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Focus 63 – **Macro and Micro Evidence: Labour Reforms Do Not Facilitate Growth in the Manufacturing Sector**

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Abstract

Three Indian states (Uttar Pradesh, Madhya Pradesh and Gujarat) recently adopted new and significant labour reforms amidst the COVID-19 pandemic - supporting companies and businesses willing to more easily hire and fire employees in the hope that this will unshackle industries and attract investments. However, some economists and workers' unions argue that these changes may affect labour markets, reduce productivity and even lead to anarchy. This article aims to explore whether labour reforms actually facilitate the growth of the manufacturing sector in India, and to achieve this through both macroeconomic and microeconomic analyses. We will review past labour reforms and their influence on the labour and manufacturing sectors, asking whether new measures could actually increase productivity - given that to a great extent they only formalise existing practices.

Keywords

Macroeconomic Analyses, Microeconomic Analyses, Employment, Formal sector, Informal sector, Labour Reforms

Introduction

If India had followed the footsteps of other developing nations during the 1980s and the 1990s, it would have witnessed that period's typical growth trajectory: after achieving an optimal growth rate in the agricultural sector, that sector's share of the GDP would decline, a loss compensated by substantial growth in the industrial sector. However, in India the decline in agriculture was accompanied throughout the 1980s and 1990s by growth in the service sector. The liberalisation policies introduced in 1991, which were aimed to benefit the manufacturing sector, failed to achieve any significant impact. It is usually observed that growth linked to a flourishing manufacturing sector allows developing nations to expand labour-intensive exports while also providing opportunities to improve imports; however, in India neither dynamic materialised (Panagariya, 2004). Despite the adoption of liberalisation reforms, the manufacturing sector has yet to substantially contribute either to the GDP or to employment; it plainly falls behind agriculture and services. Its low share of employment could be attributed to technological developments replacing manpower; however the industrial sector's average performance in India is often linked to labour regulations.

Employment, Labour Laws, and Regulations

Since Independence, India's workers were not treated as mere resources to be used for achieving developmental goals but indeed were seen as equal partners in the national quest for development (Sharma, 2006). It was considered important to protect labourers from exploitation and to ensure employment security to all. Such an approach was never considered to be anti-capitalist. It was simply believed that workers who felt secure about their employment prospects and who were provided better working conditions with reasonable hours and decent wages would be more efficient. Such an improved efficiency would cover the additional costs generated from labour regulations (Papola & Pais, 2007).

According to an analysis by Besley and Burgess, registered manufacturing businesses suffered because of these regulatory labour laws. They argued that trade unions hampered business productivity and – a fact they proved by revealing states with more pro-business policies as performing better than their counterparts. The idea was that pro-business policies such as de-licensing and tariff reduction would produce the desired results only if supported by local informal institutions (Kotwal, Ramaswami, & Wadhwa, 2010).

Informal institutions include external environmental agents such as culture, traditions, or social codes of behaviour (Chakravarty & Bose, 2011). The authors further argued that growth in the informal [non-legal] sector was possible because it was not regulated. Firms respond to strict labour regulations by hiring temporary labour - which leads to the expansion of employment in the informal sector. In order to avoid stringent laws, firms also shift business units to states with lenient labour laws - or adopt new technologies, subcontracting labour-intensive shares of the business to multiple, smaller firms. Small businesses tend to remain outside the purview of the law by not hiring workers formally so as to retain their authority over the business. Thus, the absence of labour regulations provided firms with an incentive to continue as small enterprises without trying to expand (Sharma, 2006). It must be noted here that labour regulations are implemented only in the formal sector, whose employment share constitutes only 7-10 per cent of the nation's total labour force (Papola & Pais, 2007).

Even though post-liberalisation reforms brought about an increase in productivity, wages remained stagnant because of an inadequate bargaining power by employees. Effectively the reforms provided enough leverage for capitalists to escape strict rules (Nagraj, 2004). The Industrial Disputes Act (IDA), 1947, which was enacted for the investigation and settlement of industrial disputes and which provided some leverage to employees, was actually draconian and its implementation was very ineffective. There were periods of retrenchments; however, these were not reported. The government set up the National Renewal Fund so as to finance the retrenchment of workers in the public sector - and this was an indication for the private sector to follow suit and adopt similar practices (Papola & Pais, 2007). Nevertheless, again, improvements in output linked to reforms in the IDA impacted only the legal workforce, a minuscule share of the country's total workforce (Papola & Pais, 2007).

The Trade-Off between Labour Laws and Economic Activities

The relationship between labour laws and economic development becomes very complex in the context of low and middle-income countries. In the 1950s, the 'structural adjustment' (Wohlmuth, 1984) theory forecasted that development, when understood in terms of the transition from a subsistence economy to an economy based on wage labour and formal market relations, would lead to greater equality — based on a contraction of differentials in wealth.

In 1954, the Arthur Lewis model had proposed that economies in the early stages of industrialisation would benefit from the entry of low-cost labour; however, as agriculture gives way to industry and an urban working-class is formed, this cost advantage is hampered (Lewis, 1954). This is partly because 'capitalist workers layout themselves into trade unions.'

'Labour' can be defined as the combination of mental, physical and social exertions for the production of an economy. During the lockdown-period in India due to the pandemic, labour supplies were disrupted as many economic activities slowed down. This led to a declining labour productivity as well as Total Factor Productivity (TFP).

Labour laws are known for their major impact on economic development and growth as they embed the norms of fairness in employment practices intended to overcome coordination failures within firms.

This is possible because labour laws contribute to productivity and positive employment effects across extensive economies. In industrialised economies such as India, social legislation plays a significant role in the transition to capitalism by providing mechanisms for minimising labour market risks. In low and middle-income countries, labour laws help build institutional capacity in the area of social insurance, collective bargaining and dispute verdict; they can therefore contribute to the formalisation of employment and reduce economic insecurity. However, with changes in labour laws, these fruitful contributions may become at stake and may lead to social chaos. States that extend working hours for labourers will become trapped in a vicious cycle of unemployment – and the rate of unemployment has already surged over 23% (Vyas, 2020).This is because companies are keeping a few workers and taking responsibilities only for those workers. This will force the limited number of labourers selected by the government to work for longer hours. The labour class, which is already struggling as a result of COVID-19, will become more grievous once various lawful protections are denied.

Macro and Micro Analyses

Macro-analysis provides a view of the net, collective experiences of a given economy – for example a comparison of employment rates in the formal and informal sectors, and a sign of the lack of dependence of employment rates on the growth rate of the manufacturing sector.

Macro evidence shows that the manufacturing sector's share of employment remained the same in the 1980s, while the first half of the 1990s witnessed a rise followed by a 13 per cent fall in jobs between 1995-96 and 2001-02 (Sharma, 2006).

This was a period of jobless growth. If labour laws were taken seriously in the post-liberalisation period and were implemented without any flexibility, the manufacturing sector would not have been able to eliminate so many jobs. At the micro-level, multiple factors affect decision-making by firms – for example the product market, the inputs market, the nature of the industry, the state in which the industry is located, the number of workers, the economic orientation of the government in power, the power of trade unions, and the available technology (Sharma, 2006).

Micro evidence suggests that the growth rate of wages have remained stagnant but that output has increased; this can be seen in the increase in labour productivity. Since the wage-rental ratio (the ratio between labour wages and rental prices of capital or land) has also declined, it can be inferred that increase in output is not linked to greater employment of labour against capital. Therefore, the driving force of the increased productivity could be explained as an increase in modernisation or uses of technology – i.e. increase in capital per unit of labour (Nagraj, 2004).

Workers have been unable to take advantage of improved labour productivity as real wages have remained stagnant. The benefits of the structural policy changes of 1991 were reaped by employers and consumers alone. The employers have been able to survive this reform based on the additional funds they had collected from reducing labour costs. Nagraj further points out that workers are also consumers and that the consumers' purchasing power would have fallen because of job cuts resulting in lower demand for manufactured products (Nagraj, 2004).

Labour Reforms - Formal Sector v Informal Sector

Other indicators highlighting the presence of labour reforms in the market included an increase in the number of contract workers in relation to the total workforce, which clearly indicated that formal sector jobs were being transferred to the informal sector through sub-contracting (Nagraj, 2004). The percentage of contract labourers went up from 19 per cent in 1990 to 23 per cent 2002 (Sharma, 2006). Individual state-level experiences were similar; Andhra Pradesh experienced a surge in contract labourers from 40 per cent in 1990 to 62 per cent in 2002 (Nagraj, 2004).

The increase in contract labour and the government's encouragement of this phenomenon through labour regulations clearly shows that said labour regulations were not hampering the growth of the manufacturing sector because of “insincere implementation,” as reiterated by the critiques of inflexible labour laws in India (Nagraj, 2004).

The state of West Bengal possessed a highly active, labour-orientated political scenario. However, by the end of the 1980s there was a decline in the traditional industry comprising jute and paper mills. The state government was under pressure from the working class regarding job creation; therefore, liberalisation was allowed in the state as the positive implications of the abolition of licenses were newly appreciated. Despite all these changes, the informal sector was performing better than the formal sector in terms of job creation – which was not uncommon in other states. But the uniqueness of the West Bengal experience lies in that the informal manufacturing sector performed better than the formal sector with respect to the output as well. The astonishing fact was that labour productivity was increasing as less workers were producing the same output and thus the output per worker was greater – greater even as compared to what it would have been with a larger workforce. Notwithstanding increased productivity, the rate of growth of this labour productivity was declining.

Additionally, wages were increasing. Trade unions played a role in swelling wages despite the low rate of growth in labour productivity. Trade unions worked only for the goal of improving the conditions of workers inside the system – without concerning themselves with the workers outside the system, i.e. the contractual workers. The consequential increased liquidity from subcontracting was used to increase the wages of existing permanent workers instead of pushing for more employment by making contractual labour permanent (Chakravarty & Bose, 2011). All the aforementioned macro and micro evidence are strong indicators of an imbalanced relationship between employers and employees during that time.

Resistance from trade unions eased up – as was made evident from the fall in the number of strikes and lockouts all over the nation (Papola & Pais, 2007). There were more lockouts than strikes, showing the poor bargaining power of the labour class. The major effort by trade unions was focused on earning better remunerations in case of retrenchment and on increasing wages.

Conclusion

In order to spur economic activity, the dissipated workers must not be taken advantage of during the pandemic. The long struggle for the introduction of labour laws in India and its recognition by the ILO should not be moulded in a backward manner; on the contrary, the aim should be to bring positive reforms and thus foster growth and development.

The government should ensure a universal basic income for all workers, in order to provide minimum wages. This was recently endeavoured in Spain, where the scheme is estimated to help four out of five people in acute poverty. Unemployment was already increasing before the lockdown due to displacement of workers because of artificial intelligence.

With the advent of Artificial Intelligence (AI) India, a country which is labour-abundant, is shifting towards capital-intensive techniques. Further dilution of labour laws will definitely aggravate the poor economic situation of labourers in unregulated sectors. Thus, the Indian government should focus on the necessity of labourers as economic consumers, rather than placing them under the immense strain of poverty.

By now, we have established that there were enough reforms in labour regulations and that therefore, the mediocre performance of the manufacturing sector was not an outcome of a rigid labour market. The argument that labour market reforms facilitate the growth of the manufacturing sector is misplaced as most labourers are not even covered under these regulations.

Even in recent years, the formalisation of labour and the enacting of several laws intended to protect the interests of labourers has failed to show a dependence of the manufacturing sector growth on labour laws. There needs to be a focused discussion regarding whether the changes made in labour laws by Gujarat, Uttar Pradesh and Madhya Pradesh could actually bring any change in productivity, we are only witnessing a formalisation of existing practices.

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