

Labour Regulation in India – Insurance versus Efficiency

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1. ● Legal Framework of Labour Regulation
2. ● International Comparisons with labour laws elsewhere
3. ● Empirical evidence on effect of labour laws on economic performance
4. ● Are labour regulations a source of rents for organized labour and a source of inefficiency or are they a form of social insurance?

The Legal Framework

- Industrial Relations
- Working Conditions
- Wages
- Social Security and Insurance

Industrial Relations

● Trade Unions Act, 1926

- Any 7 or more 'workmen' can apply for registration as a union.
- Workmen need not be working under the same employer
- Outside members allowed as trade union was thought of not as an organization **of** workers but an organization **for** workers.
- Most important privilege of a union is immunity from prosecution on charges of criminal conspiracy when acting in furtherance of a trade dispute.

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Industry came to have the same meaning as “any business, trade, undertaking, manufacture or calling of employers”

Accordingly hospitals, educational institutions charitable institutions and welfare organizations, professions, clubs, cooperatives, research institutes, came to be covered under the Act.

Workers in a supervisory role or earning a wage higher than a certain minimum are not considered workmen.

● **Industrial Disputes Act, 1947 – (IDA)**

- Specifies a conciliation-cum-adjudication system.
- Conciliation Officers and Boards of Conciliation are constituted by the government.
- If Conciliation Officer fails to settle a dispute he sends a 'failure report'.

- Dispute then goes to Labour Court and Industrial Tribunal.
- Labour Court deals with disputes that affect workers. Industrial Tribunals deal with cases that affect all workers in an industry such as those dealing with wages.
- IDA imposes significant restrictions on employers regarding retrenchment and exit.
- Labour Courts and Tribunals have powers to set aside any discharge or dismissal that it considers not justified and reinstatement of workers as well.

-IDA makes layoff, retrenchment and closure illegal except with the previous permission of the government for all firms with more than 100 workers as of 1982.

Permission to retrench is rarely granted and unapproved separations carry a punishment of both a substantial fine and a prison sentence for the employer.

Compensation for retrenchment is for any workman with more than 240 days of service and the entitlement is one month's notice and 15 days of compensation for every year of service at 50 per cent of basic wages + dearness allowance.

Contract workers and those in casual, temporary (paid for < 240 days) work are not considered workmen under the IDA.

Such workers exempted from application of severance pay, mandatory notice, or retrenchment authorization.

Incentive for firms to hire non-permanent workers.

Share of contract labour in manufacturing has increased from 12 per cent of manufacturing employment in 1985 to 23 per cent in 2002.

Voluntary retirements require no permission from the state.

No official data on voluntary retirement but such payments are reported to be widespread and offering 4 to 6 weeks pay per year worked.

Working Conditions -

● **The Factories Act, 1948**

- governs the health, safety, and welfare of workers in factories and service sector.
- Factory defined as place using power and employing 10 or more workers or without power and employing 20 or more workers.
- Section 85 of Act empowers state governments to extend provisions of Act to smaller factories. Under this provision in many states small and seasonal factories such as rice and oil mills, and powerlooms have been brought under the Act.

● **Industrial Employment (Standing Orders) Act, 1946**

-Requires employers of industrial units with 100 or more workers to specify working conditions in line with a model standing orders.

-Sets out rules regarding leave, disciplinary action, etc.

● **Contract Labour (Regulation and Abolition) Act, 1971**

-Contract labour can only be used for non-essential services involving unskilled manual tasks within an organization that employs at least 20 such workers and is engaged normally in a skilled/non-seasonal activity.

-Under the Act State Advisory Boards and Central Advisory Boards established consisting of Labour Commissioners.

Advisory Board decides whether work involving contract labour is of perennial nature and justifies use of casual worker.

Government prohibits contract labour on advice of such boards.

-Act specifies licensing requirements for labour contractors and safety and welfare provisions of contract labourers.

-Section 10 prevents outsourcing of most core functions or hiring workers on temporary contracts for more than 120 days.

Wages -

● **Payment of Wages Act, 1937**

- A central act the enforcement of which is the responsibility of the state except in mines, railways, oilfields, ports, and air transport.
- Act specifies standard wage period (month or less), payment day, permissible deductions, mode of payment, etc.

● **The Minimum Wages Act, 1948**

-Specifies minimum wages on basis of proposals of central and state advisory boards.

Also empowered to specify the length of the working day.

Social Security and Insurance -

● **The Workmen's Compensation Act, 1923.**

-Specifies compensation on account of injury by accident at work-site or occupational disease.

-In case of contract labour principal employer is liable.

● **The Employees State Insurance Act, 1948**

-Extends to all factories and other commercial establishments employing 20 or more people and workers earning less than a certain minimum salary within these.

-Requires contributions from both employers and employees to be paid for insurance against sickness, maternity, funeral, and disablement.

● **The Employees Provident Funds Act, 1952**

- Applies primarily to factories and specifies deposit-linked provident fund or pension schemes.

Other acts such as the Maternity Benefit Act, 1962, and the Payment of Gratuity Act, 1972 are also in existence but are of a lesser order of importance.

International Comparisons -

Compare labour laws across countries on the basis of *Doing Business* 2004, a database on employment laws across the world

<http://rru.worldbank.org/DoingBusiness>

Restrictions on hiring – measures how difficult it is to hire workers other than with indefinite, permanent contracts. Higher score indicates higher difficulty to hire through alternative contracts.

Restrictions on hours of work – Compares overtime, restrictions on night work and length of the workday and workweek. Countries where employers face more restrictions on hours of work are given a higher score.

Restrictions on retrenchment – measures legal and administrative constraints on dismissals.

Cost of dismissal – measures dismissal cost in weeks of pay. Such costs are related to the compensation that workers obtain in the event of dismissal.

Rigidity of employment – an indicator of how protective of workers are labour laws.

Country	Difficulty of Hiring	Rigid Hours	Restrictions to retrenchment	Compensation for Dismissal	Rigidity of Employment
India	33	20	90	79	48
Bangladesh	11	40	20	47	24
China	11	40	40	90	30
Malaysia	0	0	10	74	3
Pakistan	78	40	30	90	49
Sri Lanka	0	40	80	108	40
Thailand	67	40	20	47	42
Comparators Average	27	45	48	87	40
High Income Countries \bar{x}	22	49	24	41	32 ²¹
World Average	35	50.6	37.9	56	41

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Question put about extent to which labour market regulations constitute an obstacle to growth

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According to this data labour regulations are perceived to be a larger obstacle for firms' growth than in most other countries of the world.

However, on this measure China and Brazil have larger measures for firm perceived obstacles to growth from labour market regulations.

Law Enforcement

How good labour laws are depends on the enforcement of these laws. There is evidence of weakening law enforcement.

● **Union Membership and Labour Disputes**

Data on union membership is sketchy and incomplete.

Data is available for a few states which suggests that union membership has not declined.

States in which union membership has increased –
Assam, Orissa, Punjab, Gujarat

Union membership declined in Karnataka and Kerala

Decline in number of disputes during the nineties.

However, person-days lost in such disputes has increased since 1997 after a sustained decline throughout the first part of the nineties.

Seems like unions are not less able to mobilize workers than in the past.

● Labour Inspections

Labour Bureau data suggest **large decline in number of factories inspected** relative to number of registered factories.

Sharp variation amongst states -

During 1991 – 2001 period less than 25 per cent of registered factories underwent an inspection in Punjab, Goa, or Bihar.

Share was above 80 per cent in Tamil Nadu, Maharashtra, Orissa, Pondicherry.

Average Inspector Visits to establishments per year by different agencies

	Central Government	State Government
Sales Tax	0.59	1.61
Income Tax	0.51	0.42
Customs Duty	0.89	0.21
Excise Duty	2.13	1.24
Labour & Social		
Security Inspectors	0.40	1.76
Fire & Building Safety	0.21	0.66
Environment	0.19	1.26
All Others	0.12	1.46

Source: Investment Climate Survey, 2002.

● Irregularities

Do inspectors check for compliance or do they collect bribes and leave?

Average reduction in inspector visits and time spent if unofficial payments are made

Government agency	Number of Firms reporting incidents	Reduction in number of visits (%)	Reduction in time spent (%)
Tax	57	33.49	NA
Labour & Social Security	157	53.25	49.66
Environment	92	42.52	37.06
Fire & Safety	100	42.43	41.62
All others	73	38.97	36.31

Evidence suggests that **exporting** firms, and **large** firms which have a dominant market share tend to experience more state labour inspections per year than other firms.

However, once unofficial payments are made, these firms experience the same intensity of inspections as other firms.

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Hypothesis If inspections are increasing compliance with labour laws, then firms' perceptions on stringency of labour laws should increase with the number of inspections.

Evidence is that firms engaged in unofficial payments in exchange of a reduction in inspections perceive labour laws to be more binding.

Overall evidence indicates that **labour inspectors do little to enforce labour laws**. Employers and inspectors in fact collude to evade the law.

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Even though labour law enforcement is weak few firms seek permission to retrench and for those who do, permission is rarely granted.

Firms instead seek flexibility by using contract labour. Share of contract labour has increased from 15 to 29 per cent of manufacturing labour force in 1990s.

Per Cent of Contract Labour in Manufacturing across Indian states

State	1985	1995	2002
Kerala	1.6	1.5	2.33
Assam	8.2	7.9	3.95
Tamil Nadu	6.9	4.4	7.21
West Bengal	4.6	5.3	7.63
Delhi	7.5	4.8	7.64
Karnataka	11.5	8.1	9.33
Punjab	19.1	10.8	14.32
Maharashtra	5.7	12.8	16.34
Bihar	9.8	7.8	22.08
Rajasthan	8.8	14.1	22.5
Madhya Pradesh	13.6	21.5	23.94
Uttar Pradesh	14.2	13.5	25.92
Haryana	19	14.8	28.07
Gujarat	14.5	23.5	31.27
Jammu & Kashmir	25.4	16.1	31.55
Orissa	30	28.7	40.14
Andhra Pradesh	33.8	49.2	62.08
All India	12.1	16.8	23.22

Employers also actively employ **voluntary retirement** as a means of reducing the workforce as this requires no permission from the State.

No data is available on the number of voluntary retirements but casual evidence suggests it is widespread and that offers of 4 to 6 weeks pay per year of work in exchange of retirement is the norm.

Evidence on labour regulation and its effects on economic performance -

“Evidence suggests that States which have enacted more pro-worker regulations, have lost out on industrial production in general.”

Ministry of Finance, 2006.

The IDA was amended in 1976 and required firms employing 300 or more workers to obtain government permissions for layoffs, retrenchments, and closures.

A further amendment in 1982 reduced the threshold to 100 workers.

Fallon and Lucas employ a before and after methodology to examine the impact of these amendments.

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Their estimates reveal a negative effect on labour demand of job security regulation in 25 out of 35 sectors using a 25 per cent level of significance.

Fallon & Lucas also average the coefficients across all sectors (including the sectors with insignificant coefficients) to obtain the 17.5% estimate.

Moreover, there are significant rigidities in employment adjustment in the Indian labour market.

For any disturbance it takes on an average about 5 to 6 years for most of the adjustment to be completed.

Rigidity in employment calls into question the Fallon and Lucas conclusion of employment decline coinciding with the time of the amendment of the IDA in 1976.

Amendments to job security regulations made at central level are often made by state governments.

Besley and Burgess read the text of each amendment to the IDA and classify each as

- pro-worker – score of +1
- pro-employer – score of -1
- neutral – score of 0

These scores are cumulated over time to obtain a regulatory measure for each state in each year.

E.g. of pro-employer amendment –
prohibiting strikes to maintain industrial peace

E.g. of pro-worker amendment –
time frame for workers to receive payments on
being laid off being reduced.

Besley-Burgess then find that states with more
pro-worker legislation have lower levels of
employment in registered manufacturing.

Four pro-worker states identified -

Gujarat, Maharashtra, Orissa, West Bengal

Gujarat and Maharashtra are two of India's most industrialized states and perceived as good locations for setting up manufacturing plants.

How did these states which are **priority destinations** for industry get to be pro-labour?

Survey on investment climate indicated that whilst in all states firms indicated there was overmanning and that they would like to reduce employment, the **extent of overmanning** reported was **lowest in Maharashtra and Gujarat**.

Need for a distinction between **legislation and enforcement**.

Industry in Kerala that is pro-employer received twice as many inspections per year as did states like Maharashtra and Gujarat that are pro-employee.

States that are **pro-employer** such as Andhra Pradesh, Rajasthan, and Tamil Nadu are classified as pro-employer but have witnessed **declining employment** elasticities.

Pro-employee states such as Maharashtra, Gujarat, Orissa, have witnessed an acceleration in employment elasticities.

Estimated effect of various factors on log registered manufacturing output per capita

Independent Variables	OLS
Labour Regulation (t-1)	-0.014*
Log development expenditure	0.184
Log installed electricity capacity	0.082
Log state population	0.310
Congress majority	-0.0009
Left majority	-0.050
Janata majority	0.008
Regional majority	0.006
Adjusted R ²	0.94

Estimated effect of various factors on log registered manufacturing output per capita

Independent Variables	OLS	OLS with state time trends
Labour Regulation (t-1)	-0.014*	0.0002
Log development expenditure	0.184	0.241*
Log installed electricity capacity	0.082	0.023
Log state population	0.310	-1.419
Congress majority	-0.0009	0.020*
Left majority	-0.050	-0.007
Janata majority	0.008	-0.020
Regional majority	0.006	0.026
Adjusted R ²	0.94	0.95

Even though adjustment costs of regular workers may be large firms adjust by varying **work intensity** and varying the composition of the workforce between permanent and **non-permanent employment**.

Besley and Burgess also assume that regulation is costless and complete.

“In practically every ‘organized’ firm, including state run corporations, unorganized labour is selectively incorporated into the labour process”

-Harriss-White, 2003

Traditional view-

Job security regulations and unions are the main cause of rigidity and unemployment.

Firing costs are a device to protect the rents of incumbent employees.

Historical view -

Job security regulations were instituted as a response to the threat of unemployment and income insecurity.

“The paramount concern of Indian workers and thus of their trade unions relates to the question of job security.”

If labour market risk is so all encompassing then why can't we leave it to firms and employees to take care of it themselves through insurance contracts and wage bargains?

Failure to distinguish between what is good *ex ante* and what is good *ex post*.

-Kaushik Basu, 2002

Law making retrenchment difficult is good for workers who are already employed.

However, firms will be wary of hiring labour and this decreases the demand for labour as well as wages

With free contracting between workers and firms we should see contracts ranging from firing rights and high wages to low wages and long tenure.

Free contracting allows workers and firms to implicitly bargain for the efficient level of employment security.

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Freedom to contract leads to efficiency?

Only if the economy is perfectly competitive where unemployment is not an issue

What happens when labour markets do not clear?

The simultaneous existence of equilibrium unemployment and wages is demonstrated in the **efficiency wage** approach.

Workers are paid in excess of their marginal contribution to reduce **shirking** and to increase labour productivity.

Deferred payments – workers are initially paid less than their contribution and payment increases with tenure in order to induce effort over time.

When efficiency wages exceed worker's marginal contributions, firms have an incentive to terminate workers before the wages are paid.

Response to this moral hazard is to introduce employment protection.

Worker and firm agree to a contract to be executed in t_1

Effort by worker: wage w will be paid

Caught **shirking**: No compensation and worker terminated.



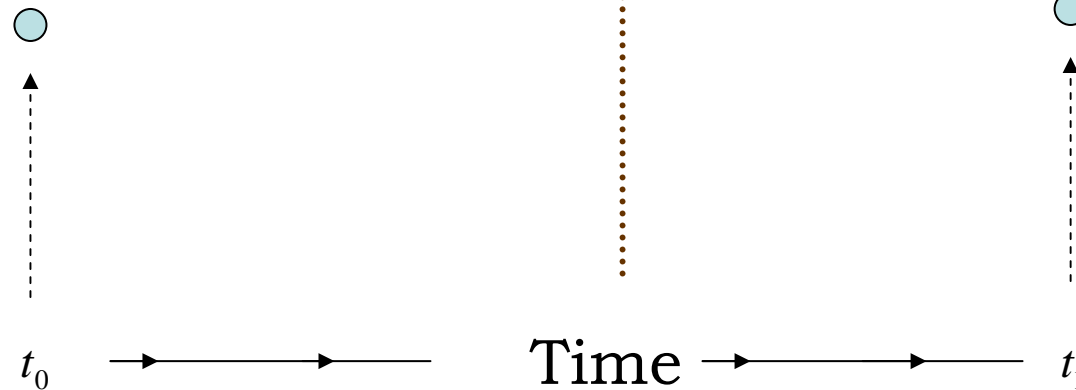
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Firm **honors contract** – Pays worker for effort & fires shirking worker

Terminate contract & capture full rents generated from employee's efforts.



Worker can be dismissed either (a) for shirking or (b) employer opportunism.

WORKER

Work	Shirk
$w - e$	pw

p : Probability that worker is not detected shirking

e : Effort expended

w : Compensation for effort

		WORKER	
		Work	Shirk
FIRM	Honour Contract	$y - w$	$p(y - w)$
		$w - e$	pw

y : Gross benefit to firm if effort is expended

p : Probability that worker is not detected shirking

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		WORKER	
		Work	Shirk
FIRM	Honour Contract	$y - w$ $w - e$	$p(y - w)$ pw
	Terminate	y $-e$	py 0

y : Gross benefit to firm if effort is expended

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Question is why there is a preference for **employment protection** legislation rather than using **unemployment benefits** to achieve security.

Job protection is more beneficial for insiders whilst unemployment benefits favour outsiders.

Insiders are skilled or public sector workers who have access to privileges in terms of benefits and security that is not available to outsiders in the informal sector.

Conflict of interests between insiders and others as well as **balance of power** is important in understanding the use of employment protection in labour markets.

Constraints on a market economy differ with the material interests of different actors

Firm owners are concerned with the rate of profit, market share, growth, etc. They measure economic performance by these variables.

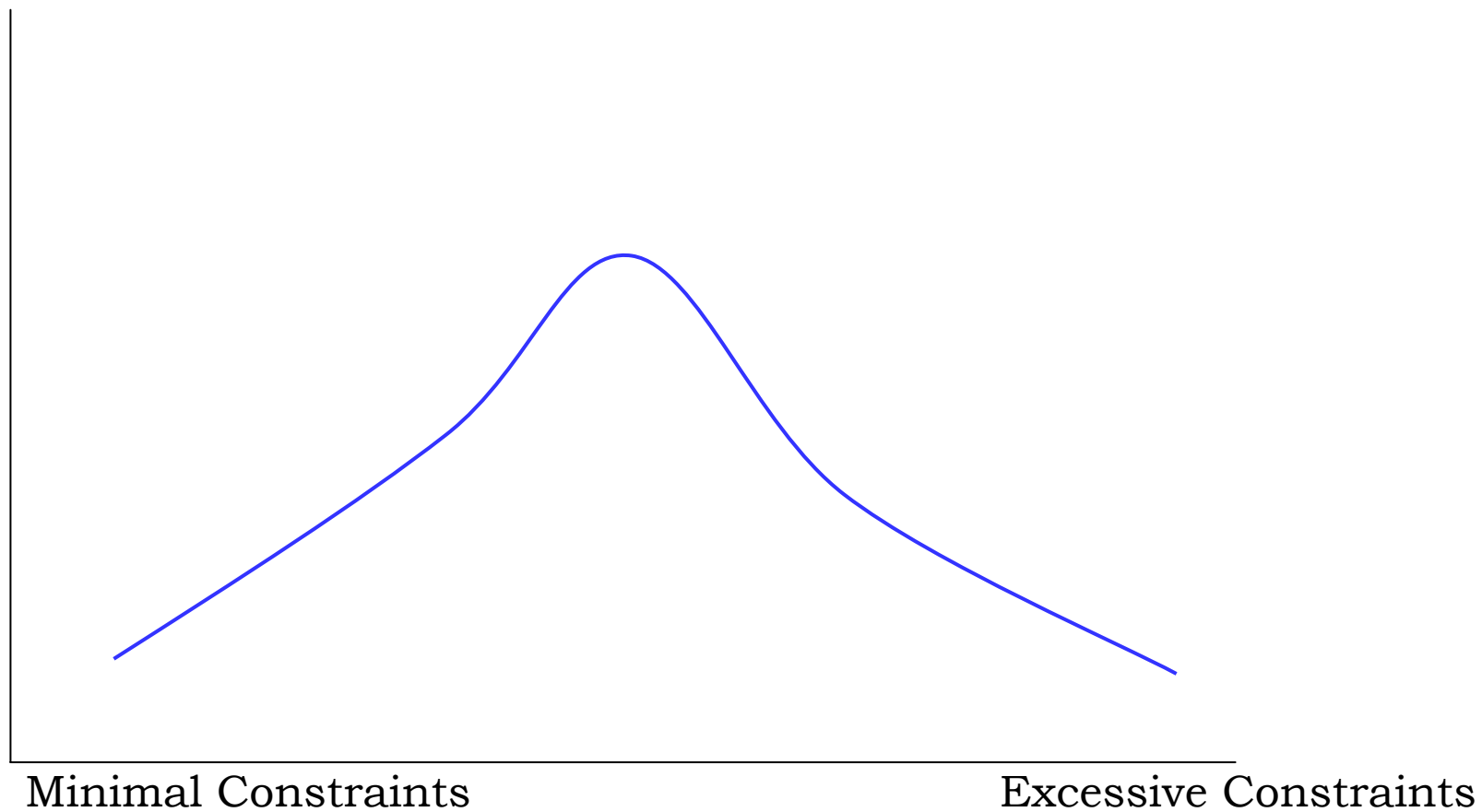
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In a highly atomized market with weak regulatory and other normative constraints opportunism will be rampant and with trust in limited supply collective action failures will abound.

On the other hand pervasive institutional regulations and normative constraints will introduce inflexibilities and result in low levels of performance.

Economic Performance



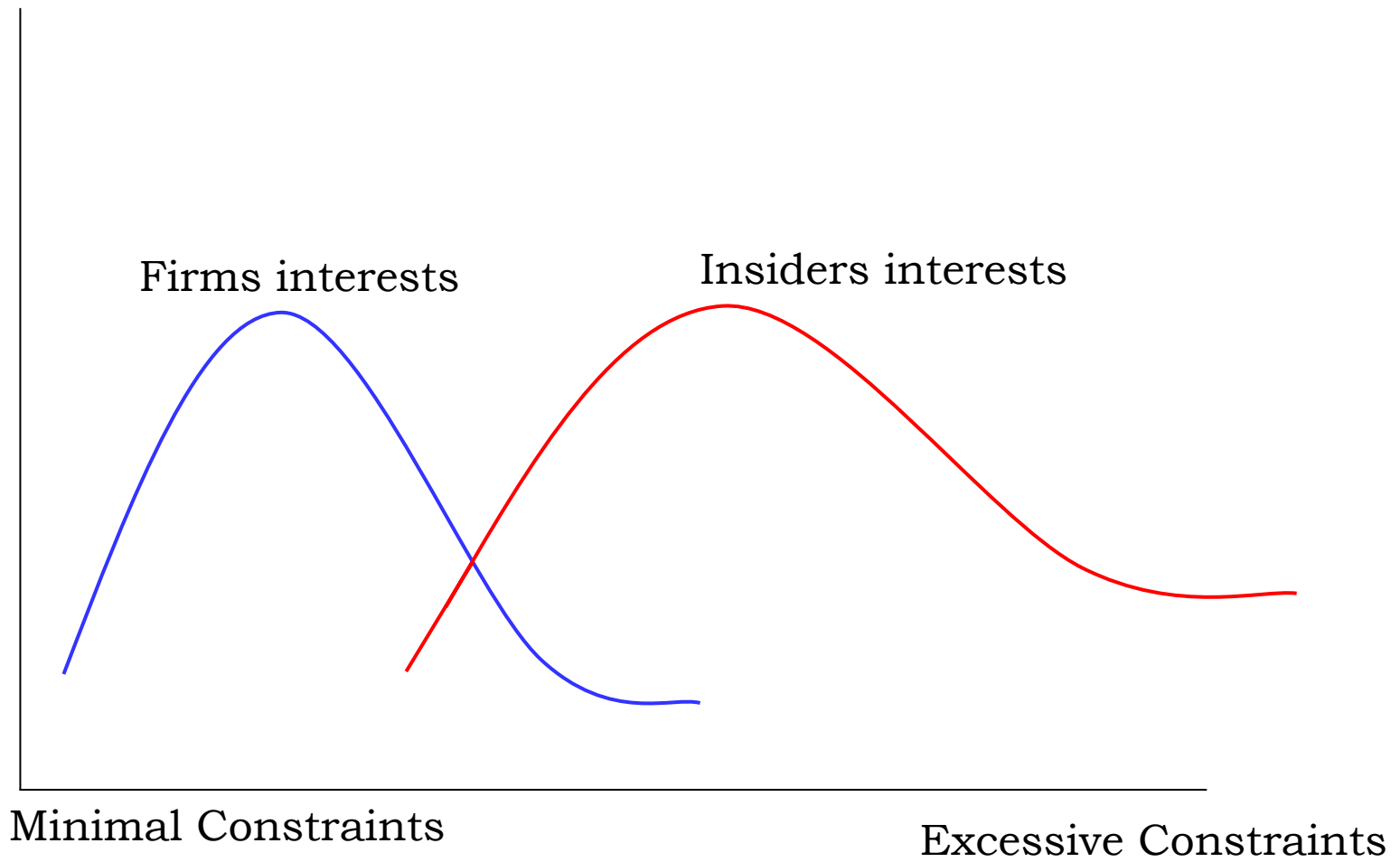
Firms will prefer an intermediate level of constraint that does not undermine the efficiency properties of markets.

However, what is good for firms is not necessarily good for society.

Workers are interested in an economic performance that includes quality of life and economic security

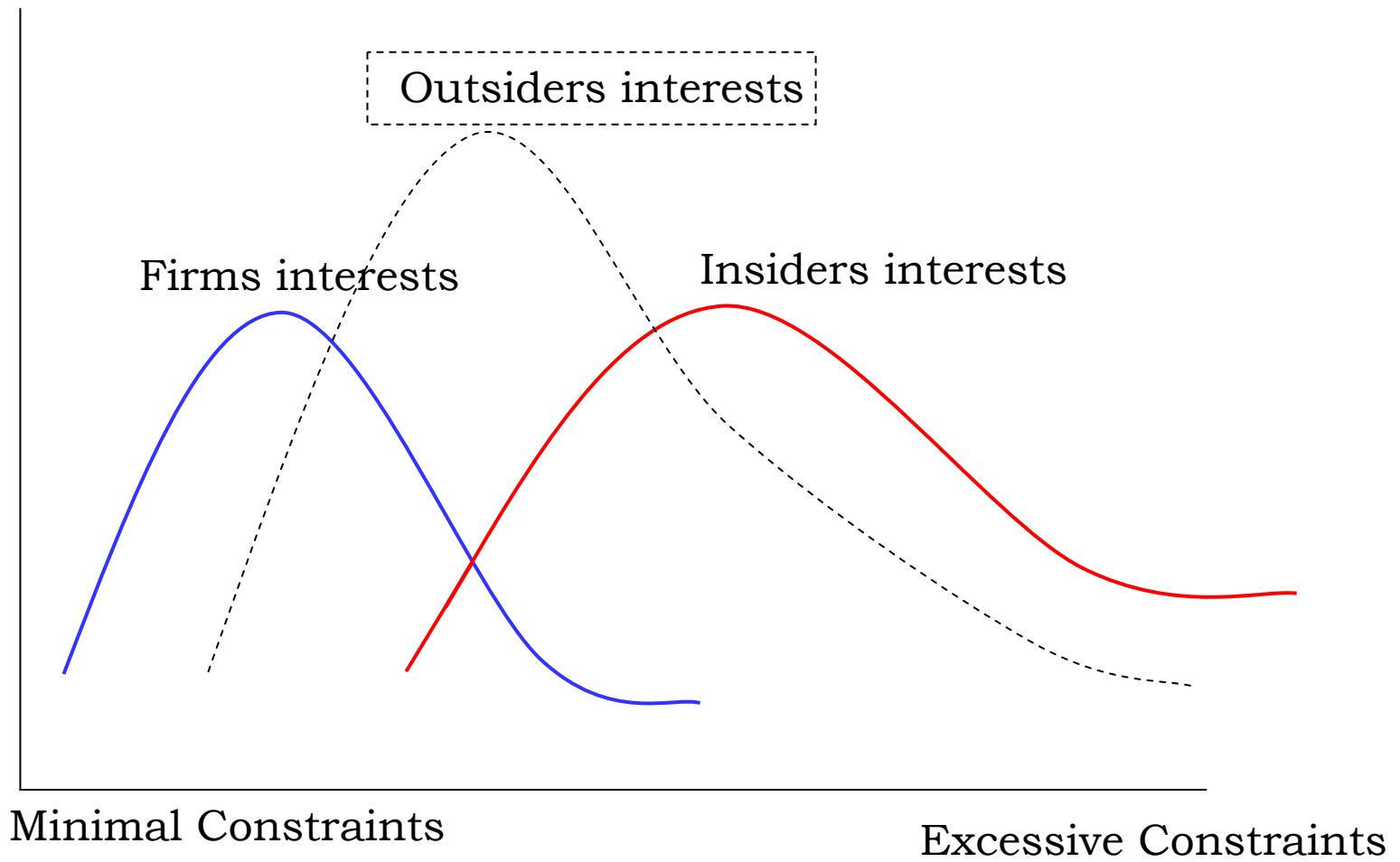
Level of institutional constraints which is beneficial for workers concept of economic performance will generally be greater than the level that realizes the interests of firm owners.

Economic Performance



Finally there are the ‘outsiders’ – those workers in the informal sector who prefer institutional constraints on the market which are somewhat intermediate. That is they define economic performance as including economic security in the form of unemployment benefits.

Economic Performance

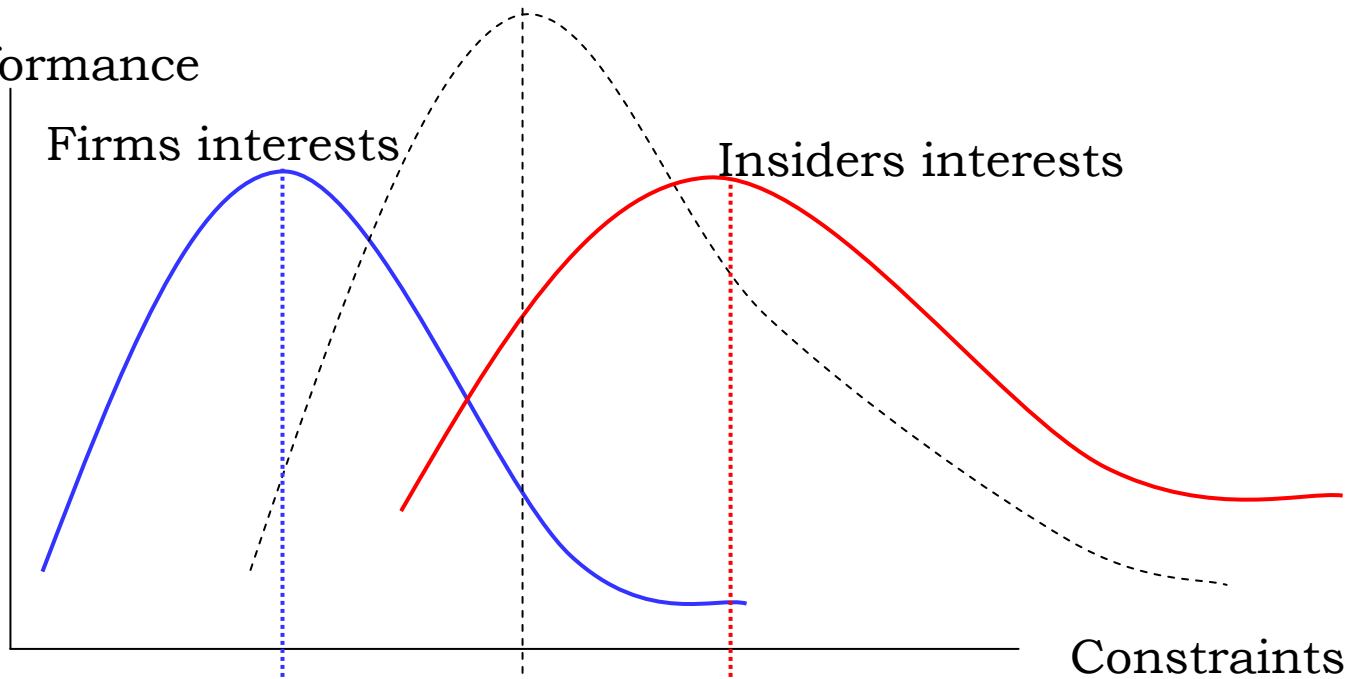


With a conflict of interest the level of institutional constraints on the market will be determined by the relative power of various actors.

In general the balance of power is not exogenous to the institutions in force.

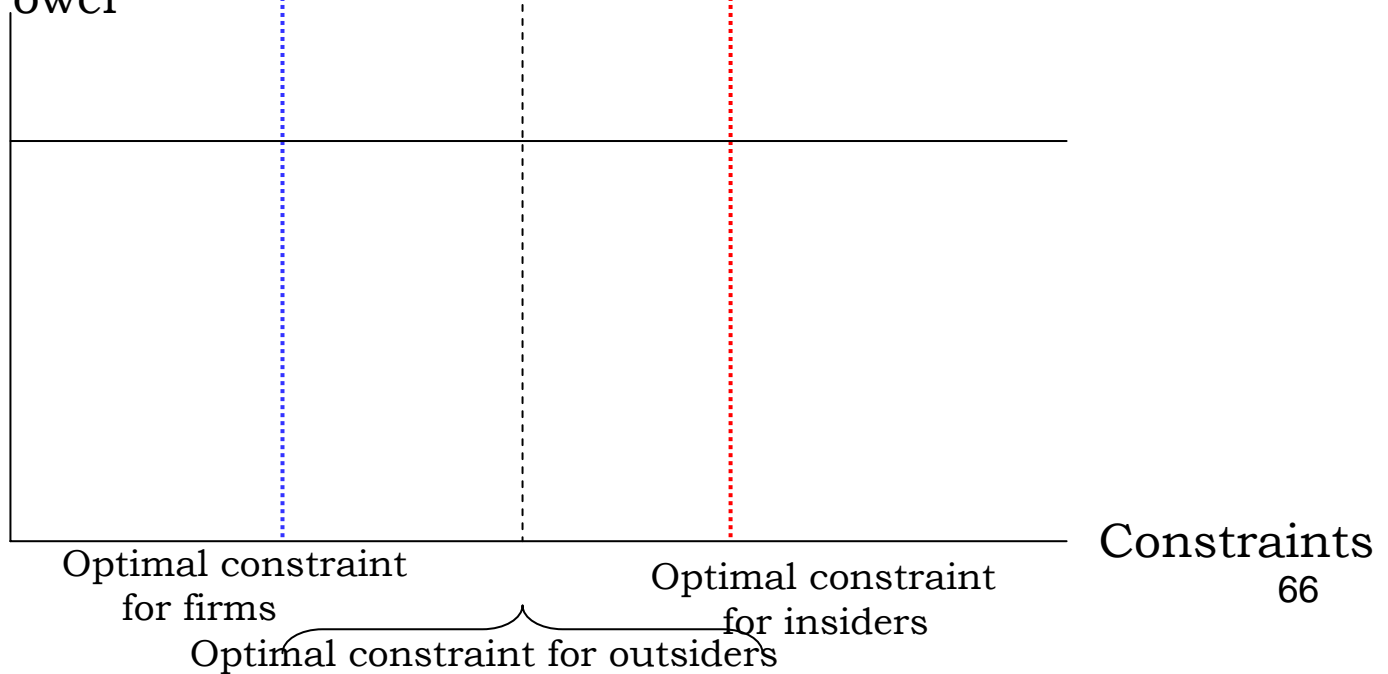
The relative power of workers should then rise with the level of institutional constraints imposed on the market.

Economic Performance

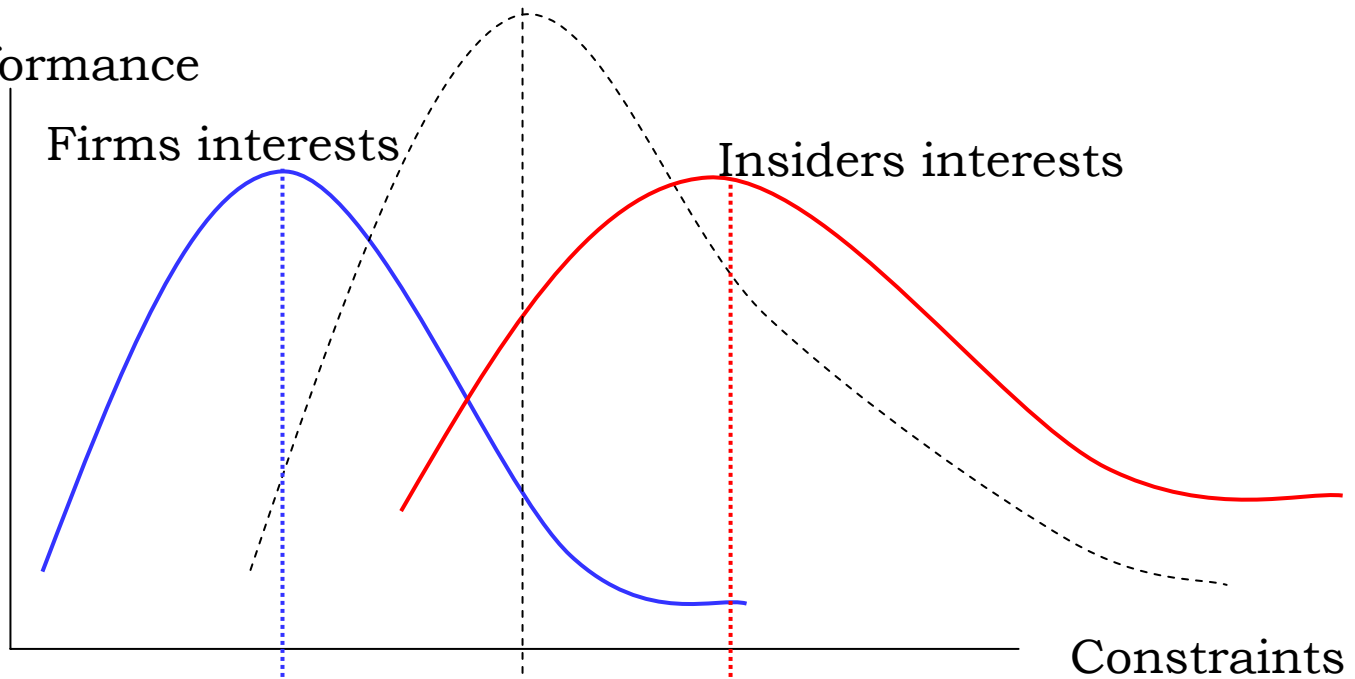


Balance of Power

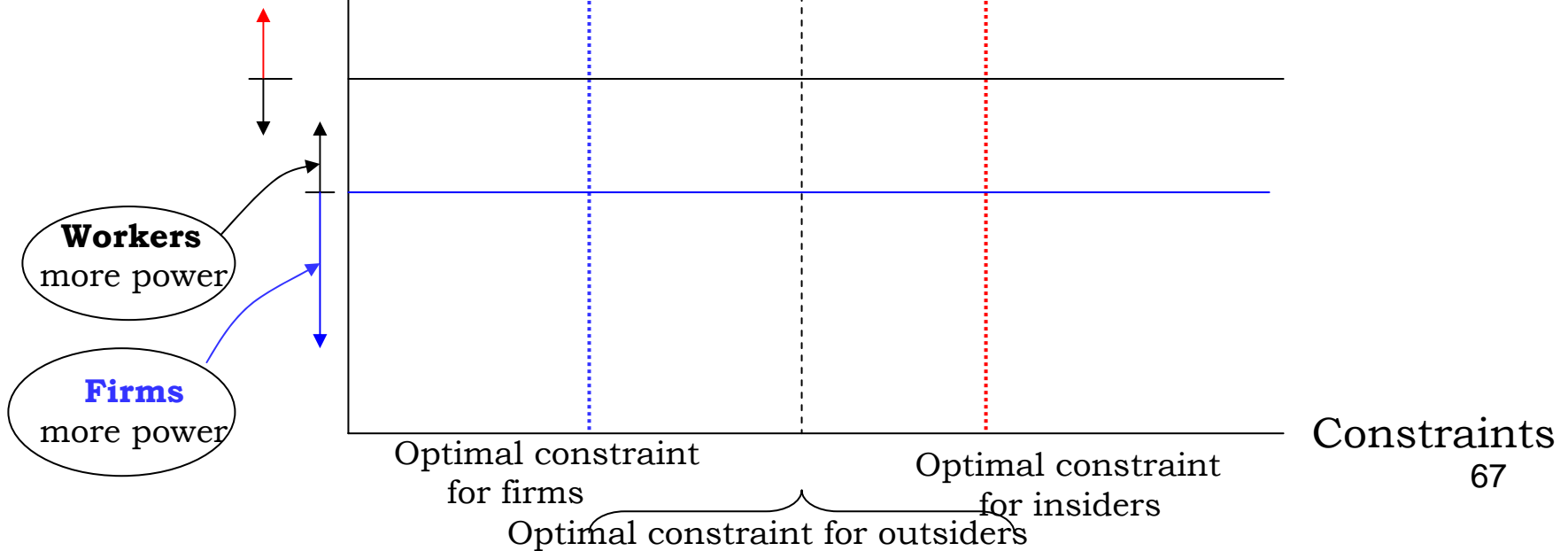
Insiders more power ↑
Firms + Outsiders more power ↓



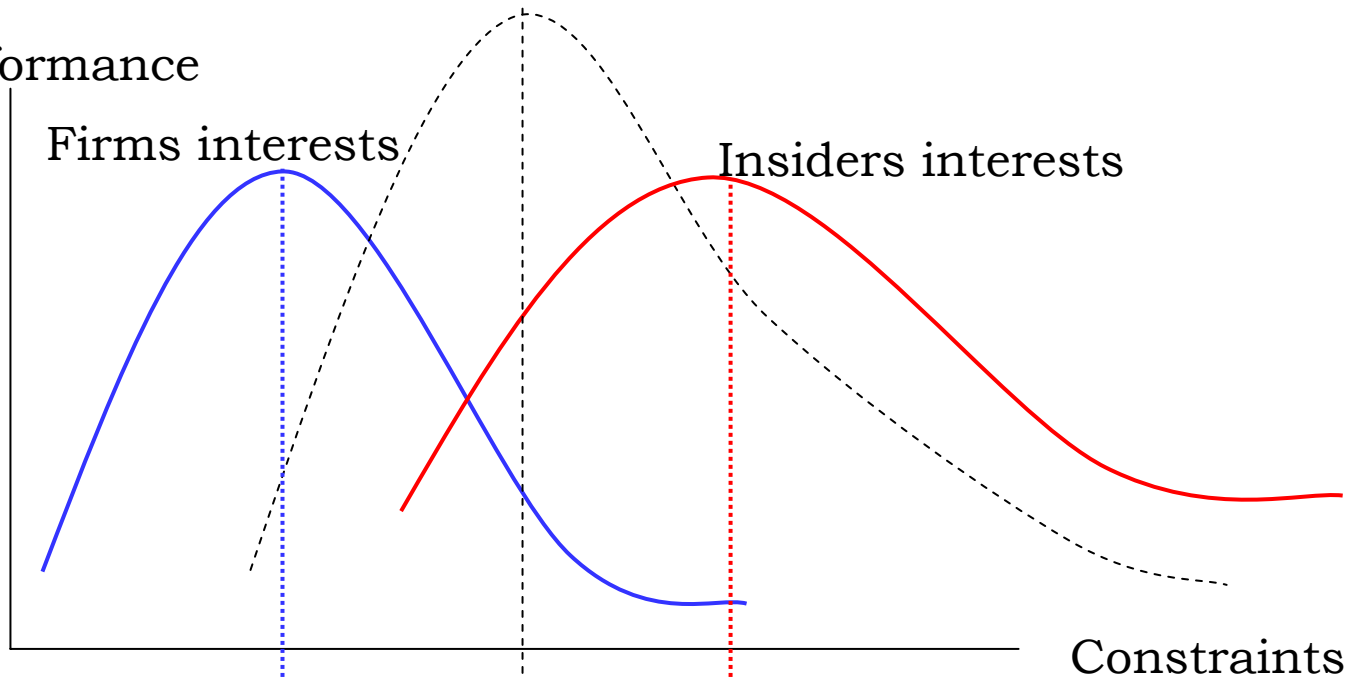
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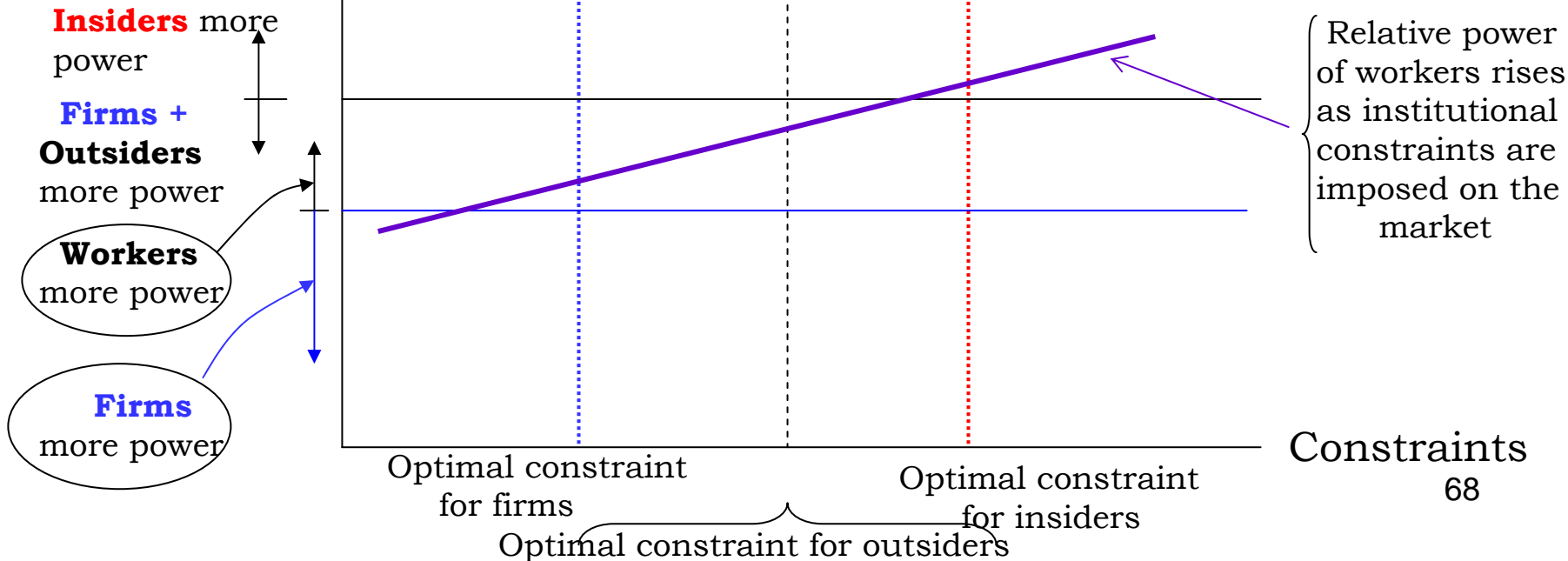
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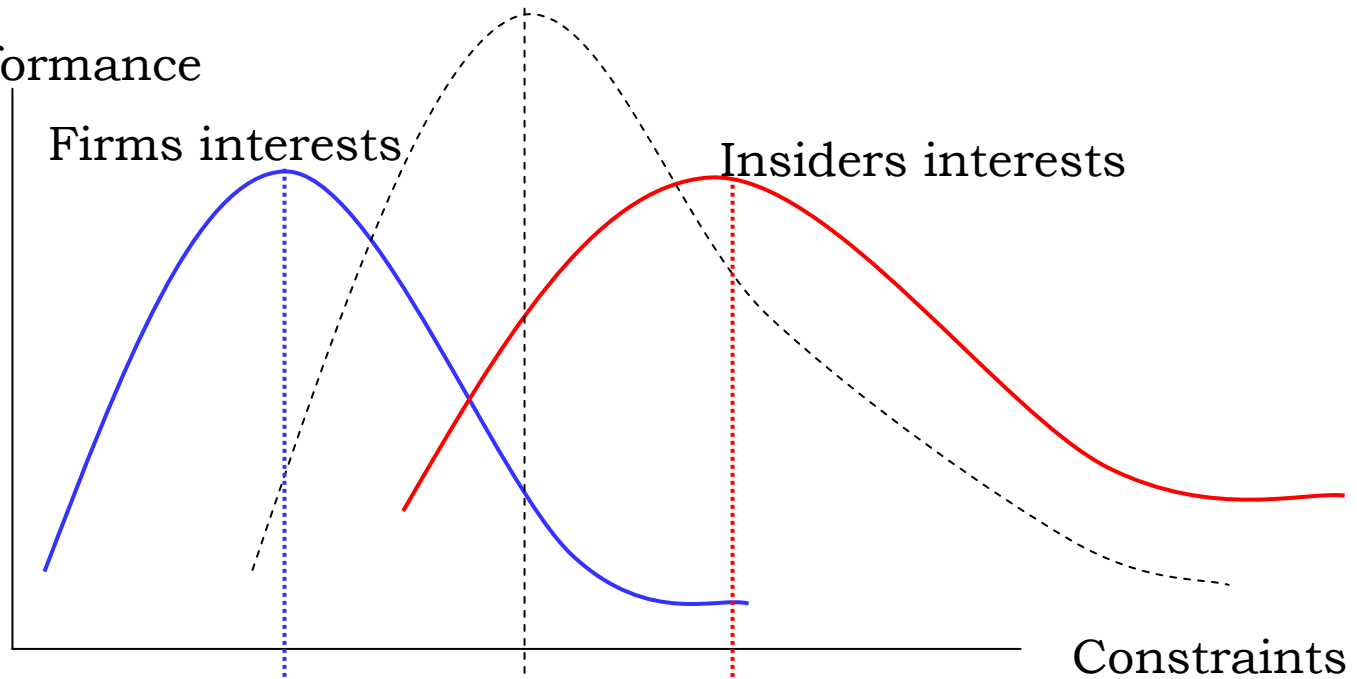
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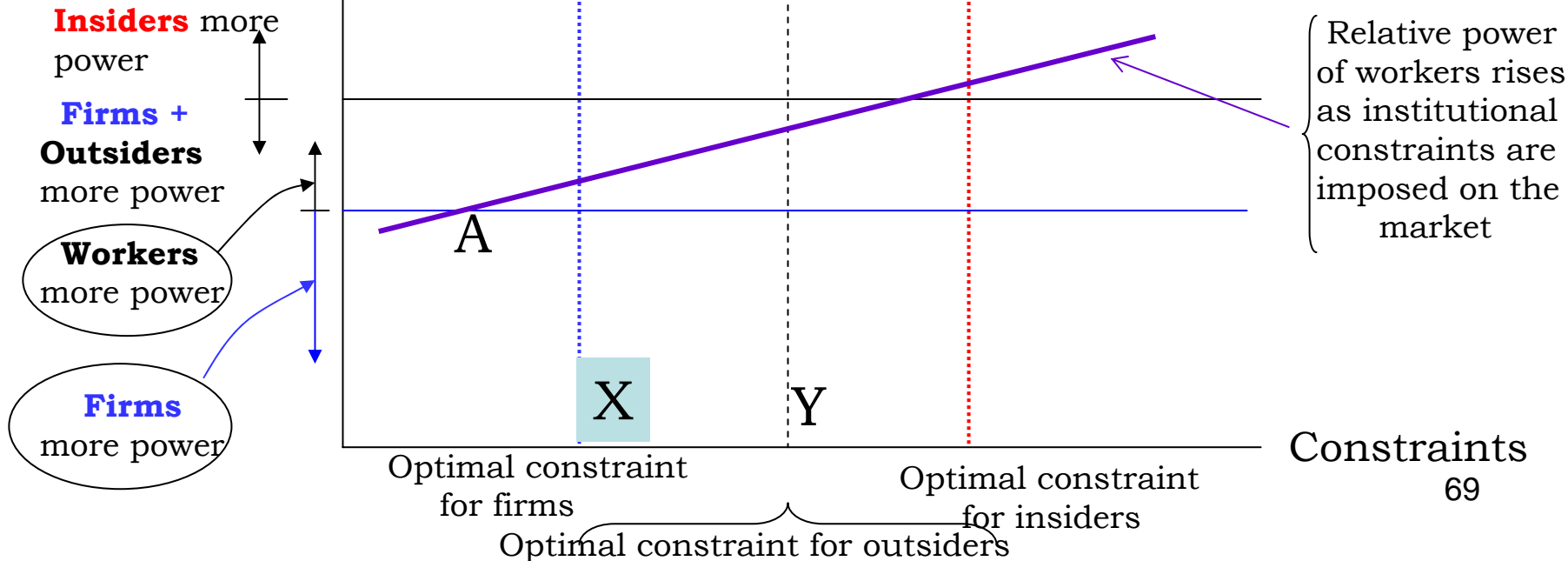
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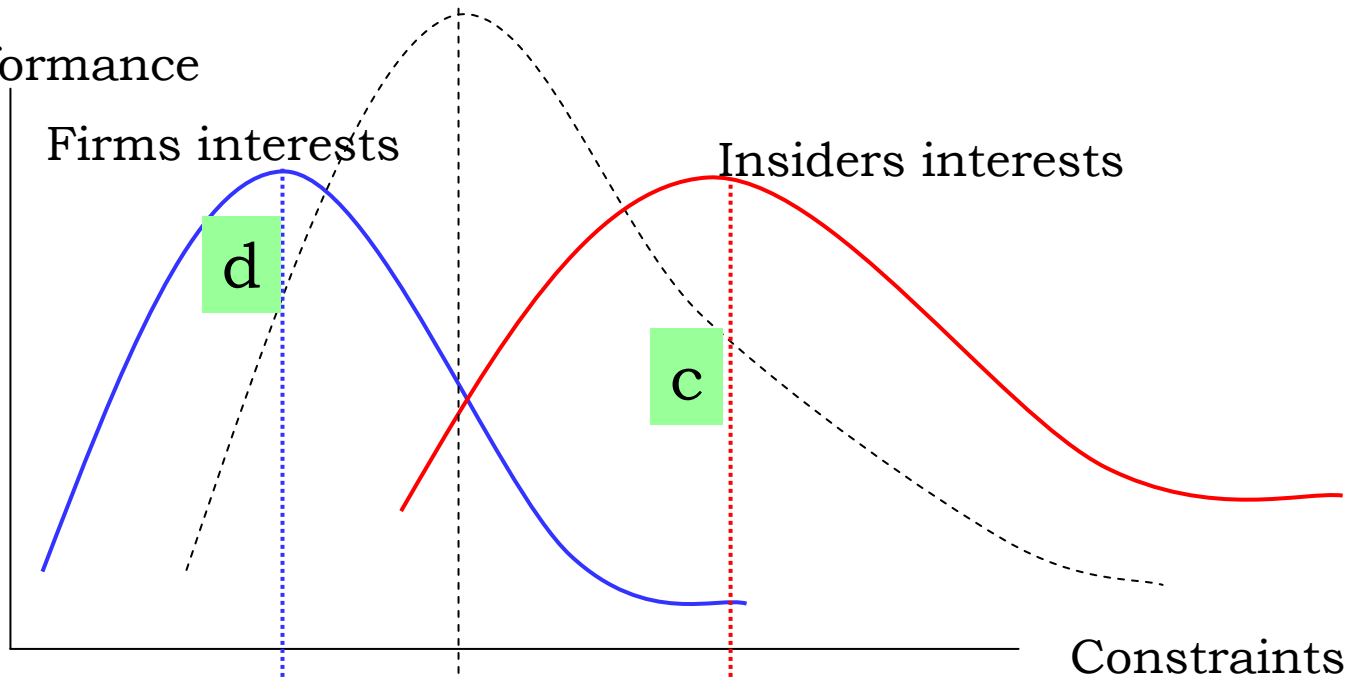
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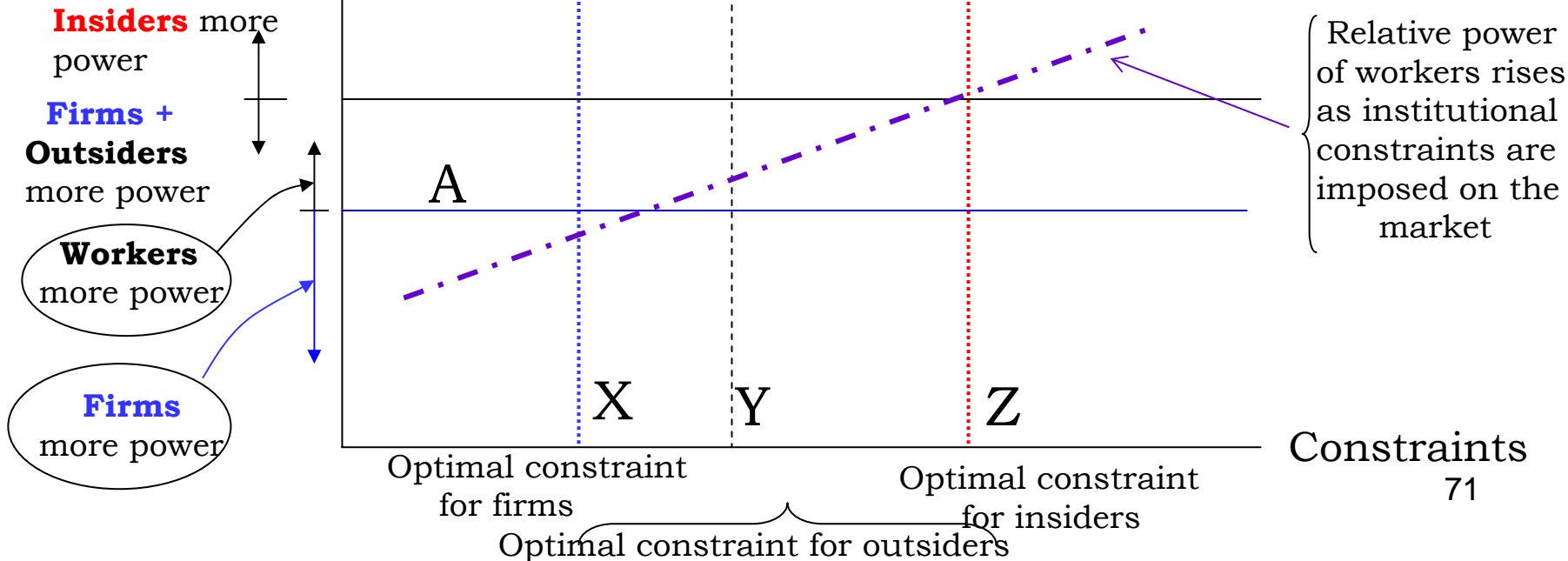
Balance of Power



Economic Performance



Balance of Power



In the reform literature there is the presumption that all that is needed is for the gainers to compensate the losers in a reform in order to maximize the political base of the reform.

Gainers from change cannot credibly commit to compensate losers *ex post* and so dysfunctional policies can continue.

Once insiders have lost their privileges and power then how can they enforce such an agreement?

Insiders may agree to structural reform if it is accompanied by institutional reforms that provide them with more voice

Reduction in the number of secure jobs - insider jobs – is also seen as the removal of the opportunity of exiting from the status of outsider by the outsiders.

Labour markets are social institutions
workers learn that the war of all against all is rarely in their interests and develop powerful norms of solidarity.

Thesis 1: Institutions that impose constraints on markets may be socially beneficial.

Thesis 2: Effective institutions for constraining the market in performance enhancing ways are usually designed for other purposes.

Such institutions not created for the purpose of economic efficiency may turn out to be sources of superior economic performance and competitiveness.

E.g.: small firms in Northern Italy and craft based apprenticeship system in Germany.

Thesis 3: It is extremely difficult to predict at time t whether a particular institutional arrangement will be performance enhancing at time $t + 1$.

Possibility is not necessity.

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Possibility is not necessity.

Possibility of a social constraint on economic action turning out to be economically beneficial depends on a creative entrepreneurial response.

Some constraints can stifle initiative – e.g. discrimination in terms of sex and caste can be powerful constraints on labour and credit markets and do not produce good economic performance