Labor Regulations In India: Impact and Policy Reform Options

Ahmad Ahsan, SASPR
Presentation to Human Development Network
New Delhi-Washington VC
November 9, 2006
Context and Motivation

- India witnessed robust economic growth of more than 6% in the 1990s. However, concerns about employment growth and quality were widespread:

  - Job growth decelerated between 1993-00, though less than official estimates.
  - There was growing “casualization” of labor and virtually no net job growth in the formal sector, especially in formal manufacturing.
  - More than 100 million working poor remain, whose earnings are inadequate to raise their families out of poverty.
  - India’s economic growth and employment pattern is atypical and raises questions about its poverty impact and sustainability.
The Issue is Obviously Important: There is a close relationship between Real weekly earnings and real per capita Household Expenditures.
Objectives of Study

Our Study analyzed the available evidence on labor market developments with the following objectives:

(i) assessing developments in labor markets

(ii) identifying the key employment challenges facing India; and

(iii) making recommendations to improve labor market outcomes.
The Report’s Three Themes.

One: Labor markets outcomes in the 1990s were better than commonly perceived.
- Wages and labor productivity grew faster even in the informal sector, and workforce was deployed more efficiently.

Two: Looking ahead, however, India faces formidable employment challenges.
- Providing good jobs for the 8 million new workers expected to enter labor force annually over the next decade and increasing earnings of the currently more than 100 million workers who live in poverty and increasing earnings in general. Addressing Gender, Caste and Regional Disparities.
- Labor Market Dualism, slow growth of formal sector jobs, and manufacturing jobs particularly.
Three: Reforms are needed in laws and active labor market policies to deliver better outcomes

- Regulatory reforms are needed to accelerate job growth. Regulations are costly and hurt workers: we estimate 30% to 40% of formal manufacturing jobs have been lost on account of these laws. Such reforms need to be complemented by:

- More effective active labor market policies to help workers, by providing protection and insurance in the informal sector, and enhancing skills
This presentation focuses on Labor Market Regulations and Outcomes -
Outline

A. Labor Regulations In India
B. Enforcement
C. Impact of Labor Regulations
D. The Way Forward with Labor Regulation Reforms
E. Need for More Effective Labor Market Policies
A. Complex labor Legislation and Regulations

- **Altogether about 45 central laws and 170 State statutes directly deal with labor market issues. Labor is a concurrent subject.**
  - Industrial Relations
    - Trade Unions Act, 1926
    - Industrial Disputes Act (IDA) 1947
  - Working Conditions
    - The Factories Act, 1948
    - The Industrial Employment (standing orders), 1946
    - The Contract Labour Act, 1961
  - Wages
    - The Payment of Wages Act, 1937
    - The Minimum Wages Act, 1948
  - Social Security and Insurance
    - Workmen Compensation Act, 1923
    - Employee State Insurance Act, 1948
    - Employees Provident Funds Act, 1952
  - Plus a number of state laws such as the Shops and Establishment Act
International comparisons

(Doing Business Data, De Jure indicators)

<table>
<thead>
<tr>
<th>Country</th>
<th>Difficulty of Hiring</th>
<th>Rigid Hours</th>
<th>Restrictions to retrenchment</th>
<th>Compensation for Dismissal</th>
<th>Rigidity of Employment</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>33</td>
<td>20</td>
<td>90</td>
<td>79</td>
<td>48</td>
</tr>
<tr>
<td>Comparators Average</td>
<td>27</td>
<td>45</td>
<td>48</td>
<td>87</td>
<td>40</td>
</tr>
<tr>
<td>High Income Countries Average</td>
<td>22</td>
<td>49</td>
<td>24</td>
<td>41</td>
<td>32</td>
</tr>
<tr>
<td>World Average</td>
<td>35</td>
<td>50.6</td>
<td>37.9</td>
<td>56</td>
<td>41</td>
</tr>
<tr>
<td>World Median</td>
<td>31</td>
<td>60</td>
<td>40</td>
<td>46</td>
<td>41</td>
</tr>
</tbody>
</table>

Other issues with labor legislation

- Key concepts such as “workman” or “factory” subject to interpretation and with different meanings across Acts

- Diseconomies of scale. Laws establish size thresholds (Factories Act: 20 L; IDA 20, but IDA, C5b 100) => It may create incentives for informalization.

- Empirical studies suggest important adverse effects on outcomes – More on this later.
Very few legislative reforms

- No recent reform initiatives regarding IDA
- Some amendments to the Trade Unions Act (2001)
- More initiatives at the state level regarding contract labor (Andhra Pradesh (Contract labor legislation, UP lifting the threshold))
B. Law enforcement – Almost wholly at the state level.

- As the saying goes the "Licence Raj" has been replaced by the "Inspector Raj".
  - Inspections per registered factory are a major source of transactions costs.
  - Although inspections have declined. IC (2002) data suggest large irregularities. 20% respondents report that inspectors reduce the number of visits in response to unofficial payments.
  - Labor inspectors were more often involved in this irregularities than other inspectors. The average reduction in visits (if unofficial payments reported) was 53 percent.
Law enforcement (Cont)

- **Inspections**
  - Unofficial payments more often reported among large firms, exporters, and firms that dominate more than 20 percent of the market for their product (profitable firms)

  - Unofficial payments more often reported among firms that perceive labor regulations as an obstacle for growth—
    - Payment of unofficial payments is the problem with regulations… or
    - Inspectors target firms for which regulations are more binding and are willing to pay more in bribes

  ➔ Current the inspection regime is probably undermining workers’ welfare.
Current laws creates incentives for prolonging disputes.

- The IDA sets three stages in dispute settlement
  - (1)-Consultation—Work Committees
  - (2)-Conciliation—Conciliation officers and Boards
  - (3)-Adjudication—Labor Courts and Labor Tribunals

Little incentives and effective at (1) & (2).

- Parties are not required to attend conciliation
- Most labor disputes deal with retrenchment issues. IDA & Labor Courts favorable to workers, workers go to stage (3) directly ➔ Overcrowding of labor courts and Tribunals.
  - Average duration of proceedings In Labor Courts take 10 years
  - When appeals are included, dispute settlement takes 20 years (Khan, 2005)
Some 533,000 Cases Pending-
28,000, for more than 10 years

<table>
<thead>
<tr>
<th>Major States</th>
<th>No. of Cases Pending</th>
<th>No. of cases pending for More than 10 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assam</td>
<td>189</td>
<td>138</td>
</tr>
<tr>
<td>Bihar</td>
<td>5,200</td>
<td>566</td>
</tr>
<tr>
<td>Delhi</td>
<td>28,837</td>
<td>2,342</td>
</tr>
<tr>
<td>Gujarat</td>
<td>133,916</td>
<td>8,616</td>
</tr>
<tr>
<td>Kerala</td>
<td>3,450</td>
<td>63</td>
</tr>
<tr>
<td>Karnataka</td>
<td>17,457</td>
<td>2,924</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>142,345</td>
<td>11,508</td>
</tr>
<tr>
<td>Madhya Pradesh</td>
<td>89,341</td>
<td>0</td>
</tr>
<tr>
<td>Punjab</td>
<td>14,784</td>
<td>110</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>20,066</td>
<td>775</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>21,713</td>
<td>150</td>
</tr>
<tr>
<td>Uttar Pradesh</td>
<td>22,539</td>
<td>10,303</td>
</tr>
<tr>
<td>West Bengal</td>
<td>2,225</td>
<td>283</td>
</tr>
<tr>
<td><strong>Total (All States &amp; UT)</strong></td>
<td><strong>533,038</strong></td>
<td><strong>28,864</strong></td>
</tr>
</tbody>
</table>
Increasing use of contract labor

**Contract Labor (as % of manufacturing employment)**
**Average per year across states**

*Average of the major 28 states. Source: Annual Survey of Industries*
In sum..

- Overly complex **legislation**, more restrictive in the area of retrenchment relative to comparators countries, world average or developed countries. Very few legislative changes since 1990.

- **Poor & ineffective labor enforcement**, coupled with increasing use of contract labor (de facto deregulation).

- **Bias towards adjudication** ➔ overloaded labor courts. Yet, **some shift in the stand of judiciary** (de facto deregulation)
C. What is the impact: High Transactions Costs may be constraining formal sector employment.

<table>
<thead>
<tr>
<th></th>
<th>1983</th>
<th>1993-94</th>
<th>1999-00</th>
<th>2002*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Self Employed (percent)</td>
<td>52</td>
<td>50</td>
<td>48</td>
<td>50</td>
</tr>
<tr>
<td>Regular Workers (percent)</td>
<td>16</td>
<td>16</td>
<td>16</td>
<td>16</td>
</tr>
<tr>
<td>Casual Workers (percent)</td>
<td>32</td>
<td>34</td>
<td>35</td>
<td>33</td>
</tr>
<tr>
<td>Total (in millions)</td>
<td>234.8</td>
<td>304.6</td>
<td>336.8</td>
<td>350.6</td>
</tr>
</tbody>
</table>

*Source: Sundaram and Tendulkar, 2005b; * Staff calculations
Leading to The Missing Middle Manufacturing Firm Size in India – Late 1980s

India 1989-90

Korea 1986

Hong Kong 1982

Hong Kong 1982

% distribution of employment

% distribution of employment

% distribution of employment

% distribution of employment

500+
200-499
100-199
50-99
10-49
5-9

500+
200-499
100-199
50-99
10-49
5-9
Which is Continuing: Labor Productivity By Different Size of Firms

- 1984-85
- 1994-95
- 2000-01
Medium Sized Firms Consider Labor Regulations to be a Significant Constraint
Assessing the effects of regulations.

- Objective
- Methodology of this study
- Data used
- Results
Objective of this section:

- We attempt to provide a quantitative assessment of the effects of labor regulations on economic outcomes in India:
  - GDP per capita, manufacturing/registered vs. unregistered sector
  - Employment/wages/labor share
  - Investment/# of Establishments.
Effects of labor regulations: Former studies


- Yet, Dutta Roy (2004) examines the 1982 amendment to IDA on the cost of adjustment of firms and finds no effect.

- Besley and Burgess (2004) study effect of state amendments. They find regulations have adverse effects on Employment and output, but bunch all regulations into a composite index— which laws are behind these effects?

- Lall and Mengistae (2005) find that labor market regulations explain differences in labor productivity gaps and location choices between cities— which laws?

→ We follow Besley and Burgess (2004) with important modifications:

1. We decompose their measure of labor regulations in various measures
2. We also assess the effect of increasing use of contract labor (de Facto deregulation)
Methodology to estimate economic effects of labor legislation


- We then compare the evolution of reforming states when non-reforming states—controlling for differences in policies and economic structure.

  “What would have happened if labor reforms would not have taken place? ” or alternatively, “what was the effect of specific reforms in the reforming states?”
Measuring Reforms

- Large number of state amendments to IDA, 1947
- We term:
  - \( A = \) Job security for workers (cost of adjusting labor for employers)
  - \( D = \) Increase opportunities and incentives to engage in labor disputes (cost of labor disputes for employers)
- All amendments to IDA refer to A or D
  - In each state-year, we code (+1) any legal amendments that increase A, or D, and (-1) any amendments that reduce A, or D.
  - In state-years where there is more than one change, we code (+1) if sum amendments increases A or D, and (-1) if it reduces them.
- Focus on period 1958-1997
- We use as our explanatory variable the cumulative sum of amendments.
Examples of coding

- Rajasthan – 1984. The procedures for layoff and retrenchment specified in Chapter Vb are applicable to establishments that employ more than 100 (A=1).

- Tamil Nadu—1982  State government can issue a special order to preserve industrial peace if necessary, while employers and workers should observe the conditions of the order. (D=-1)

- Karnataka—1988. Amendment increases the power of conciliation officer to enforce attendance of hearings regarding industrial disputes (D=-1)

- The appendix of the paper lists all codes.
Data

- Manufacturing data at the state-industry level, from Annual Survey of Industries (ASI) period 1959-1997 (Y, L, K, Number of Establishments)
- Data on industrial disputes—Labour Bureau.
# Results (1): Estimated Effects of regulations on GSDP

## De Jure Reforms and Gross Domestic Product at the State Level: 1958-1997

<table>
<thead>
<tr>
<th></th>
<th>(1) Log GDP per capita</th>
<th>(2) Log Agricultural GDP per capita</th>
<th>(3) Log Non Agricultural GDP per capita</th>
<th>(4) Log GDP in Construction per capita</th>
<th>(5) Log Manufacturing GDP per capita</th>
<th>(6) Log Registered Manufacturing GDP per capita</th>
<th>(7) Log Non Registered Manufacturing GDP per capita</th>
</tr>
</thead>
<tbody>
<tr>
<td>sumA[t-1]</td>
<td>0.011</td>
<td>0.003</td>
<td>-0.013</td>
<td>-0.018</td>
<td>-0.079</td>
<td>-0.158</td>
<td>0.055</td>
</tr>
<tr>
<td>(0.27)</td>
<td>(0.09)</td>
<td>(0.31)</td>
<td>(0.25)</td>
<td>(1.15)</td>
<td>(1.87)</td>
<td>(0.60)</td>
<td></td>
</tr>
<tr>
<td>sumD[t-1]</td>
<td>-0.045</td>
<td>0.001</td>
<td>-0.073</td>
<td>-0.078</td>
<td>-0.1</td>
<td>-0.192</td>
<td>0.031</td>
</tr>
<tr>
<td>(1.92)*</td>
<td>(0.05)</td>
<td>(2.91)**</td>
<td>(1.15)</td>
<td>(2.19)**</td>
<td>(3.33)**</td>
<td>(0.80)</td>
<td></td>
</tr>
<tr>
<td>Number of Obs.</td>
<td>591</td>
<td>591</td>
<td>591</td>
<td>591</td>
<td>591</td>
<td>591</td>
<td>591</td>
</tr>
<tr>
<td>Adjusted R-squared</td>
<td>0.99</td>
<td>0.98</td>
<td>0.99</td>
<td>0.95</td>
<td>0.98</td>
<td>0.97</td>
<td>0.95</td>
</tr>
<tr>
<td>Ftest A=D (P.value)</td>
<td>0.35</td>
<td>0.96</td>
<td>0.3</td>
<td>0.59</td>
<td>0.84</td>
<td>0.75</td>
<td>0.85</td>
</tr>
</tbody>
</table>

In addition to the regressors shown in this table, all specifications include year and state fixed effects; sumA denotes the cumulative sum of all IDA amendments relative to Adjustment of Labor; sumD denotes the cumulative sum of all IDA amendments relative to resolution of Labor Disputes; Absolute t-statistics calculated using robust standard errors clustered at the state level reported in parentheses. + significant at 10%; * significant at 5%; ** significant at 1%

Larger effects of sumD
Results (Cont)

- Results robust to controlling for state policies (deficit/GDP, log of dev. Expenditures, log of pop)
- Results robust and stronger once we estimate results at the state-industry level within manufacturing.
Estimated Effects of regulations on **GSDP**  
(state-industry level results)  
Registered manufacturing sector

<table>
<thead>
<tr>
<th></th>
<th>Log Net Manufacturing Value Added per Capita</th>
<th>Log Net Manufacturing Value Added per Capita</th>
<th>Log Net Manufacturing Value Added per Capita</th>
<th>Log Net Manufacturing Value Added per Capita</th>
</tr>
</thead>
<tbody>
<tr>
<td>sum A[t-1]</td>
<td>-0.104</td>
<td></td>
<td></td>
<td>-0.079</td>
</tr>
<tr>
<td></td>
<td>(1.66)+</td>
<td></td>
<td></td>
<td>(1.30)</td>
</tr>
<tr>
<td>sum D[t-1]</td>
<td>-0.257</td>
<td>-0.145</td>
<td></td>
<td>-0.157</td>
</tr>
<tr>
<td></td>
<td>(4.83)**</td>
<td>(1.78)+</td>
<td></td>
<td>(1.92)+</td>
</tr>
<tr>
<td>sum c5b[t-1]</td>
<td></td>
<td>-0.182</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(1.81)+</td>
<td></td>
<td></td>
</tr>
<tr>
<td>sum c5b[t-1]*sum D[t-1]</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>sum A[t-1]*sum D[t-1]</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Observations</td>
<td>8214</td>
<td>8214</td>
<td>8214</td>
<td>8214</td>
</tr>
<tr>
<td>Adjusted R-squared</td>
<td>0.89</td>
<td>0.89</td>
<td>0.89</td>
<td>0.89</td>
</tr>
</tbody>
</table>

All specifications include, state and period dummies, and control for log(pop), deficit/GDP and log(dev. Expenditures/pop).

** denotes significant at 1%, * significant at 5% and + significant at 10 percent. Robust standard errors clustered at the industry-state level.
Effects on employment, wages & investment
(State-industry level analysis)
Registered manufacturing sector

Effects of Regulations on Workers

- Log of productive capital per Factory
- Log of Workers per Factory
- Log of Factories Registered per capita
- Log of productive capital per capita
- Log of share of income to workers
- Log of wage bill
- Log of earnings per worker
- Log of workers employed per capita
- Log of persons employed per capita

(*) not statistically significant. All specifications include year and state dummies, log(pop), log(dev. Exp/pop) and Deficit/GDP.
Effects of reforms by State (employment)

Effect of State Labor Reforms on Organized Manufacturing Employment by State

Source: Ahsan and Pagés (2006)
Other Results

- Effects of A are more important in Labor Intensive industries
- Effects of D are more important in Labor Intensive industries
- Contract labor does not attenuate the adverse effects of regulation.
In sum

- While all the attention is on chapter 5b (retrenchment regulations), we uncover strong effects of dispute mechanisms.

- Regulations that increase A, increase salaries for employed workers (and job security) but also lead to lower L, lower Y, lower wage bill, lower investment, and higher share of workers in the informal economy [Labor intensive industries]

- Regulations that increase D, reduce salaries, investment, GDP and employment and do not increase labor share [Capital intensive industries] Therefore, they don’t seem to be very helpful.

- Increase resource to contract labor does not ameliorate the adverse effects of legislation, particularly on L.
But...

- The solution is not to completely de-regulate the labor market.
- The solution is to improve regulations (& enforcement) so workers’ rights can be protected and good jobs can be created.
- There is a need to improve the dispute resolution mechanisms—More conciliation, more expedite courts
- Current mechanisms to protect workers against unemployment can also be improved.

The report lists a number of proposals on how to reach a better balance between job creation and better worker protection.
D. The Way Forward with Labor Regulation Reforms: Two Main Initiatives

For Creating Jobs

- Improving overall investment climate
  - Issues – Tax policy and administration,
  - Amending Labor Regulations that restrict labor and factor mobility, raise transactions costs and lowers formal manufacturing employment

For Helping Workers - More Effective Active Labor Market Programs

- Works Program – Rural Employment Guarantee
- Insurance for Informal Sector Workers
- Technical and Vocational Education Programs
- More Effective Employment Exchanges

Note: Data are for latest available year from the Sample Registration System (1997) for MMR; Census (2001) for literacy; and National Family Health Survey (1998-99) for all others.
Labor Regulations are Important for Welfare – An important message for clients.

Asymmetry in market power between employer and employee

- Information failures – lack of knowledge by workers about existing opportunities and lack of information about firms about workers – and credit market failures. Insurance market failures; around the world, information asymmetries prevent the emergence of private unemployment insurance markets.

- Spillovers from labor markets that affect other markets and society in general; for instance unemployment lowers incomes for all and not just of the unemployed; further unemployment can strain the social fabric, creating political instability adversely affecting social interests.
Amendments to Streamline Dispute Resolution

Allow only rights based disputes to go for adjudication.

Strengthen grievance Handling Mechanism at the enterprise level: Section 9-C which created a grievance redressal mechanism at the enterprise level is yet to be enforced.

- Provide Conciliator officers with the powers currently awarded to the Board of Conciliator: Conciliation should be made a compulsory step prior to adjudication in all industrial dispute cases.

- Reintroduce the Labor Appellate Tribunals: This will reduce the work of higher judiciary

- Address the shortage of well trained, high caliber presiding officers in labor courts and tribunals.

- Fix the limit of filing disputes to say one year after disputes (by amending Section 10 of the IDA).

- Make industrial disputes awards enforceable within 30 days after decision is communicated in writing to all parties as is the case with the Civil Court: presently IDA makes laws enforceable 30 days after publication.
Eliminate the requirement for firms to seek prior permission from Governments for lay-offs: arbitrary thresholds create strong disincentives for firms to grow above the threshold.

- Waive the condition of prior Government permission for retrenchment under Section 25 N if workers accept compensation higher than prescribed by the IDA.
- Remove the requirement for prior Government permission for layoffs (25 M) and have it replaced by 25 C
- Eliminate section 25G which requires that the employer should start by retrenching the last person hired.
- Eliminate notice of change of service (sections 9.A and 9.B IDA) under which employers cannot change the conditions of service without 21 days notice to a smaller period.
- Strengthen compensation for retrenchment and firm closure.
- Raise compensation that workers now received in case of closure (section 25FFF) to the same level that compensations awarded for retrenchment.
- Make Job search assistance and training available to workers affected by retrenchment.
Regulatory Reforms
Contrareform Contract Labor and Administration

- Removing Ambiguity in Contract Labor
  - Identifying contracting activities
  - Raising Threshold

- Improving Enforcement
  - Introducing “Self-certification” and Audit
  - Publicly announced inspections
  - Mass Media campaigns

- Improving the Inspections Raj/Regime

- Reforming the Inspection Raj Regime: Corruption and non-compliance walking hand in hand.
E. Helping Workers

- Strengthen active labor market policies
- Improve social insurance
- Improving skills among India’s workforce
- Strengthen Employment Exchanges
Thank You.