

## How to accelerate labor reallocation?

Creative destruction, the mainstay of economic growth, happens to a large extent through labor reallocation. As workers move from jobs in low-productivity farms and obsolete firms to jobs in more dynamic economic units, output increases and the economy moves closer to the efficiency frontier. Differences in productivity across economic units underlie this creative destruction process. Such differences can reflect a healthy ecosystem driven by competition which offers the basis for efficiency-enhancing job reallocation. Market imperfections and government failures may hinder labor reallocation, however, resulting in a wider dispersion of productivity and many missed opportunities for growth.<sup>120</sup>

Stringent regulations that obstruct the movement of workers from low- to high-productivity areas or that prevent their separation from obsolete firms are a case in point. These regulations may stem from good intentions, such as containing congestion in cities or providing earnings stability to workers. But their cost in productivity growth can be substantial. Regulations of this kind do not sit on the efficiency “plateau” where labor policies are mainly redistributive; they are rather on the cliff, and have unambiguously negative effects on economic efficiency.

India is arguably an example of a country whose complex and cumbersome labor policies have pushed it off the “plateau.” The country has more than 40 national and state-level labor laws. Most of them apply to the organized (or formal) sector and to firms above a certain size. As firms’ employment increases, they fall under the purview of a growing number of regulations.<sup>121</sup> The Industrial Disputes Act (IDA) of 1947 is particularly restrictive. Governing employee-employer relationships, the IDA makes it extremely difficult for firms to terminate employment.<sup>122</sup>

The stringency of labor regulations is consistent with the “missing middle” phenomenon, characteristic of India and other developing countries, where medium-size businesses make up a disproportionately small share of the total. Also consistent with the stringency of labor regulations is the substantial dispersion of

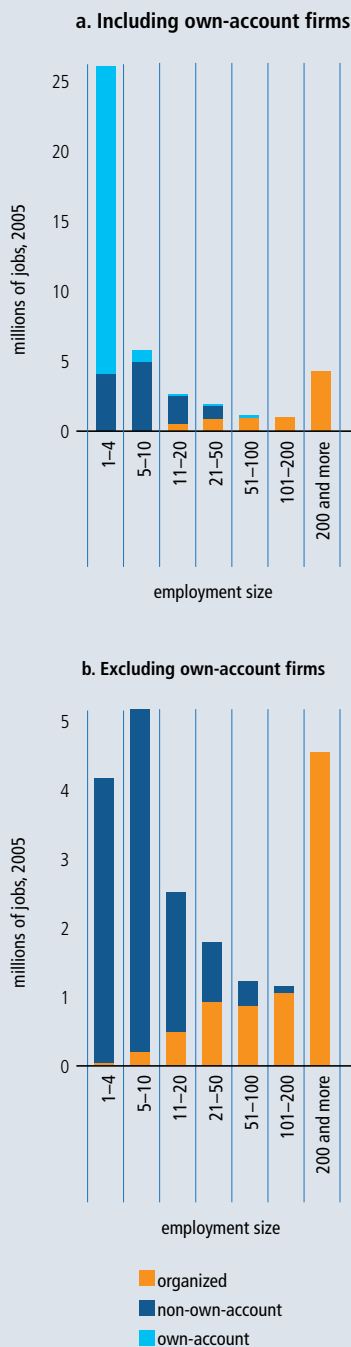
productivity. If the dispersion observed within each industry narrowed to the point of matching the dispersion observed in the United States, India’s average productivity in manufacturing could increase by more than half.<sup>123</sup> Instead, despite India’s buoyant economic growth during the past two decades, the performance of the labor-intensive manufacturing sector has been sluggish.<sup>124</sup> The bulk of the growth in nonfarm employment has been in the informal sector.

The conventional wisdom, when a country is riddled with misguided labor regulations, is to repeal them. This repeal may be easier said than done, however. India’s complex labor regulatory system has been in place for 60 years; even the ambitious reform program triggered by the balance-of-payment crisis of 1991 left labor regulations largely untouched.<sup>125</sup> The IDA of 1947 has been amended at the state level but not always toward the plateau. Between 1958 and 1992, seven states amended the IDA to give employers more latitude in labor decisions. These states subsequently experienced higher growth in output, employment, investment, and productivity in their formal manufacturing sector. But six other states changed the IDA in the opposite direction, which resulted in a worsening in firm performance and an expansion of the informal sector.<sup>126</sup> Overall, the dispersion of productivity in India’s manufacturing sector remained stable, or even increased, between 1987 and 1994.<sup>127</sup>

### *From bypassing regulatory obstacles . . .*

India’s response to these regulatory obstacles has been to learn how to live with them, and this has been achieved through widespread noncompliance.<sup>128</sup> For example, large firms rely on contractors, who in turn hire workers; thus total employment is “sliced” into smaller packages, each escaping the most stringent labor market regulations. Short-term contracts and temporary employment agencies are other mechanisms used to circumvent the regulations. The propensity of firms to hire contract workers has increased over time for all firms employing 10 or more workers and is highest among medium-

**FIGURE 9.8** *Is there a “missing middle” in the distribution of manufacturing firms in India?*



Source: Hasan and Jandoc 2010.

Note: Data for the organized, or formal, sector are from the Annual Survey of Industries (ASI) conducted by India's Central Statistical Organisation; data for the unorganized or informal sector are from the National Sample Survey Organisation (NSSO) Survey of Unorganized Manufacturing Enterprises. Own-account manufacturing enterprises are those operating without hired workers employed on a regular basis.

sized firms (50–99 workers).<sup>129</sup> A 10-year study of 1,300 firms also finds insignificant differences between medium and larger firms in their hiring of manual workers.<sup>130</sup> The share of informal workers in total employment in organized firms grew from 32 percent in 2000 to 52 percent in 2005 to 68 percent in 2010.<sup>131</sup>

Consistent with noncompliance, the distribution of firms by size does not show substantial discontinuities around the threshold levels where regulations become more stringent. Considering the entire distribution, including informal firms, the biggest discontinuity is between firms employing up to 4 workers and those employing 5 to 10 (figure 9.8a). However, there is no 5-worker threshold in the applicable labor market regulations. On the other hand, there is no discontinuity in the distribution when crossing the 50-worker cutoff point, despite it being the threshold above which firms fall under the purview of the IDA (figure 9.8b).

Admittedly, other factors could influence India's distribution of firms by size.<sup>132</sup> But overall, these patterns are consistent with firms bypassing labor regulations.

*... to actively offsetting them ...*

While India has learned how to live with cumbersome regulatory obstacles, other developing countries with similar constraints have accomplished more efficiency-enhancing labor reallocation. Sri Lanka inherited the same labor regulations from the British colonial administration as India did. Without reaching the extremes in India, many Latin American countries face similar regulatory obstacles. Although China's labor regulations were less stringent until the 1990s, its household registration (*hukou*) system represented the ultimate obstacle to labor reallocation.<sup>133</sup> Yet, all of these countries have managed to spur growth in high-productivity sectors and locations.

Sri Lanka gradually liberalized many of its markets during the 1980s and 1990s but did not reform its complicated and costly employment protection legislation. Under the Termination of Employment of Workman Act (TEWA) of 1971, firms with 15 or more employees cannot lay off workers without official authorization and are liable for termination payments of up to four years of salary, depending on the em-

ployee's length of service. Yet the country's garment industry was a runaway success. Replacing tea as the country's major source of export revenue, the industry now accounts for half of Sri Lanka's sales abroad, up from almost nothing in the 1970s. It also accounts for much of the increase in employment in manufacturing.<sup>134</sup> The success of the garment industry has been a magnet for rural migrants, with 45 percent of them moving to the western provinces where the garment industry is concentrated.

Restrictive labor market regulations are a common feature of many Latin American countries too. In Brazil, after years of economic reforms, hiring workers remains as burdensome as ever. If anything, the sustained increase in formalization over the past decade has made compliance with labor regulations more common. Yet, Brazil's labor market has been characterized by massive internal migration and remarkably high labor turnover rates. Lifetime interstate migration is estimated to have doubled between the 1980s and the 1990s, reaching two-fifths of the population by 1999. In the 1990s, one-third of the workers who changed jobs in Brazil's formal sector had migrated

across state borders to find employment. And an estimated two-fifths to one-half of formal sector workers change jobs every year.<sup>135</sup>

Nowhere is the extent of labor reallocation more striking than in China, and much of it happened under the *hukou* system. Since its introduction in the 1950s, this system governed where people could live, effectively preventing rural-to-urban labor flows and reserving employment in cities for their residents (box 9.5). With market-oriented reforms, the system was gradually liberalized, and many restrictions on internal migration were lifted. But the *hukou* system has not been completely abolished; even today it may still inhibit migrant flows and reduce the incidence of workers moving with dependents. Despite this barrier to labor mobility, China experienced phenomenal growth in labor-intensive manufacturing, involving massive internal migration from the hinterland to coastal areas, and from villages to towns and urban centers. This geographically concentrated development absorbed an important share of rural surplus labor, while integrating China into international value chains and making it the "world's factory."<sup>136</sup>

### BOX 9.5 *China's hukou system has been partially liberalized*

A *hukou* is analogous to an internal passport. Legal residency in a city, town, or village is determined by an individual's birth place. Rural and urban populations are registered separately. The *hukou* system regulates many social entitlements of citizens, including education, housing, utilities subsidies, and social protection. Together with other policies such as urban food rationing during the period under central planning the *hukou* system prevented the rural labor force from moving out of agriculture. It maintained an exclusive urban labor market with basic social welfare, and supported industrial policy, effectively creating rural-urban segmentation.

At the beginning of the reform process, cities and towns could afford basic social welfare only for a limited population. Inflows of rural workers were therefore seen as a double-edged sword that could increase the well-being of rural residents but also lead to congestion and overcrowded infrastructure. After reforms in urban areas were under way in the mid-1980s, and the growth of township and village enterprises stagnated, farmers were allowed to work in small and medium cities—but only on the condition that they continued to be self-sufficient in terms of staples, in accordance with

the food ration scheme that was still in force. Restrictions were not lifted until the mid-1990s, when reforms were well under way. By then, the fast growth of labor-intensive and export-oriented sectors and the dramatic surge of private sector activities in urban areas generated a substantial demand for low-skilled labor. Only at that point was the *hukou* system substantially liberalized.

The implementation of this liberalization process has been conducted in a decentralized way. Most medium and large cities have gradually lowered the criteria for migrants to change *hukou* identities, and hence their accompanying entitlements. However, the criteria remain exceptionally strict in major cities and in cities with high income levels, including Shanghai, Beijing, and Guangzhou. For example, Shanghai was the first city to make the residence permit system open to all, but its qualifying conditions are among the strictest. Shanghai's system favors immigrants with college degrees or special talents, and those who do business or invest. It also requires seven years of social insurance contributions before applying. In addition, the city has a tight overall quota on *hukou* conversions, and the actual number of conversions has to date been very low.

### ... through productivity spillovers

These examples point to a successful second-best approach to offset regulatory obstacles. Instead of trying to avoid or evade labor regulations, this approach involves actively taking advantage of productivity spillovers from jobs in industrial clusters, dynamic cities, or global value chains to make the regulations less relevant in practice.

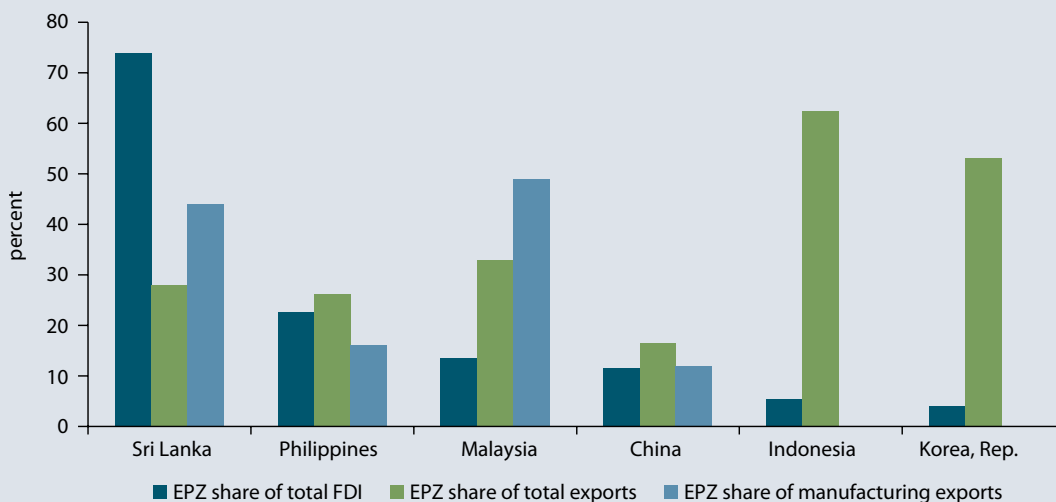
In Sri Lanka, the development of export processing zones (EPZs) drove the takeoff of the garment industry. These economic enclaves offered better infrastructure and a more favorable regulatory environment than the rest of the economy. As a result, they attracted large inflows of FDI and became the source of a large fraction of Sri Lanka's exports (figure 9.9).<sup>137</sup> Local producers in these zones were able to benefit from cluster effects. Outperforming competitors in many other developing countries, the industry has managed to move up the value chain, transforming factories into design centers.

In Brazil, the surge of internal migration is closely associated with the country's continuing integration into the global economy and a development policy that favors agglomeration effects. In the 1990s, Brazil implemented major trade liberalization measures, gradually relaxed restrictions on FDI, and devalued its currency. In this context, development policy was increas-

ingly left to subnational governments, emphasizing the importance of regional hubs and facilitating a location-specific policy agenda built on local strengths. These efforts supported the relocation of industries toward previously less-favored regions. While local policies were largely targeted at fostering small and medium firms, they also attracted bigger firms and multinational companies. The impact on internal migration was significant. A 1 percent increase in the concentration of FDI in a particular location was associated with a 0.2 percent increase in the location's immigration rate. And a 1 percent increase in employment in export sectors was associated with a 0.3 percent reduction in outmigration.<sup>138</sup>

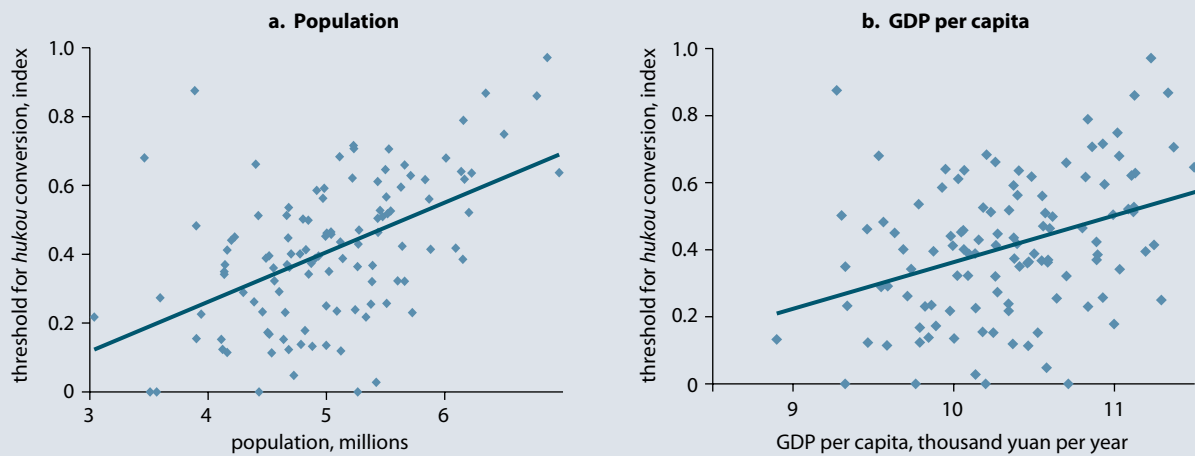
In China, labor reallocation is rooted in the development of competitive cities. The urban share of the population jumped from just 27 percent in 1990 to almost 50 percent in 2010. This transformation is unprecedented, with the urban population increasing from 170 million in 1978 to 456 million in 2000 and 665 million today. The increase was supported through a phenomenal expansion of commercial power supply, urban infrastructure, highways, and ports. In 1988, China had barely 100 kilometers of expressways; 10 years later, the total length

**FIGURE 9.9** *Export processing zones were a driver of foreign direct investment in Sri Lanka*



Source: Jayanthakumaran 2003.

Note: EPZ = Export Processing Zone; FDI = foreign direct investment. The figure summarizes EPZ activities during the 1980s.

**FIGURE 9.10** Restrictions to hukou conversion increase with city size and income

Source: Wang, Song, and O'Keefe 2012 for the World Development Report 2013.

Note: GDP = gross domestic product. The index measuring the threshold for hukou conversion takes into account requirements on investment, employment and family reunion. Each dot represents one of 120 cities in 30 provinces.

was second to the United States; and by 2009, more than 60,000 kilometers were in use.<sup>139</sup>

Regional competition and experimentation in part underpin these successes. In China, local governments have substantial autonomy to raise fiscal and nonfiscal resources. They thus have considerable scope to take responsibility for local development. The Chinese Communist Party also rewards local officials based on local performance, prompting them to actively engage in economic competition.<sup>140</sup>

This decentralized institutional setting allowed cities in China to experiment with reforms to the *hukou* system as a tool for urbanization. It has been argued that a large fraction of cities in China are too small because of it.<sup>141</sup> But the decentralized implementation of the system allowed major globalizing cities to use the *hukou* system as a screening tool to select more skilled migrants and enhance the productivity spillovers from jobs. Most medium and large cities have gradually eased the criteria for migrants to change *hukou* identities. However, bigger and richer globalizing cities have embraced a more skill-intensive pattern of growth, putting more weight on productivity growth than on poverty reduction (figure 9.10).<sup>142</sup> Ac-

cordingly, the criteria for changing *hukou* identities in these cities are generally defined by skills, investments, income, and residence requirements. The numbers of migrants meeting these criteria have been small.<sup>143</sup>

Back to India, then, where the slow pace of urbanization is even more striking than the rigidity of its labor regulations. In 1990, the share of India's population living in cities was the same as China's: 27 percent. Two decades later, it had grown only to 30 percent.<sup>144</sup> The functionality of the cities also poses severe challenges. For instance, large swaths of Delhi or Mumbai have access to no more than four to five hours of water supply a day. Energy shortfalls have increased in recent years and are perceived as the top constraint for doing business. A company can expect 17 power shut-downs a month. The cost imposed on firms by the power problem is among the highest in the world.<sup>145</sup> Judging from the experiences of Brazil, China, and Sri Lanka, and after 60 years of partial success in making labor regulations more flexible, the key for India to accelerate labor reallocation and thereby realize its development potential may lie in its urbanization policy.