic crises and overall stagnant growth gave way to the continued swelling of large informal economies and by the 2000s, the belief that Latin American labour markets could one day resemble those of industrialized countries seemed a bygone dream. Yet during the 2000s, the trend of increasing informalization was reversed in Brazil as well as in Argentina. This paper discusses the important advances that have been made in Brazil in formalizing its labour market, the reasons for this improvement, and the implications for larger policy debates.

Brazil's labour market performed well in the 2000s, with strong rates of job creation and formal job growth outpacing informal job growth by a three-to-one ratio. A principle objective of this paper is to assess the extent to which government policies contributed to the improved performance of the labour market. This question is important not only for future policy design in Brazil and larger debates within the country about the role of government, but also because it can shed light on two other on-going debates in economic development. The first debate concerns labour market flexibility — whether labour market regulations impede economic growth and job creation — and the second, somewhat parallel, debate on whether growth, in and of itself is sufficient for improving working conditions, or whether government intervention is also needed.

2 The debate on labour market flexibility in Brazil

The 1990s were a difficult time for the Brazilian economy and an even more difficult time for its workers. Unemployment rates doubled, informality rose sharply, and real wages declined. The poor performance of the labour market led to a flurry of debate in the country about its causes and possible remedies. This debate, unsurprisingly, was highly influenced by international policymakers, particularly the Washington Consensus view that in order for economic reforms to be successful, the labour market needed the flexibility to adjust. Only then, it was argued, could workers reap the benefits of the new economic model.

Many reforms were made to the Brazilian economy. In 1990, the Collor administration announced the opening of the economy. The programme called for the immediate removal of import prohibitions and nontariff barriers, followed by a gradual reduction of tariff rates, from an average of 32 percent in 1990 to 14 percent in 1993. Following the establishment of the Mercosur Customs Union in 1995, the average import tariff was further reduced to 13 percent. Brazil's financial markets were also liberalized, which entailed the removal of prohibitions on foreign investment in the stock exchange as well as the loosening of regulations on foreign financing of domestic firms. In 1992, investors were given access to options and future markets. The government also undertook drastic measures to ensure price stability and in 1994 unleashed the Real Plan, which was successful in reducing inflation to single-digit levels. Financial liberalization resulted in a surge in

portfolio investment which caused appreciation of the real exchange rate. Unfortunately, this occurred at the same time that domestic companies were being exposed to foreign competition, after previously being protected under import-substitution industrialization. Domestic industries also suffered from high interest rates, needed to attract capital investment and maintain the value of the exchange rate. From 1993 until currency devaluation in January 1999, imports grew at an average annual rate of 18 percent, compared with 3 percent annual export growth.

The backdrop to these reforms was a newly democratic government and a new Constitution from 1988, which among other things, extended labour protections. The Constitution increased the cost of dismissal without just cause by raising the penalty from 10 to 40 percent that employers have to pay on funds accrued in the Guarantee Fund for Time of Service (FGTS - Fundo de Garantia do Tempo de Serviço). The FGTS is an individual severance fund financed by a monthly employer contribution equivalent to eight percent of the employee's salary, that can be accessed at retirement, upon dismissal as well as for the purchase of a home. If dismissal is without just cause, then the employer must pay a penalty equivalent to 40 percent of the value of the fund. The 1988 Constitution also reduced working hours from 48 hours to 44 hours per week, raised overtime remuneration from 1.2 to 1.5 times the normal wage, increased vacation pay by 1/3 of the monthly salary, increased maternity leave from 90 to 120 days, and granted new fathers five days of paternity leave. The Constitution also extended some of these rights to domestic workers, who had previously been excluded from most labour protections. In addition, it removed many restrictions on unionization and on striking that had been placed during the military government.

Yet the pressure for labour market reform during the 1990s was strong, and though not as far-reaching when compared with other countries in Latin America, a number of reforms were undertaken to make the labour market more flexible. In 1994, the Law on Cooperatives was passed, which permitted the creation of cooperatives of workers to deliver services to firms without the constitution of a work contract. The law made explicit that there is no employment relationship between cooperatives and their members. Though the law was put forward to help landless peasants, it was used increasingly by employers to avoid their legal obligations with employees (MARSHALL, 2004). In 1998, the "bank of hours" was instituted, making working hours more flexible, and lowering business costs by allowing working hours to vary, thereby permitting the suppression of the payment of overtime. The measure, however, was restricted to work contracts that are negotiated collectively. Also significant was the end, with the 1994 Real Plan, of the policy of indexing wages to inflation, after almost thirty years of official wage policies. Finally, the government chose to limit increases in the minimum wage and, as a result, it fell by nearly twenty percent, from R\$ 331 in February 1990 to R\$ 269 in February 1999, measured in real terms.¹

Thus, although it is true that the Constitution of 1988 raised labour costs, the decision to stop indexing wages and let the minimum wage fall contributed to a fall in average real wages from R\$ 978 in 1995 to R\$ 914 in 1999, mitigating some of the increase in overall labour costs.² Nevertheless, many critics still maintain that it was the rigidity of the Brazilian labour market that led to the poor performance of the 1990s. Bosch, Goni and Maloney (2007), for example, used a model of gross labour flows to analyse the causes of rising informality in six Brazilian cities during the period 1983-2002 and concluded that trade liberalization had a

¹ Measured in February 2009 reais for the City of São Paulo. Data available at <http://www.dieese.org.br>. In February 2010, the prevailing exchange rate was R\$1.8 per US\$1.

² Measured in R\$ 2007 (OIT, 2009).

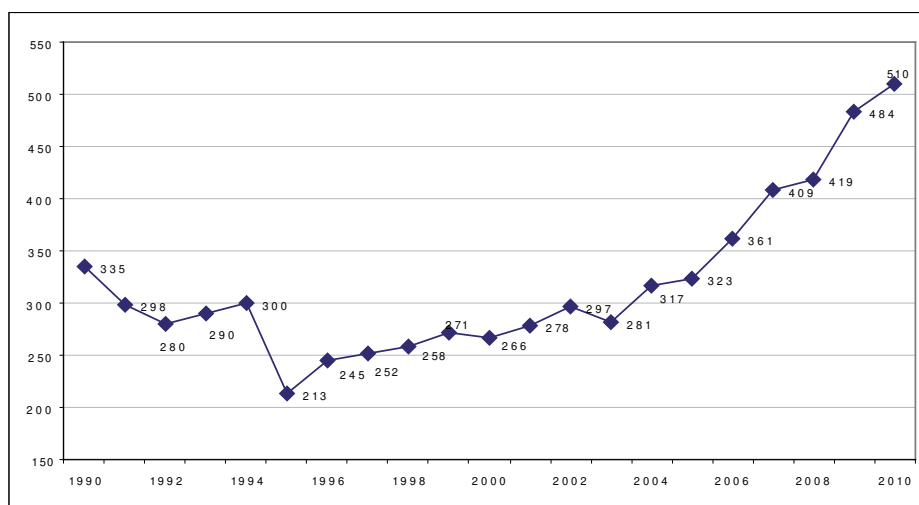
modest contribution on the increase in informality (21 percent), whereas strengthened labour rights under the Constitution of 1998 explained 76 percent of the increase.³ They argue that:

several dimensions of the Constitutional reform, in particular, regulations relating to firing costs, over-time and union power, explain much more...[the] effects work mostly through the reduction in hiring rates, rather than separation rates...overall, the findings confirm the importance of labor legislation to firms' decisions to create new formal sector jobs in Brazil (BOSCH; GONI; MALONEY, 2007, p.26).

If stricter regulations caused informality in the 1990s like Bosch, Goni and Maloney (2007) suggest, then the logical conclusion for the 2000s is that increased formalization was due to a loosening of labour market regulations. While there was some flexibilization in the 1990s, as mentioned above, the trend of the 2000s was quite the opposite. During the 2000s, the minimum wage nearly doubled in real terms, increasing from R\$ 266 in February 2000 to R\$ 510 in January 2010 (See Figure 1). The minimum wage has a significant impact on labour costs in Brazil as close to fifteen percent of the formal labour force earns the minimum wage and the minimum wage also determines the salaries of other workers on the pay scale as it is often used as a *numeraire*, with workers salaries set as multiples of the minimum wage (NERI; MOURA, 2006).⁴ Thus, it is fair to conclude that in the 2000s, there was greater institutional influence on the working of the labour market, not less. And that in spite of – or perhaps, *as a result of* – this influence, formalization increased.

Figure 1

Real Minimum Wage in Brazil, 1990-2010



Source: DIEESE.

Note: Data is for January of each year, measured in January R\$ 2010.

3 Labour market trends in Brazil in the 1990s and 2000s

In 2008, according to data from Brazil's national household survey (PNAD), 49.6 percent of the labour

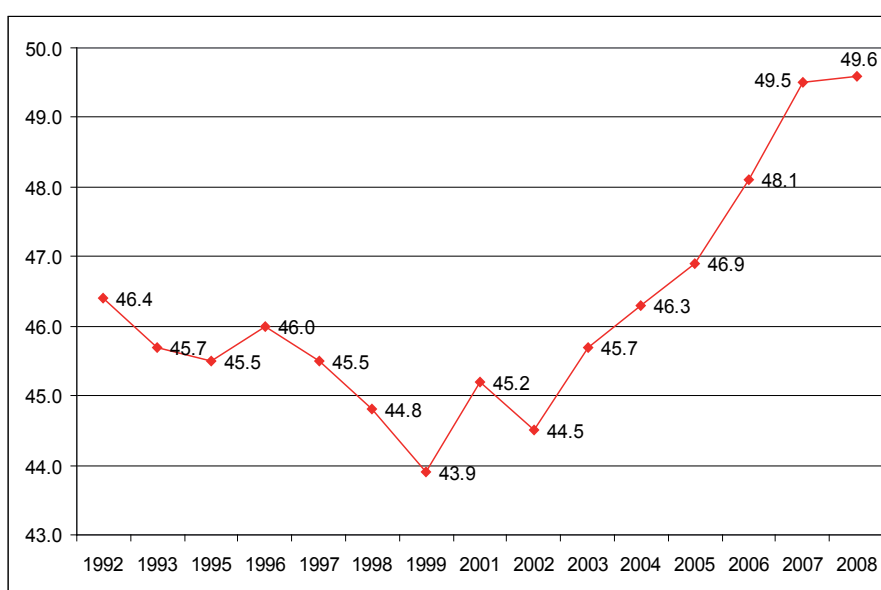
³ For a critique of Bosch, Goni and Maloney (2007), see Kucera and Roncolato (2008).

⁴ Interestingly, the minimum wage has also been shown to affect the salaries of informal workers (through the so-called “lighthouse affect”), as they negotiate salaries using the minimum wage as a reference. In 2005, 20 percent of informal, salaried workers earned the minimum wage (NERI; MOURA, 2006).

force was formally employed, using the 2002 ILO definition.⁵ According to this definition, formal employment in Brazil includes private salaried workers and domestic workers with a signed labour card (*carteira assinada*), government workers and military, as well as employers and self-employed workers who contribute to the Brazilian social security scheme (*previdência*). Informally employed workers include private-sector and domestic workers who do not have a signed labour card (*sem carteira assinada*), self-employed workers and employers who do not contribute to the social security system, unremunerated workers, and workers who produce and build for their own use. During the 1990s, the performance of the labour market was poor resulting in a fall in formality rates from 46.4 percent in 1992 to 43.9 percent in 1999. In the 2000s, the pattern was reversed resulting in an increase in formality to 49.6 percent in 2008 (See Figure 2).

Figure 2

Share of Formal Employment in Brazil, ILO Definition, 1992-2008 (percent)



Source: Author's calculations based on IBGE/PNAD.

Note: Workers aged 16 years and older. Does not include the rural areas of the Northern states, with the exception of Tocantins. The PNAD survey was not undertaken in 1994 or 2000.

Table 1 shows the dramatic difference in the growth of formal and informal jobs between the two periods. During 1992-1999, annual formal job growth was a mere 1.3 percent, whereas informal jobs grew at a rate of 3.0 percent annually. In the second period, 1999-2008, the patterns were reversed. Formal jobs grew at an annual rate of 5.3 percent, whereas informal job creation fell to 1.7 percent annually.

The rise in formality rates was driven principally by an increase in the percentage of salaried workers with a signed labour card, who in 2008, made up 34.5 percent of total employed. Between 1999 and 2008, this category grew at an average annual rate of 6.6 percent, compared with just 0.7 percent annually between 1992 and 1999. In comparison, during 1992-1999, the category of informal salaried workers (*sem carteira*

⁵ For purposes of analysis, I use data from the years 1992, 1999 and 2008. There was a methodological change in the PNAD data prior to 1992 that prohibits the use of earlier years. I use 1999 as opposed to 2000, because there was no PNAD survey in 2000, as this was a census year. The year 1999 also marks a turning point in the economy as the real was devalued substantially in January 1999. Finally, 2008 is the latest data available for the PNAD survey. The data are restricted to workers that are sixteen years or older, as per the Brazilian legislation, which prohibits the hiring of worker under the age of 16, unless the worker is on an apprenticeship contract (valid for 14-16 year olds).

assinada) grew annually by 3.3 percent, whereas the rate of growth fell to 2.0 percent annually during the second period.

Self-employed workers account for nearly 21 percent of the labour force, of whom only 14.5 percent contribute to the social security system. Job growth in this category also slowed in the second period and there was also a small improvement in the number of self-employed workers who contributed to the social security system, though still low at a mere 0.6 annual growth rate in the second period. The more important trend was the sharp slowdown among non-contributing self-employed workers, where job growth declined from a 3.9 percent annual rate during 1992-1999 to 1.3 percent annual growth in 1999-2008.

More employers also contributed to the social security system increasing from 2.0 percent annually between 1992-1999 to 3.2 percent annually between 1999-2008. Similarly, the number of non-contributing employers fell from 6.2 to 5.8 percent annual growth during the two periods, aiding the improvement in formality rates.

Table 1

Annual Employment Growth by Job Category

	<i>Formal and Informal Occupational Categories</i>	<i>Annual growth, 1992-1999</i>	<i>Annual growth, 1999-2008</i>	Percentage of occupied workers, 2008
	Total Formal	1.3%	5.3%	49.6%
	Salaried, private-sector workers with a signed labour card	0.7%	6.6%	34.5%
	Government workers, including military	3.2%	3.6%	7.7%
	Domestic workers with a signed labour card	11.7%	3.4%	2.0%
	Self-employed workers who contribute to the social security system	-0.6%	0.6%	3.0%
	Employers who contribute to the social security system	2.0%	3.2%	2.4%
	Total Informal	3.0%	1.7%	50.4%
	Salaried, private-sector workers without a signed labour card	3.3%	2.0%	17.5%
	Domestic workers without a signed labour card	1.6%	2.8%	5.5%
	Non-contributing, self-employed workers	3.9%	1.3%	17.7%
	Non-contributing employers	6.2%	5.8%	2.1%
	Unremunerated workers	-0.4%	-2.6%	3.6%
	Work for own consumption and production	-0.2%	2.7%	4.0%
	Total Formal and Informal	2.2%	4.2%	100.0%

Source: Author's calculations based on IBGE/PNAD.

The two periods witnessed a continued downward trend in the number of unremunerated workers, falling by 0.4 percent annually during 1992-1999 and by 2.6 percent between 1999-2008. Nevertheless, there was an increase in workers producing for their own use from a fall of 0.2 percent annually in 1992-1999 to an annual increase of 2.7 percent between 1999-2008.

An interesting trend that deviates from the pattern of other job categories — and to which we will return to in a later section — is the strong growth of formal job creation among domestic workers (those whom have a signed labour card) during the 1992-1999 period. The rate of formal job creation among domestic workers was 11.7 percent annually whereas job growth among informal domestic workers was 3.4 percent annually. During 1999-2008, formal job growth among domestic workers still outpaced informal job growth at 3.4 percent annual growth versus 2.8 percent annual job growth, but at a much slower pace. Still, by 2008, only 27 percent of domestic workers had formal jobs.

Studies on informality sometimes use other definitions, such as the percentage of workers who contribute to the social security system, typically because of the paucity of detailed labour market data that exists in most developing countries. By this definition, there has also been an improvement in the 2000s, whereas no gains were made in the 1990s. In 1992, 42.5 percent of workers contributed to the social security system, in 1999, 42.3 percent were contributing, but by 2008, the percentage had grown to 52.1 percent.

4 What explains the rise in formalization?

While the rise in formality in Brazil in the 2000s has not gone unnoticed by Brazilian policymakers, there has been little systematic research of the causes, with the exception of Cardoso (2007) and to a lesser extent, Baltar, Krein and Moretto (2006) and Chahad and Macedo (2003). Chahad and Macedo (2003), studying the 1999-2003 period, argues that the increase in formality is due to the introduction of the *Simples* law, which facilitated registration and lowered the rate of taxation for small businesses. Baltar, Krein and Moretto (2006) attribute the improvement in the labour market to the improved economic environment following the exchange rate depreciation in 1999 and the export boom that began in 2003, as well as to the government's efforts in ensuring compliance with labour law through increased inspection and jurisprudence. The most detailed analysis to date on the issue is by Cardoso (2007), who studies the years 2001-2005. He attributes the growth in formality to the growth and decentralization of public spending, the growth of domestic credit, the growth and diversification of exports, the *Simples* law as well as improvements in labour intermediation and inspection.

This section reviews the principle reasons given as well as some additional reasons and assesses the importance of each to increasing formality. I argue that macroeconomic policies have increased the demand for workers in formal occupations, that demographic shifts and education policies have reduced the supply of youths in the labour market who typically occupy precarious jobs, and that there have been micro-level policy interventions that have altered the behaviour of firms and employers, resulting in greater formalization. These include the introduction of the *SIMPLES* law, which simplified and lowered taxes for small- and medium-sized enterprises, improved labour inspection as well as greater legal awareness among workers, which I illustrate with the example of domestic work.

4.1 Increased demand for formal workers

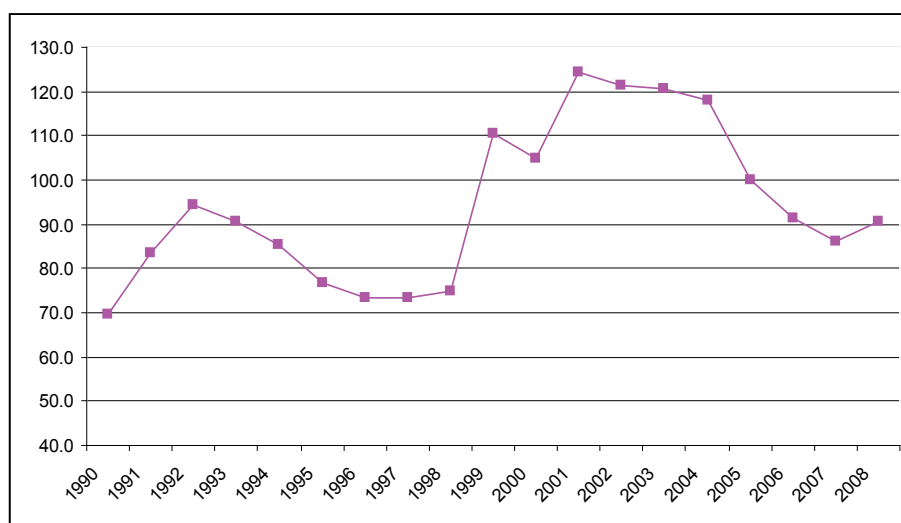
There are two favourable aspects about macroeconomic performance in the 2000s when compared with the 1990s that aided the growth of formal jobs. These are: a) the growth in exports, aided by the boom in commodities as well as the more competitive exchange rate, and b) an increase in internal demand, driven by a more inclusive pattern of growth and the emergence of a sizeable middle class.

As mentioned previously, in the early 1990s, Brazil liberalized trade and capital inflows which led to a steady appreciation of the currency during the decade that was not reversed until the devaluation in January 1999 (See Figure 3). An incipient liberalization coupled with an overvalued currency resulted in a fall in domestic production and a negative trade balance between 1995 and 2000. Jobs were lost. Data from administrative records on formal employment shows that between 1990 and 1999, there was an average annual job loss of 2.9 percent in the mining sector, 8.0 percent in the agriculture and fishing sectors and 1.9 percent in the manufacturing sector.⁶ Indeed, during the 1990s, only the non-tradable sectors (construction, commerce, services and public administration) experienced positive, net formal job growth.

In the 2000s, the pattern shifted. Following the devaluation of the real in 1999 and until 2005, the real exchange rate remained highly competitive, boosting exports and protecting domestic industries from import competition. The Brazilian labour market benefited as new jobs were created, particularly in the export sector — where exports grew by 80 percent between 2000 and 2008 — but also in the import-competing manufacturing sector. Between 2000 and 2008, the mining industry added formal jobs at an annual rate of 8.1 percent, the manufacturing industry at an annual average rate of 5.2 percent and the agriculture and fishing sector at an annual rate of 3.6 percent. The experience of Brazil confirms the findings of Frenkel and Ros (2006), in their study of 17 Latin American countries during the period 1990-2002, that there is a significant and positive relationship between the movements in the real exchange rate and the rate of unemployment.

Figure 3

Brazil: Real Effective Exchange Rate, 1990-2008 (2005=100)



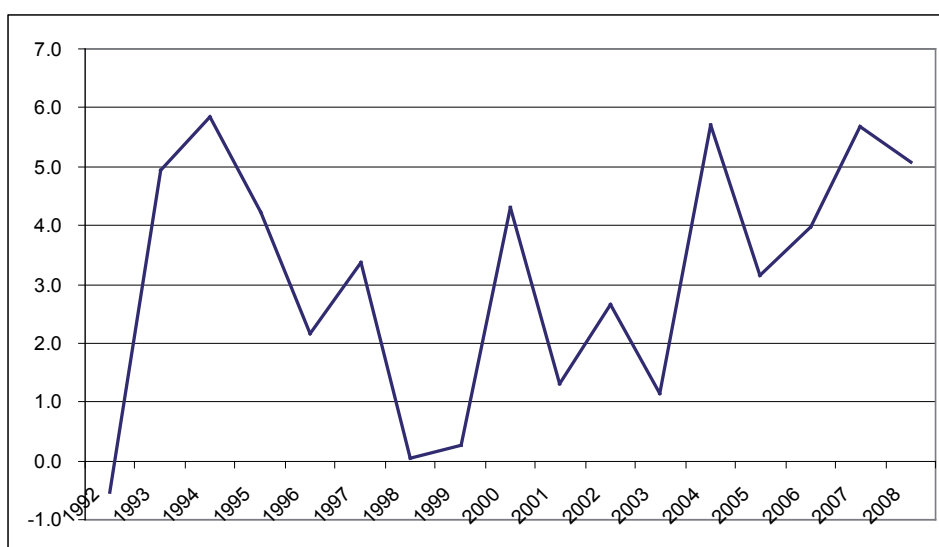
Source: IPEADATA, 2009.

⁶ The RAIS (Relação Anual de Informações Sociais) is a registry of formal establishments and jobs, administered by the Brazilian Ministry of Labour.

For an emerging economy such as Brazil, economic growth during 1992-2008 has not been exceptionally robust. Comparing the two periods, growth was higher in 1999-2008, averaging 4.2 percent annually, or 2.5 percent on a per capita basis. During 1992-1999, the average rate of growth was 3.2 percent, one percentage point lower than the second period, and a mere 1.4 percent annual growth on a per capita basis (See Figure 4). The strongest growth years were during 2003-2008 when growth averaged 5.2 percent annually and 3.7 percent annually per capita. Growth was therefore important during the second period, but the differences in growth rates are not large enough to explain the divergence in labour market performance.

Figure 4

Real GDP Growth, 1992-2008



Source: Central Bank of Brazil.

There is, however, a characteristic of growth that may help to explain part of the difference. In the second period, growth was inclusive. In 1992, the Gini coefficient for Brazil was 0.58 percent, rising to 0.59 in 1999. In the 2000s, there has been a steady improvement in distribution leading to a reduction in the Gini coefficient to 0.54 in 2008. While the Gini coefficient is still extremely high, the reduction during the 2000s demonstrates that the benefits of economic growth are being more fully shared. The redistribution is due to principally due to the doubling of the minimum wage during the 2000s but also to the creation and expansion of the Bolsa Familia conditional-cash-transfer programme in 2003 as well as the expansion of the rural pension and the Benefício de Prestação Continuada (BPC) social assistance programme. Saboia (2007), in an analysis of the impact of the minimum wage on the reduction in inequality during 1995-2005, found that 64 percent of the improvement in income inequality at the household level was due to increases in the minimum wage. A similar analysis undertaken by IPEA for the 2000-2008 period found that 66 percent of the drop in inequality was due to the increase in the minimum wage, 16 percent was due to the increase in pension benefits, 6 percent was due to the BPC programme and 12 percent was due to the Bolsa Familia programme (IPEA, 2009).

The expansion of the social safety net during the 2000s has been important for making growth more inclusive. The BPC is a social assistance programme that provides benefits equivalent to the monthly minimum wage to persons aged 65 or older, or to persons who are unable to work due to disability of any age, whose per capita household income is less than one-fourth of the minimum wage (the extreme poverty line). In 2009,

1.5 million elderly and 1.6 million disabled households received benefits through the BPC. The rural pension, which represents thirty percent of the benefits paid under the general pension system, covered approximately 8.2 million individuals in the first half of 2010 (up some 30 per cent since 2000). For 2010, this amounts to a transfer of approximately R\$50 billion (1.6 per cent of GDP) to rural areas of the country that are typically the neediest. The Bolsa Família programme was created in 2003 and by 2008, 11.1 million families, or 46 million people, approximately one-quarter of the population benefited from the programme.⁷ The average benefit was R\$80 (US\$44) per month and, though meagre, the assistance has been an important source of revenue particularly in rural areas of the North and Northeast states, where most of the beneficiaries reside. Studies have shown that the benefit has been used primarily for the purchase of food, but also for clothing and shoes (DUARTE et al., 2008; CEDEPLAR, 2007 apud ILO, 2009). The benefits received from these social policies have been important for boosting consumption and economic growth in rural and poorer areas and has enabled small retailers to depend on a steady source of demand for their products (CARDOSO, 2007). Although these small retailers may not necessarily be employing formal workers, the boost in demand affects other parts of the value chain where new job creation is likely to be formal, such as in manufacturing or distribution as well as large retailers such as supermarket chains and hypermarkets.

In Brazil in the 2000s, and particularly since 2004, there has been the emergence of a sizeable middle class. This middle class, referred to as class C and defined as having family income of between R\$ 1,064 and R\$ 4,561 per month,⁸ grew by 22.8 percent between 2004 and 2008 to comprise 52 percent of Brazilian households (NERI, 2008). A defining characteristic of this middle class is the consumption of durable goods — refrigerators, washing machines, televisions, and cars — that has driven internal demand, contributing to strong and sustainable economic growth and the growth of new, formal jobs.

4.2 Reduced Labour Supply

Surprisingly little attention has been given to the role of demographics in explaining labour market trends in the 1990s and 2000s.⁹ Brazil is in the process of demographic transition from a country of high fertility rates and a large youth population to one of low fertility rates and an ageing population. In 1980-1985, the fertility rate was 3.8 births per woman, falling to 2.3 in 2005-2010 (ECLAC, 2009). Life expectancy between 1980 and 2008 increased from 62.7 to 72.5 years. The demographic transition that Brazil is undergoing meant that during the 1990s, an additional six million youths, aged 15-24, entered the labour market when compared with the 1980s. In the decade of the 2000s, the net entry of youths was reduced by 300,000 over the previous decade (BERCOVICH, 2005). Indeed, between 2005 and 2008, based on PNAD data, there was an absolute reduction of 1.45 million among the 15-24 population, reducing the share of youths in the total population from 18.6 percent to 17.7 percent. The reduction has alleviated pressure on the labour market of new entrants, reducing growth in precarious work.

Another important policy change that has reduced the number of youths looking for work is the increase in the percentage of adolescents, aged 15 to 17, who study. In 1992, a shockingly high 40.3 percent of youths in this age group did not attend school. A concerted policy effort to increase secondary enrolment

⁷ During 2009, the Bolsa Família Programme was expanded to 12.4 million families and average benefits were increased to R\$95 per month, or approximately US\$53.

⁸ The analysis divides Brazil into five classes: A-E, with A being the richest. Class C is the statistical middle of the five groups.

⁹ Neither Cardoso (2007); Baltar, Krein and Moretto (2006) or Chahad and Macedo (2003) discuss the role of demographic trends.

rates resulted in a marked improvement in this indicator. By 1999, only 21.5 percent of youths aged 15-17 did not attend school and the percentage was further reduced to 17.7 by 2007. The Bolsa Familia programme, initiated in 2003, has contributed to the goal of increasing school enrolment rates of youths by requiring that children up to the age of 17 attend school in order for their families to receive the cash benefit. As a result of these policies and the improved labour market conditions, the number of youths aged 15-17 that were not economically active increased from 57 percent in 1999 to 65 percent in 2008.

Data from the PNAD gives a picture of the type of jobs that economically active youths, aged 15-24, perform and their occupational shifts.¹⁰ In 2008, 16.5 percent of youths were unemployed, slightly lower than the 18.3 percent rate recorded in 1999. Following the trend of increased formality for the population as whole, 38 percent held formal jobs compared with 30 percent in 1999. Another important shift concerned the share of unremunerated workers, which fell from 14 percent in 1999 to 7.5 percent in 2008. It appears as though some of these unremunerated workers became remunerated, though continued to be informal, as there was an increase from 29 percent in 1999 to 32.7 percent in 2008 of informal, salaried workers. Self-employment is not as prevalent for youths as it is for the population as a whole. In 2008, 21 percent of the workforce was self-employed compared with 9.3 percent for youths aged 15-24. In 1999, 10.8 percent of employed youths were self-employed. Data on place of employment corroborates these trends. The share of youths who work in a store or office increased from 58 percent in 1999 to 68 percent in 2008. There was a sharp fall in youths who work on a farm from 17.8 percent in 1999 to 10.7 percent in 2008. Finally, the number of youths who engage in home work fell from 5 percent in 1999 to 4 percent in 2008.

At the other end of the age spectrum, longer life expectancy and an adjustment in the laws governing eligibility for retirement benefits, meant that an increased number of workers in their fifties have stayed on in the labour force. In 1999, the government instituted the “fator previdenciário,” a formula that calculates pension benefits based on years of contribution and age at retirement. Under the formula, workers younger than the legal retirement age (men under the age of 65 and women under the age of 60) would have their benefits reduced if they opted to retire early, even if they had sufficient years of contribution. As a result of this change in the law, workers have stayed on longer in the labour market. Paiva (2009), analysing household survey data from 2007, found that only six percent of pension beneficiaries in that year were of workers who were younger than the legal retirement age but who had sufficient years of contribution.

4.3 The *SIMPLES* Law

In 1996, the government instituted a new system of tax exemption and simplification for small and micro enterprises, known as the *SIMPLES*.¹¹ The original ceiling set for qualification in the programme was gross annual sales of R\$720,000. In 1998, the ceiling was raised to R\$1.2 million; and in 2005, it was doubled to \$2.4 million (or approximately US\$1.3 million).

The *Simple*s law has a progressive tax structure, which taxes companies at differentiated, but reduced

¹⁰ A 1988 amendment to the Constitution raised the legal working age in Brazil from 14 to 16 years of age, however, children aged 14-16 can be employed as apprentices.

¹¹ “Sistema Integrado de Pagamento de Impostos e Contribuições das Microempresas e Empresas de Pequeno Porte,” or in English, “Integrated System for the Payment of Taxes and Contributions by Micro and Small Enterprises.”

rates, according to their gross sales.¹² The collection of taxes is made simpler through the use of one single form, known as the *Darf* (Documento de Arrecadação da Receita Federal), which collects the different federal taxes, and, where agreements have been made between municipal, state and federal government, it also provides for the collection of state and municipal taxes. Under the *Simples*, firms pay a reduced income tax, they are exempted from contributing to the *Sistema S*, a network of training agencies run by employers' organisations, and there is also a reduction of the firm's contribution to the social security system through the PIS/Pasep and the Cofins taxes. Previously, the PIS/Pasep and Cofins taxes were calculated based on total payroll, but it was de-linked from the payroll and substituted for gross sales of the firm, on a progressive scale (GONZÁLEZ, 2006). The overall tax burden of firms under the *Simples* programme is reduced by up to 8 percent of annual revenue (MONTEIRO; ASSUNÇÃO, 2006). Firms must still, however, make the necessary social security contributions for each employee and pay the FGTS.

Analysis of the *Simples* law on the formalization of firms reveals that it has boosted formality (DELGADO et al., 2007; MONTEIRO; ASSUNÇÃO, 2006). Delgado et al. (2007) estimate that the law contributed to the formalization of close to 500,000 microenterprises during 2000-2005, accounting for 2 million jobs. During the five-year period studied, annual GDP growth was 2.9 percent, yet there was a 7 percent annual increase of businesses registered under the *Simples*. In their analysis, they determine that the typical *Simples* business is one that employs 2.4 workers, is in retail trade, and has gross sales of between R\$1,000 and R\$5,000 per month. Based on their findings, they conclude that “without the establishment of the *Simples*, it is unlikely that the majority of the new establishments created or which already existed informally would have joined the conventional tax and social security system” (DELGADO et al., 2007, p. 39).

Monteiro and Assunção (2006) analyse the ten-month period following the enactment of the *Simples* law. They find that the *Simples* led to a 13 percentage-point increase in formal licensing among retail firms, when compared with their control group of firms in ineligible sectors. Moreover, they test whether formalization leads to greater investment and find that while formalization does not change the decision to invest or not, it did result in an increase in investment for those firms that were investing. They find that, on average, licensed firms invested R\$5,390 more, which for firms in their sample, represents 34 percent of the average annual revenue. This is not surprising, given that one of the principal benefits of being registered is attaining access to formal credit channels. In this respect the *Simples* created a virtuous circle: firms could more easily register, they then had access to credit which improved their chances for survival, they thrived and because they were legitimate businesses, they were able to, and had a greater incentive to register their workers.

4.4 Improved labour inspection and new approaches to formalization

Labour inspection is fundamental for ensuring compliance with labour law and improvements in how inspection is undertaken in Brazil have aided the increase in formality. Improved labour inspection in Brazil is not due to an increase in the number of labour inspectors in the country — the number of labour inspectors has fluctuated at about the 3,000 mark since 1990 and the ratio of labour inspectors to the workforce has actually

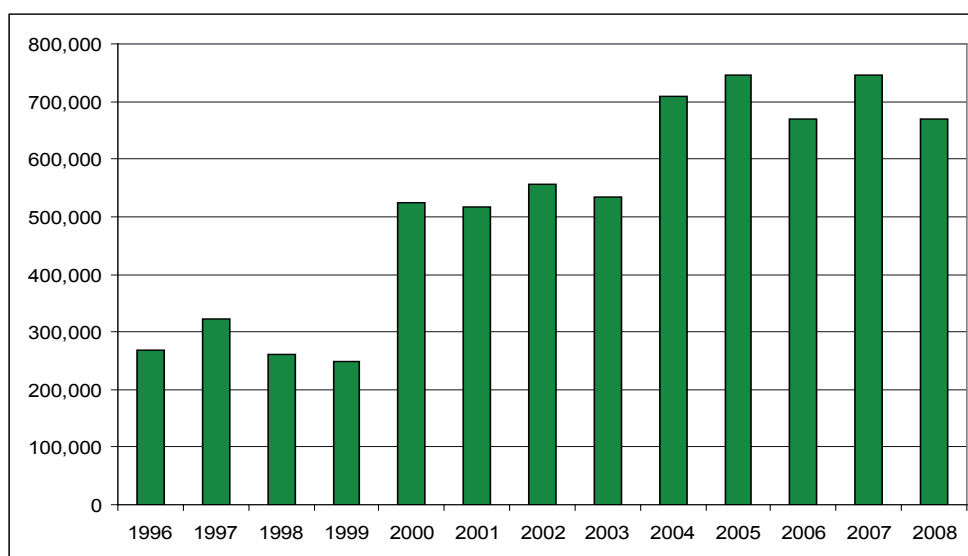
¹² For more details on the *Simples* Law, see Delgado et al. (2007).

fallen¹³ — rather, it is due to changes in the incentive structure as well as new methods for meeting inspection targets, introduced since the mid-1990s.

There have been two significant trends. The first was the introduction in the mid-1990s of a bonus system by which a substantial percentage of inspectors' salaries were tied to individual performance targets as well the total performance of the labour inspectorate. The new system made explicit the goal of formalizing workers, the collection of employer contributions to the FGTS fund as well as the number of workers covered in inspection. The second approach has been the development of teams of inspectors dedicated to tackling specific problems, usually tied to a particular sector. The inspectors who comprise the team are not evaluated by individual performance targets, but rather through team progress reports that demonstrate their ability to address sector-wide problems (PIRES, 2009). The objective is not merely to inspect and sanction (the command-and-control model of labour inspection), but rather to find ways to work with firms so that they can address the problem at hand, be it child labour, work accidents, or pervasive informality. Working in parallel, the two approaches have had an important impact on the success of labour inspection in the country. As Figure 5 demonstrates, between 1996 and 2008, the number of workers registered as a result of inspection increased from 268,000 to 669,000.

Figure 5

Number of workers registered as a result of labour inspection



Source: Labour Inspection Secretariat, Ministry of Labour.

Note: The Secretariat's database begins in 1996.

Nevertheless, because of the way the system is structured, the majority of the workers that have been registered have been informal workers working in formal firms. They comprise approximately 2.2 percent of the total number of workers covered by labour inspection activities. Registering informal workers in formal firms is an important accomplishment and should not be downplayed, but as most of informality concerns informal workers working in unregistered firms, other approaches are also needed.¹⁴

¹³ In 2008, there were 3,113 labour inspectors for an occupied population of 92 million or one inspector for every 30,000 workers, whereas the ILO standard for an industrializing country is one inspector for every 15,000 workers (ILO, 2006). As the number of inspectors did not increase during the time period studied, the ratio of inspectors to working population actually fell from 0.45 in 1992 to 0.36 in 2008 due to the increase in the size of the workforce (OIT, 2009).

¹⁴ Other categories of informality, such as self-employed workers, do not fall under the purvey of labour inspection because there lacks the existence of an employment relationship.

Almeida (2008) discusses the experience of three manufacturing clusters located in small, interior cities of the country that were composed almost entirely of informal firms and how the firms in these clusters, working in partnership with the government through their business associations, were formalized.¹⁵ In all three cases, the government granted subsidies to the firms which were important for improving the productivity and competitiveness of the clusters. The clusters were also given grace periods for complying with the law (tax, environmental and labour) so as to not impair the businesses with debilitating sanctions during the transition period. In all three cases, the firms in the clusters came into compliance with the law and achieved greater financial success after the investments were made to improve their productivity.

The case of the shoe production cluster in the city of Nova Serrana, Minas Gerais, is illustrative. In 1995, this business community was suffering as a result of the economic crisis and the subsequent restrictions on domestic credit. The industry sought help from SEBRAE (Serviço Brasileiro de Apoio às Micro e Pequenas Empresas), a government-run agency that provides assistance to small businesses, as well as the state government, but neither SEBRAE nor the state government were willing to help the business association due to the high degree of non-registered businesses in the cluster. The association proposed instead a plan that involved customized courses, given by external consultants, which would be made available to those businesses that would be willing to join the association and comply with the law. Sebrae would finance the cost of the courses. The objective was to help the businesses find ways to cut costs, in order for them to be able to afford to register their firms and their workers. As many of these firms were underproductive, this was not difficult to do. The business association also negotiated a grace period with the regional labour inspectorate for registering their workers, under the fear that if sanctions were applied incipiently, this could have negative consequences on firm survival. The programme was successful, measured by a variety of benchmarks. Competitiveness increased and during 2001-2005, GDP growth for the city was 9.1 percent annually. In 1995, there were 298 registered firms in the shoe-production cluster; by 2005, the number of registered firms had increased to 659. Similarly, in 1995, there were 3,121 registered workers in the cluster, jumping to 12,490 by 2005, 93 percent of whom worked in firms that had fewer than 100 workers.

Although it is not possible to say how many experiences such as this have been repeated in the country, Almeida (2008) does provide evidence that 58 percent of the increase in formal manufacturing employment between 2000-2005 occurred in municipalities with fewer than 100,000 inhabitants. But perhaps the more important lesson to be drawn from the case studies is how to go about formalizing firms and their workers. Almeida (2008) argues that for small businesses, many of which are uncompetitive, the command-and-control model runs the risk of incapacitating firms. Inspection is needed, but it needs to be undertaken in conjunction with other government agencies and the business community, so that the support can be given to these businesses for developing a high-road competitiveness strategy that ensures respect of the law. Fortunately, it seems as though this approach is being more widely used in Brazil.

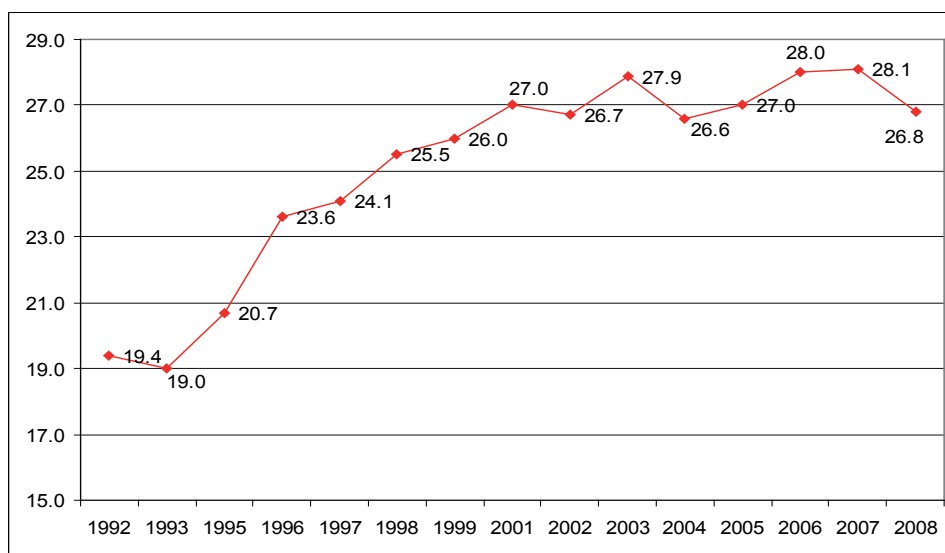
4.5 Greater legal awareness – The case of domestic workers

¹⁵ The work of Almeida (2008) looks at how a wide array of government agencies worked to ensure compliance of environmental, tax and labour regulations. In many of these instances the impetus to comply with the law was not initiated through the actions of the labour inspectorate, but rather through other governmental bodies. The cases are illuminating because they demonstrate how addressing informality cannot be left solely to the labour inspectorate, but require the actions of a wide array of actors. The examples from Pires (2008, 2009) also support the view that in order to effectively target sector-wide problems, it is essential for the labour inspectorate to work with the business community, labour unions and other groups.

Despite the overall increase in informality in the 1990s, domestic workers experienced a notable increase in their rate of formalization during this decade. In 1992, according to PNAD data, only 19.4 percent of domestic workers had a signed labour card. By 1999, there had been a 34 percent increase in the rate of formalization, with the number of registered domestic workers rising to 26.0 percent. Formalization continued to increase during the 2000s, but at a much slower rate, reaching a peak of 28.1 in 2007, only to fall to 26.8 percent in 2008¹⁶ (See Figure 6).

Figure 6

Percentage of Registered Domestic Workers, 1992-2008



Source: Author's calculations based on PNAD.

Note: Workers aged 16 years and older. Does not include the rural areas of the Northern states, with the exception of Tocantins.

Domestic workers have been excluded historically from labour legislation in Brazil. The Consolidation of Labour Laws (CLT – *Consolidação das Leis do Trabalho*) of 1943, which governs employment relationship, specifies in article 7 that the rights do not apply to domestic workers. Similarly, the law of 1949 regulating weekly rest, excludes domestic workers in its article 5. In 1972, for the first time, Law n° 5.859 was approved entitling domestic workers the right to twenty days of paid vacation and making contributions to the social security system, on the part of the employer and the domestic worker, obligatory. The Constitution of 1988 conceded even more rights to domestic workers, though at a more limited level than the rights given to other workers. Of the 34 rights given to workers, only nine were applicable to domestic workers. Nevertheless, it was an important advance as it entitled domestic workers to a series of rights that they did not previously have. These included the right to the minimum wage, the 13th month salary, weekly rest, thirty days paid vacation, maternity leave (16 weeks), advance notice of one month upon dismissal and pension. Moreover, it gave domestic workers the right to organize. Prior to the Constitution of 1988, the few workers' organizations that existed were associations, with no legal rights.

¹⁶ The fall in formality among domestic workers in 2008 is due in part to the increase in workers working on a daily as opposed to a monthly basis. According to data from the PNAD, there has been a steady increase over time in the percentage of domestic workers who work as day maids, proxied by the percentage of workers who work in more than one house per week. In 1999, 16.4 percent worked in more than one house compared with 22.8 percent in 2006 and 25.4 percent in 2008. In 2004, the Superior Labour Court ruled that an employment relationship can be established only for those domestic workers who work in the same place of employment for more than two days per week, thus day maids are less likely to have a signed labour card. See *Diário de Justiça*, 2 April 2004, *Recurso de Revista* 776.500/2001.

It is clear that the Constitution made the hiring of domestic workers more costly, thus it is surprising, from this perspective, that there was such a large increase in registration. It thus seems likely, as argued also by Chahad and Macedo (2003), that the Constitution engendered greater respect for the law on the part of employers and made them more prudent, and that domestic workers were in a better position to exercise their rights. As Lee and McCann (2009) demonstrate, greater legal awareness is associated with better working conditions as workers are better informed and thus better positioned to negotiate.

Cases of domestic workers brought to the Superior Labour Court (Tribunal Superior do Trabalho) have received media attention and since 2002, the outcomes of important cases are posted as press releases on the web page of the Superior Labour Court.¹⁷ Though many of these cases concern an infringement of rights of registered domestic workers, there have also been cases of domestic workers suing their employers for not having had a signed labour card, with the court ruling in favour of the domestic worker and demanding back pay from the employer for lost benefits.¹⁸

The Constitution of 1988 allowed domestic workers to form trade unions, giving them an additional vehicle by which to demand their rights. Because of the difficulty in unionizing workers – they work in individual households, there is no way to collect union dues – fewer than two percent of domestic workers (101,170 workers in 2005) are unionized. Nevertheless, the various regional unions that do exist as well as the National Federation of Domestic Workers (FENATRAD), have lobbied successfully for improving rights of domestic workers (BERNARDINO-COSTA, 2007). In 2001, after much pressure from the union, the government passed a law giving domestic workers the right to have the FGTS fund, though employers' contributions were made optional. In 1999, the Fenatrad became an affiliate of the Central Worker's Union (CUT), the largest trade union federation. The Fenatrad often works in partnership with the government, in particular, the Special Secretariat for Women's Policies (SPM) and the Special Secretariat for Racial Equality (SEPPIR), as well as various international organizations, to develop policies to improve working conditions for domestic workers.¹⁹ They also carry out grass-roots campaigns, frequenting areas where domestic workers can be found, so that they can educate them on their rights, raise their self-esteem, let them know about the union, and encourage them to demand from their employer that their labour card be signed.²⁰

4.6 Improving upon the advances in formalization

Government policies have been instrumental in achieving the increases in labour market formality in Brazil during the 2000s. It is thus reassuring to know that the government has continued to institute laws and policies that can further extend formality.

In 2006, the government passed a provisional measure, which was later converted into law, allowing employers of domestic workers to deduct the cost of social security contributions from their income that is

¹⁷ See http://www.tst.gov.br/ASCS/materias_tematicas/trabalhoDomestico.php.

¹⁸ See for example the case of the domestic worker who proved that she had been working for the same employer since 1975 and was granted back pay for unpaid benefits (“Diarista em um dia na semana obtém reconhecimento de vínculo empregatício,” available at http://ext02.tst.gov.br/pls/no01/NO_NOTICIAS.Exibe_Noticia?p_cod_noticia=8492&p_cod_area_noticia=ASCS&p_txt_pesquisa=%20domestico).

¹⁹ During the first administration of the Lula government, the President of Fenatrad, Maria Cueva de Oliveria, was a member of the National Council on Women and the National Council on Racial Equality (BERNARDINO-COSTA, 2007).

²⁰ “Apenas 544 mil de 1,6 milhão de domésticas têm carteira assinada,” InvestNews (Brazil), April 26, 2006.

subject to taxation. Employers can only deduct the cost of one worker and are limited to the value of social security contributions made on the minimum wage.²¹ Due to existing income tax exemptions, the measure is of benefit to those employers whose monthly incomes are above R\$2,500 and thus opt for the full income tax declaration. According to calculations from the Secretariat of Policies of the Ministry of Social Security, there are approximately 475,000 domestic workers who could benefit from this policy, which corresponds to roughly 20 percent of informal domestic workers (CABANAS GUIMARÃES, 2008). Although the measure was designed as an incentive for registering workers, the policy has received little visibility as only one publicity campaign was undertaken and it was limited in scope. As a result, the number of claims made since the measure was first put into effect has not increased, suggesting that the employers who are benefiting are those whom had already registered their worker. Still, an effective publicity campaign could help inform households about the measure, thus there remains the potential for this policy to be successful.

Also with regard to domestic workers, the government issued a decree in September 2008 that increased the minimum age for domestic employment from 16 to 18 years of age. The decree considers domestic work under the age of 18 as one of the worst forms of child labour, and makes reference to Convention 182 of the ILO, which defines the worst forms of child labour as “work which, by its nature or the circumstances in which it is carried out, is likely to harm the health, safety or morals of children.” In issuing the decree the government made reference to the occupational risks in domestic work including intense physical activity, isolation, physical, psychological and sexual abuse and long working hours. At the time of the decree, 245,000 workers aged 16 and 17 were employed as domestic workers. Employers caught employing under-aged workers are subject to a fine up to R\$ 2,012 and must pay back-pay on unpaid benefits.²² Though inspecting homes is difficult and requires a court order, the law makes it less culturally acceptable to employ adolescents as domestic workers. Of adolescents aged 16 and 17 that were employed as domestic workers in 2006, less than 0.2 percent had a signed labour card.²³

In June 2009, the Brazilian government launched the Individual Entrepreneur Law (*Lei do Empreendedor Individual*), which facilitates the registration of micro businesses with up to one employee and reduces the cost of social security contributions. One of the criticisms of the social security system is that it places an unduly large burden on the self-employed as they have to pay both the employer (12 percent) and the employee’s contribution (8 percent), deterring formalization. Under the new law, micro-entrepreneurs with annual revenues below R\$36,000 per year, can legally register their business and obtain a tax identification number (known as the CNPJ) and will be exempt from federal taxes. They will have to pay social security contributions equivalent to 11 percent of the minimum wage (or R\$52 per month in 2010), but this will entitle them to pension, invalidity and maternity benefits. The government aims to register one million businesses, approximately 3 percent of the number of uncovered, self-employed workers in the first year. Several publicity campaigns have been planned to help spur registration.

²¹ Social security contributions are twelve percent of the wage. Because the measure is limited to the minimum wage, the employer would be able to reduce their income subject to taxation by R\$ 735 in 2010 (12% of R\$ 510 per month).

²² “Trabalho doméstico está proibido no Brasil para menores de 18 anos,” *Folha de São Paulo*, 18 de setembro de 2008.

²³ According to PNAD data for 2006, of employed adolescents aged 16 and 17, a bit over 10 percent were engaged in domestic work.

5 How sustainable are the advances in formalization?

During the 2000s, Brazil made important progress in improving working conditions, reversing the 1990s trend of increased informality. But how sustainable are these increases? This paper has proposed five principle explanations for the increase in formalization in the 2000s: a) a more favourable macroeconomic environment characterized by a more competitive exchange rate and more inclusive pattern of growth; b) reduced labour supply; c) the *Simples* law; d) improved labour inspection and new approaches to formalization; and e) greater legal awareness and respect for the law. Although it is not possible to know what the relative contribution was of each of the explanations, we attempt in this section to evaluate their importance both for the experience of the 2000s, as well as for the future.

There can be improvements in working conditions without economic growth, but sustaining improvements over time requires growth. With the exception of 2003-2008 when economic growth averaged 5.2 percent annually, economic growth in the two periods has been highly volatile and not that robust. But the macroeconomic conditions of the 2000s were more favourable to job creation. During the 1990s, firms were adjusting to the economic opening, but an appreciated exchange rate and restrictions on domestic credit, following the 1995 crisis, hampered their viability causing hiring to nearly halt. In the 2000s, a more favourable exchange rate and a greater availability of domestic credit, albeit at high interest rates, allowed firms to invest and expand. Domestic demand was robust due to the emergence of a new middle class that benefited from the minimum wage increases and the resumption in hiring.

For 2010-2015, the government predicts that growth will average 5.0 percent as domestic demand continues to expand, fuelled by substantial public investments in infrastructure from the Growth Acceleration Programme (PAC) and other programmes, as well as domestic consumption. The government has taken steps to halt the appreciation of the currency, which has risen since 2004 (with the exception of the first nine months following the onset of the international economic crisis in September 2008). In October 2009, the government levied a two percent financial transaction tax on foreign currency inflows for investment in the Brazilian capital markets. This measure will help, but a sustained appreciation does run the risk of hurting tradable industries, which are important employers of formal labour.

The only explanation that qualifies as “luck” is the demographic transition which has decreased the number of youths in the overall population, and, by extension, in the labour market. Still, even with regards to youth, the government has increased secondary enrolment and has provided incentives to poor families to keep their adolescent children in school through the *Bolsa Familia* programme. The trend in Brazil is for continued improvement in school enrolment rates, resulting not just in a better prepared labour force but a labour market with less supply pressure from youths and fewer precarious jobs.

The government has taken important steps to formalize small and micro-sized businesses. The *Simples* law of 1996 eased business registration and lowered taxes, encouraging firms that may not have registered under the previous system due to bureaucratic hassle and expense. As such, the law opened new economic opportunities for these businesses, as they became eligible to access formal credit markets or to pursue work contracts with large, formal firms and the public sector. The 2009 Individual Entrepreneur Law is a step in the same direction. Entrepreneurs will not only be able to access the social security system at an affordable cost,

but will obtain a tax identification number that will facilitate access to credit and business transactions in the formal economy. It is an important initiative, though there does remain the risk that firms, rather than hiring a worker, will prefer a contractual relationship with the entrepreneur. Government actions to minimize disguised employment relationships are therefore needed.

Brazil has half the number of labour inspectors that the ILO recommends and the workforce would be well served by dedicating more resources to inspection. Nevertheless, Brazil's labour inspectorate has devised strategic ways to increase the number of workers covered and registered through inspection. By resolving problems that are sector-wide, the inspectorate's work has a far greater impact, as firms from the sector may not necessarily be inspected but will learn of the adjustments that are required in order to be in compliance with the law. Efforts to work with the business community and other government agencies to improve working conditions have been fruitful and all indications are that this approach will continue in the future.

Although it is difficult to assess whether there is greater respect for the law among a citizenry, the case of domestic worker formalization during the 1990s indicates that raising legal awareness can help change cultural patterns and encourage workers to demand their rights. Additional legislation, such as the classification of domestic work under the age of 18 as one of the worst forms of child labour is also important for changing cultural norms.

6 Conclusions

The experience of Brazil in the 1990s and 2000s highlights the important role of government policy in ensuring that workers reap the gains from economic growth. Brazil is one of the most unequal countries in the world and it was not until the 2000s that the country began making inroads on reversing this trend. Still, an alarming one-quarter of the population lives on less than US\$100 dollars per month, despite a GDP per capita of US\$8,600 per year. There is a long way to go, but progress is being made.

Formal workers in Brazil enjoy important benefits and protections — pension, sickness, disability and death benefits, paid annual leave, parental leave, restrictions on working hours and a guaranteed minimum wage — that informal workers are not guaranteed and must continuously negotiate with their employers if and when they are granted. Even then, they are excluded from social security benefits, which in the case of sickness, disability or death can easily bring about financial ruin in families. It is thus extremely welcome that more workers are employed formally and that measures have been taken to extend social security benefits to the self-employed.

The labour market flexibility debate has been exaggerated, at least in the case of Brazil. The experience of the 1990s and 2000s does not support the claim that labour regulations caused growing informality, and the strong growth in formal jobs in the 2000s at the same time that the minimum wage nearly doubled in real terms, demonstrates that labour laws are not an impediment and that some policies, such as the minimum wage, can be important for stimulating growth and job creation. Rather than focusing on deregulating the labour market, governments should take steps to encourage firms to register their businesses and their workers, either through simplifying registration, lowering taxes or providing incentives to develop high-road competitiveness strategies.

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