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India's Segmented Labour Markets, Inter-State Differences, and the Scope for Labour Reforms

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The Indian labour market is segmented. It has a labour aristocracy of unionised workers who are highly paid and highly protected, along with an overwhelming mass of unorganised workers, many of whom are unable in practice to exercise even legal rights. The high protection given to organised workers creates labour rigidities that discourage employment and encourage capital-intensive modes of production. It discourages Chinese-scale investment in labour-intensive industries (like garments and footwear) where high labour flexibility may be required because of fluctuating demand from overseas markets in different seasons. This is one reason why barely one-tenth of all workers are in the formal or organised sector: companies are reluctant to add to their formal labour rolls. Thus the protected status of the labour aristocracy comes at the expense of the the nine-tenths of workers in the unorganised sector, who are unable to get formal sector jobs.

Many analyses of labour laws focus just on labour rigidities and flexibility in hiring and retrenchment. But we need to consider several other issues too relating to labour. One such issue is the existence of a host of obsolete rules and regulations (such as the need to maintain manual labour rolls: modern computerised records are not allowed in some states!). Another major problem is the "inspector raj"—the problem all enterprises face (but small ones most of all) in dealing with an army of corrupt inspectors. Yet others relate to limiting hours of operation for shops, or limiting hours for female employment.

In contrast with developed economies, and also in contrast with several developing economies, a large chunk of Indian employment occurs

in the rural sector. Outside agriculture, informality can be defined in one of three different ways. First, there is a definition in terms of exemptions from paying indirect taxes. Second, there is a definition in terms of small-scale industry (SSI), which again is defined in terms of threshold levels of investment in plant and machinery. Third, there is a definition in terms of labour laws. That is, an enterprise is unorganised if it uses power and employs fewer than 10 people or does not use power and employs fewer than 20 people.[1] The last definition is the one that is used most often.

Some labour laws come under the jurisdiction of the central government, some in that of state governments and others in the Concurrent List (joint jurisdiction). Most labour laws are in the Concurrent List. At the state level, there can be two kinds of labour laws. First, where a basic Central statute already exists, there can be State-level amendments. Second, there can be *de novo* State laws in areas with no Central statutes. The Kerala Labour Laws (Simplification of Returns and Registers of Small Establishments) Act of 2002 is an instance. However, government labour regulations go well beyond the statutes. The statutes provide an enabling framework, within which administrative law is framed, consisting of rules, orders and regulations. The Factories Act, 1948, is statutory. But rules under the Factories Act, 1948, are executive in nature and are part of administrative law. The implication is clear: even with a given central government statute, labour regulations can vary widely across states.

State intervention is often equated with implementation of laws on industrial relations, but this is an oversimplification. Many State interventions, often obtuse and comic, are common in areas that have no direct bearing on industrial relations too, such as the number of urinals and spittoons! The Factories Act says that "the State Government may prescribe the number of latrines and urinals to be provided in any factory" and "may make rules prescribing the number of spittoons to be provided and their location in any factory." The State government may also make rules "requiring the provision therein of suitable places for keeping clothing not worn during working hours and for the drying of wet clothing."

Such intervention can become even more obtuse and unwarranted when it comes to rules issued under various Acts. They often prescribe practices that were common a century ago and ignore new realities brought by electricity or computers. For instance, some rules say that factories must be whitewashed (painted with white lime). Apparently plastic paint won't do. The Rules say earthen pots filled with water are required. Apparently mechanised water coolers won't suffice. Red-painted buckets filled with

sand are required by the Rules. Fire extinguishers won't do. There must be crèches (day-care centres for liitle children) within the factory. Making transport arrangements for accessing crèches outside the factory won't be enough.

In many states, the Shops and Establishments Acts prescribe which day of the week must be observed as a weekly holiday. They impose restrictions on employing women outside what are perceived to be regular working-hours, a clause that adversely affects the efficient functioning of call-centres and discriminates against female employees. This is not the place to provide a comprehensive list but several instances can be cited to illustrate dysfunctional and unnecessary State intervention. Several inspectors can descend on a factory under assorted labour laws and a system of having a single inspector for all labour laws does not exist.

Nor is there any standardisation of documentation requirements or time periods for which records have to be kept. The laws and rules prescribe that manual records have to be maintained: electronic records are not acceptable. And so on. Such procedural problems characterise all three stages of an enterprise's operations—entry, functioning and exit. These impose high transaction costs that render Indian business uncompetitive. Part of the problem with administrative decisions is that they bestow a large degree of discretion on petty functionaries. These encourage corruption and rent-seeking. This is especially damaging for the small self-employed entrepreneur, who lacks scale economies to deal with a plethora of rules and inspectors.

It is difficult to quantify the extent of the "inspector raj", apart from occasional surveys undertaken by industry chambers. Not only are these perception-based, they tend to have very small samples. That apart, the extent of the inspector *raj* clearly varies from State to State. When business complains about the inspector *raj*, this is not necessarily in relation to labour laws. Several inspections are connected to taxation, or environment, or safety. The ICS (Investment Climate Survey) data do not suggest that inspections related to labour laws are particularly onerous. An average enterprise had 0.40 Central government inspections under the labour and social security category, and 1.76 state government inspections.[2] However, there was much variation across the States, ranging from 0.32 inspections in Delhi to 4.65 in Punjab. What matters is not just the number of inspections but the opportunity this gives inspectors to engage in corruption and rent-seeking. Thanks to their discretionary powers, they can threaten various kinds of harassment that could be fatal for the financial health of enterprises.

Some laws, statutory and administrative, and reform initiatives, are within the province of the Centre. But there is much variation across States. Some State governments (Andhra Pradesh, Gujarat, Karnataka, Madhya Pradesh, Maharashtra) wish to make labour laws flexible, in order to encourage investment and reduce differentials in the treatment or organised and unorganised labour. Flexibility has been sought particularly in special economic zones (SEZs) and other special enclaves. Some States have suggested there could be greater flexibility in hours of work, allowing women to work at night or in minimum wages. But these sorts of flexibility would require Central legislation, which is not on the anvil, and looks politically impossible right now. Since 1989, all governments in New Delhi have been coalitions, and these coalitions have typically lacked a majority in the Upper House of Parliament. This has made the passage of any legislation problematic. India is a unique country in that virtually all major political parties have a trade union wing. This means political parties are reluctant to legislate on labour flexibility, since this would antagonise their own trade union wings.

States such as Uttar Pradesh, Andhra Pradesh, Punjab, Gujarat, Karnataka, Orissa and Rajasthan have consciously tried to reduce the number of inspectors, and Gujarat, Punjab, Rajasthan and Maharashtra have introduced self-certification. In Uttar Pradesh, labour inspectors can carry out inspections only after consent has been obtained from someone of the rank of a Labour Commissioner or District Magistrate and advance information about the inspection has been provided. Rajasthan and Andhra Pradesh have exempted certain kinds of enterprises from the ambit of labour inspections. For instance, Andhra Pradesh has introduced self-certification for information technology (IT) services, IT-enabled services, bio-technology, export oriented units (EOUs), units in export processing zones (EPZs) and tourism-based enterprises. Rajasthan has done the same for IT, IT-enabled services and biotechnology. This is a second-best solution, since the inspector *raj* still flourishes for enterprises outside the enclaves. Uttar Pradesh's reforms focus on enclaves such as SEZs but its other aspects are more broad-based. Although there are wide State-level variations, the number of labour inspections has declined in some States after the liberalising reforms of 1991. Because it is politically difficult to tackle the inspector *raj* head on, politicians have attempted it only in selected enclaves.

We now turn to industrial relations. The three relevant statutes are the Contract Labour (Regulation and Abolition) Act, the Trade Unions Act and the Industrial Disputes Act (IDA). The third one is the most discussed. The Contract Labour (Regulation and Abolition) Act was never meant

to prohibit contract labour. It provided central and state governments discretion in prohibiting contract labour in selected areas. States like Andhra Pradesh have introduced amendments relating to contract labour, separating core activities from non-core. But as regards the Trade Unions Act or the IDA, there is little States can do on their own.

Two academic studies have sought to directly compute the impact of IDA. The first, by Peter Fallon and Robert Lucas,[3] was published in 1991, and is dated. The second, by Timothy Besley and Roger Burgess in 2004,[4] is not only more recent but seeks to capture the impact of the IDA across States. It investigates whether the industrial relations climate in Indian states affected the pattern of manufacturing growth in the period 1958–1992 (well before the reform era of the last two decades). It codes all labour regulations as pro-labour (defined as making it difficult for managements to hire, discipline or retrench labour, or to close down losing units) or anti-labour. The study shows that states that amended the IDA (to the extent permitted by state-level jurisdiction) in a pro-worker direction experienced lowered output, employment, investment and productivity in registered or formal manufacturing. In contrast, output in unregistered or informal manufacturing increased. Regulation in a pro-worker direction was also associated with increases in urban poverty. Laws supposedly aimed at protecting labour actually ended up hurting the poor. The IDA did not help labour as a whole: it helped only the labour aristocracy.

Two caveats to the Besley and Burgess study are required. First, does it make sense to focus on IDA alone, to the exclusion of other labour laws? What about the impact of minimum wages legislation, the Shops and Establishments Act, inspections by inspectors or strikes and lockouts? Second, there is some subjectivity in the "anti-labour" (-1) or "pro-labour" (+1) coding given in Besley and Burgess. Two examples will illustrate the point. In 1982, Andhra Pradesh introduced an amendment that merged the powers of industrial tribunals and civil courts. This has been regarded as anti-labour but may very well have reduced transaction costs in resolving disputes. Alternatively, in 1974, Maharashtra introduced an amendment that reduced the qualifications of judges. This was coded as "0" or neutral but may well have increased the number of judges and reduced transaction costs.

As an alternative approach, a transaction cost-based labour law ecosystem index for India's states was worked out by TeamLease, a contract employment company. It found that Maharashtra is by far the best as measured by a good labour law and regulation index. Next come Karnataka and Punjab. Gujarat and Delhi follow, though they are not highly different

from each other in terms of the index values. The worst States in this respect are West Bengal, J&K, Assam, Uttar Pradesh and Kerala.[5]

Clearly India needs to reduce rigidity in its labour laws, of which, Chapter V-B of IDA is one instance. This obliges any company with over 100 workers to get permission from the government before retrenching (dispensing with the services of) any employee, and this permission is rarely given. In Bangladesh, a worker can be retrenched after giving one month's notice to the worker. This helps explain how Bangladesh, once a negligible exporter of garments, has now overtaken India as a garment exporter.

Japan in the 1950s, the four East Asian tigers in the 1960s and 1970s, and then the south-east Asian tigers all became miracle economies by harnessing cheap labour for export-oriented industries. China is the latest and most successful example. But India has failed altogether to jump onto the labour-intensive bandwagon, and labour rigidity is the main reason. Employers dare not hire thousands of workers in massive factories (as in China) for fear of not being able to retrench them in the event of a sudden fall in export demand, or a change of seasons requiring a big change in the sort of garments to be produced. No exit translates into no entry for workers in large scale manufacturing. This perpetuates a situation where the organised sector accounts for barely one-tenth of workers.

While labour flexibility is important, gains can also be made by reforming other aspects of labour law, which are politically less controversial and so politically easier to implement. It is a mistake to equate labour reforms with changes in Chapter V-B of IDA (which limits retrenchment, layoffs and closure in factories with over 100 workers). The result has been a political refusal to contemplate even the less controversial laws, such as the abolition of obsolete clauses (like mandating manual registers instead of electronic), laws relating to the inspector *raj*, laws limiting shop hours, laws limiting female participation at night, and so on.

Even if it proves politically difficult to scrap Chapter V-B of IDA, it may be possible to segregate the layoff, retrenchment and closure provisions, providing some flexibility. The IDA was tightened over a period of time and its tightening offers insights into how it can be progressively relaxed too. Layoffs, retrenchment and closure are actually three separate concepts and reflect increasing degrees of severity. They must be unbundled. Layoffs and retrenchment are more acceptable to trade unions and political parties than closures.[6] Thus, it is easier to sell reforms that, to begin with, apply only to lay-offs and maybe to retrenchment but not

closures. For lay-offs and retrenchment, if compensation is increased from 30 days pay per year worked to 45 days, political resistance may diminish. It might diminish even more if existing contracts are grandfathered and the new provisions apply only to new labour contracts.

Third, it should also be possible to amend the Constitution to move labour issues entirely to the State list. This will mean that any state wishing to have flexibile labour laws will be able to legislate accordingly and not have to wait for New Delhi's legislation on the matter. Economic reforms have increased competition between states to attract industry and this has induced some States to be more forthcoming in granting permissions to retrench labour under Chapter V-B, although others have not. A change in the Seventh Schedule would explicitly allow and expedite, without legal complications, some trends already in evidence in the states.

Almost the entire pro-reform literature focuses on raising the threshold for the application of Chapter V-B to cover enterprises with more than 1000 workers, ten times the current threshold of 100. This will discriminate against smaller enterprises but the only clear argument to this effect is found in the afore-mentioned report of the Planning Commission.[7] Raising the threshold to 1,000 workers will dilute the impact of a bad labour concept but will not do away with it. Even an increased threshold will have many of the same adverse consequences: it will favour capital-intensity and discriminate against labour-intensive factories that are appropriate at India's current level of development. Far better will be a return to the pre-1976 status of IDA, which made no reference to any threshold. This will imply a complete repeal of Chapter V-B. It may be politically impossible right now but is the direction in which we should move.

End Notes

1. Strictly speaking, this is a Factories Act definition.
2. See, Ahsan, A., C. Pages and T. Roy (2008). "Legislation, enforcement and adjudication in Indian labour markets: Origins, consequences and the way forward", in D. Mazumdar and S. Sarkar (eds.), *Globalization, Labor Markets and Inequality in India*. New York: Routledge.
3. Fallon, Peter R. and Robert E.B. Lucas (1991). "The impact of changes in job security regulations in India and Zimbabwe", *World Bank Economic Review* 5(3): 395-413, September. World Bank Group.
4. Besley, Timothy and Roger Burgess (2004). "Can labour regulation hinder ecohnomic performance? Evidfence from India", *Quarterly Journal of Economics*.
5. *India Labour Report 2006*: *A Ranking of Indian States by their Labour Ecosystem*. TeamLease Services.
6. Labour Bureau statistics show that between 1998 and 2005, between 2000 and 4000 workers were retrenched per year, with the numbers dropping sharply in 2006 and 2007, 2007 being the last year for which data are available. However, the number of units affected has continuously declined from

195 in 1998 to 23 in 2007. That is, fewer units are affected but the number of workers per affected unit has gone up. There has been a similar trend for lay-offs. Between 200 and 300 units were affected by lay-offs from 1998 to 2002. This dropped below 200 in 2003 and below 100 in 2006. Workers laid off have also declined from 45,243 in 1998 to 12,255 in 2005 and 6,992 in 2007.

7. An example is the *Report of Planning Commission's Task Force on Employment Opportunities, 2001, http://planningcommission.nic.in/aboutus/taskforce/tk_empopp.pdf*