Disentangling the labour law debate: What does the evidence really say?

Wholesale suspension of type-1 labour laws is unlikely to improve worker welfare or substantially increase employment. Removing type-2 laws will improve welfare by increasing employment only if retrenched workers are provided with adequate social security

There is no justification for the wholesale suspension of labour laws, which leave workers completely unprotected and firms only marginally better-off(Satyabrata Tripathy/HT Photo)

The coronavirus-related lockdown has made more than 130 million people jobless. Many of them are the migrants returning to their home states. During the last few weeks, some states, particularly the traditional out-migrant states, have issued ordinances to significantly relax or suspend labour laws. These changes are aimed at removing potential impediments to employment generation so as to absorb the unemployed — especially the returning migrants — and/or attract foreign direct investment. There are several issues related to the constitutionality of these ordinances, but that's for lawyers and legal scholars to debate. As economists, our research, based on the readings of the evidence available, highlights the costs and benefits of these modifications.

The adopted changes are a motley set. Madhya Pradesh has, among other measures, limited the role of inspectors and removed many provisions of the Factories Act (the law governing health and safety in manufacturing firms). Gujarat has retained the industrial safety rules and the Minimum Wage Act, but scrapped all other laws for new industrial establishments. Uttar Pradesh has removed all but a few laws for a period of three years (pending approval by the State legislature and the President of India for laws in the Concurrent List). Several states have amended daily work hours from eight to 12 (some with, and others without, overtime payment). Assam's focus is different. It has legalised the fixed-term employment (earlier, it needed a licence under the Contract Labour Act) and stipulated equal social security benefits to fixed-term workers as permanent workers in the same unit.

These changes can be usefully distinguished into two types. One, those that aims to lower firms' labour costs by reducing workers' benefits such as minimum wages, health and safety regulations, provident fund payments and bonus payments, and two, those that aim to increase firms' flexibility by reducing firing costs such as the employment protection legislation. The conceptual implications and empirical evidence for each type are different.

In a basic supply and demand framework, reducing firms' labour costs should increase labour demand. But when you consider information asymmetries or market power, this prediction falters. Where workers' effort is hard to observe, employers may provide higher than market wages in order to increase the productivity and minimise turnover (the efficiency wage theory). In markets where employers have wage-setting power, the most low-wage labour markets, introducing a minimum wage does not necessarily lead to adverse employment effects as empirically shown by Arindrajit Dube and co-authors, and, in fact, it can even generate employment gains, as shown by Vidhya Soundararajan, the co-author of this article.

Further complications arise as the laws on the books are often not enforced. Urmila Chatterjee and Ravi Kanbur find that the Factories Act is characterised by a widespread non-compliance. Despite the non-compliance, these laws still seem to impose costs on some firms: In a recent paper, Amrit Amirapu and Michael Gechter find that the de facto costs imposed by type-1 regulations on firms can be very high (up to 40% of labour costs), but only in states with high levels of corruption or those which have not reformed their inspector rules. This implies that if there are corrupt inspectors, labour laws are sufficiently complex and opaque to provide them with leverage to extract bribes. Yet, they fail to

generate full compliance, leaving workers under-protected. This might explain why, according to the 2014 World Bank Enterprise Survey, only 11% of (medium and large) Indian firms reported that labour regulations are a “major constraint”, while 36% thought corruption to be a “major constraint”.

The solution, then, is not to remove these benefits altogether, but to consolidate and simplify them — so that they can be implemented effectively with less room for extortionary practices. Indeed, Parliament has already started deliberating on the issue, and it should be allowed to continue in a careful, if expedited, manner. There is no justification for the wholesale suspension of such laws, leaving workers completely unprotected and firms only marginally better-off.

Turning now to the “reforms” of type-2: These relate to the employment protection legislation (EPL), which restricts hiring and firing. The relevant legislation in India is the Industrial Disputes Act (IDA) 1957. Most aspects of this law are fairly standard. For example, Section V-A of the law stipulates that a retrenched or laid-off worker must be adequately compensated, which is similar to policies in many other countries including Germany, France, and the United Kingdom. It is Chapter V-B of the law which prohibits firms with 100 or more permanent workers from firing even a single worker without government consent — and this stands out for its stringency (at least on paper). It is possible that this part of the IDA aims to compensate in some way for the lack of social insurance mechanisms (unemployment benefits/public health insurance) in India. The problem with using EPL as social insurance is two-fold. First, India’s EPL is limited to medium and large formal firms, so that only a fraction of the non-agricultural workforce is covered. Second, it might distort the efficient functioning of labour markets by dissuading firms from hiring permanent workers.

The empirical evidence for whether India’s EPL has in fact reduced employment or output in India is not conclusive, and the debate started by Timothy Besley and Robin Burgess has been rebutted by Aditya Bhattacharjea (in 2006, 2009 and 2019) and others. However, there is clearer evidence from other countries that strict EPL can reduce employment, firm productivity, and investment (employment and productivity in the US by David Autor and co-authors, and Italy by Federico Cingano and co-authors). There is also evidence from India that EPL incentivised the use of contract work (as shown by Ritam Chaurey), the share of which grew from 15% to 34% in Indian manufacturing between 1999 and 2015. This phenomenon may have reduced incentives to invest in human capital and lowered productivity, in addition to undermining the bargaining power of trade unions, as shown by Nancy Chau and co-authors.

Overall, the international evidence suggests that type-2 laws do constrain the employment generation, investment, and productivity. In India, although conclusive evidence is elusive, at least Chapter V-B, the most stringent part of IDA, could be removed and replaced with a more effective and expansive social insurance mechanism (such as unemployment insurance or UBI). These measures will provide firms with greater flexibility without undercutting the welfare of workers.

How, then, do we understand these “reforms” in light of the above evidence and the demands of the moment? Given the tragic situation of migrant workers and general mass unemployment, the first-order concern should be to immediately save lives through a combination of cash and in-kind transfers. The next concern should be to improve livelihoods, by doing the necessary to facilitate re-employment.

Given the stark human costs of unemployment on the scale witnessed, it is understandable that states wish to urgently remove impediments to hiring, even if that means tilting the balance of power towards firms. However, our reading of the academic literature suggests that the wholesale suspension of type-1 laws is unlikely to improve the worker’s welfare or substantially increase employment, and, should, therefore, be restored immediately. Removing type-2 labour laws would improve welfare by increasing employment only if redundant and retrenched workers are provided with adequate social security. Providing the latter should be the urgent task of the moment.

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The views expressed are personal