CONTENTS

INDEX

DVS International Journal of Multi-Disciplinary Research ISSN NO 2454-7522
ISSUE: 01 Vol : 1, No. 1 July – September 2015

Labour Laws Reforms in Manufacturing Sector : Issues & Challenges

Dr.Gajendra Kumar
PDF in the Department of Commerce,
D.N. College, Meerut

Dr. Shiv Kumar
PDF in the Department of Commerce,
D.N. College, Meerut

Dr. Megha Verma
PDF in the Department of Commerce,
D.N. College, Meerut

Abstract

With the gradual reforms of labour regulations, not only will the political opposition to these reforms erode, the political support for such reforms will grow as workers realize that they are the biggest beneficiaries of such reforms ...the implementation of labour laws falls within the jurisdiction of the states. Thus, there is considerable variation in labour market rigidity across states. The small size of labour-intensive firms prevents them from reaping economies of scale, thereby lowering India's comparative advantage in labour-intensive manufacturing.

Introduction

In labour-abundant India, labour-intensive manufacturing is concentrated mainly in small, "unorganized" or "unregistered" manufacturing firms which are rarely at the technological frontier, while most of the production activities within the "formal" manufacturing sector are capital-intensive (Panagariya, 2008 and Kochhar et al, 2006). Thus, despite its labour abundance and the large size of its population and economy, India has a small share of the world market in labour-intensive products. While some commentators have put the blame for this poor performance on India's rigid labour markets arising out of its restrictive labour regulations, others have argued that Indian

businesses have found ways to get around these laws. In this article, I examine the role, if any, of labour regulations in constraining India's manufacturing sector and the possible need for labour reforms, along with some policy recommendations.

Labour Laws in India

igidities in the Indian labour market mainly result from outdated labour regulations that are very restrictive in that, they make labour adjustment by firms in response to demand and technology shocks, very difficult. Among approximately 200 labour laws, including 52 Central Acts (Bhagwati and Panagariya, 2013), the most restrictive, though not the only restrictive, labour law is the Industrial Disputes Act (IDA). This Act requires firms employing more than 100 workers to seek permission from their respective state governments to retrench or lay off workers. This permission is seldom granted. In addition, the Industrial Employment (Standing Orders) Act makes job description modifications and inter-plant transfers within a firm (with more than 100 workers in some states and more than 50 in others) very difficult and virtually impossible. The Trade Union Act leads to the formation of multiple unions by allowing any seven workers within a firm to form a union. As one can imagine, the multiplicity of unions becomes a potentially difficult situation for employers to manage. The Trade Union Act also provides unions the right to strike and represent workers in legal disputes with employers. As this law requires a minimum of seven workers to form a union, it naturally does not apply to firms with less than seven workers. Thus, it encourages firms to remain very small, especially in labour-intensive industries.

There are a number of other labour regulations, such as the Employees' State Insurance Act, the Factories Act, the Employees' Provident Fund and Miscellaneous Provisions Act, Minimum Wages Act, Maternity Benefits Act etc that become applicable at various threshold employment levels and apply to a wide variety of establishments (Bhagwati and Panagariya, 2013). These regulations specify minimum work conditions and benefits.

Finally, there is the Contract Labour Act that regulates and restricts the use of contract labour, thereby limiting the substitutability between permanent and contract workers, and

restricting, at least on paper, an important channel through which, the firms can reduce costs. For certain tasks, the use of contract labour is prohibited.

Since the area of industrial relations belongs to the concurrent list of subjects of the Constitution of India, state governments have been able to make their own amendments to the IDA, even though it is a central (federal) act. Moreover, the implementation of labour laws falls within the jurisdiction of the states. Thus, there is considerable variation in labour market rigidity across states.

Recent Labour Reform Initiatives

Almost throughout the post-independence period, there have been amendments to labour laws by the states, to make those laws applicable within those states, either pro-employer or pro-employee relative to central regulations, depending on the ideological inclinations of those respective state governments. Unlike in the past, the recent changes to labour regulations are taking place in the context of attempts to attract Foreign Direct Investment (FDI), improve infrastructure and promote a more liberalized trade regime.

The State Government of Rajasthan's recent amendment raises the threshold for seeking permission from the state government for retrenching or laying off workers under the IDA from 100 to 300 workers. It also increases the threshold employment for registration of a firm under the Factories Act, which, as mentioned above, is a regulation that puts a number of stipulations on work hours, work days, minimum age requirement etc. In addition, Rajasthan is raising the minimum membership for the registration of a representative union from 15 per cent of the firm's employment to 30 per cent. Such a change can reduce productive managerial and labour time lost in building consensus and resolving conflict among multiple unions. In addition, the state government's amendment to the Apprenticeship Act will stimulate skill development, i.e., what economists call "human capital formation."

At the Centre, there has been a very little movement in the direction of labour reforms, with the burden of bringing about such reforms largely being put on the states. Among the very few important things done by the Centre in this regard is the recent setting up of a unified web portal where firms can themselves file their -compliance reports pertaining to 16 central labour acts. Such a web portal is expected to have a built-in algorithm that

will determine which firms need to be visited by inspectors. This is, therefore, a movement away from the Inspector Raj in that, by reducing the discretion of inspectors in this regard, harassment and rent seeking are expected to be considerably reduced. Moreover, the recent central reforms aimed to increase the portability of provident funds will encourage labour mobility as provident fund portability enables employees to transfer funds in their provident fund accounts when they change jobs. Furthermore, the modifications to the Apprenticeship Act by the current government will encourage skill formation. In addition, as mentioned in Finance Minister's recent budget speech, there is a now a new "Ministry for Skill Development" which will soon announce a number of important measures to further boost skill acquisition.

It is important to note that restrictions on firing of workers also acts as virtual exit barriers. In addition, firms in India have always faced serious direct exit barriers, stemming from the lack of modern bankruptcy laws. These exit barriers, in turn, make new firms, foreign and domestic, reluctant to enter the Indian market. This problem will hopefully be made less severe by the "Bankruptcy Law Reform" through the design of a modern bankruptcy code that, according to the Finance Minister's budget speech, will bring about "legal certainty and speed," and is a top priority for him for the upcoming fiscal year.

Impact of Labour Laws Performance on Indian Economy

As mentioned above, different states have brought about different kinds of amendments to centrally enacted labour laws. In addition, the degree of enforcement varies across states. This creates some variation in labour market rigidity across states that can be exploited by researchers to study how economic performance of the manufacturing sector, as seen at the firm/plant level or at the industry or even aggregate level varies across states that differ in their labour market flexibility. Besley and Burgess (2004) was the first study of this kind. Using state-level data on aggregate registered manufacturing output, investment, employment and productivity, they found that all these variables declined with pro-employee (restrictive or rigid) labour regulations. The corresponding aggregates for informal (unregistered) manufacturing showed the opposite relationship with such labour regulations, snowing that the informal sector picks up the growth that is suppressed by labour market rigidities in the formal sector. Subsequent studies extend this work further by using more disaggregate data.

Hasan, Gupta and Kumar (2009) is a study at the level of industry by state. They find that states with relatively restrictive labour regulations have experienced slower growth of labour-intensive industries and their overall employment than have other states. An even more disaggregate study is by Hasan and Jandoc (2013), where they pool data on formal and informal manufacturing firms. They find virtually no difference in the firm employment distribution between restrictive labour states and others. However, when they restrict focus to only labour-intensive sectors, the employment share of firms with 0-9 employees is much higher in the restrictive labour regulation (pro-worker) states than other (pro-employer) states (about 60 versus 40 per cent). The ranking is reversed for firms falling in the category of 200-plus employees (roughly 10 versus 25 per cent). They find nothing as striking when they perform a similar comparison between high- and low-. infrastructure states. One interesting finding of their study is that while employment in the Indian apparel industry is concentrated in small firms (employing less than 9 workers each), in the Chinese apparel industry, it is concentrated in very large firms (each employing more than 2000 workers).

A recent paper by Dougherty, Frisancho Robles and Krishna (2014), using plant-level data along with the OECD employment protection measure (considered by them to be the most comprehensive with respect to coverage of both formal and informal sectors and the various acts and their implementation and monitoring) shows that total factor productivity in firms in labour-intensive industries as well as in industries facing highly volatile demand (requiring frequent input adjustments) was on average about 1 1 - 1 4 per cent higher in the states with less restrictive labour laws compared to others.

Labour Laws and Globalization

Given the above evidence on the negative effects of restrictive labour regulations, it is not surprising that labour-intensive enterprises in India are not growing rapidly despite major reforms in India’s trade and foreign direct investment regimes, ending of small scale reservation in labour intensive industries, delicensing and the expiration of the Multi-Fiber Arrangement (See Bhagwati and Panagariya, 2013). Moreover, unskilled labour

intensive sectors such as food and beverages, apparel, textiles, furniture etc have had a constant or even a slightly declining share in GDP over the last two decades, while skill-intensive and capital-intensive industries such as automobiles, petroleum, refining, engineering goods, telecommunication, Pharmaceuticals, finance, software etc., have grown much faster and have increased their shares in India's exports from 41 percent in 1990-91 to 65 per cent in 2007-08 (Das, Wadhwa and Kalita, 2009). On the contrary, given India's abundance in labour, trade liberalization (which normally leads to specialization in activities intensive in the use of the abundant inputs or factors of production) should have led to the expansion of labour-intensive manufacturing relative to the rest of the economy. In fact, India has been losing world market share in apparel slowly to Bangladesh and quite rapidly to China. As mentioned above, while employment in the Chinese apparel industry is concentrated in very large firms (each employing more than 2000 workers), in the Indian apparel industry, it is concentrated in small firms (employing less than 9 workers each), thereby leading to the sacrifice of significant economies of scale. Unsurprisingly, India's performance in the apparel sector is considerably worse than that of Bangladesh, a much poorer country with a higher poverty rate, worse infrastructure and higher corruption levels. This comparison is highly suggestive of the negative role played by India's rigid labour regulations.

How do rigid labour regulations affect India's comparative advantage and the performance of labour-intensive firms in India relative to those in other parts of the world? Apart from directly raising labour costs, rigid labour regulations constrain the size of firms, as explained above (see Panagariya, 2001). The small size of labour-intensive firms prevents them from reaping economies of scale, thereby lowering India's comparative advantage in labour-intensive manufacturing.

Contrary to the inferences recently made by some commentators', the absence of bunching of firms at the employment thresholds associated with these laws does not mean that constraints imposed by these regulations are not binding. In labour-intensive firms, the selection of technology or product type requiring large-scale production might be discouraged by such regulations. The smaller-scale production techniques or product types that firms are pushed to choose by these regulations might have an optimal employment size that is much smaller than, for instance, the IDA threshold. Additionally,

there is imperfect enforcement of these regulations. This means that small violations of the legal thresholds might either go unnoticed or disregarded by the inspectors.

Restrictive labour regulations prevent firms from making the required adjustments to their inputs in response to shocks to demand and technology. In the presence of trade, this can handicap domestic firms relative to firms in countries where labour market rigidity is not a problem. The realization of the beneficial effects of trade requires both substantial amounts of labour reallocation across industries as well as across firms within an industry. Both types of reallocation, inter- as well as intra-industry, are constrained by restrictive labour regulations. These laws also discourage firms from employing a large number of permanent workers and steer them towards employing more casual or contract workers, who have limited incentive to learn on the job and acquire firm-specific skills. In addition, these regulations will also steer firms towards substituting capital for labour, i.e., they will end up using more capital-intensive techniques of production and produce relatively more capital-intensive varieties of products within each industry. Thus, these labour laws will be working against India's factor abundance based comparative advantage, which is in labour-intensive manufacturing, and will constrain its gains from trade.

We next turn to the empirical evidence regarding the interaction between international trade and labour laws and the impact of this interaction in determining firm performance. Mitra and Ural (2008) find a productivity increasing effect of trade reforms across various two-digit industries across the 15 largest states for the period 1988-2000, with this impact being 33 per cent greater than the rest in the relatively flexible labour market states. Qualitatively, similar effects are also found in the case of employment, output, value added, capital stock and investment. It is, therefore, not surprising that Sundaram, Ahsan and Mitra (2013) find that trade liberalization boosts employment, output and value added more in the, rigid labour market states (as compared to the flexible labour market states) for informal enterprises with more than five workers. This indicates that the trade-induced growth of formal manufacturing that is constrained by restrictive labour regulations is picked up to a certain extent by the informal manufacturing sector.

As explained above, the relationship between trade and labour regulations can be further understood by looking at the impact of the latter on factor intensities, since it is factor intensities in combination with factor abundance that determines comparative advantage and specialization under trade and, in turn, the gains from trade. Looking across industries and countries over time, Hasan, Mitra and Sundaram (2013a) find that labour market imperfections, arising from restrictive labour regulations, in particular, the combination of hiring and firing regulations, minimum wage regulation and unemployment benefits, are associated with an increase in capital intensity in the various industries of the manufacturing sector, in particular, the unskilled labour intensive industries and industries whose demand and technology are volatile enough to demand frequent labour adjustments. Therefore, not surprisingly, Hasan, Mitra and Sundaram (2013b) find that India uses more capital-intensive techniques of production than predicted, by its level of development than thos used by China in many industries including paper and printing, leather, rubber and plastics, chemicals, non-metallic minerals, base metals, metal products, electrical equipment and instruments, petroleum etc.

Another important labour-market variable which we find that is affected by the interaction of trade and labour market rigidity is the unemployment rate. Hasan, Mitra, Ranjan and Ahsan (2012) find evidence for an unemployment reducing effect of trade liberalization in states with flexible labour markets, with roughly 37 per cent of the actual unemployment decline being possibly attributed to trade liberalization. These results on unemployment are consistent with the results of the study of Hasan, Mitra and Ramaswamy (2007) using two-digit industry level data by state for the period 1988-1997 which finds that trade reforms led to a statistically significant increase in the responsiveness of employment reductions to wage increases, with this responsiveness and the increase in it (due to trade liberalization) relatively greater in states with flexible labour markets (those with less restrictive labour laws). As Rodrik (1997) has argued, this responsiveness inversely reflects the bargaining power of workers which diminishes due to trade liberalization. One channel is quite direct and arises due to cheaper and a larger variety of inputs that can compete with the services of domestic labour after trade liberalization. The other channel is more subtle and arises from the fact that domestically

produced goods face more competition from goods produced abroad after trade liberalization. This means that any wage increase, that leads to a cost increase arid in turn, a price increase, now leads to a much bigger reduction in quantity of output demanded and, therefore, in employment. This might diminish negotiated wages, which most models of unemployment would predict to lead to a decline in unemployment. This channel is expected to work to its full potential in the presence of a relatively flexible labour market.

Policy Recommendations and Implications

There is clearly an overwhelming evidence to support the view that India's outdated and restrictive labour regulations are a serious impediment to growth of its manufacturing sector, especially the relatively labour-intensive industries within that sector. These regulations constrain the firms by curtailing their size and depriving them of significant potential economies of scale. They also force them to adopt relatively capital-intensive techniques of production and to choose the production of capital-intensive varieties of products within each industry, thereby making them go counter to India's factor-abundance based comparative advantage. Furthermore, these laws encourage the use of temporary workers who have no incentive to learn on the job and in whom, the firms have no incentive to invest. Thus, Indian manufacturing firms, especially in labour-intensive industries such as textiles and apparel, are seriously disadvantaged relative to their counterparts in China, Bangladesh, Vietnam etc where labour markets are much more flexible.

As is obvious, the only way to provide good jobs to India's vast working population is by expanding labour-intensive manufacturing. While the services sector in India recently has been expanding rapidly, it cannot be its main engine of growth beyond a point since it will run into the constraint imposed by the limited availability of educated workers. The transformation of the work force needed for sustained services-led growth to take place will take decades. Thus, labour regulations have the need to be reformed.

What kind of labour reforms are needed? While raising the IDA threshold employment from 100 to 300, as has been done in Rajasthan, might be useful, it should be further raised in steps to much higher levels, with the threshold ultimately completely done away

with. And reforms need to go beyond Chapter VB of the IDA, which most commentators usually focus on. As regards the amendment of the Chapter VB of the IDA itself, Bhagwati and Panagariya (2013) suggest excluding, from the definition of retrenchment, the downsizing of employment in response to a shrinking demand or a change in technology and the non-confirmation of a worker on probation. Furthermore, they argue that the Industrial Employment (Standing Orders) Act should be modified to allow greater flexibility in moving a worker across tasks for which he/she is qualified.

I would recommend that multiple unions within a firm be disallowed as they can lead to messy situations resulting in huge productivity losses. As mentioned above, the newly initiated self-reporting of compliance with regulations on web portals is expected to end the Inspector Raj. The number of regulations covered under this scheme needs to be expanded.

While the economic costs of India's restrictive labour regulations are widely recognized, their reforms are viewed by most as politically not viable. Labour unions are viewed as politically very organized and pivotal in the political process. However, recent empirical evidence suggests that this political constraint need not be taken as given. For example, there is evidence now that greater trade openness has led to a decline in the bargaining power of formal sector workers in India, as well as to their deunionization in the form of declining union membership and union presence (see Ahsan and Mitra, 2014 and Ahsan, Ghosh and Mitra, 2015). Thus, with the gradual reforms of labour regulations, not only will the political opposition to these reforms erode, the political support for such reforms will grow as workers realize that they are the biggest beneficiaries of such reforms.

References

- Ahsan, Reshad N. and Devashish Mitra, 2014. "Trade Liberalization and Labour's Slice of the Pie: Evidence from Indian Firms," Journal of Development Economics 108, 1-16.
- Ahsan, Reshad N., Arghya Ghosh and Devashish Mitra, 2015. "International Trade and Unionization: Theory and Evidence," mimeo, Department of Economics, Syracuse University.
- Amirapu, Amrit and Michael Gechter, 2014. "Indian Labour Regulations and the Cost of Corruption: Evidence from the Firm Size Distribution," mimeo, Department of Economics, Boston University. Available at https://drive.google.com/viewerng/viewer?a=v&pid=sites & srcid=ZGVmYXV sdGRvbWFpbnxhbXJpdGFtaXJhcHV8Z3g6 NjE3YWRmMjJlOWNhMjglNw
- Bardhan, Pranab, 2014. "The Labour Reform Myth," Ideas for India, September 14.
- Besley, Timothy and Robin Burgess, 2004. "Can Labour Regulation Hinder Economic Performance? Evidence from India," Quarterly Journal of Economics 119(1), 91-134.