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Article on

How Should India Reform Its Labour Laws?

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Abstract

We examine the current policy debate around the reform of labour laws in India, which has been stimulated in part by the success of the Gujarat model of economic development. Gujarat's deregulatory reforms have included changes to the legal regime governing employment terminations, which could form a basis for a change in national-level labour laws. Evidence linking labour law deregulation to growth, however, is weak, whether the focus is on India or the experience of other countries. Building labour market institutions is a long-term process which requires investment in state capacity for the management of risks associated with the transition to a formal economy.

Keywords: labour law, institutions, India, law reform, Gujarat model

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1. Introduction

Labour law reform is currently on the political agenda in India, particularly in the wake of the election of the new Modi-led government at the center. India's labour laws are decades old and are said to suffer from rigidities which are holding back economic development. Worker-protective labour laws, it is argued, are deterring investment and stalling the growth of formal employment. India's labour laws are set at an inappropriately high level for a developing economy, which would otherwise be in a position to use low-cost labour as a source of comparative advantage. The strict regulation of employment terminations ('retrenchments') in Part V-B of the Industrial Disputes Act 1947 (as amended) has been a particular focus of criticism. Critics of this law argue that as it targets larger plants and enterprises for regulation, it discourages the growth of firms, and contributes to labour informality.

Viewed in a comparative perspective, India's recent focus on labour law reform is not unique: other middle-income countries have been having similar debates about the form and content of labour regulation. While these debates sometimes lead to deregulation, there is no worldwide trend towards the weakening of worker-protective labour laws (Adams and Deakin, 2015). Although the discourse of the World Bank and other international financial institutions remains focused on the need for flexibility in labour markets, there is an emerging view at country level that labour flexibility is not a sufficient condition for economic development, and perhaps not even a necessary one. Instead, the focus is increasingly on how to build institutions for managing labour market risks in the transition to a formal economy (Marshall and Fenwick, 2015).

In this paper we seek to locate the debate over the future of labour law in India in the context of global trends, as seen through the lens of recent theoretical and empirical contributions to the study of labour regulation, and in relation to India's own experiments in regulatory reform, in particular the Gujarat model. Section 2 below outlines the movement of labour market theory away from equilibrium-based models, with their emphasis on labour law as a distortion of competition, towards an evolutionary understanding of labour market institutions, which takes a more nuanced view of their efficiency effects. Section 3 reviews recent empirical evidence on the operation of labour law systems, including India's. Section 4 looks at the Gujarat model and its combination of labour law deregulation, financial

incentives for business and infrastructural investment. Section 5 concludes.

2. Developments in the theory of labour regulation

Beginning in the 1980s and gathering strength during the years of the Washington consensus, the economic critique of labour law was part of a wider case against regulation, which saw state interference as the source of distortions and inefficiencies in the operation of markets. This argument depended critically on the validity of its main premise, which is that markets, if unregulated, will move naturally or spontaneously to an equilibrium state. Neoclassical economics, which is the foundation of this view, has been highly effective in describing, and mathematically modelling, a state of the world in which, through perfect competition, supply and demand are equalized, and the aggregate wealth (or, in some versions, well being) of market actors is thereby maximized. In such a world, any outside interference with free exchange will, by definition, have negative effects on economic welfare. This follows axiomatically from the assumptions of individual rationality (consistent preferences coupled with maximization) and market equilibrium which underlie neoclassical models (Becker, 1976).

It is one thing to model pure competition as a possible state of the world, and another to assume that it is the norm. Since the mathematical formalization of the competitive market economy reached its apogee in the middle decades of the twentieth century (Arrow and Hahn, 1971), economic theory has directed its attention towards understanding how market exchange comes to be established in the first place, a very different question. This research agenda has gradually coalesced around the idea that perfect competition is a highly unusual state of affairs that it is not often, if indeed ever, replicated in real-life market economies (Coase, 1988). Meanwhile, the processes by which markets are instituted and sustained are still poorly understood, with historical research pointing to a range of causally relevant institutions (North, 2005).

The reorientation of the social sciences away from the study of markets in equilibrium towards analysis of the dynamics of institutions and institutional change has significant implications for labour markets in general and for the experience of developing countries in particular. A long tradition in economics, dating at least from Adam Smith (1776), recognises

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that power is unevenly distributed within the employment relationship. Modern institutional economics generally avoids using the term 'power' but recognizes that labour markets are far from perfect. Labour market outcomes are skewed by transaction costs arising from uncertainty and incompleteness of contracting (Williamson, Wachter and Harris, 1975) and by externalities arising from asymmetric information (Shapiro and Stiglitz, 1984). Characteristic features of labour market regulations in industrial market economies can be understood as evolved responses to the coordination problems associated with the distinctive form of the employment contract (Deakin and Sarkar, 2008): these include social insurance (Esping-Andersen, 1996), employment protection (Acharya, Baghai-Wadji and Subramanian, 2014) and worker representation (Rogers and Streeck, 1995). The right to strike, in addition to being framed as a human right deriving from the principle of freedom of association, can also be analysed as an counterweight to the managerial prerogative which law and custom together vest in the employer, with results that may in principle be conducive to the efficient operation of the market (Moore, 2014).

This point of view does not imply that labour market regulation is always and everywhere efficient. In the context of industrial economies with established institutions, there is a debate to be had over the appropriate form of regulation and over the degree of worker protection which is compatible with the use of the market as a mechanism of resource allocation. There may be trade-offs between equity and efficiency under certain circumstances, and complementarities between a fairer distribution and sustainable economic growth in others (Deakin and Wilkinson, 2005). In the final analysis these are empirical questions which cannot be addressed through theoretical reasoning alone, but a theory grounded in the experience of real-life economies is to be preferred to one based on axiomatic reasoning.

In developing economies, the debate takes a distinct form. Where the institutions which might underpin a formal labour market are still in the process of emerging, the issue for policy makers is, or should be, whether labour laws are likely to advance that process, or to hinder it (Marshall, 2015). On the one hand, there is a case against transplanting into a developing country context laws which were designed for mature industrial systems. In particular, laws which presuppose the existence of a formal economy in which wage dependence is the norm may have little relevance for economies in which the majority of the

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population relies on access to the land or the family for subsistence.

On the other hand, the transition to a wage-based economy with formal labour market relations does not occur in an institutional vacuum. Loss of access to traditional means of subsistence is compensated for by new forms of mutualization and protection for the working population. In the global north, the transition to an industrial economy occurred conterminously with the evolution of institutions for managing and diffusing labour market risks, including laws on wage regulation, poor relief and apprenticeship, which anticipated later features of modern welfare states in Europe and North America (Deakin and Wilkinson, 2005). Thus, the claim that developing countries have no need of laws to underpin emerging labour market institutions, whatever other arguments might be made in its favor, is not supported by the historical record of the countries which were first to industrialise. On the contrary, it was largely through the legal framework that labour capacity, which is not a 'natural commodity' (Marx, 1847; Polanyi 1944), acquired the form needed to sustain the complex economic relations and deep division of labour of a market economy (Deakin and Supiot, 2009).

Middle income countries today are very far from being pure subsistence economies. The characteristic pattern is for a formal economy consisting of a minority (of varying size) of the working population to coexist with a larger informal sector. In the informal sector, workers and households tend to rely for subsistence on a combination of waged work and access to the land and family incomes. Employment in the informal sector is irregular and discontinuous, as well as being insecure in the wider sense of providing limited access, at best, to collective mechanisms for sharing and diffusing labour market risks. In economies with this type of mix, it is far from clear that labour laws are irrelevant to the operation of the economy. Even when reliance on wage labour is partial or incomplete, laws which regularise the hiring process, protect the right to wages and permit workers to self-organise for the purpose of collective bargaining can address needs of workers in the informal sector for greater income security. Similarly, bringing informal enterprises into the coverage of social insurance systems can help mitigate the economic risks to which informal sector workers are exposed.

Much has been made of the argument that poverty in developing countries is the result of the failure of the legal system to recognise the interests of the poor in land and other

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tangible assets which could, with appropriate legal title, be used as collateral (De Soto, 2000). The limited success of land titling programmes to date suggests that the simple equation of legal rights with developmental capacity is misplaced (Haldar and Stiglitz, 2013).

While there may be many reasons in practice for the failure of land titling to realise hoped-for economic benefits, the insight that the legal system plays a significant role in supporting economic exchange in middle income countries is not necessarily mistaken (Chen and Deakin, 2015). But it is striking that the proponents of legal formality in credit and capital markets should have had little to say about the role the legal system could play in promoting access to labour markets in middle income countries. There is an inconsistency in regarding credit as an institutional commodity when labour power is seen as a natural one, requiring nothing more than the free play of market forces. This omission is the more surprising since extending wage protection and social insurance systems has the potential to benefit a far higher proportion of the working age population in these countries than can be reached through land titling schemes.

3. Empirical evidence on the economic effects of labour laws

Just as theory has moved on since the high point of the Washington consensus, the same trend can be observed in the empirical literature on labour regulation. In the late 1990s and early 2000s a small but influential literature appeared to have settled the debate in favour of the supporters of deregulation and labour market flexibility. Fallon and Lucas (1999), using a cross-national panel data analysis, found evidence of a negative relationship between worker-protective labour law and labour demand in a number of countries, including India. This finding was repeated in the larger panel dataset of labour laws across the world constructed by Botero et al. (2004). Of most significance for India was the study carried out by Besley and Burgess (2004), which found evidence of a negative impact on employment and investment of the adoption of worker-protective laws at sub-national (state) level. This study has been used to support claims that labour laws are one of the factors contributing to the relatively small size of the formal economy in India, which in 2014 accounts for less than 10 per cent of the total labour force.

Much has been written on the Besley-Burgess study. On one view, the methodology

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used to measure differences in state-level labour laws is insufficiently robust to justify clear conclusions being drawn from their analysis (Bhattarcharjea, 2006, 2009; Jha and Golder, 2008). On another, once the Besley-Burgess index is corrected for coding errors, negative impact of labour laws is found (Ahsan and Pagés, 2009). Even so, the results of the original study do not survive once account is taken of limited effectiveness, including court delays and difficulties of accessing the judicial system, in the enforcement of labour laws in India (Fagernäs, 2010). The econometric method used to test for correlations between the scores in the index and outcome variables measuring employment and investment has also been called into question (D'Souza, 2010). There is evidence that, in so far as there is a correlation between worker-protective labour laws and economic indicators, changes in the law are endogenous to those in the wider economy. Thus, for the most part, Indian labour law has largely been responsive to wider factors in the economy, rather than a determining cause of them (Dutta Roy, 2004; Deakin and Sarkar, 2011).

An obstacle to achieving a better understanding of the role of labour law in economic development has been the lack of a data that can track changes in the legal framework over time in both developed and developing countries. The most widely used index for employment protection law is the OECD's Employment Protection Index ('EPI') (OECD, various years). However, it does not cover many developing countries, and while its ambit has recently been extended to include some systems outside the OECD, it does not provide a continuous time series for these countries. India and China, for example, are coded from 2008 only, and Brazil from 2010. The World Bank's Employing Workers ('EWI') Index provides longitudinal data on dismissal regulation (among other things) going back to the 2000s (World Bank, various years), but has been subject to criticism for its methodology (Manuel Report, 2013), in particular its focus on the regulations governing a standard employment relationship of full-time, permanent work which is not typical, in practice, for emerging markets. In both the EPI and EWI, data are based on mixture of survey evidence and analysis of legal materials, making it hard to discern the source of the codings.

The Centre for Business Research Labour Regulation Index (CBR-LRI) is a dataset constructed by researchers at Cambridge University (including one of the present authors) which provides a continuous time series on country- level changes in labour law going back to the early 1970s (or late 1980s/early 1990s in the case of former socialist systems) (for

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explanations of the methodology used in the construction of the dataset, see Deakin, Lele and Siems, 2007; Adams and Deakin, 2015). The data in the CBR-LRI are based on content analysis of legal texts and other primary sources of labour law rules, using a coding algorithm designed to capture gradations of labour the same

protection (so that on a 0-1 scale, a higher score indicates a greater degree of protection for the worker). As such, the dataset can only capture cross- national variations in the formal (de jure) law, but it can be combined with other indices, including the World Bank's Rule of Law Index (World Bank, 2015), to give a more complete picture of the operation of the law (see Deakin and Sarkar, 2008; Deakin, Malmberg and Sarkar, 2014; Deakin, Sarkar and Fenwick, 2014).

4. Conclusion

The Gujarat model emphasizes the streamlining of governance structures as the pathway to development, with the deregulation of labour laws a key element of this process. The state appears to have reaped significant benefits from this approach in terms of attracting investment and augmenting growth. It is consequently a noteworthy model, and its successes are worth studying. However, implicit in the model are a range of normative and policy choices that need to be examined carefully before adopting it as a template for the entire country.

In particular, it is not clear that a policy of deregulation and subsidization of business through fiscal exemptions is sustainable over the longer term. This strategy may produce some quick wins for state governments keen to attract inward investment, but it will not lead to sustainable growth unless it is coupled with investment in institutional capacity. For the labour market, this means supporting the institutions through which human capital is created and sustained, in particular education and training systems and social insurance. Without such changes, it is unlikely that access to the formal employment will become a reality for more than a small minority of Indian workers, as it is at present. There may be a case for modulating the strict controls over employment terminations set out in Part V-B of the Industrial Disputes Act. However, removing all regulation of the termination decision and leaving workers with a limited financial claim following dismissal is unlikely to encourage investment in firm-specific skills. Such an extensive deregulation of dismissal protection

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would do little to help firms remain competitive over the long run. For India to embed the Gujarat approach to labour law at national level at a time when other middle-income countries, including China, are strengthening employment protection rights, would raise many questions over the direction of policy.

The Gujarat model also poses some difficult questions over potential trade offs between equity and efficiency. Weakening workers' rights is generally regressive in distributional terms, and economic growth without social cohesion comes at a wider cost. For India's policy makers, labour law reform poses the question of whether growth is to be seen as an end in itself or a means to other ends.

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