1st Place Winner Fraser Institute 2009 Essay Contest

What's good for business is good for the poor

The case of India's labour laws

by **Nikhil Joseph**
Indian Institute of Technology Madras, Chennai, India

On May 16, 2009, after almost two decades of fractured verdicts and fractious coalition politics, when even fringe players could hold a ruling government's policies hostage, participants in the world's single largest democratic exercise bucked the predictions of political pundits everywhere and granted Manmohan Singh's ruling United Progressive Alliance (UPA) coalition a decisive mandate for the next five years. In the editorial pages of *The Economist* following the election, the magazine asked the Indian prime minister, quite simply, not to waste it—and with good reason.

In the hands of Dr. Singh, the architect of the liberalization reforms that have yielded almost 19 years of hitherto unseen economic growth, is a unique opportunity. For the past five years, critics have pardoned the sluggishness of the government over reforms towards greater economic freedom, citing the need for pragmatism in an era of coalition *realpolitik*. The most notable roadblock has been the fact that the Communist Party of India has been the UPA's most important ally. Today, though, there is no such excuse.

Despite consistently being one of the two fastest growing economies in the world, almost 42% of the Indian population lives below the global poverty line of $1.25 per day (Mozumder and Tuck, 2008). In India, that translates into a staggering number: 456 million people. In China and in many of the East Asian Tigers, the economic growth that has raised millions from poverty has been led by growth in the manufacturing sector, but this has not happened in India (Besley and Burgess, 2004). Many economists point to this failure as being primarily responsible for so many people being unable to reap the fruits of the last two decades of economic growth (see, for example, Bhagawati, 1998, and Stern, 2001).

One of the main conclusions of the 2008 *Economic Freedom of the World* report (Gwartney et al., 2008)—one that hundreds of other studies have validated—is that greater economic freedom means greater prosperity and less poverty. In India, economic freedom is severely restricted by labour laws. For example, Indians are notoriously difficult to fire (legally, at least). Such restrictions of economic freedom, this essay seeks to argue, lies at the heart of why millions of Indians are so desperately poor.

"The law is an ass"

Although the Dickensian character who first used the above phrase was talking of the laws concerning marriage, it quite easily applies to India's labour laws as well. In India, labour and all matters concerning it fall under the Concurrent List. This means that both federal and state governments can pass labour-related legislation. The most important piece

of legislation concerning labour in India is the Industrial Disputes Act (IDA) of 1947. Although numerous state-level amendments may act as riders to parts of this legislation, in essence, it still contains provisions that make it impossible for any law-abiding firm employing more than a 100 employees to lay off any one of them without government permission (Section 25M); or even reassign a particular employee without first giving 21 days notice (as per Section 9A). Laws like this one (and others, such as the Contract Labour Act of 1970 and the Factories Act of 1948) have "reduced the productivity of both labour and capital and hence the viability of the enterprise" (Tendulkar, 2003).

Private sector employers, however, have not taken this lying down. As would be expected of any business interested in its own survival, businesses in India have found ways to adapt to these cumbersome restrictions or even bypass them completely. Such measures include adopting capital intensive technology to minimize the employment of permanent workers; outsourcing activities to unregulated and unregistered units; moving units to areas with lax enforcement; and even splitting an establishment into multiple smaller units to avoid coming under the purview of legislation.

This propensity of employers to seek labour outside the bounds of regular contractual employment, in particular, has resulted in the exacerbation of what Suresh D. Tendulkar of the Delhi School of Economics calls the "organized-unorganized duality" of the Indian labour force (2003). The "organized" sector constitutes a tiny minority of India's working class who fully enjoy the privileges that India's labour laws guarantee, while the vast majority of Indians, who work in the "unorganized" sector, are unable to experience even the benefits that regular contract-based employment can provide.

Evidence from other parts of the world also substantiates this point—that greater regulation results in an increase in the size of the unofficial economy and a less impressive performance on economic, political, and social indicators. This finding is borne out by an 85-country study conducted by Djankov et al. (2002) that looked at regulations governing the start of businesses. It is not for nothing that, in India, the 1980s are referred to as the "decade of jobless growth," when manufacturing output grew 7.1% per annum while manufacturing employment stagnated (Bhalotra, 1998). Unsurprisingly, evidence shows that the 1976 and 1982 central amendments to the IDA that further strengthened job security regulations resulted in less demand for labour in firms covered by the regulations, but not in small firms that were not covered by the regulations (Fallon, 1987).

How a lack of economic freedom hurts the poor

The problem with economic truths, as Bastiat prize-winning journalist Amit Varma (2008) puts it, is that they often seem counterintuitive. This is, in a way, also the problem with labour laws. Laws that are enacted with the intention of keeping jobs secure and setting centralized minimum wages end up having completely unintended effects, chief among them the reduction of employment altogether. If, for example, the owner of a café decided that she needed extra help for the summer in order to better service the seasonal increase in demand, she would ideally hire an employee for this very short period of about three months and let him go afterward. But if the entrepreneur in question decided that the extra help would not be worth the trouble of dealing with the bureaucratic red tape involved in laying off an employee, then the

"Allowing the invisible hand to work often produces the most desirable results"

labour law in question would reduce welfare all around—that of the employer, who might have benefitted from the extra help in the summer months, and of the employee, who might have found the extra income useful.

The above example is, admittedly, a simplistic one, yet it highlights an important point: that allowing the invisible hand to work often produces the most desirable results. In 2002, Timothy Besley and Robin Burgess of the London School of Economics authored a remarkable study that highlighted this same point. They looked at state-level amendments to the Industrial Disputes Act between 1958 and 1992 and classified these into three categories: pro-worker, pro-employer, and neutral. They then coded each of these with the values of plus one, minus one, and zero, respectively. Upon regressing the labour regulation variable with indicators of economic development and poverty levels, they found that "regulating in a pro-worker direction was associated with lower levels of investment, employment, productivity, and output in registered [organized sector] manufacturing."

Their most striking conclusion concerns poverty levels. They found that "regulating in a pro-worker direction was associated with increases in urban poverty," and that if Andra Pradesh (a state considered pro-employer) had not implemented pro-employer reforms, then urban poverty levels would have been 110% of actual 1990 levels. On the other hand, if West Bengal, a state considered pro-worker, had implemented pro-employer reforms, then poverty levels would have been 10% lower in 1990.

The sad irony here is that it is those who claim to be acting in the interests of the poor who seem to do them the greatest disservice. The claim that economic freedom does not benefit the poor is, therefore, not only a false one, but also a harmful one.

Nikhil Joseph is the 1st Prize winner in the 2009 Fraser Institute Student Essay Contest. He is a Master's student in Development Studies at the Indian Institute of Technology Madras, Chennai, India.

References

Besley, T., and R. Burgess (2004). Can Labor Regulation Hinder Economic Performance? Evidence from India. *Quarterly Journal of Economics* 119: 91–134.

Bhagwati, J. (1998). The Design of Indian Development. In Isher Alhuwalia and Ian Little (eds.), *India's Economic Reforms and Development: Essays for Manmohan Singh* (Oxford University Press): 23–39.

Bhalotra, S. (1998). The Puzzle of Jobless Growth in Indian Manufacturing. *Oxford Bulletin of Economics and Statistics* 60, 1: 5–32.

Djankov, S., R. La Porta, F. Lopez-de-Silanes, and A. Shleifer (2002). The Regulation of Entry. *Quarterly Journal of Economics* 117, 1: 1–37.

The Economist (2009, May 21). Good News: Don't Waste It. <http://www.economist.com/opinion/displaystory.cfm?story_id=13692881>.

Fallon, P. (1987). *The Effects of Labor Regulation upon Industrial Employment in India*. World Bank Research Department Discussion Paper No. 287. World Bank.

Gwartney, J. D., and R. Lawson, with S. Norton (2008). *Economic Freedom of the World: 2008 Annual Report*. Fraser Institute.

Mozumder, S., and M. Tuck (2008). New Data Show 1.4 billion Live on Less than $1.25 a Day, but Progress against Poverty Remains Strong. News release (August 26). <http://tinyurl.com/cvupaj>.

Stern, N. (2001). *A Strategy for Development*. World Bank.

Tendulkar, Suresh D. (2003). *Organised Labour Market in India Pre and Post Reform*. University of California, Berkeley. <http://globetrotter.berkeley.edu/macarthur/inequality/papers/TendulkarLabor.pdf>.

Varma, Amit (2008). *Profit's No Longer a Dirty Word: The Transformation of India*. Library of Economics and Liberty. <http://www.econlib.org/library/Columns/y2008/Varmaprofit.html>.