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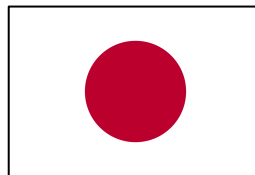
Labour Laws, the Business Environment and the Growth of Micro and Small Enterprises in South Asia



Labour Laws, the Business Environment and the Growth of Micro and Small Enterprises in South Asia



Norad



ILO/Japan
Multi-bilateral
Programme

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Foreword

Enterprises, in particular micro- and small enterprises or MSEs, are considered the growth engine for creating productive jobs. They play a crucial role in enabling countries achieve the goal of decent work for all. However, enterprises often face significant obstacles in the forms of red tape, lack of access to financing and markets. These challenges are among the contributing reasons why entrepreneurs decide to operate in the informal economy.

The International Labour Organization (ILO) has identified the informal economy as representing a significant obstacle to achieving decent work for all. Entrepreneurs who operate in the informal economy are less productive and unlikely to achieve the full growth potential of their enterprise. Furthermore, workers employed in informal enterprises generally receive lower salaries and enjoy fewer, if any, of the benefits the formal economy workers do. Enterprises operating in the informal economy, at times, also contribute to unfair competition by avoiding taxation and the cost associated with compliance with labour laws and other regulations. Facilitating the formalization of enterprises and workers is a key priority guiding the work of the ILO.

The studies were conducted to support the ongoing policy dialogue in South Asia on strategies to support the formalization of the informal economy. While informal economy issues affect entrepreneurs and workers alike, these studies focus on the enterprise side of informality. The series of four country studies commissioned by the ILO research the impact of labour laws and the cost of regularization on entrepreneurs' decisions to formalize their businesses. The countries covered by this research are India, Nepal, Bangladesh, and Sri Lanka. In India, the research focused on four sectors: agro processing, woodworking, textiles and garments, and hospitality. The first part of this study was completed in 2007. In the second part of the study, which was completed in 2011, the research was expanded with a number of large-scale enterprise surveys.

The appendices contain a list of the people who were involved with this large project. This report was commissioned to Dr Simon White, who offered advice through the consolidation stage of the study. Professor T.S. Papola of the Institute for Studies in Industrial Development, New Delhi has provided comments and has been responsible for guiding the four country studies. Hideki Kagohashi (Senior Enterprise Specialist) of the ILO's Decent Work Team for South Asia has been responsible for conceptualizing and overseeing the research. Thomas Kring (Chief Technical Advisor, 'Way Out of Informality' project) oversaw and managed the finalization of the study.

This project was made possible through support from the Norwegian Agency for Development Cooperation, with additional support from the Japanese Government provided under the "Way Out Of Informality: Facilitating Formalization of Informal Economy in South Asia sub-regional project.

Tine Staermose

ILO Decent Work Team for
South Asia and Country Office
for India
New Delhi

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Executive summary

This report presents the results of a major three-year assessment undertaken by the International Labour Organization (ILO), in partnership with the Norwegian Agency for Development Cooperation (NORAD), in four countries in South Asia: Bangladesh, India, Nepal, and Sri Lanka. It provides empirical evidence on the influence labour-related laws and regulations have on enterprise growth and the promotion of decent and productive employment. This evidence fills a gap in our understanding of how labour laws and regulations affect the decisions of micro- and small enterprise (MSE) owners and managers. It helps us to better understand the ways in which policy and legal and regulatory reform can improve the conditions for MSE employment. This evidence provides a basis for continued social dialogue between governments, employers and workers in South Asia.

The goal of the research programme, entitled “Labour-related laws and the MSE growth trap In India, Nepal, Sri Lanka, and Bangladesh” was to contribute to a policy and legal environment in India, Nepal, Sri Lanka, and Bangladesh that is conducive to the growth of MSEs. The programme sought to ILO constituents’ and other stakeholders’ understanding of the impact of labour-related laws on the growth of MSEs, and to inform the discussion among these stakeholders as to what is required to improve labour-related laws and the business environment in these countries.

There were three phases that framed the implementation of this programme. The first involved the preparation of four country reports that reviewed the policy, legal and regulatory environment and its effect on MSE growth and employment. The second phase involved a survey of 4,625 MSE owners and managers in Bangladesh, Nepal, Sri Lanka, and three states in India: Maharashtra, Orissa and Tamil Nadu. These surveys gave an insight into the ways in which enterprise owners and managers respond to the policy, legal and regulatory frameworks they operate within. In addition, a review on labour law enforcement was conducted for India and Nepal. The third phase involved a synthesis of the findings of the four country assessments and six MSE surveys, i.e. this report.

The programme has produced a wealth of detailed information contained in the four country reports and six survey reports. This *Final Synthesis Report* does not attempt to cover all the findings produced by the surveys and national assessments. Instead, it focuses on those findings that directly help to answer the key questions that have framed this research. For full details on the research findings, please consult the relevant country and survey reports.

The central question pursued through this research programme was: how does the legal and regulatory framework for labour affect MSE employment and growth in the South Asia region?

In answering this question, three sub-questions were considered:

- How does the effect of labour-related laws and regulations compare with other business laws and regulations found in the business environment?
- Do the thresholds in the labour regimes under study encourage compliance and job quality, or do they act as constraints to enterprise growth?
- What are the strategic management decisions that MSE employers make in response to these conditions?

Four broad themes were assessed through this research programme:

1. Labour-related laws and regulations: this theme investigated a number of common elements in the labour regime in which MSEs in South Asia operate to determine their effect on business decisions and enterprise growth. Six common elements to the labour-related legal and regulatory framework were examined in all four countries. Some countries examined additional elements that were specifically of relevance to them. Most of the elements examined contain thresholds of one kind or another. In some cases, there are only a few, broad thresholds. In other cases, MSE employers find themselves among a complex matrix of thresholds.
2. Other business laws and regulations: in addition to labour issues, four other business laws and regulations were assessed. Here, again, the use and effect of thresholds was examined.
3. Incentive programmes: this theme examined the role of incentive programmes, including MSE development services and benefits. Gaining access to these services may require compliance with labour-related and other business laws and regulations.
4. Strategic choices: this theme examined the perceptions and actions of MSE owners and managers. It enquired into the ways in which MSEs view the labour and business regime they operate within and how they respond to it. This included an assessment of the knowledge of the relevant laws, regulations and thresholds and the possible strategies they employ to avoid compliance (such as the creation of parallel or multiple firms and the payment of bribes or other forms of informal payments).

Summary of high-level findings

The answer to the first sub-question asked by this research appears to be that, as far as their perception-based ratings were concerned, the labour-related laws and regulations in the four countries studied were not found to influence MSE growth either positively or negatively compared to other elements of business laws and regulations, although there do appear to have been various techniques used by MSE owners and managers to deal with these issues. However, when combined with the assessment of their behaviour vis-à-vis each of the specific laws and regulations, selected labour laws do have significant influence on the behaviour of MSEs that is comparable to the effect of important business regulations such as those on tax and environment.

The answer to the second sub-question, which focused on the role of thresholds, is that while all four countries examined employ the use of thresholds, there was no evidence found to suggest that these thresholds were inhibiting the growth of MSEs or their workforce. Three reasons were identified for this.

First, thresholds have little or no impact on growth when MSE owners and managers are not aware of them. In a number of cases, MSE owners and manager claimed they were not aware of specific provisions that involved thresholds. However, this is not the generic scenario since the awareness and knowledge on the legal obligations, specific requirements,

penalties and informal payments to avoid them significantly varied across the labour policy areas, across size of the enterprise and across sectors/countries.

Second, many MSE employers simply chose not to comply with specific provisions of labour or business law. Weak legal enforcement means that those firms that choose not to comply do not suffer the penalties for this decision.

Third, MSE owners and managers sometimes under-reported their performance in order to stay below a threshold level. This was more common in the area of income tax and value added tax (VAT) than in labour-related laws and regulations. While the reported levels of firm performance may be under-reported in response to these thresholds, the firm's actual performance is not.

Across the 4,625 firms surveyed, the number of respondents that had benefited from a government- or NGO-supported incentive scheme was extremely low. In all cases this was less than ten per cent and in some surveys there were no respondents that had benefited from an incentive scheme. Thus, encouraging compliance through participation in an incentive programme, while theoretically appealing, has not been the reality in the four countries studied.

The answer to the third sub-question is that, when required, MSE owners and managers do take action to avoid the penalties associated with non-compliance. However, due to the explanations given above, very few penalties are extended to non-compliant firms. When required, firms do pay bribes or other kinds of informal payments. There were some variations in these findings, but the most commonly cited fields in which this occurred was in income tax and VAT. Depending on country, other labour and non-labour obligations were avoided in the same manner, including compensation for injury or death, contribution to EPF, environmental certificates and so on.

Finally, there were very few cases found where MSE owners and managers had established parallel enterprises in order to spread their workforce across more than one enterprise to keep below a threshold level. This is clearly not a strategy employed by the MSEs in the four countries studied.

These findings support the following recommendations for labour-related business environment reform in the region:

- Labour-related laws and regulations should be considered an integral part of a comprehensive legal and regulatory framework in which enterprises of all sizes operate. As governments seek to improve the business environment, they should ensure labour issues are recognized and incorporated into a holistic and integrated reform programme. The evidence provided by this study could help move policy dialogue in the direction.
- Labour and business laws and regulations should provide easy entry points for compliance and formalization. The surveys provided concrete evidence on the monetary and transaction cost for different types of registration and licensing. These could serve as a reality check to keep improving the regulatory environment.
- The concept of a sliding scale of compliance requirements is relevant. Fine-tuning of the sliding scale can only be done against the reality check such as the one done by this study.

- Linking incentives with compliance still appears to offer an opportunity for policy-makers and legislators to encourage compliance, but further attention needs to be given to how meaningful incentives can physically be provided. Emerging good practices, such as the successful formalization of informal economy enterprises in Brazil, could provide practical lessons on this.
- Some MSEs are highly aware and knowledgeable about certain regulations that concern their enterprise. This indicates ample room for targeted communication as well as fine-tuning the cost of compliance of the selected legislations through informed social dialogue.
- The lack of enforcement, in some cases, despite good coverage by inspectors, undermines the influence of the policy, legal and regulatory framework. Policy-makers and legislators should pay greater attention to enforcement mechanisms, and seek to combine it with win-win opportunities, e.g. those provided by the responsible workplace practices being promoted through the Sustainable Enterprise Agenda of the ILO.

List of abbreviations

BDT	Bangladeshi taka
ESP	Committee on Employment and Social Policy
FTEEs	Full-time equivalent employees
ILO	International Labour Organization
ILS	International Labour Standards
INR	Indian rupee
LKR	Sri Lanka rupee
MSEs	Micro- and small enterprises
NORAD	Norwegian Agency for Development Cooperation
NPR	Nepalese rupee
SCORE	Sustaining Competitive and Responsible Enterprises
SECO	Swiss State Secretariat for Economic Affairs
SMEs	Small and medium-sized enterprises
TEWA	Termination of Employment of Workmen (Special Provisions) Act
VAT	Value added tax

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Exchange rates

The following rates provide a general approximation of the currencies referred to in this report.

United States dollar (US\$)	Other currency
1	80 Bangladeshi taka (BDT)
1	50 Indian rupees (INR)
1	85 Nepalese rupees (NPR)
1	130 Sri Lanka rupees (LKR)

Chapter 1: Introduction

Micro- and small enterprises (MSEs) are a major source of employment in developing economies around the world, including those in South Asia. They also are significant contributors to value addition and economic growth. However, the quality of jobs in many MSEs is often very poor. A key challenge for the International Labour Organization (ILO) and its member States is to guide and support the establishment of legal and regulatory frameworks that promote Decent Work in MSEs while facilitating productivity and economic growth.

Labour and labour-related laws can be an important means of promoting Decent Work. They typically promote International Labour Standards (ILS) and provide mechanisms for ensuring the quality of employment. However, MSE owners and managers in developing economies often fail to comply with these laws, which they often perceive as imposing costly and unsustainable regulatory burdens and costs.

This report presents the results of a major three-year assessment undertaken by the ILO in four countries in South Asia: Bangladesh, India, Nepal, and Sri Lanka. It provides empirical evidence of the influence labour-related laws and regulations have on enterprise growth and the promotion of decent and productive employment. This evidence fills a gap in our understanding of how labour laws and regulations affect the decisions of MSE owners and managers. It helps us to better understand the ways in which policy, legal and regulatory reform can improve the conditions for MSE employment. This evidence provides a basis for continued social dialogue between governments, employers and workers in South Asia.

1.1 *The ILO–NORAD partnership*

In 2007, the Norwegian Agency for Development Cooperation (NORAD) and the ILO initiated the programme, “Labour-related laws and the MSE growth trap In India, Nepal, Sri Lanka, and Bangladesh”. This programme built on the findings of a number of smaller action-research projects that had been undertaken in the region. It sought to better understand the relationship between labour laws and MSE growth and employment. NORAD shares the ILO’s concern regarding the importance of promoting Decent Work as a key strategy for the reduction of poverty in developing economies. It has worked closely with the ILO on a number of programmes and projects in this field.¹

The ILO’s technical work in this field has grown out of a series of policy and legal assessments previously conducted in India, Nepal and Pakistan, some of which NORAD also funded. These assessments identified policy and legal thresholds that exempted enterprises from full compliance with labour laws on the basis of enterprise size and contributed to policy-induced “growth traps” (Reinecke and White, 2004).

Initially entitled “Labour-related laws and the SME growth trap project”, this programme was designed to provide a framework for “brainstorming” and practical dialogue based on

¹ In addition to the programme reported on in this document, NORAD has supported two phases of the Law-Growth Nexus project in Africa. Beginning in 2008, the first phase of the project focused on 12 African countries, while the second phase has intensified the project’s efforts in Kenya and Zambia.

country cases drawn from sub-regional discussions and a global issues paper, which would be prepared by the ILO in Geneva (ILO-Norad, 2007,). The programme was designed to consider three critical issues:

- How the potential of MSEs for creating productive jobs can be harnessed better for the economic growth of the respective countries.
- How the compliance requirements of labour-related laws affect the growth and job creation potential of MSEs in these countries.
- How the “growth trap” for MSEs can be eased while extending appropriate labour law requirements to MSEs to ensure both protection for their workers and to create an enabling environment for employment growth.

The existing knowledge base in India and Nepal on what constitutes a conducive policy and regulatory environment for the creation of quality jobs through growth of MSEs was to be consolidated and extended through this programme. The programme was designed to lead to:

- An agreed set of required labour law reforms or required improvements in labour law administration.
- An agreed set of pointers for policy formulation and implementation mechanisms.
- A set of capacity-building measures with implementation strategies and achievement indicators for each of the ILO constituents in order to further their contribution to resolving the issues raised by the dialogue.
- An inventory of practical resources available to ILO constituents in resolving the relevant issues.

The programme was originally designed to assess the labour and labour-related laws and MSEs in Bangladesh and Sri Lanka. However, since its launch, a number of refinements were made to its design and strategy. These included the inclusion of Bangladesh and Sri Lanka into the programme and a decision to focus on three states in India. Thus, the programme has established a broader South Asia focus.

Overall, the influence labour and labour-related laws have on MSE growth, formality and job quality is a highly relevant field of research and dialogue for the ILO. There is much to be learned and the ILO–Norad partnership provides a significant opportunity to do this.

1.2 Purpose of the research

The original programme document (dated June 2006) described the following development objective for the programme:

To contribute to a policy and legal environment conducive to the growth of micro and small enterprises (MSEs) through dialogue and consensus among ILO constituents and other stakeholders on required improvements and simplification in labour-related laws and their implementation leading towards higher enterprise performance in India and Nepal with possible inclusion of Bangladesh and Sri Lanka subsequent to an assessment.

On 1 October 2009, the goal of the programme was revised: “to contribute to a policy and legal environment conducive to the growth of MSEs in India, Nepal, Sri Lanka and Bangladesh”. The programme was refined to contribute to “dialogue and build consensus” amongst ILO constituents and other stakeholders on required improvements and simplification of labour-related laws and their implementation leading towards greater job creation potentialities through higher enterprise performance.

Two objectives were set:

- 1 To enhance ILO constituents’ and other stakeholders’ understanding of the impact of labour-related laws on the growth of MSEs in the context of the overall business environment in the four countries involved as well as the limits of the present inspection system and ways to improve compliance.
- 2 To assist ILO constituents and other stakeholders in starting informed discussions to better address the issues of labour-related laws and the business environment in respective countries.

The attainment of these objectives was to be measured by the following:

- The number of MSE growth traps on labour regulations and other regulatory environment identified and the magnitude of their limitations properly assessed in the four countries.
- The number of issues with the present inspection system identified and properly analysed in India and Nepal.
- The number of recommendations elaborated to better address the identified MSE growth traps and the issues on inspection and compliance.
- The number of stakeholder dialogue-meetings and national and sub-regional workshops carried out to discuss study findings and recommendations.

This report provides a synthesis of the overall findings of the programme and the attainment of the objectives based on these measures.

This programme was implemented in three phases:

The first phase involved the preparation of the four country reviews. These provided a review of the policy, legal and regulatory environment and its effect on MSE growth and employment. Drawing from existing literature, these studies identified the key features of labour laws and other relevant policy, legal and regulatory frameworks that were likely to affect the employment decisions of MSE owners and managers. These reports were used to establish the general context for the programme and to inform the design of the MSE surveys that were conducted in each country.

The second phase involved a survey of MSE owners and managers. These surveys were conducted in selected areas and industry sectors. They provided a profile of MSEs and gave an insight into the ways in which enterprise owners and managers respond to the policy, legal and regulatory frameworks they operate within. The MSE surveys were conducted in Bangladesh, India, Nepal, and Sri Lanka. In the case of India, the surveys focused on three states: Maharashtra, Orissa and Tamil Nadu. India’s federal political structure and the state-

based nature of many of its labour laws created the need for a different approach to conducting these surveys, compared with Bangladesh, Nepal and Sri Lanka.

The third phase of the programme involved a synthesis of the findings of the four country assessments and six MSE surveys. It identified common issues found across these countries and states and sought to propose reforms that would help MSEs grow and contribute to the growth and development of the South Asian region through the promotion of more productive and decent work.

The term “micro- and small enterprise” has different official definitions in each of the countries investigated in this study. Precise definitions based on official documentation are provided in Appendix II. When referring to MSEs within a specific country, the specific definition will apply. However, this report will also refer to MSEs in a more generic sense, and while there is no international definition given to this term, it will be used here to refer to privately-owned enterprises that are at the smaller end of the size spectrum.

1.3 Report structure

The following chapter presents the context in which the investigation into the effect of labour laws and MSE employment has been located. It describes the global dimension to this issue, before focusing on South Asia.

Chapter three presents the research strategy this programme employed. It describes the research questions and methodology.

Chapters four, five, six and seven present a synopsis of the country reports and survey findings for Bangladesh, India, Nepal, and Sri Lanka respectively.

Chapter eight summarizes the findings presented in the four preceding chapters in an effort to distil from these results the influence labour laws have on MSE growth, the role of labour and tax thresholds on MSE management decisions, and the influence of incentive schemes assigned to specific enterprise-size categories on management decisions. It then presents the major conclusions of the programme along with recommendations for policy reform and proposals for future research in this field.

Appendix I contains a list of the people involved in the programme, including country and survey research teams.

Appendix II provides the official definitions of MSEs in the four countries studied.

The programme produced the following reports in 2011 and 2012, which have been used as primary sources for this report.

- Bangladesh country report — cited as Bangladesh CR 2011
- Bangladesh survey report — cited as Bangladesh SR 2012
- Nepal country report — cited as Nepal CR 2012
- Nepal survey report — cited as Nepal SR 2012
- India country report — cited as India CR 2012
- India state survey report: Maharashtra — cited as Maharashtra SR 2012

- India state survey report: Orissa — cited as Orissa SR 2012
- India state survey report: Tamil Nadu — cited as Tamil Nadu SR 2012
- Sri Lanka country report — cited as Sri Lanka CR 2012
- Sri Lanka survey report — cited as Sri Lanka SR 2012

Full details on these reports are provided in the list of references at the end of this report (before the appendices).

Chapter 2: Labour laws and MSE employment

2.1 *The challenge of job creation and employment quality in MSEs*

In November 2006, the International Labour Organization's (ILO's) Governing Body Committee on Employment and Social Policy (ESP) discussed the role of labour laws in promoting decent and productive employment among micro- and small enterprises (MSEs). This discussion focused on the dilemma of striking a balance by minimizing the cost of the regulatory burden on MSEs and enhancing the prospects for competitiveness and growth, without compromising the protection of those who work in MSEs.

The ESP noted the range of factors that typically prevent MSEs from complying with labour and labour-related laws:

- Many MSEs are in a precarious financial position,
- Legislation is typically not well-adapted to MSEs.
- High transaction costs such as the costs associated with accessing information, legal and bureaucratic procedures and labour inspection have created barriers for compliance by MSEs in many countries.
- A high tax on labour that can discourage formal employment and stimulate informality.
- The outreach of authorities to enforce labour and labour-related laws in MSEs is very uneven across countries and often insufficient.
- The exclusive reliance on traditional enforcement approaches, with a strong focus on sanctions, has not necessarily resulted in widespread compliance among MSEs. In fact, it has contributed to circumstances that increase corruption.
- Procedural weaknesses hinder compliance by MSEs.
- There is typically a lack of information about labour legislation provided to MSE employers and workers.

One of the outcomes of the discussion within the ESP was the encouragement the committee gave to the ILO to examine the "win-win territory", where it is possible to reduce compliance costs for MSEs and simultaneously improve protection for workers in those enterprises.

Recent ILO reports on the impact labour and labour-related laws and regulations have on MSE employment have identified a number of broad concepts and dynamics that are relevant to reforms designed to improve MSE compliance and the quality of work created in this sector. Faundez (2008), for example, claims that the International Labour Standards (ILS) regime has, since its inception, been responsive to the special needs and interests of MSEs and has evolved in line with economic, social and cultural changes. Some of the factors the conventions take into account are related to the size of the enterprise and the practical problems MSEs can face when complying with the labour regime. His survey of national MSE policy and legislation shows that labour legislation in developed and developing countries makes ample use of the exemptions and exclusions allowed by the ILS

regime. However, while the ILO fully endorses efforts to adapt and tailor labour law provisions to the needs of MSEs, these adaptations can only be justified if they contribute towards a more effective application of the fundamental principles and rights at work. Such reforms “should not involve any lowering of core labour standards” (Faundez 2008:41).

Fenwick et al. (2007) argue that labour regulation should pursue three interrelated and mutually reinforcing objectives: promoting human capabilities, improving job quality and encouraging the formalization of MSEs. Furthermore, the basic values of the Decent Work agenda should underpin labour reform and should recognize that all those who work have rights. Labour regulation should also be responsive: it should be designed through participatory processes and make use of periodic reviews; it should take into account the enforcement and application of labour regulation; and it should be targeted specifically at MSEs.

Across this broad field there are a number of topics that are particularly pertinent to the ILO’s Decent Work agenda and the broader demand for economic growth and poverty reduction. Two topics in particular have emerged.

The first concerns the connection between labour-related laws and growth. There is a pervasive view in the development community, led in part by the World Bank, which suggests that labour and labour-related laws and regulations contribute to the stifling of business and economic growth.¹ A recent World Bank report on the effects of business environments on development suggests that labour regimes are among the most significant issues of business environment reform that appear to affect enterprise growth (Xu, 2010). Within this and similar debates, further knowledge is required to better understand the link between labour and labour-related laws and business growth, and especially the link with MSEs and economic growth.

The second topic that has arisen within this field concerns the linkages between labour-related laws and the formalization of informal enterprises. The concept of “formalization” refers to the process of encouraging an enterprise to move from various states of informality to becoming fully compliant with the legal and regulatory framework. The role of labour and labour-related laws and regulations in encouraging informality or discouraging formality is a central concern of the ILO. Fenwick et al. (2007) demonstrates a critical relationship between the goals of job quality for MSE workers and the formalization of MSEs. “It is not sufficient for regulation to be aimed broadly at formalization of MSEs”, they say, “without targeting job quality issues” (Fenwick et al 2007:112). While labour and labour-related laws appear to play an important role in the formality–informality dynamic, more needs to be understood about the relative importance of this compared with other domains such as taxation.

¹ The recently abolished Employing Workers Index in the annual World Bank *Doing Business* assessments, for example, was especially criticized in this regard. This index was found to disregard the provisions set forth in numerous International Labour Conference (ILC) Conventions and to dismiss the view that labour laws are often part of a package of complementary laws and policies designed to achieve a particular policy objective (Berg and Cazes, 2007).

2.2 Identifying “win-win” opportunities

From an ILO perspective, there is a bottom line to the kinds of reforms that can be introduced in labour law, without undermining the core labour standards, as argued by Faundez (2008). The 2006 deliberations of the ILO’s ESP Committee strongly encouraged the Office to examine the “win-win territory”, where it is possible to reduce compliance costs for MSEs and simultaneously improve protection for workers in those enterprises.

However, finding this territory, if it exists, requires careful analysis of the problem as well as closely documenting experiments and pilot reforms to find out what works and what doesn’t. It also requires careful monitoring of existing reform efforts and the identification of good, best and bad practice in this field.

The design of this programme placed a high degree of emphasis on policy-induced growth traps. ILO studies on the role of policies and laws on MSE employment have found that while governments in some countries have created mechanisms that exempt MSEs from full compliance with the labour law, this not only leaves workers unprotected, it also creates growth traps for enterprises close to the maximum threshold for exemption. Exemptions of this kind may undermine the incentives for MSEs to upgrade their production and to produce for more demanding markets.

While these studies found that most MSE employers do not identify labour laws and regulations as a principal constraint to growth, general exemptions appeared to reinforce a view that MSEs should be treated differently. Thus, the regulatory system can promote or hinder MSE growth, as can various kinds of non-regulatory instruments. General exemptions of MSEs from labour laws and regulations leave many workers unprotected and have a negative effect on job quality. Exemptions create a growth trap by providing incentives for enterprises close to the exemption threshold size to either stop hiring workers or to hire informally. To examine the possible effects of sized-based regulatory thresholds, the programme was designed to survey firms above and below the thresholds in each country or state to determine the extent to which labour law contributes to or hinders growth, compared with other regulatory and non-regulatory items.

The role of labour and labour-related laws in inhibiting or enabling employment growth in MSEs is the central concern of this programme. However, there is also an interest in determining the extent to which regulations influence enterprise growth and/or formalization. Results from initial programme reports highlight the role of business licensing procedures in inhibiting growth, as well as the role of incentive and subsidy schemes in promoting formalization/growth. This includes the practice of exempting MSEs from taxation. Thus, the MSE survey endeavours to assess the extent to which labour law and other regulatory instruments enable or inhibit employment growth in MSEs, and will compare these to determine which instruments are most influential.

Chapter 3: The research strategy

3.1 Core research questions

This research programme sought to better understand how labour laws and the broader business environment affected management decisions of MSE owners and managers with regard to employment. The central question pursued through this research programme was:

How does the legal and regulatory framework for labour affect MSE employment and growth in the South Asia region?

In answering this question, three sub-questions were considered:

- 1 How does the effect of labour-related laws and regulations compare with other business laws and regulations found in the business environment?

Here, the research was interested in positioning the overall effect of labour laws and regulations among the broader range of issues faced by MSE owners and managers. The influence of labour laws and business decisions may, for example, be insignificant compared to other business-related laws and regulations. Alternatively, it may be that labour laws and regulations have a direct and discernible effect on a manager's decision to expand, reduce or maintain the size of the enterprise's workforce.

- 2 Do the thresholds in the labour regimes under study encourage compliance and job quality, or do they act as constraints to enterprise growth?

This sub-question is more focused than the first. It specifically sought to examine the behaviours of MSE owners and managers. Size-based thresholds have been introduced by legislators in the understanding that it is often extremely difficult for MSEs to fulfil all the obligations of the labour law. While all employers, regardless of the size of their workforce, must comply with the core elements of the labour law, there are other elements of the labour law that only concern enterprises with larger workforces. However, this can create a situation in which a small employer may enjoy these special conditions so much that she or he is reluctant to grow out of them. Thus, the employer may attempt to stay within the threshold by simply not growing or by forming new, additional enterprises that increase the overall size of the workforce, but spread the workforce across more than one enterprise in order to appear small.

- 3 What are the strategic management decisions that MSE employers make in response to these conditions?

The term "strategic management decision" is used here to describe a range of actions that may be taken by MSE employers in response to the issues under study. For example, an employer may choose to comply with all laws and regulations. While such exemplary behaviour may simply indicate the employer's desire to be a good citizen, it may also reflect a strategic choice that balances the benefits and costs of compliance with the benefits and costs of non-compliance. Similarly, the decision not to comply with specific provisions of

the labour regime may be strategically determined based on the extent to which those provisions are strongly sanctioned and enforced, or the anticipated problems and costs associated with compliance. In some cases, employers may choose not to comply, to avoid official observation and to operate informally. There may be tactics developed to hide from the eyes of government inspectors and to avoid the penalties of non-compliance. Sometimes, bribes or informal payments may be made by the employer to avoid the penalties of non-compliance.

By answering these questions, the research programme sought to generate evidence that could be used to inform social dialogue in the countries investigated and across the region. This dialogue would engage social partners and help them to consider more carefully the trade-offs that are required when reforming the labour regime in order to promote more decent and productive jobs for women and men in the South Asia region.

3.2 Research themes

Four broad themes were assessed through this research programme.

3.2.1 Labour-related laws and regulations

The first theme assessed reflects the primary focus of the study: the influence of labour-related laws and regulations. This theme identified a number of common elements in the labour regime in which MSEs in South Asia operate that would be investigated to determine their effect on business decisions and enterprise growth because their perceived cost of compliance appeared higher than others in respective country contexts.

The following aspects of labour-related laws and regulations were examined in all the six countries and states:

- Use of employment register
- Labour inspections
- Payment of the minimum wage
- Payment of employment pension fund contributions
- Gratuity payments
- Trade union membership

All of the above aspects of labour laws in the region contain thresholds of one kind or another. In some cases, there are only a few, broad thresholds. In other cases, MSE employers find themselves among a complex matrix of thresholds.

Beyond the above list, the following labour-related laws were identified for investigation within some of the countries and states. Again, each of these has specified thresholds.

- Paid annual leave (Nepal only)
- Compensation for injury or death (Bangladesh and Nepal only)
- Retrenchment payments (Sri Lanka and India only)

- Provision of shelter, rest room, lunch Room, children’s room (Bangladesh only)

3.2.2 Other business laws and regulations

The second theme assessed recognizes the other non-labour issues that may affect business decisions and growth. These issues were investigated to determine the influence they have on MSE management and growth. Four regulatory issues that were perceived to have high compliance cost were assessed:

- Business registration and licensing
- Income tax
- Value added tax (VAT) registration and payment
- Environmental regulations (Bangladesh, Nepal, except the IT sector, and Sri Lanka only)

Here, too, the role of thresholds was investigated. In some cases, such as taxation, the thresholds were not based on the number of workers, but on the volume of enterprise turnover instead.

3.2.3 Incentive programmes

The third theme examined the role of incentive programmes, including MSE development services and benefits. Gaining access to these services may require compliance with labour-related and other business laws and regulations. This might also involve benefits that are available to the enterprise based on size. Thus, MSEs may consider it advantageous to remain small to benefit from the services provided by a government or non-governmental organization (NGO) support programme.

3.2.4 Strategic choices

The fourth theme examined the knowledge and actions of MSE owners and managers. It enquired into the ways MSEs view the labour and business regime they operate within and the kinds of activities they engaged in as a response. This included an assessment of:

- The knowledge of costs of compliance and the penalties associated with non-compliance.
- The creation of parallel or multiple firms to avoid outgrowing a legal or regulatory threshold.
- The payment of bribes or other forms of informal payments to avoid the penalties that may result from non-compliance.

3.3 *Research methodology*

The ILO’s Decent Work Technical Support Team for South Asia, based in New Delhi, India (DWT-New Delhi), managed the overall research programme, with assistance from the ILO’s Headquarters in Geneva. Country Research Teams were established in Bangladesh, India, Nepal, and Sri Lanka to manage and conduct the research in each country. These teams reported to the New Delhi office and were supported by consulting specialists in research

and statistical analysis that the New Delhi office commissioned. Thus, while the four Country Research Teams focused on the specific requirements of the research within their allocated territories (i.e. national surveys in Bangladesh, Nepal and Sri Lanka, state surveys in India), ILO's DWT-New Delhi coordinated all elements of the programme's activities to ensure the data and findings could be synthesized in a manner that addressed the core research questions and the overall objectives of the programme.

Appendix I provides a list of the personnel who were involved.

3.2.1 National assessments

The first step undertaken in this research programme was to assess the policy, legal and regulatory framework for MSEs in the four countries. This resulted in focused regulatory reviews that guided the selection of laws and regulations to be surveyed and the detailed designing of the questionnaire for each country. The reviews were based on the legal and regulatory provisions as well as available secondary data, which in most cases was complemented by some statistical analysis and consultations.

For full details on the findings of the national assessments, please refer to the specific country report.

3.2.2 MSE survey

Drawing from the findings in the legal and regulatory review, the programme identified key areas for closer examination through a survey of MSE owners and managers. The MSE surveys followed a general approach, which was modified where necessary to suit the conditions and interests of the six countries and states that were studied. There were two main interests pursued through these surveys.

Awareness and knowledge

The key question here was: how do MSE owners and managers think the legal and regulatory elements affect business growth?

The perceptions of MSE owners and managers were considered important for a number of reasons. First, understanding perceptions helps us understand whether or not owners and managers know of the legal and regulatory instrument. For example, it is possible that owners and managers of micro-enterprises are not fully aware of all the provisions of labour law and their compliance obligations.

Second, MSE owners and managers can provide valuable information on how they balance the costs and benefits of specific laws and regulations, which can be used to understand their decisions to comply with or avoid these obligations.

Thresholds

The key question here was: do exemption thresholds based on enterprise size affect growth decisions made by owners and managers?

Using the legal and regulatory reviews, the consulting teams identified the most likely thresholds that appeared to present a plausible growth trap in the six countries and states under investigation. The laws and regulations were divided across two categories: labour-related laws and regulations and other business laws and regulations.

The MSE survey was designed to obtain the views of MSE owners and managers and to interpret these views in line with the findings of the national assessments. Each of the surveys conducted were designed according to a central research framework. This framework established the broad parameters in which country and state surveys were designed. Table 3.1 presents an overview of the sample frames used in the six surveys. Some 4,625 MSEs were surveyed in total. More details on these sample frames are presented in the chapters that follow, but for full details please refer to the relevant country report.

Table 3.1. Overview of MSE surveys: Bangladesh, India, Nepal, and Sri Lanka

	Bangladesh	India (total of three states)	Nepal	Sri Lanka
No. of respondents	611	3 029	409	576
Industry sector	Agro processing Leather Light engineering Garments, Textiles, Handlooms	Food processing Leather Textile Automobile	Agro processing Garment and Carpet Tourism Information technology	Agro processing Woodworking Textiles and garments Hospitality
Enterprise size	3–5	4–6	5–9	5–14
Thresholds	6–25	7–9	10–70	15–70
(based on the number of full-time equivalent employees or FTEEs)	26–40 41–50 51–70	10–20 21–49 50–70		

Source: Country reports.

All surveys focused on specific industry sectors, as shown in table 3.1.

In addition, all survey samples were stratified according to the national thresholds that were found in the labour laws. In some cases, such as Nepal and Sri Lanka, this involved only two enterprise size categories. In Bangladesh and India, five categories were applied.

The term full-time equivalent employee (FTEE) is used throughout this report. While the governments of the four countries studied provide official definitions for a full-time worker, there was some variation found among these definitions. The country reports provide full details on the definitions of all key terms used. For ease of reference in this report, an FTEE is a general term used when referring to the number of workers in an enterprise size category.

Furthermore, there is significant variation in the official definitions provided for a “micro-enterprise”, “small enterprise”, and “medium-sized enterprise”. Appendix II provides an account of these definitions in the four countries studied. However, the term “micro- and small enterprises” (MSEs) is used in this report in a general sense. Where required, specific details on the size of an enterprise workforce are given.

All survey respondents were either owner or principle manager of the enterprise they reported on. All had been operating the enterprise under investigation for at least three years. Enterprises employing less than three employees were not sampled; neither were those that employed more than 70 FTEEs.

The generic survey instrument was prepared and each survey team modified this to suit the country or state requirements and to incorporate any additional issues identified in the legal and regulatory review. The generic questionnaire contained the following elements:

- Profile of the MSE owner–manager (the respondent)
- Business profile (key features of the enterprise, including the number of workers)

- Perceptions regarding the general investment climate
- Perceptions regarding the business environment (laws and regulations)
- Perceptions regarding labour laws and regulations
- Experience complying with business laws and regulations. including:
 - Business registration and licensing
 - Income tax
 - VAT registration and payment
 - Environmental regulations
- Experience complying with labour laws and regulations, including:
 - Use of employment register
 - Labour inspections
 - Payment of the minimum wage
 - Payment of employment pension fund contributions
 - Gratuity payments
 - Trade union membership
 - Other country-specific laws and regulations where relevant
- Incentive programmes (i.e. participation in programmes)
- Knowledge of labour laws and regulations, including knowledge of penalties for non-compliance
- Strategies used to avoid compliance, such as bribes or informal payments and the establishment of “parallel units”

The programme produced a wealth of detailed information through the six country/state surveys contained in the four country reports. This Synthesis Report does not attempt to cover all the findings produced by the surveys and national assessments. Instead, it focuses on only those findings that directly help to answer the research questions presented in section 3.1. For full details on the findings from the country and state surveys, please consult the country reports.

Chapter 4: Labour laws and MSE employment in Bangladesh

4.1 Introduction

Following Bangladesh’s independence from Pakistan in 1971, the British era legislation that had continued to function in Pakistan, as well as the post-1947 legislation enacted by Pakistan, remained the bases of Bangladeshi laws. In an effort to consolidate and codify the various regulations, the Bangladesh Labour Act, 2006 was enacted by repealing most of the significant labour laws of Bangladesh. The laws were codified to enable the application of legal obligations to a wider range of premises and enterprises as well as to create broader provisions for prosecution processes. A significant outcome of the codification was the eradication of a minimum threshold for a number of workers that have to be employed before the code’s obligations apply to an establishment, excepting a handful of exemptions based on size.

Figure 4.1 presents seven different thresholds found in the Bangladesh Labour Act, 2006 that were identified in the country report. These provided a basis for the sampling of firms for the MSE survey presented further ahead.

Figure 4.1. Bangladesh labour-related thresholds based on size

SEVENTH THRESHOLD S.87: Sick room with medical dispensary							
SIXTH THRESHOLD S.58(3): Ensuring adequate supply of drinking water							
FIFTH THRESHOLD S.98: Provision for compulsory group insurance							
FOURTH THRESHOLD S.234: Establishment of participation and welfare funds for workers S.241: Eligibility of workers to participate in the funds S.242: Utilization of participation funds							
THIRD THRESHOLD S.62(8) Arrangement of mock fire-fighting S.205 Provision for participation committee S.208: Implementation of recommendations of participation committee							
SECOND THRESHOLD S.89: Maintenance of safety record book							
FIRST THRESHOLD S.62(7): Creating awareness of the means of escape when work is in close proximity of inflammable materials							
Bangladesh Labour Act, 2006 (all sections except the above)							
1+	10+	25+	50+	100+	200+	250+	300+

Source: Bangladesh CR 2014.

The MSE survey in Bangladesh covered 611 firms and focused on five enterprise size categories, reflecting the thresholds found in the national labour legal and regulatory framework and presented in the Bangladesh country report. These were:

- Size Category 1: Enterprises employing 3–5 FTEEs
- Size Category 2: Enterprises employing 6–25 FTEEs
- Size Category 3: Enterprises employing 26–40 FTEEs
- Size Category 4: Enterprises employing 41–50 FTEEs
- Size Category 5: Enterprises employing 51–70 FTEEs

All respondents were male MSE owners and managers. Around 22 per cent were located in rural areas.

Four industry sectors were selected for investigation:

- Agro processing
- Leather
- Light engineering
- Garments, textiles and handlooms

Survey details are outlined in Table 4.1. For full details on the sampling and the rationale for sampling, please refer to the Bangladesh survey report.

Table 4.1. Overview of Bangladesh MSE survey samples

Bangladesh MSE survey	Actual sample size: 611 enterprises
Sample frame (the list): 3 568 enterprises	Sample selected for the survey: 958 enterprises
Enterprise size threshold sample: (total 611)	Industry sectors sampled: (total 611)
Enterprise Size: 3–5 FTEEs (377)	Agro processing: 154
Enterprise Size: 6–25 FTEEs (202)	Leather: 151
Enterprise Size: 26–40 FTEEs (14)	Light engineering: 151
Enterprise Size: 41–50 FTEEs (5)	Garments, textiles and handlooms: 155
Enterprise Size: 51–70 FTEEs (13)	
Sex of MSE owners in sample: (total 611)	Urban–rural distribution of sample: (total 611)
Male: 611/Female: 0	Urban: 476/Rural: 135

Source: Bangladesh CR 2014.

4.2 Labour-related laws and regulations

The Bangladesh study indicates that most MSE respondents had a relatively benign attitude towards labour-related laws and regulations. Many expressed a positive attitude toward a substantial number of aspects of the labour law, including maintaining an employment register, paying minimum wages, complying with health and safety standards, dismissal procedures and disputes, paying for annual leave, workers injury compensation, limits on working times, and insurance and welfare fund. The only aspects of the labour regime deemed as having a negative effect on the growth of their firms were severance payments, provident fund contributions, and the provisions for unions and collective bargaining.

4.2.1 Use of employment register

The Bangladesh country report indicates that maintenance of an employment register is a regulatory requirement for all sizes of enterprise. However, very few MSEs were found to maintain an employment register.

One-third of the surveyed firms did maintain a register. The proportion was highest in the light engineering sector (41 per cent) and lowest for the leather sector (25 per cent). Around 34 per cent of those not maintaining an employment register claimed it was not legally required. The proportion was highest in the light engineering sector (44 per cent) and lowest for the textiles, garments and handloom sector (25 per cent). The daily payment of salaries was another common reason given for not complying with this requirement (25 per cent for all, 30 per cent for the leather sector), followed by the complexity of doing it without benefits (23 per cent for all, 29 per cent for the leather sector).

4.2.2 Labour inspections

Around 24 per cent of the surveyed MSEs received a visit from at least one inspector over the year preceding the survey. The incidence of inspection visits was higher in the agro processing sector (46 per cent) compared to other sectors. Health inspectors had visited 21 per cent of respondents in the last year and officials from the food and technology department dealing with agro processing had visited 24 per cent of respondent enterprises in the sector. These inspections were much more common than other types of inspections.

4.2.3 Payment of the minimum wage

Payment of minimum wage is applicable to all firms in Bangladesh. The labour law provides for the establishment of a Minimum Wages Board and allows for the periodical review of the minimum wage in specific industries, taking into account the changing economic conditions. Minimum wages are legally enforceable and violations are punishable by fines and imprisonment. The country report describes the way enterprises attempt to pay below minimum wage by maintaining a pool of surplus standby workers, thereby creating pressure on regular workers and reducing their bargaining power significantly. Often part-time or casual (*badli*) workers are engaged full time, but paid on a part-time basis, thus avoiding the payment of minimum wages. In addition, the country report describes how workers were harassed with penalties for non-performance and substandard work as a means of reducing wage payments.

The MSE survey found that almost half (47 per cent) of the MSEs surveyed were not aware of their obligations to pay a minimum wage. This was highest among firms in the

leather sector (69 per cent) and lowest among firms in the light engineering sector (34 per cent). It was also higher among unregistered businesses (53 per cent) and, interestingly, higher among urban-based firms (50 per cent) than rural ones (36 per cent).

Only 43 per cent of respondents reported paying their employees the minimum wage. Around ten per cent of respondents indicated they were aware of, but did not pay, minimum wage. This was highest in the light engineering sector (12 per cent) and lowest in agro processing (6 per cent). The main reasons for failing to pay the minimum wage were: “Too costly”, “It is not legally required” and “it is legally required, but not enforced”.

Around 32 per cent of respondent firms indicated they had paid or knew of someone in their sector paying informal payments to avoid being fined for their failure to pay the minimum wage. This was higher among unregistered businesses (44 per cent).

4.2.4 Payment of employment pension fund contributions

Contribution to the employees’ provident fund (EPF) is required for all businesses in Bangladesh, but non-compliance in this field is very high. Less than one per cent of respondents reported contributing to employee pension funds. Around 80 per cent of respondent MSEs were not aware of the obligations to make pension fund contributions. This was highest among unregistered businesses (86 per cent). Among the firms aware of the obligations, the main reasons for failing to make these contributions were: “It is legally required, but not enforced”, “Too costly”, “Workers have not demanded it” and “Employees prefer to receive higher take-home pay”.

Around 12 per cent of respondents had heard of informal payments being made to avoid penalties and six per cent reported making such payments. This was the highest score among types of regulations for which the MSEs made informal payments.

4.2.5 Gratuity payments

Gratuity payments apply to all enterprises in Bangladesh, but none of the surveyed firms had paid their employees a gratuity payment upon separation. This is not surprising given that an employee must have 25 years of employment with the firm before she or he becomes eligible for such a payment. Around 79 per cent of respondent MSEs were not aware of the need to make gratuity payments. Indeed, with 21 per cent of respondent enterprises being in existence for 16 or more years, it is notable that the same ratio of businesses were aware of the obligations. Around 42 per cent of the partnership businesses were aware of the obligations, 16 per cent of the respondents (29 per cent of partnership firms) claimed they knew the gratuity rate, and 12 per cent had heard of informal payments being made to avoid penalties.

4.2.6 Trade union membership

Where an enterprise employs five or more FTEEs, these workers become entitled to join a trade union¹. However, none of the surveyed MSEs had a trade union at their premises.

¹ Although the Bangladesh Labour Act, 2006 does not provide an explicit threshold for the formation of a trade union, there is an implicit threshold set by its Article 179(k) which demands the following

Respondents reported that this was mainly because their employees had not demanded it (67 per cent of those above the threshold), it was not legally required (when in fact it is) (19 per cent), and that while it is legally required, it is rarely enforced (15 per cent). Around 23 per cent of firms with 51–70 workers attributed the absence of a trade union to it being too costly for them to have one.

Around 16 per cent of respondents indicated they knew of informal payments being made to avoid the penalties that result from a failure to comply with these regulations and, out of those, four per cent indicated they had in fact made such payments.

Beyond the survey data, the Bangladesh country report notes that employers tend to avoid the creation of trade unions by influencing opinion leaders among the workers. These workers yield significant influence over other workers and are provided with various benefits, enabling employers to exert control over employees' activities. Other common practices identified in the report include the use of political parties as well as intimidation, harassment and violence to influence workers.

On the other hand, the trade union threshold level was not found to be an impediment to growth. Only 11 per cent of businesses with less than six employees were aware of the right of these workers to form or join a trade union. Among the respondents that were aware of this issue, none had decided to keep their business small to avoid dealing with trade unions.

4.2.7 Compensation for injury or death

There are a number of features of the labour law that were examined in the Bangladesh study that go beyond those examined in the other countries due to high perceived cost of compliance. Compensation for injury or death is one of them.

All businesses in Bangladesh are required to give compensation for injury or death at work. The country report indicates that, irrespective of their location, structure or registration type, most businesses are aware of the compulsory compensation provisions for workers for any death or injury at work. The MSE survey in Bangladesh indeed found that a significant proportion of MSEs were aware of these provisions (86 per cent) and knew the kind of compensation to be made (83 per cent).

Only in a small number of cases (9 per cent of those aware of the provisions) were these payments made. While the majority of respondents (94 per cent of those never paid) indicated that there were no injuries or deaths that warranted these payments, as many as 39 per cent of respondents indicated they “have heard of informal payments” to avoid the penalties of non-compliance with this law.

4.2.8 Provision of shelter, rest room, lunch room, children's room

These are also issues specific to Bangladesh, but tied to employment thresholds. Of particular concern to researchers was the need for enterprises with more than 24 female

as part of the registration requirements of a trade union: “the number of members of the executive which shall not be less than five and more than thirty-five as may be prescribed by rules”.

FTEEs or more than 49 regular FTEEs to provide a shelter, rest room or cafeteria.² As with other labour-related regulations, the concern for the research team was whether or not enterprises that were below this threshold would attempt to keep their workforce small in order to remain below the threshold. In particular, would firms employ fewer women in order to remain below this threshold? Linked to this provision is the requirement of firms to provide a nursery facility for every 40 female workers.³

Overall, these regulations were not found to be a growth trap. The MSE survey found that most firms below these thresholds (86 per cent) were unaware of the threshold for providing shelter/rest room/lunch room. In addition, 93 per cent of respondent MSEs with less than 41 female FTEEs were not aware that there was a requirement to provide children's facilities. Among those who were aware, only one decided not to grow in order to avoid providing shelter/rest room/lunch room, but none (0 per cent) decided not to grow in order to avoid the provision of children's room.

With regard to compliance, none of the surveyed businesses with more than 24 female FTEEs or more than 49 regular FTEEs provided a shelter, rest room or cafeteria. When it comes to provision of children's room, there was no eligible enterprise among the sample (i.e. none of the surveyed MSEs had 40 or more female FTEEs). Around nine per cent of the surveyed MSEs had heard of informal payments being made for non-compliance with regard to the provision of shelter/rest room/lunch room; six per cent were aware of informal payments being made for non-compliance with regard to the provision of a children's room.

4.3 Business laws and regulations

The Bangladesh research team looked beyond the influence of labour-related laws and regulations to determine the relative importance of other factors. The perception-based rating included in the survey indicates that respondents believed there were a number of factors in the business environment that inhibited growth. These were:

- Cost and time required to register a business
- Cost and time required to obtain a business license
- Requirements to comply with banking and credit regulations
- Cost and time required to register for taxation
- Cost of taxation

² Section 93 of the Bangladesh Labour Act, 2006 makes a provision of a rest room for every 50 or more workers and a separate rest room for female workers numbering over 25. But if the number of female workers is below 25 then the factory management shall manage a curtain in the same rest room to create a separate resting space for female workers. The threshold of 50 workers had been decreased from 100 and a separate rest room provision for female workers came into being in the new law.

³ The Bangladesh Labour Act, 2006 has made a provision of a children's room for every 40 female workers with children below six years of age. The threshold had been lowered from 50 female workers. The room is required to be of such an area so that it can provide 600 square centimetres (previously it was 20 square feet) of space for each child and the minimum height of such a room shall not be less than 360 centimetres.

- Time required for tax administration

There was little variation recorded across enterprise size classes or sectors. The four areas of business laws and regulations that were assessed are presented ahead.

4.3.1 Business registration and licensing

Around 15 per cent of the surveyed firms in Bangladesh were unregistered. The most popular type of registration is trade license (85 per cent of the sample firms) followed by tax registration (16 per cent) and value added tax (VAT) registration certificate (15 per cent). Interestingly, it took a relatively short time (on average, 16 to 19 days) to complete these registrations/licenses. For other not-so-common ones, it took 28 to 43 days, on average. In the worst case, it took 180 days to obtain a trade license, followed by 150 days to complete the registration with the labour department. The registration/licensing fees that MSEs paid ranged, on average, from 1,634 Bangladeshi Taka (BDT) (for trade license) to BDT2,751 (for company/cooperative/chamber registration), but they also had to pay an annual renewal fee – BDT953 for trade license and BDT2,000 for company/cooperative/chamber registration.

Mostly, respondents reported they were not aware of the need to register (48.4 per cent). A smaller proportion claimed it was not legally required for them to register (24.5 per cent) and less than nine per cent (8.9 per cent) complained that the process was too complicated and they did not see any benefit in registering. Thus, avoiding the cost of compliance was not a major issue. Unregistered businesses demonstrated a lower level of compliance with labour- and tax-related regulations than registered ones.

4.3.2 Income tax

The threshold for the payment of personal income tax in Bangladesh is BDT165,000 in terms of annual earnings for sole proprietorship and partnership businesses as well as unregistered ones. The country report indicates that while the practice of income tax payment is not common among MSEs, it is unclear whether this affects enterprise growth.

Most respondents (78 per cent) indicated they were not paying income tax. This was the case for all unregistered enterprises. Furthermore, most respondents (71 per cent) were unaware of the income tax exemption threshold. The ratio of MSEs unaware of the threshold was higher among those without registration (82 per cent) than those registered (69 per cent). Sector-wise, the ratio was highest in the leather sector. On the other hand, nearly half of the sample firms (45 per cent) were aware of penalties, and the ratio is higher among unregistered businesses.

While a precise determination of how many non-payers were exempt from income tax because of their low earnings was not possible, the key reasons presented for not paying income tax were: “It is not legally required/exempted”, “Too costly”, “Unnecessarily complicated” and “It is legally required, but not enforced”.

Informal payments were found to be a relatively common strategy of non-payers to avoid penalties. Around 41 per cent of respondents indicated they had “heard of” informal payments being made for this purpose. However, only three per cent of them indicated they had made such payments.

4.3.3 VAT registration and payment

The threshold for the payment of VAT is an annual turnover at BDT2 million. The VAT rate is four per cent below the threshold and 15 per cent above.

Very few respondent MSEs (19 per cent) made VAT payments. Around 81 per cent of respondent enterprises reported not paying VAT. The incidence of non-payment was high among MSEs without registration (99 per cent) compared to registered enterprises (78 per cent). The payment of VAT was reported to be much less in the leather sector than in the light engineering sector. Unsurprisingly, 97 per cent of unregistered firms did not pay VAT. Among the registered firms, only 21 per cent of sole proprietorships reported paying VAT. Most respondents (90 per cent) claimed they were unaware of the threshold for a lower VAT rate. This was highest in the leather sector (96 per cent).

Around 37 per cent of respondents knew of others who had made informal payments to avoid the penalties of non-compliance, but only four per cent indicated making such payments themselves.

4.3.4 Environmental regulations

The final non-labour-related regulation investigated in the Bangladesh study was the extent to which MSEs are affected by environmental regulations, more specifically the requirement to obtain an Environmental Clearance Certificate (ECC). Around 94 per cent of the surveyed MSEs did not have an ECC. This was the case among all the unregistered enterprises surveyed. About 39 per cent of respondents had either made or knew of people in their sector who had made informal payments to avoid any problems arising from this. For those who had obtained the ECC, it took, on average, 19 days to prepare reports, 38 days for the government to process the documents, and nearly BDT3,000 as government fee.

4.4 Incentive programmes

About half the survey respondents (52 per cent) were able to identify at least one incentive programme. However, just less than ten per cent of respondents had made use of such a programme and only 7.5 per cent had gained assistance from a programme to start their enterprise.

Many of the MSEs that had benefited from an incentive programme (88 per cent) were aware of the eligibility ceiling of such programmes. Out of those, about one-third (35 per cent) were concerned about losing these benefits if they were to outgrow the programme's threshold level. However, since the number of respondents that had benefited from an incentive programme was so low, the proportion of those who feared outgrowing the size threshold is only three per cent of the total sample.

4.5 Strategic management decisions

4.5.1 Knowledge of compliance costs and penalties

MSEs' knowledge of compliance costs and penalties varies across legislations. A high level of awareness was found on issues relating to compensation for injury or death at work (83 per cent) and minimum wage (55 per cent). MSEs knew much less about the provision of

gratuity (16 per cent), the rate of EPF contribution (13 per cent) and the provision for a children's room (6 per cent). Sector-wise, awareness was found to be lowest in the leather sector.

Awareness regarding the penalties for non-compliance was found to be highest in the areas of income tax (48 per cent), VAT (44 per cent), environmental regulations (42 per cent), compensation for injury/death (41 per cent), and minimum wage (34 per cent). Business sector-wise, awareness was lowest in the leather sector.

4.5.2 Creation of parallel or multiple firms

Only two per cent of the survey respondents indicated they had established "parallel units". Most of these were in the agro processing sector, but the actual instances are in fact very low. Thus, this strategy appears to be relatively uncommon.

4.5.3 Payment of bribes or other informal payments

The survey found that many MSEs were aware of informal payments being made to avoid the penalties for non-compliance. The survey found that this was highest in the areas of income tax (49 per cent), environmental regulations (39 per cent), compensation for injury and death (39 per cent), VAT (37 per cent), and minimum wage (32 per cent). The country report also claims it is widely known that enterprise inspections, whether by labour, health or any other kind of inspector, can be avoided by paying a bribe to the respective authority or officer.

Chapter 5: Labour laws and MSE employment in India

5.1 Introduction

The India country report highlights the complicated and ambiguous nature of the India labour regime and the problems faced by employers of all sizes in understanding and navigating this framework. As a federal state, India has a legal framework that goes beyond national government. However, the country report indicates that the most significant laws and regulations affecting MSE employment and growth are at the national level. Indeed, while three states were chosen for investigation in the India case, the analysis maintained a focus on federal laws and regulations rather than those instigated by the state governments.

Box 5.1. India: Major labour laws and their applicability

Trade Unions Act, 1926: Applicable to all establishments and all employees.

Industrial Disputes Act, 1947: Generally applicable to all establishments. Limitations are Chapter VA (Lay-Off and Retrenchment not applicable to establishments of seasonal nature or less than 50 workers; VB (Provisions relating to lay off, Retrenchment and closure in certain establishments applies to establishments with 100 or more workers) and Section three regarding the formation of Works Committee.

Industrial Employment (Standing Orders) Act, 1946: Applicable to enterprises with one hundred or more employees. In Karnataka, West Bengal, Gujarat and Tamil Nadu the number of workers is more than 50; in Uttar Pradesh this limit is further reduced and all the factories under section 2m are covered, i.e. ten workers with power or 20 without power.

Payment of Wages Act, 1936: Applicable to all factories.

Minimum Wages Act, 1948: Applicable One or more employees in any scheduled employment where minimum wage rates have been fixed under this Act.

Payment of Bonus Act, 1965; Payment of Bonus Rules, 1975: Where 20 or more workers are employed, inclusive of those also who are drawing more than 1,600 rupees (INR) per month. The establishment shall continue to be governed by this Act, notwithstanding that the number of persons employed therein falls below 20.

Factories Act, 1948: Applicable to ten or more workers on any manufacturing activity with the aid of power, and 20 or more workers working without any aid of power.

Contract Labour (Regulation & Abolition) Act, 1970: Applies to all establishments where 20 or more workmen are employed. Applies to contractor employing 20 or more workmen.

Workmen's Compensation Act, 1923: Applicable to all establishments.

Employees' State Insurance Act, 1948: Applies, in the first instance, to the factories and could be extended to other establishments with due process.

Employees' Provident Fund and Miscellaneous Provisions Act, 1952: To every establishment which is a factory and in which 20 or more persons are employed.

Shops and Establishments Act: Applies to every shop and establishment, not registered under the Factories Act, 1948.

Maternity Benefit Act, 1961: To every shop and establishment employing ten or more persons are employed.

Equal Remuneration Act, 1976: Applicable to all establishments.

Payment of Gratuity Act, 1972: Applies to all factories and establishments where ten or more

persons are employed.

Source: India CR 2012.

The India country report claims that the size and complexity of India’s labour laws hardly affect the MSEs in the informal sector because most of these enterprises are not running factories and are employing less than ten FTEEs. However, the report goes on to indicate that the various thresholds (or “filters” as it refers to these) encourage enterprises to manipulate their records to avoid compliance. This, says the report, has “adverse consequences for the wages and working conditions of workers”.

Figure 5.1 presents two major thresholds identified by the India research team.

Figure 2.1. India: labour-related thresholds based on enterprise size

SECOND THRESHOLD		The Contract Labour (Regulation and Abolition) Act, 1970 The Payment of Bonus Act, 1965 The Employees Provident Fund and Miscellaneous Provisions Act, 1952
FIRST THRESHOLD	Labour Laws (Exemption from furnishing returns and monitoring registers) Act Labour Laws (Exemption from furnishing returns and monitoring registers) Act The Payment of Gratuity Act, 1972 The Factories Act, 1948 The Employees State Insurance Act, 1948 The Payment of Wages Act, 1936 Maternity Benefits Act, 1961 Labour Laws (Exemption from Furnishing Returns and Maintaining Registers by Certain Establishments) Act, 1988.	
ALL ENTERPRISES		
Shops and Establishments Acts of State Governments Workmen’s Compensation Act, 1923 Child Labour (Prohibition & Regulation) Act, 1986 Bonded Labour System (Abolition) Act, 1976 Equal Remuneration Act, 1976 The Industrial Disputes Act 1947 [with the exception of Chapters VA and B applicable to enterprises with 50 and above and 100 and above workers respectively] Minimum Wages Act, 1948 Trade Union Act, 1926 Labour Laws (Exemption from furnishing returns and monitoring registers) Act (in some states)		
Number of Workers 1–9 FTEEs	Number of Workers 10–19 FTEEs	Number of Workers 20–49 FTEEs

Source: Adapted from the India CR 2011.

The MSE survey in India focused on three states: Maharashtra, Orissa and Tamil Nadu. The results of these surveys are presented in three survey reports, while the overall India assessment is contained in the India country report.

Across the three states, a total of 3,029 enterprises were surveyed: Maharashtra (1,204), Orissa (600) and Tamil Nadu (1,225). Five enterprise size categories were sampled, reflecting the thresholds found in the national labour legal and regulatory framework and presented in the India country report. These were:

- Size Category 1: Enterprises employing 4–6 FTEEs
- Size Category 2: Enterprises employing 7–9 FTEEs
- Size Category 3: Enterprises employing 10–20 FTEEs
- Size Category 4: Enterprises employing 21–49 FTEEs
- Size Category 5: Enterprises employing 50–70 FTEEs

Across the three surveys, less than one per cent of the respondents were female. Thus, all respondents were male MSE owners and managers. On average, 24 per cent of the respondents from the three surveys were located in rural areas, although this varied across states.

There was also some variation in the industry sectors that were surveyed in each state:

- Food processing (Maharashtra, Orissa and Tamil Nadu)
- Textile (Maharashtra, Orissa and Tamil Nadu)
- Leather (Maharashtra and Tamil Nadu)
- Automotive (Maharashtra)

Please see table 5.1. For full details on the sampling and the rationale for sampling, please refer to the three survey reports.

Table 5.1. Overview of India's MSE survey samples

Maharashtra state MSE survey		Actual sample size: 1,204 enterprises	
Sample frame (the list): 1,721 enterprises		Sample selected for the survey: 1,336 enterprises	
Enterprise Size Threshold Sample: (total 1,204)		Industry sectors sampled: (total 1,204)	
Enterprise Size: 4–6 FTEEs (829)		Textile: 300	
Enterprise Size: 7–9 FTEEs (196)		Automobile: 304	
Enterprise Size: 10–20 FTEEs (133)		Food processing: 300	
Enterprise Size: 21–49 FTEEs (30)		Leather: 300	
Enterprise Size: 50–70 FTEEs (16)			
Sex of MSE owners in sample: (total 1,204)		Urban–rural distribution of sample: (total 1,204)	
Male: 1,204. Female: 0		Urban: 1,074/Rural: 130	
Orissa state MSE survey		Actual sample size: 600 enterprises	
Sample frame (the list): 936 enterprises		Sample selected for the survey: 644 enterprises	
Enterprise size threshold sample: (total 600)		Industry sectors sampled: (total 600)	
Enterprise Size: 4–6 FTEEs (353)		Textile: 300	
Enterprise Size: 7–9 FTEEs (79)		Food processing: 300	
Enterprise Size: 10–20 FTEEs (50)			
Enterprise Size: 21–49 FTEEs (40)			
Enterprise Size: 50–70 FTEEs (78)			
Sex of MSE owners in sample: (total 600)		Urban–rural distribution of sample: (total 600)	
Male: 566/Female: 34		Urban: 209/Rural: 391	
Tamil Nadu state MSE survey		Actual sample size: 1,225 enterprises	
Sample frame (the list): 1,678 enterprises		Sample selected for the survey: 1,376 enterprises	
Enterprise size threshold sample: (total 1,225)		Industry sectors sampled: (total 1,225)	
Enterprise Size: 4–6 FTEEs (661)		Textile: 301	
Enterprise Size: 7–9 FTEEs (193)		Automobile: 314	
Enterprise Size: 10–20 FTEEs (229)		Food processing: 300	
Enterprise Size: 21–49 FTEEs (87)		Leather: 310	
Enterprise Size: 50–70 FTEEs (55)			
Sex of MSE owners in sample: (total 1,225)		Urban–rural distribution of sample: (total 1,225)	
Male: 1214/Female: 11		Urban: 1,027/Rural: 198	

Source: Maharashtra SR 2012, Orissa SR 2012, Tamil Nadu SR 2012.

5.2 Labour-related laws and regulations

Across the three states, most respondents expressed a relatively neutral view on the kind of influence labour-related laws and regulations have on growth. There was some variation in this, but these were minor. In Maharashtra state, respondents were generally positive about the laws and regulations for employment registers and limits on working hours. They expressed a generally negative view on the influence of provisions for insurance, injury compensation and severance payments. In Orissa state, respondents were generally positive

about the minimum wage provisions, but expressed a generally negative view on the influence of provisions for annual leave payments, unionization and collective bargaining. In Tamil Nadu, respondents were generally positive about the provisions for health and safety, employment registers and the minimum wage. They expressed a generally negative view on the influence of provisions for dismissals, unionization and collective bargaining.

5.2.1 Use of employment register

There was some variation found across the states surveyed in the use of an employment register by MSEs.

In Maharashtra, 59 per cent of the surveyed firms reported keeping an employment register. This practice was least reported among firms in the leather sector, where only one in 300 firms maintain a register. The practice was more common among smaller firms (79 per cent for firms with 4–6 FTEEs).

In Orissa, only one-third of the surveyed firms reported keeping an employment register. Around 58 per cent of respondent firms in the textile sector were not keeping a register. The main reason reported for failing to maintain a register was that it is unnecessarily complicated to do so (62 per cent). Around 15 per cent indicated that maintaining an employment register was not required because they paid employees on a daily basis.

In Tamil Nadu, about half of the respondent enterprises reported keeping an employment register. The most popular reason for not maintaining a register was that the law did not require it. The second most cited was that it is not required as payments are made on a daily basis. The third most popular reason is that maintaining an employment register is unnecessarily complicated.

5.2.2 Labour inspections

Here again, some variation in the experience of labour inspections was observed, with respondents in Maharashtra experiencing high levels of inspection compared to Orissa where inspections were significantly less.

In Maharashtra, 93 per cent of respondent enterprises had received an official inspection or two in the last year. Health and labour inspections were found to comprise 68 per cent of all inspections made, followed by factory inspections (32 per cent). In the textile industry, health and labour inspections were the most common (15 per cent), followed by the factory inspections. In the automobile sector, factory inspections were more common, while in the food processing and leather sectors, the only inspections reported were by health and labour inspectors.

In Orissa, 54 per cent of respondent firms had not been inspected in the past year. Among those who had been inspected, factory inspections in the food processing and textiles sectors stood at 23 per cent and 12 per cent respectively. There was very little observable change to this among firms of different size classes.

Around 20 per cent of respondents in Tamil Nadu indicated they had not been visited by any kind of official in the year prior to the survey. Most (70 per cent) had been inspected once or twice a year. Factory inspections, followed by health or labour inspections, were the most common forms of inspections. Third was the tax inspector. Visits by factory inspectors

were the most common, irrespective of the sector surveyed. Health inspections were mostly found in the textile and leather sectors.

5.2.3 Payment of the minimum wage

There were significant variations found in this field across the three states, with the highest levels of compliance reported in Orissa and the lowest levels reported in Maharashtra.

Around 40 per cent of respondents in Maharashtra claimed they were complying with the minimum wage requirements of the state. The most common reason cited for non-compliance was that there was no legal requirement to do so and that no steps had been taken by the authorities to ensure that these practices are put into effect. Many respondents explained that implementing the Minimum Wages Act would be an unnecessarily complicated and costly exercise to put into practice. These sentiments were primarily expressed by the food processing industry.

Around 91 per cent of respondents in Orissa claimed they were complying with the minimum wage requirements of the state. As in the other Indian states, the most common explanation for this is that it was not legally required.

Around 71 per cent of respondents in Tamil Nadu claimed they were complying with the minimum wage requirements of the state. While the most common explanation for this is that such payment is not legally required, the survey report indicates that this “can be attributed to the lack of knowledge of enterprise owners”.

5.2.4 Payment of employment pension fund contributions

Employers in India are required to contribute to their employees’ pension fund when they employ more than 21 FTEEs.

In Maharashtra, only 46 of the 1,204 firms surveyed employed more than 21 FTEEs and 71 per cent of these were not complying with the provision. Across all enterprise size groups, only six per cent indicated they were aware of these requirements.

In Orissa, 118 of the 600 firms surveyed employed more than 21 FTEEs. Around 70 per cent of respondents in the state indicated they were paying pension fund contributions. Overall, 82 per cent indicated they were not aware of the need to make pension fund contributions once their workforce grew beyond 21 FTEEs.

The most common reason given for non-compliance (32 per cent) was that workers had not demanded it and that it was unnecessarily complicated. This response came from six units of the food processing sector. The second highest reason (16 per cent) is that rather than a pension contribution, employees prefer taking a much higher take home pay.

In Tamil Nadu, 143 of the 1,225 surveyed firms employed more than 21 FTEEs. Most of these (about 70 per cent) were making these pension contributions. This is a much higher proportion than the other states.

5.2.5 Gratuity payments

The Payment of Gratuity Act, 1972 mandates all factories and establishments where ten or more persons are employed to make gratuity payments. This is a federal law affecting all states. In Maharashtra, only 20 per cent of respondent enterprises employing ten or more

FTEEs indicated they had ever made such a payment. In most cases, this appears to have been that workers had not demanded it. Around 13 per cent of respondent enterprises with less than ten FTEEs indicated they knew they would be required to make gratuity payments to employers after five years of employment. None of these enterprises reported this issue had hindered their growth.

In Orissa, only 15 per cent of respondent enterprises employing ten or more FTEEs indicated they had ever made such a payment. In most cases, it appears that the workers had not demanded it. Of the total reasons cited by respondents for not making gratuity payments, the top reason (33 per cent) was that gratuity payments take too much time. The second most popular reason (28 per cent) is that the workers had not demanded gratuity payments. Around 17 per cent of respondent enterprises with less than ten FTEEs indicated they knew they would be required to make gratuity payments to employers after five years of employment. None of these enterprises reported this issue had hindered their growth.

In Tamil Nadu, 44 per cent of the firms with ten or more FTEEs were complying with this provision. Of those who were not, 47 per cent believed they were not required to and 62 per cent claimed their employees had not requested such payments.

5.2.6 Trade union membership

In all three of the Indian states investigated, union membership is required when the enterprise's workforce contains seven or more FTEEs. Only four per cent of the respondent firms in Maharashtra with seven or more FTEEs reported they had complied with this law. The most common reason given (29 per cent) among those who did not comply was that they held regular meetings with workers, which rendered union membership unnecessary.

In Orissa, only nine respondents out of a total of 936, with 247 employing seven or more FTEEs, reported compliance with this provision. The most common reason presented for non-compliance was that the employer conducted regular meetings with workers, making formal unionization unnecessary.

Only nine per cent of respondents with seven or more FTEEs in the state of Tamil Nadu indicated they were complying with this provision. Of those not complying, 54 per cent claimed they were not required to and 53 per cent argued that their employees had not requested this.

5.2.7 Retrenchment payments

In India, retrenchment payments are only applicable when the enterprise employs more than 50 FTEEs. The Maharashtra state sample contained only 16 respondents employing 50–70 FTEEs. Of these, only eight per cent reported they had made a retrenchment payment.

In Orissa, only six per cent of respondents claimed to have been aware of the law concerning retrenchment payments. Of those who were aware of this, only four per cent reported that this might negatively affect the growth of a firm.

In Tamil Nadu, only 55 of the 1,678 respondents employed more than 50 FTEEs. Of these, only eight per cent indicated they had made a retrenchment payment. Of those who had not, 19 per cent claimed it was not necessary and 16 per cent indicated that separation had been voluntary.

5.3 Business laws and regulations

Across all the three states surveyed there was a common perception of the investment climate, with most respondents indicating a positive link between enterprise growth and the market demand for products and services, transport infrastructure, the availability of electricity, water and sanitation facilities, and raw materials.

The low cost of labour was cited as a positive influence in Maharashtra and Tamil Nadu, but a negative influence in Orissa. The majority of respondents in all states indicated the negative influence that the cost of land, tax regulations and increasing corruption had on business growth.

When the business environment was considered (i.e., policy, legal and regulatory framework) the majority of respondents from all states indicated that the cost or time required to register a business or obtain a business license was a positive factors for business growth. In Orissa, respondents also indicated that tax registration and administration had a positive influence, while in Tamil Nadu maintaining minimum product standards and certification was cited as a positive factor.

All states indicated that banking and credit regulations negatively influenced growth. Respondents in Orissa also indicated that a negative influence was produced by import and export regulations, while those in Tamil Nadu expressed concern over tax registration and administration. Only in Maharashtra did respondents report on the negative influence that labour law had on growth.

5.3.1 Business registration and licensing

All survey respondents in Maharashtra reported some level of business registration and licensing. Indeed, 39 per cent reported the possession of two registrations or licenses and slightly less than this number had four. Firms in the leather industry reported lower levels of compliance, followed by food processing and the automotive sector. Tax registration licenses were the most frequently obtained licenses (30 per cent), followed by other licenses such as trading licenses, municipal licenses and licenses from the District Industries Commissioner (25 per cent) and Registrar's Office (22 per cent). Most respondents (79 per cent) reported that registration and licensing was a basic requirement of running a business, which is why they complied, while a very small proportion of respondents indicated they did this to access a government or non-governmental organization (NGO) support service or to qualify for finance.

In Orissa, almost half the respondents (49 per cent) were found to have no registration or license. Around 47 per cent of these were in the textile sector. Around 37 per cent of respondents in the state reported having three kinds of registration or license. Factory licenses and other types of license like trading licenses, licenses from municipality or District Industries Commissioner were the most frequently obtained licenses, each having 32 per cent share of the total licenses that have been obtained by the surveyed units or enterprises in the state. Around 29 per cent of the total licenses obtained by respondents were related to taxation. The legal necessity for registration and licensing was cited as the most common reason for compliance (45 per cent). Other reasons were to access a government or NGO support service, to obtain business finance (16 per cent) and because suppliers and buyers required it (13 per cent).

The prime reason for failing to register or obtain a license was because the procedures involved were too complicated and costly (42 per cent), while 36 per cent claimed they were unaware of the need for registration and licensing, and 16 per cent indicated that the authorities did not enforce compliance.

More than one-third of the surveyed firms in Tamil Nadu were completely unregistered and unlicensed. The automotive sector, followed by the food processing sector, had respondents with the least registrations. Factory licenses and tax registrations were the most common types of registrations obtained by respondent MSEs. Among those that were registered, firms in the automotive sector lead with the maximum number of registrations, followed by firms in the leather sector. Most registrations with the Registrar's Office or Department of Company Affairs are of units belonging to the automotive sector. A majority of factory license, import license and export license owners are units belonging to the leather sector. The prime reason reported for failing to register or obtain a license was because the procedures involved were too complicated and costly. Around 46 per cent of respondents in the leather sector claimed that this was not necessary because the authorities did not enforce compliance.

5.3.2 Income tax

While thresholds exist in the laws and regulations regarding income tax in India (indeed, in all the four countries under study), these are not based on enterprise size. However, the results show how the owners and managers of smaller enterprises were less likely to be regularly paying income tax than those from the larger enterprise size categories. Presumably, this reflects increased personal earnings among the owners and managers of larger enterprises. There was some variation across the states, with Orissa displaying the lowest level of compliance and Maharashtra the highest.

In Maharashtra, 80 per cent of respondents reported they were regularly paying income tax. The smaller the enterprise, the less likely the respondent would report income tax payment. For example, 40 per cent of the respondents employing between four and nine FTEEs were not paying tax, while only six per cent of respondents employing 50–70 FTEEs were not paying income tax.

In comparison, in Orissa, only 31 per cent of respondents reported that they were regularly paying income tax. Most respondents (e.g. 73 per cent of respondents in the textile sector) explained that they did not pay tax because the payment procedures were complicated. Around 92 per cent of respondents claimed they were not aware of the income tax ceiling.

In Tamil Nadu, about half (47 per cent) of the enterprises reported paying income tax. Consistent with the other states, income tax payment was less likely in the smaller enterprise size categories.

5.3.3 Value added tax (VAT) registration and payment

The thresholds for VAT registration are based on annual turnover and not on the number of workers. However, as with income tax, larger enterprises were found to be more likely to pay VAT than smaller ones. Again, compliance in Orissa is much lower than in the other two states.

In Maharashtra, 43 per cent of respondents reported they were paying VAT. Only 32 per cent of firms, employing between four and six FTEs, reported paying VAT, compared with 100 per cent of those employing 50–70 FTEs.

In Orissa, only 24 per cent of all respondents indicated they were paying VAT. Only ten per cent in the enterprises with four and six FTEs reported making VAT payments, while 63 per cent of firms with 21–49 FTEs and 37 per cent firms with 50–70 FTEs reported this. The most common reason for not paying VAT was that this was a highly complicated procedure. Most respondents claimed to be unaware of the threshold ceiling for VAT registration and payment.

In Tamil Nadu, 45 per cent of respondents reported they were paying VAT. Only 40 per cent of firms employing between four and six FTEs reported making VAT payments, compared with 57 per cent of those employing 50–70 FTEs.

5.4 *Incentive programmes*

None of the respondents in the three Indian states of Maharashtra, Orissa and Tamil Nadu indicated they had made use of an incentive programme from the government or an NGO. Thus, the survey reports from these three state-based surveys do not address this issue.

5.5 *Strategic management decisions*

5.5.1 Knowledge of compliance costs and penalties

Across the three states surveyed, there was generally a low level of understanding exhibited by respondent firms regarding labour-related and business laws and regulations. This general lack of awareness explains a further lack of awareness regarding the specific size-related thresholds. This confirms the India country report's contention that the legal and regulatory framework for labour in India is complicated and ambiguous.

5.5.2 Creation of parallel or multiple firms

No evidence was found in any of the three states to indicate that respondents were creating multiple or parallel firms to avoid growing beyond a specific labour-related or business legal or regulatory threshold.

5.5.3 Payment of bribes or other informal payments

The three survey reports do not provide conclusive data or analysis on the payment of bribes or other forms of informal payments to avoid the penalties of non-compliance with labour-related or business laws and regulations.

Chapter 6: Labour laws and MSE employment in Nepal

6.1 Introduction

Nepal's labour laws are applicable to enterprises with ten or more employees. However, there are a few exceptions to this. These include provisions for minimum wages, prohibition of child labour and the protection of children and women. In addition, there are a few provisions that apply to enterprises with 50, 400 and 1,000 or more full-time equivalent employees (FTEEs). These refer to the provision of crèche, rest room, and health and medical personnel and facilities.

The labour regulations that apply to enterprises with ten or more employees that were considered by the Nepal research team to have a high probability of creating growth traps were:

- Contribution to the provident fund
- Payment of gratuity
- Compensation for injury or death
- Annual paid leave

In addition to these labour-related laws and regulations, income tax and value added tax (VAT) in Nepal have exemption thresholds in terms of annual earnings and turnover.

The MSE survey in Nepal focused on two enterprise size categories, reflecting the thresholds found in the national labour legal and regulatory framework and presented in the Nepal country report. These were:

- Size Category 1: Enterprises employing 5–9 FTEEs
- Size Category 2: Enterprises employing 10–70 FTEEs

Only 13 per cent of these enterprises were owned and managed by women, while 27 per cent were located in rural areas.

Four industry sectors were selected for investigation:

- Agro processing
- Carpets and garments
- Tourism
- Information technology(IT)

Please see table 6.1 for an overview of Nepal's survey samples. For full details on the sampling and the rationale for sampling, please refer to the Nepal survey report.

Table 6.1. Overview of Nepal’s MSE survey samples

Nepal MSE survey	Actual sample size: 409 enterprises
Sample frame (the list): 487 enterprises	Sample selected for the survey: 480 enterprises
Enterprise size threshold sample: (total 409) Enterprise Size: 5–9 FTEEs (294) Enterprise Size: 10–70 FTEEs (115)	Industry sectors sampled: (total 409) Agro processing: 135 Carpets and garments: 85 Tourism: 176 Information technology: 13
Sex of MSE owners in sample: (total 409) Male: 355/Female: 54	Urban–rural distribution of sample: (total 409) Urban: 299/Rural: 110

Source: Nepal SR 2012.

6.2 Labour-related laws and regulations

Many of the MSE employers surveyed in this study were non-committal regarding the perceived influence that labour-related laws had on enterprise growth. Many (36 per cent, overall) answered “non-applicable” to questions on this matter. However, certain aspects of the labour law, such as the provisions for health and safety standards, workers’ injury compensation, minimum wage, and limits on working time, were considered positively. The provisions for dismissal and disputes were ranked most poorly.

6.2.1 Use of employment register

Use of an employment register among respondent firms was found to be low, regardless of the size of the firm or the sector it operated within. Around 62 per cent of respondent enterprises did not maintain an employment register. The main reasons for this were: “It is not legally required” (34 per cent), “Unnecessarily complicated” (17.3 per cent), “Not necessary, daily wage payment” (16.5 per cent), and “It is legally required, but not enforced” (14 per cent). Only three per cent indicated it “Takes too much time” and less than one per cent complained it was “Too costly”.

6.2.2 Labour inspections

Slightly more than half (54 per cent) of the respondent firms had never been inspected. There were significant variations found among those who were inspected in the year prior to the survey based on the sector they operated in: IT (70 per cent), agro processing (53 per cent), tourism (44 per cent) and carpets and garments (33 per cent).

6.2.3 Payment of the minimum wage

Around 64 per cent of respondent MSEs were paying their employees at least the minimum wage. Around 12 per cent were aware of the need to pay a minimum wage, but did not do this. The major reasons for not paying minimum wage were: “It is not legally required” (37 per cent) and “Too costly” (20 per cent).

One-third of respondents indicated they knew of or had themselves made informal payments to avoid the legal consequences of failing to pay the minimum wage. Around ten

per cent indicated they had made such payments to avoid the penalties associated with non-compliance.

6.2.4 Payment of employment pension fund contributions

Around 73 per cent of the respondent firms with 5–9 employees were not aware of their obligations in this area. Around 38 per cent of respondent enterprises claimed they knew the rate of the pension fund contribution they were required to make and 37 per cent claimed they had heard of the penalties for non-compliance. Of these, 27 per cent were able to describe at least the category of penalty correctly, more by the firms in the IT sector (76 per cent) and less in the carpets/garments sector (12 per cent).

The instances where a firm chose not to grow in order to stay below the threshold level and avoid making pension fund contributions were insignificant. However, some 16 per cent indicated that they had heard of informal payments being made to avoid compliance.

6.2.5 Gratuity payments

Besides being applicable to businesses with ten or more FTEs, employers in Nepal are only required to make a gratuity payment after seven years of employment.

Around 24 per cent of the survey respondents reported they knew how much the gratuity payment would be for employees completing seven years of service, while 31 per cent indicated they had heard of the penalties for non-compliance. Of these, 22 per cent were able to describe at least the category of penalty correctly, more by the firms in the IT sector (61 per cent) and less in the carpets/garments sector (10 per cent).

Of those who were required to make these payments but did not, 23 per cent claimed that this was because the employee did not demand it and eight per cent said it was because while it was legally required, it was not enforced. Around 12 per cent of respondents indicated they knew of employers who had made informal payments to avoid penalties for a failure to pay, with only one per cent indicating they had made such payments themselves.

Around 81 per cent of enterprises were unaware of their gratuity obligations. None of the surveyed MSEs indicated that they had decided not to grow or employ workers beyond seven years in order to avoid making gratuity payments.

6.2.6 Trade union membership

Despite the threshold of ten FTEs, the Trade Union Act of 1993 allows enterprises employing less than ten FTEs to join a union formed in other enterprises, making the Act applicable to all sizes of businesses.

Around 57 per cent of the surveyed firms indicated they were not aware that any regular employee can join a trade union federation and enterprises with ten or more workers can form a trade union within the enterprise. Some claimed that their employees had not demanded this (36 per cent) and that it is not legally required (23 per cent). Others claimed that union membership was not necessary because they regularly consult with their employees (18 per cent).

6.2.7 Paid annual leave

The proportion of enterprises that have preferred to stay below the threshold level to avoid paying annual paid leave was very low at two per cent in businesses with 5–9 FTEEs. Just over one-third of respondents (35 per cent) of enterprises with 5–9 FTEEs were not aware of the regulations on annual paid leave.

Overall, some 39 per cent of the MSEs surveyed indicated they had heard of informal payments being made by employers to avoid penalties of non-compliance. This varied dramatically: 72 per cent in the IT sector and only 15 per cent in the carpets and garments sector.

6.2.8 Compensation for injury or death

The MSE survey found that 41 per cent of respondents employing 10–70 FTEEs had not made any compensation payments. Around 62 per cent claimed they knew of the need to compensate employees for injury or death.

Around 42 per cent of respondents had heard of informal payments being made to avoid the penalties for non-compliance, with four per cent reporting they had made such payment themselves.

The proportion of enterprises that have preferred to stay below the threshold level to avoid paying compensation for injury was very low at two per cent. Some 29 per cent of enterprises with 5–9 employees were not aware of the regulations on compensation for injury or death.

6.3 Business laws and regulations

When the research team sought to understand how the influence of business laws and regulations affected enterprise growth compared with labour laws and regulations, they were again faced with a high level of non-commitment. However, the elements of the business environment identified as positive contributors to enterprise growth were: the cost and time required to obtain a business license; the cost and time required to register for taxation; the minimum product standards and certification; and food and health standards. In contrast, the factors identified as creating a negative influence on enterprise growth in Nepal were the cost of taxation (i.e. income tax, sales tax, VAT) and the time required for tax administration. Labour issues were treated relatively neutrally.

6.3.1 Business registration and licensing

Around 22 per cent of the enterprises surveyed were not registered with any of the eight common types of registration or license. However, some 47 per cent were unregistered in the carpets and garments sector, while all of the firms in the IT sector were formally registered. Of those that were registered, 80 per cent were registered as sole proprietorships, seven per cent as partnerships and six per cent as private limited companies.

The main reason given for failing to register was that it was not legally required. Other major reasons given included: “It is legal, but not enforced” (19 per cent) and

“Complicated/do not see the benefit” (11 per cent). Around ten per cent of respondents indicated they were unaware of the registration requirements.

6.3.2 Income tax

Around 44 per cent of the surveyed MSEs were not paying income tax (carpets and garments: 67 per cent, tourism: 42 per cent). However, it is unclear how many of those not paying are legitimately exempt because their earning is less than the threshold level. Out of those not paying income tax, 59 per cent either believed it was not legally required or that they were exempt. Others gave reasons like “Unnecessarily complicated/do not see the benefit” (12 per cent) or “It is legally required, but not enforced” (11 per cent). Less than one per cent of the respondents indicated they had tried to keep their income below the exemption threshold to avoid paying income tax, while 77 per cent claimed they were not aware of the threshold.

Almost all respondents (99 per cent) indicated that it took less than a week to file and pay for income tax, with little variation across sectors and firm size. Around 56 per cent reported they had heard of the penalties for non-compliance and, of these, 35 per cent were able to describe at least the category of penalty correctly. Many more respondents could do this in the IT sector (72 per cent) compared with the carpets and garments sector (27 per cent).

Around 32 per cent of respondents reported that they had heard of informal payments being made to avoid the penalties of non-compliance, with 11 per cent indicating they had made such payments themselves.

6.3.3 Value added tax (VAT) registration and payment

Around 75 per cent of respondents did not pay VAT (85 per cent in carpets and garments, 82 per cent in agro processing, 68 per cent in tourism, and 27 per cent in IT). A large share of owners (71 per cent) claimed this was not legally required or that they were exempted from making VAT payments. While this may be true given the high threshold for annual turnover (2.0 million Nepalese rupees [NPR]) as well as exemptions given to cottage industries, the carpets and garments sector and the three sub-sectors of agro processing (i.e. rice mill, oil mill and flour mill), it is hard to determine if the respondents were indeed exempt. Only nine per cent indicated that their non-payment of VAT was because the laws were not properly enforced and six per cent complained that their non-payment was because the system was “Unnecessarily complicated”.

Only two per cent of respondents indicated that they tried to avoid compliance by staying below the VAT threshold. Around 54 per cent claimed they did not know the threshold level. Half of the respondents indicated they had heard of the penalties for non-compliance and 32 per cent were able to accurately describe these. Those in the IT sector could do this more accurately than those in the carpets and garments sector (72 per cent and 24 per cent respectively).

Around 28 per cent of respondents reported that they knew of informal payments being made to avoid the penalties of non-compliance, while six per cent indicated they had personally made such payments.

6.3.4 Environmental regulations

Around 57 per cent of the non-compliant respondent firms indicated that they were not legally required to comply with environmental regulations and 30 per cent were not aware they were required to comply with any environmental obligations. Around 20 per cent indicated they knew of or had themselves made informal payments to avoid complying with environmental regulations. Around 47 per cent had heard of the penalties for non-compliance with environment laws and regulations. Of these, 29 per cent were able to describe at least the category of penalty correctly.

6.4 Incentive programmes

The influence of incentive programmes on MSE management decisions appears to be negligible. Only two per cent of the surveyed MSEs reported using an incentive programme of any sort. Thus, there is no evidence to suggest that MSEs attempt to alter the size of their workforce to become eligible for an incentive programme.

6.5 Strategic management decisions

6.5.1 Knowledge of compliance costs and penalties

Just more than half of the MSE respondents claimed they were aware of the provisions and penalties associated with income tax (56 per cent), compensation for injuries (55 per cent) and payment of the minimum wage (51 per cent). Just less than half knew of the provisions and penalties associated with environmental regulation (47 per cent), paid leave (40 per cent), pension fund contributions (37 per cent), and gratuity payments (31 per cent).

The lack of legal enforcement was the major argument presented by non-compliant MSEs. This was especially in the fields of environmental regulations, minimum wage, gratuity, and income tax and VAT payments.

6.5.2 Creation of parallel or multiple firms

Only three per cent of the surveyed MSEs had established “parallel units” and only about half of these units had an FTEE number that kept them below the threshold level of ten employees.

No evidence was found among the respondents to support the view that enterprises attempt to stay below the threshold of labour or taxation laws: this kind of activity was reported by less than two per cent of respondents.

Among the 22 per cent of surveyed MSEs not registered with any of the eight common forms of registration and licensing, there was some indication that respondents were intentionally remaining unregistered to avoid compliance with certain laws and regulations such as taxation. In most cases, non-compliance was based on a lack of awareness. For example, 30 per cent of those not complying with environmental regulations were unaware of these regulations. Around 22 per cent of all respondents were unaware of the minimum wage and 57 per cent of the requirements regarding trade union formation.

6.5.3 Payment of bribes or other informal payments

The use of informal payments to avoid the penalties of non-compliance appeared to be quite common. While many more respondents indicated they had heard of these payments being made by their peers instead of reporting they had made such payments themselves, the results are clear: one-third of respondents (33 per cent) indicated they had heard of informal payments being made with respect to non-compliance with minimum wage payments and ten per cent claimed they had made such payments themselves. Similar proportions were found in relation to income tax (28 per cent, 11 per cent), VAT (28 per cent, six per cent), environmental regulations (20 per cent, three per cent), and annual leave payments (18 per cent, two per cent). As many as 42 per cent of respondents claimed they had heard of informal payments made with respect to compensation for injury/death, with four per cent reporting they had made informal payments to avoid penalties themselves.

Some 94 per cent of the respondent MSEs in the carpets and garments industry in Nepal paid their workers on piece-rate basis. Sector-wise, the carpets and garment sector consistently showed the lowest knowledge of the costs of compliance and penalties. The IT sector was more aware of these issues.

Knowledge of these matters in Nepal varies with the level of inspection. The percentage of establishments that were visited by inspectors during the previous last 12 months was highest in the IT sector (70 per cent) followed by agro processing (53 per cent), tourism (44 per cent) and carpets and garments (33 per cent).

Chapter 7: Labour laws and MSE employment in Sri Lanka

7.1 Introduction

There are a number of legal provisions established to govern the Sri Lankan labour market. See box 7.1 for the relevant labour-related laws and regulations. The Sri Lanka country report cites a range of research that provides a generally negative critique on the effect the labour regime has on labour market flexibility and employment in the MSE sector.

Sri Lankan labour law generally applies to all enterprises regardless of the size of the enterprise. The two exceptions to this are the Termination of Employment of Workmen (Special Provisions) Act (TEWA) of 1971 and the Payment of Gratuity Act 12 of 1983, which are applicable only to enterprises which employ more than 15 workmen. A few other regulations formulated under specific statutes provide for minor requirements based on enterprise size, but these do not relate to significant aspects of employment or workers' rights.¹

Coverage under Sri Lankan law arises from the definition of “workman” in the Industrial Disputes Act No. 43 of 1950:

Any person who has entered into or works under a contract with an employer in any capacity, whether the contract is expressed or implied, oral or in writing, and whether it is a contract of service or of apprenticeship, or a contract personally to execute any work or labour, and includes any person ordinarily employed under any such contract whether such person is or is not in employment at any particular time, and includes any person whose services have been terminated. (Industrial Disputes Act No. 43 of 1950, Article 48)

Other statutes use this definition, such as the employees' provident fund (EPF), employees' trust fund (ETF) and workmen's compensation. Thus, any person defined as a “workman” is covered under these laws and regulations, regardless of the size of the enterprise in which the person is employed. Some differentiation occurs on the basis of the nature of the business of the enterprise, but all enterprises are covered by all labour legislation, with the exception of TEWA and the Payment of Gratuity Act.

Box 7.1. Sri Lanka: Relevant labour-related laws and regulations

Collective bargaining and freedom of association

Articles 14(1)(c) & (d) of the Constitution of Sri Lanka (1978) guarantees to all citizens the freedom of association, and the freedom to form and join a trade union respectively. However, the Constitution provides that all fundamental rights may be restricted by law in the interests of national security, racial and religious harmony or national economy.

POTENTIAL TO CONSTRAIN GROWTH: LOW

The Trade Unions Ordinance No. 14 of 1935: Although a trade union is required to register under this statute to qualify for the privileges and immunities available under the Act, the initial membership requirement of only seven workers provides a reasonably liberal

¹ Many of the regulations have been formulated under the Factories Ordinance and provide for sanitary conveniences such as the provision of toilets based on number of workers.

<p>environment for forming and joining a trade union. Without representative status of 40 per cent membership, the employer is not obliged to bargain collectively.</p> <p>POTENTIAL TO CONSTRAIN GROWTH: LOW</p> <p>The Industrial Disputes Act No. 43 of 1950 provides for the entering into and registration of collective agreements, and the amending act of 1999 makes it an unfair labour practice for an employer to refuse to bargain with a trade union having in excess of 40 per cent of those employed in that enterprise in its membership. Results in collective agreement which confer superior terms and conditions of employment relating to wages, cost of living payments, enhanced leave benefits and other privileges far in excess of what is laid down in the law.</p> <p>POTENTIAL TO CONSTRAIN GROWTH: LOW</p>
<p>Anti-discrimination/equal opportunity</p>
<p>Article 12 of the Constitution of Sri Lanka provides that “all persons are equal before the law and are entitled to the equal protection of the law”, and that “No citizen shall be discriminated against on the grounds of race, religion, language, caste, sex, political opinion, place of birth or any such grounds”.</p> <p>POTENTIAL TO CONSTRAIN GROWTH: LOW</p>
<p>Prohibition on forced labour/child labour</p>
<p>Article 14(1)(g) of the Constitution guarantees to every citizen “the freedom to engage by himself or in association with others in any lawful occupation, profession, trade, business or enterprise” and, therefore, no person can be compelled to engage in any form of labour against his will.</p> <p>The Employment of Women, Young Persons, and Children Act No. 47 of 1956 prohibits the employment of a child below the age of 14 years.</p>
<p>Overtime/working time</p>
<p>Stipulated under the Wages Boards Ordinance No. 27 1941 by the relevant Wages Board</p> <p>POTENTIAL TO CONSTRAIN GROWTH: HIGH</p>
<p>Paid time off</p>
<p>Stipulated under the Wages Boards Ordinance No. 27 1941 by the relevant Wages Board</p> <p>POTENTIAL TO CONSTRAIN GROWTH: MEDIUM</p>
<p>Payment of gratuity</p>
<p>Payment of Gratuity Act. 12 of 1983 Section 5 upon termination of employment provides for half month’s salary for each year of completed service after five years. This regulation only applies to enterprises with 15 or more employees. In the event of non-compliance, a fine, not exceeding 500 Sri Lankan rupees (LKR), or imprisonment, not exceeding six months, or both is exacted as penalty. The amount recovered will be within a surcharge laid down under Section 5(4) of the Act.</p> <p>POTENTIAL TO CONSTRAIN GROWTH: HIGH</p>
<p>Social security</p>
<p>Employees’ Provident Fund Act, No. 15 of 1958 provides for a contributory scheme of superannuation for all employees other than those directly employed by the state, with the minimum contribution being 12 per cent of earnings by the employer and eight per cent of earnings by employee. Some large private sector organizations operate their own pension funds, but the EPF provides a one-off payment at retirement or permanent cessation of employment. Applies to all sizes of enterprises.</p> <p>Non-compliance: Dues and surcharge plus fine not exceeding LKR1,000 or imprisonment</p>

<p>not exceeding six months or both. In addition, liable to a fine not exceeding LKR50 for each day of default.</p> <p>POTENTIAL TO CONSTRAIN GROWTH: HIGH</p>
<p>Unemployment insurance</p>
<p>Employees' Trust Fund Act, No. 46 of 1980 requires employers to contribute a sum of three per cent of the salary of all employees to this fund, which is intended to enable employees to overcome a period of unemployment; the amount lying to the credit of an employee can be withdrawn once every five years if s/he ceases to be employed for any reason. However, this is not an insurance scheme and only provides a one-off payment and there is no provision for the continuation of benefits during unemployment. Applies to all sizes of enterprises.</p> <p>Non-compliance: Amount defaulted and surcharge plus fine not exceeding LKR1,000 or imprisonment for a term not exceeding six months or both.</p> <p>POTENTIAL TO CONSTRAIN GROWTH: LOW</p>
<p>Workers' compensation</p>
<p>The Workmen's Compensation Ordinance, No. 19 of 1934 provides for compensation to any worker in the event of accident/injury sustained in the course of work, or for industrial and occupational diseases contracted whilst working.</p> <p>POTENTIAL TO CONSTRAIN GROWTH: LOW</p>
<p>Protection against unjust dismissal</p>
<p>A worker dismissed for any reason can challenge such termination before a Labour Tribunal under the Industrial Disputes Act (IDA) No. 43 of 1950.</p> <p>POTENTIAL TO CONSTRAIN GROWTH: LOW</p>
<p>Occupational safety and health</p>
<p>The Factories Ordinance No. 45, 1942 regulates the occupational safety and health of workers in factories and industrial establishments covered by the Act. The Ordinance applies only to workplaces defined as factories, and covers approximately 30 per cent of the working population in the country. A further 37 per cent of the workforce engaged in agricultural activities, including plantation workers, is not covered by any health, safety and welfare legislation.</p>
<p>Advance notice (for large-scale lay-offs)</p>
<p>Termination of Employment (Special Provisions) Act, No. 43 of 1971 prevents any employer from terminating the services of an employee without: (a) the express consent of the employee; or (b) where that consent is not forthcoming, the permission of the Commissioner of Labour (CGL) (subject to the payment of such compensation as may be ordered by the CGL). Although an employer can request permission to lay-off workers or to terminate workers, the CGL is not required to grant such permission, and may refuse permission, compelling an employer to continue to employ that worker. The publication of a formula for the calculation of compensation has not removed the requirement to apply to the CGL for permission to lay-off workers. However, this Act applies only to workplaces where more than 15 workers have been employed in the 12 months preceding the termination.</p> <p>POTENTIAL TO CONSTRAIN GROWTH: MEDIUM</p>
<p>Parental/family leave</p>
<p>The Maternity Benefits Ordinance, No. 32 of 1939 provides for paid maternity leave and other maternity benefits for female workers covered by the Factories Ordinance, and</p>

<p>prevents the employment of female workers in hazardous activities in the period before and after confinement. Women workers are entitled to 12 weeks of leave with pay for the first and second live births and six weeks for any subsequent births. There is no provision for paternity leave in the private sector. It applies to enterprises of all sizes.</p> <p>Non-compliance: Magistrate courts fine not exceeding LKR500 and recovery of the amount defaulted. Time spent about is six to 12 months on legal proceedings in magistrate courts.</p> <p>POTENTIAL TO CONSTRAIN GROWTH: MEDIUM</p>
<p>Protection of rights on transfer of undertaking</p>
<p>Guaranteed by law only in relation to public corporations. In the private sector, disputes would be settled on a case-by-case basis.</p> <p>POTENTIAL TO CONSTRAIN GROWTH: LOW</p>
<p>Installing and maintaining a sanitary bathroom</p>
<p>Factory (Washing Facilities General) Regulation 1965 Section 47 and 105 and Factory (Sanitary Conveniences) Regulation 1965, Section 15 and 105. Only applicable to enterprises with 20 or more employees.</p> <p>POTENTIAL TO CONSTRAIN GROWTH: LOW</p>
<p>Provision of proper ventilation</p>
<p>Factories Ordinance, Sections 4 and 5: Before the plan is approved the factory has to be approved by the Chief Inspector of Factories attached to the Department of Labour. No local authority can issue a license to carry on any trade or business in a factory unless the premises are registered as a factory under the Factories Ordinance. Shops and offices are exempted. Affects all industries</p> <p>POTENTIAL TO CONSTRAIN GROWTH: LOW</p>
<p>Provision of a fully equipped medical room and/or ambulance</p>
<p>Factories Ordinance Section 105 read with Subsection 50. The regulation is referred to as Factories First Aid Regulation No. 1 of 1995. Applies if ten or more persons are employed. In Sri Lanka, first aid kit or cupboard is expected to be installed.</p> <p>POTENTIAL TO CONSTRAIN GROWTH: LOW</p>

SOURCE: Adapted from the Sri Lanka CR 2011.

The MSE survey in Sri Lanka focused on two enterprise size categories, reflecting the thresholds found in the national labour legal and regulatory framework. These were:

- Size Category 1: Enterprises employing 5–14 FTEEs
- Size Category 2: Enterprises employing 15–70 FTEEs

Only 17 per cent of these enterprises were owned and managed by women, while half of all respondents were located in rural areas.

Four industry sectors were selected for investigation:

- Agro processing
- Textiles and garments
- Woodworking
- Hospitality

Please see table 7.1 for an overview of Sri Lanka’s survey samples. For full details on the sampling and the rationale for sampling, please refer to the Sri Lanka survey report.

Table 7.1. Overview of Sri Lanka’s MSE survey samples

Sri Lanka MSE survey	Actual sample size: 576 enterprises
Sample frame (the list): 4,331 enterprises	Sample selected for the survey: 600 enterprises
Enterprise size threshold sample: (total 576) Enterprise Size: 5–14 FTEEs (480) Enterprise Size: 15–70 FTEEs (96)	Industry sectors sampled: (total 576) Agro processing: 151 Textiles and garments: 192 Woodworking: 120 Hospitality: 113
Sex of MSE owners in sample: (total 576) Male: 480/Female: 96	Urban–rural distribution of sample: (total 576) Urban: 287/Rural: 289

Source: Sri Lanka SR 2012.

7.2 Labour-related laws and regulations

The Sri Lanka MSE survey displayed a generally positive attitude among MSE employers towards labour-related laws and regulations. The survey report claims most of the respondents indicated that these laws had a positive or strongly positive influence on business expansion. The most positive aspects of the labour-related laws cited in the report are: maintaining an employment register, paying the minimum wage, paying provident funds and workers’ injury compensation. This suggests that these laws generally assist and do not hamper business expansion in all sectors.

A small proportion of the respondents reported that the following laws had a strongly negative or negative influence on business expansion: limits on working time (22 per cent), compliance with procedures for dismissals and disputes (13 per cent) and health and safety standards (ten per cent), severance payments (11 per cent), and provident fund contributions (11 per cent).

7.2.1 Use of employment register

Around 71 per cent of the respondent firms reported maintaining employment registers. While the overall perception of the respondents was that the employment register was not necessary, as wages were paid on a daily basis, a small number of MSEs in the woodworking sector was found to avoid the use of an employment register as strategy to avoid the requirement to register for tax. Just over 90 per cent of registered companies reported maintaining an employment register in all enterprise sectors and sizes. In all cases, the larger enterprises were more likely to maintain a register.

7.2.2 Labour inspections

Some 65 per cent of the respondent firms had received labour and health inspectors in the last year. Health inspectors had visited 94 per cent of firms in the hospitality sector, while less than half of the firms in woodworking and textiles and garments had received inspectors in the last year.

Tax inspectors had paid a visit to 31 per cent of respondent firms, and to exactly half of the respondent firms operating in the hospitality sector. Environmental officers had visited 21 per cent of all respondent firms and 40 per cent in the woodworking sector.

7.2.3 Payment of the minimum wage

Minimum wages are stipulated in relation to specific trades for which Wages Boards have been set up under the Wages Boards Ordinance No. 27 1941. While these boards determine minimum wages through a tripartite mechanism, in reality the country report suggests that the market rate for real wages are often substantially higher. This is especially in sectors such as hospitality and construction, where wages could be several times higher than the stipulated minimum. However, wages are generally a matter for individual negotiation, based on relative bargaining strengths of employer and worker, and would be unlikely to be set as a result of collective bargaining.

Around 38 per cent of respondents were not aware of the minimum wage obligations and 57 per cent were aware of and paid the minimum wage. Around five per cent of respondents were aware of the minimum wage obligations, but did not pay the minimum wage. This was highest in the textiles and garments Sector (11 per cent).

7.2.4 Payment of employment pension fund contributions

Around 36 per cent of the respondent firms claimed to be unaware of their obligation to contribute to employee pension funds (30 per cent in hospitality, 40 per cent in woodworking). More female-headed micro- and small enterprises (MSEs) were found to be unaware (53 per cent) than male-headed MSEs (33 per cent). Of those who were aware of the obligations, 60 per cent reported compliance, while 40 per cent (26 per cent of the total sample) avoided these obligations. The avoidance was high in the woodworking Sector (44 per cent), particularly among firms with 15–70 employees (73 per cent). The two most frequent reasons given were: “Employees prefer to receive a higher take-home pay” and “Workers have not demanded it”. The proportion of MSEs aware of the pension fund contribution rates (72–86 per cent) was higher than the proportion that initially responded as being aware of the pension fund obligations (62 per cent), as were those knowing the penalties (71–83 per cent). This indicates that the respondents were not entirely honest when asked about their level of awareness at the first instance and there may be more businesses practising avoidance strategies than reported.

Interestingly, the most recently released World Bank report, *Doing Business 2013*, describes how, in the 12 months prior to the survey, Sri Lanka computerized and expedited the process of obtaining registration numbers with the employees’ provident fund (EPF) and employees’ trust fund (ETF). This reform cut time by 29 days.

7.2.5 Gratuity payments

In Sri Lanka, an enterprise employing more than 15 workers must make a gratuity payment to an employee who has resigned or retired after providing five years of service. Only seven per cent of the surveyed firms reported ever making such a payment. The main reason for this was that no employees were eligible (i.e. no employee with the relevant years of service had resigned or retired). However, some also reported that while these payments were stipulated by law, they are rarely monitored or enforced. Around 18 per cent of respondent

enterprises employing 5–14 workers (i.e. 15 per cent of the total sample) were aware of their obligation to pay gratuity and tried to stay below the threshold by either employing less than 15 workers or by limiting the duration of employment to within five years.

7.2.6 Trade union membership

Around 26 per cent of the respondent MSEs were aware of the legal requirement to form a trade union. However, of these, less than two per cent had accommodated a trade union. Out of those who reported having heard of the penalties of not allowing the formation of a trade union, 83 per cent did not know the details.

7.2.7 Retrenchment payments

Only five per cent of the businesses employing 5–14 full-time equivalent employees (FTEEs) (or one per cent of the total sample) were aware of the retrenchment regulations and tried to stay below the threshold level. Among businesses with 15–70 FTEEs that did not seek government permission nor make any retrenchment payments, “It was not legally required” was not the most frequently given reason (18 per cent). Other popular reasons were: “The separation was voluntary” (42 per cent), “It has not been demanded” (24 per cent) and “It has not been necessary” (6 per cent). These are grey cases and may not be interpreted as defiance to legal obligations, but could indicate that “Seeking voluntary separation” and “No action unless demanded” may be the popular avoidance strategies of retrenchment regulations. Only eight per cent of the firms with 15–70 FTEEs have ever undergone the formal retrenchment process according to regulations.

7.3 Business laws and regulations

Most MSE employers responding to the survey indicated that market demand, the low cost of labour, transport infrastructure, and the availability of electricity, water and sanitation were the most positive factors affecting enterprise growth. A higher proportion rated as strongly negative or negative the access to skilled workers, cost of electricity, cost of land and premises, and government corruption. A majority considered factors such as effectiveness of courts in dealing with disputes, industrial safety and, to some extent, government corruption as not influencing growth.

Across all sectors, 65–85 per cent of respondents indicated a positive or strongly positive influence on regulatory issues such as the cost or time required to register or obtain a business license, as well as complying with labour regulations or environment and sanitary standards, maintaining minimum product standards and certification, and in complying with food and health standards. Thus, these regulatory issues were not seen as constraints to business expansion. However, respondents generally expressed a negative attitude towards issues such as the cost of taxation, banking and credit regulations, the cost and time required to register for taxation, labour regulations, the time required for tax administration, and the procedures for registering land and other property.

7.3.1 Business registration and licensing

Most enterprises in Sri Lanka appear to be registered in some fashion. The survey found that less than three per cent of respondents were unregistered. However, it is unclear how many

of these actively sought to remain unregistered. Almost all (i.e. 95–98 per cent) of respondents in the four sectors surveyed had obtained at least one of the common types of registration or license. Around 87 per cent of respondents were registered as sole proprietorships.

7.3.2 Income tax

Around 58 per cent of respondent enterprises were not paying income tax. According to 64 per cent of MSEs this was because they were not legally required to (i.e. they were exempt because they earned less than the threshold level).

With regard to knowledge of penalties, only 14 per cent of firms in the textiles and garments sector claimed to have heard of the penalties for non-compliance, while this number ranged from 77–80 per cent in the other sectors. Of those who had heard of the penalties for non-compliance, 73 per cent could refer to the category. This suggests that those who knew the tax regulations knew them well, although few MSEs were aware of them.

Of those respondents that avoided the payment of income tax, ten per cent claimed it was because the system was too complicated, eight per cent because it was too costly, and eight per cent because it was required, but not properly enforced. A quarter of the respondents indicated that they had tried to stay below the income tax threshold.

7.3.3 Value added tax (VAT) registration and payment

A large majority (90 per cent) of enterprises did not pay VAT, but many claimed this was not legally required (67 per cent). Around 21 per cent of respondents indicated that they had tried to stay below the VAT threshold.

Around 39 per cent of respondents from the textiles and garments sector and 48 per cent from hospitality indicated that they were aware of the penalties for non-compliance in this field. Out of those who had heard of the penalties, 47 per cent knew at least one category of penalty while 53 per cent did not know the category or the amount.

7.4 Incentive programmes

Only three per cent of the respondent MSEs reported benefiting from an incentive programme. Very few expressed concerns of outgrowing the ceiling of the programmes. Thus, no evidence was found that firms might manipulate the size of their workforce to benefit from incentive programmes.

7.5 Strategic management decisions

7.5.1 Knowledge of compliance costs and penalties

Awareness and information on the penalties for non-compliance of labour laws varied. It was high on the aspects of labour law concerning pension fund contributions, but very low on issues such as gratuity payments (this ranged from 28 per cent in the woodworking sector to 33 per cent in agro processing and 84 per cent among larger enterprises).

There was a high level of awareness concerning the penalties for non-compliance with income tax regulations. In the case of income tax, awareness and information ranged from 14 per cent in the textiles and garments sector to 80 per cent in the agro processing sector and 79 per cent among larger enterprises. In the case of VAT, information and awareness ranged from 39 per cent in the textiles and garment sector to 58 per cent in the hospitality sector and 59 per cent among larger enterprises. In the case of minimum wage, awareness and information ranged from 55 per cent in the textiles and garments sector to 67 per cent in the agro processing sector.

The results suggest that respondents are generally aware of the penalties for non-compliance, for all major laws, excepting the provision of gratuity where the level of awareness is low. Penalties for non-compliance of pension fund contributions and income tax payments appear to be the best known in all sectors and enterprise sizes, except in the case of income tax in the textiles and garments sector and among smaller enterprises.

7.5.2 Creation of parallel or multiple firms

The survey report does not comment on the issue of creating parallel or multiple firms as a strategy for keeping within an employment threshold.

7.5.3 Payment of bribes or other informal payments

A very small percentage of MSEs reported actually making informal payments to avoid labour laws. Where they were reported, informal payments were found to be more common to avoid the penalties of non-compliance in the payment of income taxes (up to 14 per cent of respondents). Otherwise, there was little evidence to indicate that the payment of bribes or other forms of informal payments was very common.

Chapter 8: Summary and conclusions

This chapter draws from the findings of the six country/state surveys compiled into the four country reports in order to consider how they help us answer key research questions and what the implications of these findings are for policy, legal and regulatory reform, and for future investigations into this important but complex issue.

8.1 *The influence of labour laws on MSE growth*

Overall, the labour-related laws and regulations in the four countries studied were not found to influence MSE growth either positively or negatively, although there appear to be various techniques used by MSE owners and managers to deal with these issues. These are discussed later in this chapter. While MSE owners and managers identified positive and negative influences of the labour regime, there was little evidence found to suggest that any one aspect or element of the legal and regulatory framework inhibited growth. The issue would be more on how to deal with the various techniques used by MSEs, which will be discussed in section 8.2.

The first sub-question this research programme sought to answer was: how does the effect of labour-related laws and regulations compare with other business laws and regulations found in the business environment?

The research was interested in positioning the overall effect of labour-related laws and regulations among the broader range of issues faced by MSE owners and managers. To understand this, there are two categories of analysis to summarize.

The first is how respondents perceive the investment climate and business environment according to its effect on growth, and how they perceive labour-related laws and regulations in this regard.

The second is how the specific aspects of the legal and regulatory framework – both labour-related and business in general – have been shown to affect MSE growth and employment in the four countries of the region.

These two categories of analysis are presented below.

8.1.1 Perceptions

The six surveys sought to find out from respondents how they perceive the investment climate and business environment and which aspects of these contribute to nurturing or constraining enterprise growth.

Across the region, survey respondents identified a range of issues affecting the investment climate and business environment in which they are operating. It was broadly recognized that the issues associated with market demand, infrastructure and transportation affected business growth. However, it was often hard to determine whether respondents saw these issues as simply significant or whether they were positively contributing to enterprise growth in the region. The low cost of labour in the region was raised in a number of survey results. The most common negative influence on growth cited in the reports was the regulation of credit and finance.

The effect of labour-related laws and regulations on enterprise growth was rarely elevated above non-labour or business regulatory issues. In general, respondents to the surveys displayed a relatively neutral stance in this regard. However, there were clearly aspects of labour law that featured more positively or negatively than others.

In Bangladesh, many respondents expressed a positive attitude towards the provisions for maintaining an employment register, paying minimum wages, complying with health and safety standards, dismissal procedures and disputes, paying for annual leave, workers' injury compensation, limits on working time, and insurance and welfare fund. The only aspects of the labour regime deemed as having a negative effect on the growth of their firms were severance payments, provident fund contributions, and the provisions for unions and collective bargaining.

Across all the three states surveyed in India there was a common perception of the investment climate, with most respondents indicating a positive link between enterprise growth and the market demand for products and services, transport infrastructure, and the availability of electricity, water, sanitation facilities and raw materials. The low cost of labour was cited as a positive influence in Maharashtra and Tamil Nadu, but a negative influence in Orissa. Most respondents in all states indicated that the cost or time required to register a business or obtain a business license was a positive factor for business growth. In Orissa, respondents also indicated that tax registration and administration had a positive influence, while in Tamil Nadu maintaining minimum product standards and certification was cited as a positive factor.

All states indicated that a negative influence on growth was created by banking and credit regulations. Respondents in Orissa also indicated the negative influence produced by import and export regulations; those in Tamil Nadu expressed concern over tax registration and administration. Only in Maharashtra did respondents report on the negative influence that labour law had on growth.

In Maharashtra, respondents were generally positive about the laws and regulations for employment registers and limits on working hours. They expressed a generally negative view on the influence of provisions for insurance, injury compensation and severance payments. In Orissa, respondents were generally positive about the minimum wage provisions, but expressed a generally negative view on the influence of provisions for annual leave payments, unionization and collective bargaining. In Tamil Nadu, respondents were generally positive about the provisions for health and safety, employment registers and minimum wage. They expressed a generally negative view on the influence of provisions for dismissals, unionization and collective bargaining.

In Nepal, the elements of the business environment identified as positive contributors to enterprise growth were: the cost and time required to obtain a business license, the cost and time required to register for taxation, the minimum product standards and certification, and food and health standards. In contrast, the factors identified as creating a negative influence on enterprise growth in Nepal were the cost of taxation (i.e. income tax, sales tax, VAT) and the time required for tax administration. Many MSE employers surveyed were non-committal regarding the perceived influence labour-related laws and regulations had on enterprise growth. However, aspects of the labour law, such as the provisions for health

and safety standards, workers' injury compensation, minimum wage, and limits on working time, were considered positively. The provisions for dismissal and disputes were ranked most poorly.

In Sri Lanka, a higher proportion of respondents assigned importance to the influence of access to skilled workers, cost of electricity, cost of land and premises, and government corruption. Respondents typically displayed a generally positive attitude towards labour-related laws and regulations, with the most positive aspects of the labour-related laws being: maintaining an employment register, paying the minimum wage, paying the employees' provident fund and workers' injury compensation.

8.1.2 Legal and regulatory framework

A summary of the key MSE survey findings on the legal and regulation framework is presented below.

KEY LABOUR-RELATED LAWS AND REGULATIONS

Use of employment register

There was some variation in the use of employment registers across the region. MSEs in Bangladesh rarely kept employment registers, while in Nepal only 38 per cent of respondent firms reported the use of a register. This finding strangely contests the perceptions presented by many respondents in these countries in which the use of an employment register was reported as a positive factor of the labour law. In contrast, in Sri Lanka, 71 per cent of respondents reported use of a register. There was considerable state variation reported in India, ranging from 59 per cent in Maharashtra, and around one-half in Tamil Nadu and one-third in Orissa.

Labour inspections

In general, the level of inspection appeared quite high in the region, with the exception of Bangladesh where only 24 per cent of respondents had received an inspector in the last year. By contrast, in Maharashtra, 93 per cent of respondent enterprises had received an official inspection or two in the last year, with health and labour inspections being the most common. Inspection rates in the other states were at 80 per cent in Tamil Nadu and 54 per cent in Orissa. Nepal and Sri Lanka reported inspection incidents at 54 and 65 per cent respectively.

Payment of the minimum wage

Awareness, or the lack of awareness, appears to have been a major issue in the payment of minimum wages in the region. In Sri Lanka, 38 per cent of respondents were not aware of the minimum wage obligations and only 57 per cent paid the minimum wage. Only five per cent of respondents were aware of the minimum wage obligations, but did not pay the minimum wage. Almost half (47 per cent) of the MSEs surveyed in Bangladesh were not aware of their obligations to pay a minimum wage. In Nepal, only 24 per cent were not aware of the obligations, while 64 per cent were paying their employees at least the minimum wage. In India, there were significant variations found in this field across the three states, with the highest levels of compliance reported in Orissa and the lowest levels reported in Maharashtra.

Payment of employment pension fund contributions

Non-compliance in this field was very high in Bangladesh where less than one per cent of respondents reported contributing to employee pension funds. In Sri Lanka, 36 per cent of the respondent firms claimed to be unaware of their obligation to contribute to employee pensions, and of those who were aware, 60 per cent reported compliance. In India, where employers are required to contribute to their employees' pension fund when they employ more than 21 FTEEs, Maharashtra and Orissa reported relatively low rates of compliance, while about 70 per cent of the mandated firms indicated they were making these payments in Tamil Nadu.

Gratuity payments

None of the surveyed firms in Bangladesh had paid their employees a gratuity payment. However, this is not surprising given that an employee must have 25 years of employment before becoming eligible for such payment. In Sri Lanka, where an enterprise employing more than 15 workers must make a gratuity payment to an employee who has resigned or retired after five years of service, only seven per cent of the surveyed firms reported ever making such a payment. In India, firms with ten or more FTEEs are required to make gratuity payments. However, in Orissa, only 15 per cent of respondent enterprises in this size category indicated they had ever made such a payment. This increased to 20 per cent in Maharashtra and 44 per cent in Tamil Nadu. Employers in Nepal are only required to make a gratuity payment after seven years of employment and when they employ ten or more FTEEs. Here, while 81 per cent of the survey respondents claimed to be unaware of the gratuity obligations, 24 per cent reported that they knew how much the gratuity payment would be for employees completing seven years of services. Around 31 per cent indicated they had heard of the penalties for non-compliance.

Trade union membership

Enterprises employing five or more FTEEs in Bangladesh are required to allow their workers to join a trade union. However, none of the surveyed MSEs with six or more FTEEs had done so. Respondents reported that this was mainly because their employees had not demanded it. In all the three Indian states investigated, union membership is required when the enterprise's workforce contains seven or more FTEEs, yet only four per cent of the respondent firms in Maharashtra in this size category had complied with this law. The most common reason given among those who did not comply was that they held regular meetings with workers, which rendered union membership unnecessary. In Nepal, the provision for union membership effectively applies to enterprises of all sizes. Around 57 per cent of the surveyed firms indicated they were not aware of these provisions. In Sri Lanka, 26 per cent of the respondent MSEs were aware of the legal requirement to form a trade union. However, of these, less than two per cent of MSEs had accommodated a trade union.

Compensation for injury or death

The issue of compensation for injury or death was examined in Bangladesh and Nepal. The MSE survey in Bangladesh found that while MSEs' awareness and knowledge of these provisions was found to be high (86 per cent and 83 per cent respectively), only nine per cent of respondents who were aware of the obligations indicated they had made these payments. While the majority of respondents (94 per cent of those who never paid) indicated that there were no injuries or deaths that warranted these payments, as many as 39 per cent of respondents indicated they "have heard of informal payments" being made

to avoid the penalties of non-compliance with this law. In Nepal, the MSE survey found that 41 per cent of respondents employing 10–70 FTEEs had not made any compensation payments. Around 62 per cent claimed they knew of the need to compensate employees for injury or death.

Retrenchment payments

In India and Sri Lanka, the provisions concerning retrenchment payments were examined. In India, retrenchment payments are only applicable when the enterprise employs more than 50 FTEEs. The Maharashtra state sample contained only 16 respondents in this category and, of these, only eight per cent reported making such payments. In Orissa, only six per cent of respondents claimed to have been aware of the law concerning retrenchment payment. Of those who were aware of this, only four per cent reported that they tried to stay smaller than the threshold. In Tamil Nadu, only eight per cent of the firms in this size category indicated they had made a retrenchment payment. In Sri Lanka, only five per cent of the businesses employing 5–14 FTEEs (or one per cent of the total sample) were aware of the retrenchment regulations and tried to stay below the threshold.

Provision of shelter, rest room, lunch room, children's room

This issue was examined only in Bangladesh, where enterprises with more than 24 female FTEEs or more than 49 regular FTEEs are required to provide a shelter, rest room or cafeteria. Furthermore, enterprises employing more than 39 female FTEEs are required to provide a nursery facility. The MSE survey found that most firms below these thresholds (86 per cent) were unaware of the threshold and 93 per cent of respondent MSEs with less than 41 female FTEEs were not aware of these requirements. None of the eligible firms provided shelter/rest room/lunch room. Compliance with the provision of children's room could not be assessed since there was no firm with 40 or more female workers among the surveyed firms.

Paid annual leave

In Nepal, the only country of the four to examine this issue, the proportion of enterprises that have preferred to stay below the threshold to avoid paying for annual paid leave was very low at only two per cent of businesses with 5–9 FTEEs. Just over one-third of respondents (35 per cent) of enterprises with 5–9 FTEEs were not aware of the regulations on annual paid leave.

BUSINESS LAWS AND REGULATIONS

Business registration and licensing

There was a high degree of variation in the levels of registration and licensing found among respondents in the six surveys. The country with the lowest levels of registration was Nepal, where 72 per cent of the enterprises surveyed were not registered with any of the eight common types of registration or license. In Bangladesh, 85 per cent of the surveyed firms had some form of registration or license, while in Sri Lanka most respondents reported to be registered in some fashion. Here, the survey found that less than three per cent of respondents were unregistered. However, in India there were dramatic variations reported: in Maharashtra, all respondents reported some level of business registration and licensing, while in Tamil Nadu all the surveyed firms were completely unregistered and unlicensed.

Income tax

In Bangladesh, most respondents indicated that they were not paying income tax. This was the case for all unregistered enterprises. Furthermore, most respondents were unaware of the income tax thresholds. The ratio of the MSEs unaware of the threshold was higher among those without registration than those registered. In Nepal, 47 per cent of the surveyed MSEs were not paying income tax, and in Sri Lanka, 58 per cent were not paying income tax. In Maharashtra, 80 per cent of respondents reported that they were regularly paying income tax. The smaller the enterprise, the less likely the respondent would report income tax payment. For example, 40 per cent of the respondents employing between 4–9 FTEEs were not paying tax, while only six per cent of respondents employing 50–70 FTEEs were not paying income tax. By comparison, in Orissa, only 31 per cent of respondents reported that they were regularly paying income tax; in Tamil Nadu, about half (47 per cent) reported that they were paying income tax.

Value added tax (VAT) registration and payment

In Sri Lanka, a large majority of enterprises did not pay VAT and 21 per cent indicated they tried to stay below the VAT threshold. In Nepal, 75 per cent of respondents did not pay VAT. Similarly, in Bangladesh, just more than 80 per cent did not make VAT payments – most were not aware of rate of VAT or the VAT tax ceiling. However, in India, the pattern was a little different: 43 per cent of respondents in Maharashtra reported they were paying VAT, 45 per cent in Tamil Nadu, and 24 per cent in Orissa.

Environmental laws and regulations

The requirement to comply with environmental laws and regulations was examined in Bangladesh, Nepal and Sri Lanka. In Bangladesh, where an Environmental Clearance Certificate (ECC) is required, 94 per cent of the surveyed MSEs did not have such a certificate. Some 39 per cent of respondents had made or knew of people in their sector who had made “informal payments” to avoid any problems arising from this. In Nepal, 57 per cent of the non-compliant respondent firms indicated that they were not legally required to comply with environmental regulations and 30 per cent were not aware they were required to comply with any environmental obligations.

8.2 Strategic management decisions

The term “strategic management decisions” is used to describe the research findings on how MSE owners and managers respond to the legal and regulatory framework they operate within. It recognizes that MSE owners and managers are actors with agency; they make strategic choices they believe will benefit them.

Two specific kinds of choices were investigated in this research programme.

The first concerned the way MSE employers responded to the thresholds that characterize the legal and regulatory framework in the four countries under study. Do they, for example, try to keep within a smaller size threshold in order to avoid the costs associated with growing into a larger size threshold?

The second concerned the use of other avoidance strategies that MSE employers might employ to escape the perceived constraints or costs associated with full compliance with

the legal and regulatory framework. Do they pay bribes or start parallel businesses to avoid meeting the legal and regulatory obligations associated with growth?

In addition to these two areas was an underlying question regarding awareness. Exploring how MSE employers make these strategic decisions requires an assumption that these actors are fully aware of and understand the legal and regulatory framework they operate in. Thus, it was important to assess the level of awareness and knowledge MSE owners and managers had of the legal and regulatory framework.

These three topics are reported on ahead, beginning with the issue of awareness and knowledge.

8.2.1 Knowledge and awareness

In Bangladesh, MSEs' knowledge on compliance costs and penalties varies across legislations. A high level of awareness was found on the issues related to compensation for injury or death at work and minimum wage. Awareness regarding the penalties for non-compliance was found to be highest in the areas of income tax, VAT, environmental regulations, and compensation for injury or death.

Across the three states surveyed in India there was generally a low level of understanding exhibited by respondent firms regarding labour-related and business laws and regulations. However, businesses with number of employees just below the threshold tended to demonstrate higher awareness than those with lesser number of employees. This requires further analysis about the impact of the thresholds.

Overall and compared with the other countries, awareness levels in Nepal were quite high. Slightly more than half of the MSE respondents claimed they were aware of the provisions and penalties associated with income tax, compensation for injuries and payment of the minimum wage. Just less than half knew of the provisions and penalties associated with environmental regulation, paid leave and pension fund contributions. The lack of legal enforcement was the major argument presented by non-compliant MSEs. This was especially in the fields of environmental regulations, minimum wage, gratuity, and income tax and VAT payments.

In Sri Lanka, awareness and information on the penalties for non-compliance of labour laws varied. It was high on the aspects of labour law concerning pension fund contributions, but very low on issues such as gratuity payments. There was a high level of awareness vis-à-vis the penalties for non-compliance with income tax regulations. Respondents were generally aware of the penalties for non-compliance, for all major laws, excepting the provision of gratuity where the level of awareness is low. Penalties for non-compliance of pension fund contributions and income tax payments appear to be the best known in all sectors and enterprise sizes.

8.2.2 Thresholds and MSE management

The second sub-question this research programme sought to answer was: do the thresholds in the labour regimes under study encourage compliance and job quality, or do they act as constraints to enterprise growth?

It is clear that all four countries examined in this programme employ the use of thresholds, although Bangladesh had consolidated various labour regulations into a single

labour code in 2006, except for relatively minor ones such as provision of shelter/rest room/lunch room and children's room. In the case of labour-related laws and regulations, these thresholds are typically based on the size of the enterprise, based on the number of FTEs. In the case of taxation (i.e. income tax and VAT), these thresholds are generally based on the annual turnover of the enterprise.

This sub-question specifically sought to examine the behaviours of MSE owners and managers. Size-based thresholds have been introduced by legislators in the understanding that it is often extremely difficult for MSEs to fulfil all the obligations of the labour law. While all employers, regardless of the size of their workforce, must comply with the core elements of the labour law, there are other elements of the labour law that only concern enterprises with larger workforces. However, this can create a situation in which a small employer may enjoy these special conditions so much that she or he is reluctant to grow out of them. Thus, the employer may attempt to stay within the threshold by simply not growing or by forming new, additional enterprises that increase the overall size of the workforce, but spread the workforce across more than one enterprise in order to appear small.

Across the six surveys conducted, there was no evidence to suggest that the thresholds were inhibiting the growth of MSEs or their workforce. This appears to be a result of three factors.

The first of these factors is awareness. Where MSE owners and managers claim not to be aware of the specific provisions of the threshold, it is safe to assume that the employer will not consciously attempt to remain below them. Thus, thresholds would not form a part of the strategic decisions made by the enterprise owner or manager. The apparent exception to this was in the field of taxation, but there were other selected legislations as well depending on the country. While there were variations, there appeared to be some consistency with the finding that a number of MSE managers reported they were familiar with the thresholds associated with income tax and VAT. Tax issues appeared to feature more prominently in the employer's mind than labour issues in general, although in some countries selected labour issues were of much interest. The latter requires further analysis.

The second explanation for the lack of a clear impact based on thresholds is the high levels of non-compliance that were reported. While there are enormous variations in this field based on the actual labour or business regulatory provision examined and the sector, size and location of the enterprise, there are many examples of respondents who simply chose to non-comply with a particular legal or regulatory provision. The lack of legal enforcement was the most common explanation given for these incidences of non-compliance. Thus, MSE employers experienced no problem or penalties arising from their lack of compliance simply because the law or regulations were not effectively or consistently enforced. When inspected, making informal payments was found to be a prevalent behaviour (see details in section 8.2.3).

The third explanation for the lack of a clear impact of the thresholds is under-reporting. This was most apparent in the provisions concerning income tax and VAT, where MSE owners and managers indicated they under-reported their annual incomes and enterprise turnover to remain below a specific threshold. However, this behaviour is likely shared with taxpayers around the world and it has not been possible to establish whether this behaviour is greater among MSE owners and managers in South Asia.

The impact of incentive schemes on MSE management

Across the 4,625 firms surveyed in this programme, the number of respondents that had benefited from a government- or NGO-supported incentive scheme was extremely low. In the case of Bangladesh, only 7.5 per cent of respondents indicated they had accessed the support of an incentive scheme. This was the highest proportion across the six surveys. In Nepal and Sri Lanka, only three per cent reported benefiting from an incentive scheme, while in India there were no respondents reporting such support.

While it is understood that an enterprise development programme or incentive scheme would develop a criteria for selecting the kinds of firms it supports, the outreach of these programmes and schemes is generally limited.

These findings seem to confirm the view that enterprise development programmes and incentive schemes have no impact on the decisions of MSE owners and managers. However, the emerging cases of successful formalization linked to access to financing, such as Brazil, indicates that there are better ways to structure incentive schemes from which South Asian programmes could extract lessons.

8.2.3 Avoidance strategies

The third sub-question around which this research programme was designed was: what are the strategic management decisions that MSE employers make in response to these conditions? This focused on the range of actions that may be taken by MSE employers in response to the issues under study. Beyond the influence of thresholds, the research programme sought to assess the extent to which firms establish additional, parallel firms in order to split their workforce and keep below a specified threshold. It also endeavoured to determine the extent to which bribes or informal payments were being used to avoid the penalties associated with non-compliance.

Creation of parallel or multiple firms

Only two per cent of the survey respondents in Bangladesh indicated they had established parallel or multiple firms. Most of these were in the agro processing sector, but the actual instances were in fact very low. No evidence was found in any of the three states in India to indicate that respondents were creating multiple or parallel firms to avoid growing beyond a specific labour-related or business legal or regulatory threshold. In Nepal, only three per cent of the surveyed MSEs had established a parallel firm and only about one-half of these units had an FTEE number that kept them below the threshold of ten employees.

Among the 22 per cent of non-registered MSEs in Nepal, there was some indication that respondents were intentionally remaining unregistered to avoid compliance with certain laws and regulations, such as taxation. In some cases, non-compliance was based on a lack of awareness. For example, 30 per cent of those not complying with environmental regulations were unaware of these regulations. Around 22 per cent of all respondents were unaware of the minimum wage and 57 per cent were unaware of the requirements regarding trade union formation. As stated above, many others simply chose not to comply with a particular legal or regulatory provision.

Payment of bribes or other informal payments

The Bangladesh survey found that many MSEs were aware of informal payments being made to avoid the penalties of non-compliance. The Bangladesh survey report claims that this was highest in the areas of income tax, environmental regulations, compensation for injury and death, VAT, and minimum wage. The report also claims that it is widely known that enterprise inspections, whether by labour, health or any other kind of inspector, can be avoided by paying a bribe to the respective authority or officer. Informal payments used to avoid the penalties for non-payment of income tax were found to be a relatively common strategy. While 41 per cent of respondents indicated they had heard of informal payments being made for this purpose, only three per cent indicated making such payments. On the assumption that respondents would be hesitant to report that they had made such payments, the former indicator on the basis of “have heard of” could be considered better reflecting the situation of the sector.

In Nepal, the use of informal payments to avoid the penalties of non-compliance also appeared to be quite common. While many more respondents indicated they had heard of these payments being made by their peers, instead of reporting that they had made such payments themselves, the results are clear: one-third of respondents indicated they had heard of informal payments being made with respect to non-compliance with minimum wage payments and ten per cent claimed they had made such payments themselves. Similar proportions were found in relation to income tax, VAT, environmental regulations, and annual leave payments.

In Sri Lanka, too, making informal payments was found to be a prevalent practice. In terms of awareness (“have heard of”), informal payments related to income tax were the most prevalent ones (58 per cent) followed by EPF (37 per cent), VAT (27 per cent), minimum wage (14 per cent), and gratuity (10 per cent). The hospitality sector demonstrated the highest ratio of awareness on informal payments in most of these issues.

In India, the three surveys do not provide conclusive data or analysis on the payment of bribes or other forms of informal payments to avoid the penalties of non-compliance with labour-related or business laws and regulations. Further analysis would be required.

8.3 Policy recommendations

These findings support the following recommendations for labour-related business environment reform in the region.

Labour-related laws and regulations should be considered an integral part of a comprehensive legal and regulatory framework in which enterprises of all sizes operate. The interplay between labour and other business laws and regulations means that these can't be easily divided. As governments seek to improve the business environment, they should ensure labour issues are recognized and incorporated into a holistic and integrated reform programme. The evidence provided by this study could help move policy dialogue in the direction.

Labour and business laws and regulations should provide easy entry points for compliance and formalization. The surveys provided concrete evidence on the monetary and transaction cost for different types of registration and licensing. These could serve as a reality check to keep improving the regulatory environment. The steps required to start a business and employ a worker should be as simple and straightforward as possible. While

there is a need for basic minimum standards to be enshrined in these processes, care should be taken not to overburden nascent enterprises with overly complicated or difficult-to-navigate systems. Degrees of complexity can increase as enterprise maturity and size increase, but here, too, care should be taken at all times to ensure that systems are as user-friendly as possible. This also requires governments to understand who the users are and how these systems can be designed to suit their needs and capabilities. This is one of the purposes of regular social dialogue.

The concept of a sliding scale of compliance requirements is relevant. While threshold can be designed around such a sliding scale approach, the point here is to avoid a jump in cost of compliance that could lead businesses to develop undesirable coping strategies such as those identified through this study. Fine-tuning of the sliding scale can only be done against the reality check, such as the one done by this study.

Linking incentives with compliance still appears to offer an opportunity for policy-makers and legislators to encourage compliance. However, the challenge lies in how to extend these incentives to non-compliant firms. Government programmes are notoriously limited in their capacity to reach out to this vast target group. Thus, while incentives might work, further attention needs to be given to how meaningful incentives can physically be provided. Emerging good practices, such as the successful formalization of informal economy enterprises in Brazil, could provide practical lessons on this.

Some MSEs are highly aware and knowledgeable about certain regulations that are applicable to them. This indicates ample room for targeted communication as well as fine-tuning the cost of compliance of the selected legislations through informed social dialogue.

The lack of enforcement, in some cases, despite good coverage by inspectors, undermines the influence of the policy, legal and regulatory framework. Policy-makers and legislators should pay greater attention to enforcement mechanisms. This implies that the legal and regulatory framework needs to be reformed in a manner in which enforcement is possible, efficient and meaningful. Governments need to devise enforcement mechanisms that recognize the financial and physical challenges that enforcement faces and develop new strategic approaches that address these.

Finally, policy-makers should look beyond the conventional enforcement through inspection and penalties. There are emerging examples of the win-win programmes that promote higher level of compliance with labour standards while enhancing productivity and competitiveness of enterprises. These are called responsible workplace practices¹ under the Sustainable Enterprise Agenda discussed at the 96th session of the International Labour Conference (ILC) of 2007. Combining these with business environment reforms and strengthening of the law enforcement mechanism is a practical way to realize the new holistic approach to decent work.

¹ There has been an expansion of programmes targeting medium- and large-scale enterprises among the export garment manufacturers (the Better Work programme) and the sugar industry (SIMAPRO). For small and medium-sized enterprises (SMEs), the ILO has been promoting the Sustaining Competitive and Responsible Enterprises (SCORE) project in partnership with NORAD and the Swiss State Secretariat for Economic Affairs (SECO).

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Appendix II. Official definitions of micro- and small enterprises (MSEs)

Bangladesh

The Industrial Policy, 2005 defines enterprises by size in the following “industry” categories:

Large industry: one in which more than 100 workers work, or in which the value/replacement cost of durable resources other than land and factory buildings is above 100 million Bangladeshi Taka (BDT) (US\$1=BDT70 approx.).

Medium industry: one in which 25–100 workers work, or in which the value/replacement cost of durable resources other than land and factory buildings is between BDT15 million and BDT100 million.

Small industry: one in which fewer than 25 workers work, or in which the value/replacement cost of durable resources other than land and factory buildings is under BDT15 million.

Micro-enterprise or cottage industry: one in which members of a family are engaged part time or full time in production or service-oriented activities – considered micro-enterprise.

India

The Micro, Small and Medium Enterprises Development Act of 2006 established the following investment ceilings for enterprises in the manufacturing and service sectors.

Table A.1. Investment ceiling (in INR) for different categories of enterprises since 2006

Manufacturing sector	
Enterprises	Investment in plant and machinery (in INR)
Micro-enterprises	Not exceeding 2.5 million
Small enterprises	More than 2.5 but not exceeding 50 million
Medium enterprises	More than 50 but not exceeding 100 million
Service sector	
Micro-enterprises	Not exceeding 1.0 million
Small enterprises	More than 1.0 million but not exceeding 20 million
Medium enterprises	More than 20 million but not exceeding 50 million

Source: The Micro, Small and Medium Enterprises Development Act, 2006, Ministry of Law and Justice, Government of India, New Delhi.

Nepal

The Nepal country report indicates that the Government of Nepal does not apply a uniform definition to describe the MSE sector. Instead, there are a number of isolated policies and laws that refer to discrete segments of the sector. These include the following:

- The Industrial Enterprises Act (1992) defines a cottage industry on the basis of level of investment and power usage. In general, this definition places emphasis on the cottage nature of the enterprise and focuses exclusively on certain kinds of manufacturing activity.
- The Central Bureau of Statistics (CBS) collects data on enterprises it classifies as “informal”, using the criterion of employment. An informal enterprise has less than ten workers.
- The Ministry of Labour uses the same criterion as the CBS.
- The Value Addition Tax Act (1995) applies a tax threshold on enterprises with an annual turnover of less than two million Nepalese rupees (NPR).
- The Income Tax Act exempts cottage industries as defined by the Industrial Enterprises Act (1992) from the requirement to pay income tax.
- The Financial Intermediary Act defines a micro-enterprise as employing less than ten people.

The lack of a common official definition for MSEs in Nepal creates a number of problems for the sector. Without a definition that clearly describes the sector, the size of the MSE sector cannot be accurately measured, nor can the contribution of the sector to national development goals (e.g. employment, productivity, domestic production) be assessed.

Sri Lanka

The Sri Lanka country report indicates there is more than one definition being used within one country. All available definitions have been based largely on four main criteria. They are:

- Value of fixed assets
- Number of employees
- Value of turnover
- Value of fixed assets and employment taken together

The Ministry of Rural Industries, the Ministry of Industrial Development, the Industrial Development Board, the National Development Bank, and the Export Development Board each have a definition for small and medium-sized enterprises (SMEs) when providing their services. It has been observed that while variances in defining SMEs exist, these authorities assign no clear demarcation between small and medium enterprises. One common thing in their definitions is that the demarcation has been made either on value of fixed assets or employment, or a combination of both.

Defining MSEs on the value of fixed assets requires amendments allowing for inflation from time to time. As revaluation of assets is not done in a uniform manner by all enterprises, this criteria does not appear to be a realistic norm for the definition. Considering employment as the sole criteria also poses problems, as many different forms of employment are found in the MSE sector. Employment under temporary, casual or contract basis is not easy to demarcate in the MSE sector, while family members are often found as managers and workers in this sub-sector.

Micro-enterprises are often considered synonymous with cottage and village/household industries. Evidently, all industries located in rural areas cannot be considered MSEs. MSEs need to have characteristics and requirements that differentiate them from large and medium enterprises. In this regard, small and cottage industries including rural non-farm activities located in rural areas as well as townships can be considered for the study. The definition for MSEs has to be clear enough to use in demarcating policies, and collecting information and data.

The National Strategy for Small Medium Enterprise Sector Development in Sri Lanka White Paper, prepared by the inter-ministerial task force, has agreed to consider enterprises with assets to the value of 20 million Sri Lankan rupees (LKR) to one million as small enterprises. In this context, enterprises with assets of a value of less than one million will be considered micro-industries. The term “enterprises” in this regard is defined to include any business activity or enterprise engaged in industry, agri-business, and/or services, whether single proprietorship, partnership or corporate venture. In measuring the size of the enterprise by employment numbers the following definitions are often used:

- Micro (less than five employees)
- Small (between five and 29 employees)
- Medium (between 30 and 149 employees)
- Large (150 employees and above)