

Moving toward greater labor market flexibility: India's uneven path

About 1.5 billion people in developing countries are employed in low-productivity informal sector jobs with no social security benefits and poor working conditions. What can governments do to create better jobs, and more of them? India's experience shows that states with more flexible labor regulations and lower costs of compliance tend to have greater labor mobility and higher productivity and employment in the formal manufacturing sector.

India has one of the most rigid labor markets in the world. Labor market issues are governed by 45 central government laws and more than 100 state statutes, many of which overlap. The most controversial laws regulate worker firings and closures of manufacturing firms. A statute dating back to 1947, the Industrial Disputes Act (IDA), requires factories with more than 100 workers to obtain government permission to lay off employees and close their operations. Such permissions are rarely granted, and employers face substantial fines and even a prison sentence if they fire workers illegally. Many other laws govern work conditions, minimum wages, and benefits. Firms with 10 or more workers that use electric power are required to register under the Factories Act and to keep records and file regular reports on such matters as overtime work, wages, attendance, sick leave, and worker fines. Compliance with these requirements, as well as multiple inspections, is costly, particularly for smaller firms.

Although the regulations are meant to enhance the welfare of workers, they often have the opposite effect by encouraging firms to stay small and thus circumvent labor laws. To avoid compliance costs, firms reportedly break down their operations into several small separate units. In many states, firms are increasingly relying on contract laborers, who do not receive the same benefits as regular employees. Excessive protections stipulated by labor laws also discourage hiring. Large Indian firms use less labor than is justifiable given the prevailing low wages. As a result of these distortions, nearly 9 in 10 Indian workers are employed in the informal sector and have little or no social insurance or fringe benefits. This informality is associated with markedly lower productivity. Value added per worker in India's informal manufacturing sector averages about one-eighth that in the formal sector.

A varied regulatory burden within India by state

Because Indian states have the authority to amend central labor laws, the regulatory burden on enterprises varies greatly by state. Some states have made their labor laws more flexible relative to the provisions of the central acts, while others have adopted additional restrictions. This variation has created the ideal conditions (a "natural experiment") to assess the economic effects of labor laws because, while individual states have changed their labor

regulations, most other legislation has remained similar across states. This has prompted a number of studies, several of which are summarized in table S5.1.

Learning from the experience of labor reform in India and elsewhere

Most of the reforms in Indian states were aimed at improving procedures and reducing the costs of regulatory compliance, rather than at enacting comprehensive structural changes. Only two states (Uttar Pradesh and Uttaranchal) relaxed the threshold for applying IDA's restrictions on worker layoffs. The more common reforms eased the regime for use of contract labor; simplified reporting requirements; limited the number of registers that need to be kept; allowed shift work; and introduced self-certification of compliance with labor regulations to streamline or reduce the number of inspections. Two other states (Haryana and Punjab) introduced a single annual inspection for compliance with all labor laws, and several states now require government authorization for surprise inspections. The reforms have improved the business environment and reduced transaction costs. These efforts are mostly piecemeal, however; few states have addressed the vast body of administrative requirements systematically.

To create the sort of labor flexibility that promotes formalization and the benefits that accompany it, India needs to reduce the number of and simplify labor laws, modernize the IDA, and further improve administrative procedures. Although no single blueprint exists for how to design and implement effective labor market reforms, several developing countries offer examples of policy changes that increase labor market flexibility.

Malaysia does not limit the duration of fixed term contracts, prohibit night and weekend work, or require government permission to fire redundant workers. Labor regulations protect the interests of workers but are generally not too burdensome for employers and thus do not discourage them from hiring formal workers. The level of informality, estimated at about 35 percent of total employment, is low relative to other developing countries. Colombia has reduced severance payments for employees and introduced a wider definition of fair dismissals. To process mass dismissals more quickly, it has eased the requirement for advance notice of firings. The Czech Republic and Slovakia

TABLE S5.1 *Studies of labor regulations in India*

Study	Methodology	Findings
Besley and Burgess 2004	Constructed an index summarizing state-level amendments to the Industrial Disputes Act (IDA) between 1949 and 1992.	<ul style="list-style-type: none"> States with less flexible labor regulations had lower output, productivity, investment, and employment in formal manufacturing than they would have had if their regulations were not so rigid. Output in informal manufacturing increased in the same states.
Sharma 2009	Used the Besley-Burgess methodology to estimate the impact of reforms in 1991 that removed licensing requirements to set up and expand factories.	<ul style="list-style-type: none"> After deregulation, the number of informal establishments declined by 25 percent in states with more flexible labor laws, compared with states with more rigid regulations.
Ahsan and Pagés 2009	Updated the Besley-Burgess index, and estimated the effects of difficulties in resolving labor disputes and restrictions on labor layoffs.	<ul style="list-style-type: none"> States that increased labor law rigidity above the level stipulated in the IDA experienced declines in registered manufacturing and output relative to states that did not implement such changes. Rigid regulations for settling disputes reduced output more than the IDA provisions on layoffs. West Bengal has lost more than 620,000 manufacturing jobs because of its restrictive regulations in these two aspects of the law alone. Andhra Pradesh and Tamil Nadu have created more than 130,000 formal manufacturing jobs, thanks to improvements in their dispute resolution regulations.^a
Dougherty 2008	Examined a broader range of labor regulations in 21 states. Analyzed 8 major labor legal areas. Constructed an Organisation for Economic Co-operation and Development (OECD) labor reform index based on 50 subjects of possible reform, many of which could be implemented by administrative procedure rather than through formal amendments to the law.	<ul style="list-style-type: none"> The most common area of reform was contract labor; the least common were changes in rules governing inspections. Overall, the degree of reform was modest: no state has introduced more than 28 reforms out of a possible 50 reform subjects measured. States with higher labor reform indexes had greater job turnover rates—vital for technological change and economic growth.
Goldar 2011	Used the labor reform index developed by Dougherty	<ul style="list-style-type: none"> States with higher labor reform indexes tended to have greater employment elasticity and a higher growth of organized employment in manufacturing compared with states that introduced few reforms.

a. World Bank 2010a.

increased the maximum duration of fixed term contracts and reduced redundancy costs.

India may well choose a different path, but the overall principle guiding reform efforts should be protecting workers—through such means as social assistance, skill building, and help finding jobs—rather than protecting jobs.

Sources

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