THE POLITICAL ECONOMY OF POLICY REFORM:

LABOUR MARKET REGULATION IN INDIA

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ABSTRACT

The central questions posed by this thesis are: what are the effects of labour market regulations pertaining to job security in India, and why are these regulations so difficult to reform? The thesis finds that job security regulations have a negative effect on both efficiency and equity. They have a significantly negative impact on employment in all categories. They benefit a small minority of highly educated and high human capital workers, while excluding the large majority of the labour force from secure, protected work. They also have a negative impact on output, as they discourage investment. This is shown through a ranking of twenty four Indian states according to the strictness of job security regulations. Highly labour regulated states have lower levels of investment, leading to a negative impact on output, employment and real wage. In this way, these regulations harm both efficiency and equity. In saying this, this thesis supports the distortion view of job security regulations as held by the World Bank, and refutes the institutional view as held by the International Labour Office (ILO). The findings of this thesis show that the result of high levels job security regulations do not cause a necessary trade-off between efficiency and equity (sacrificing the former to get more of the latter), but that the result is a negative impact on both efficiency and equity.

The thesis then asks why policies that reduce both efficiency and equity are so difficult to reform in a democracy like India. It explores this by doing an inter-state analysis of policy reform in ten Indian states, considering each state as a separate democracy. It finds conclusive evidence that political factors influence the capacity and motivation to carry out labour policy reform, and it analyse what factors these might be.

We use a multi-pronged political economy approach in this thesis. We use extensive historical and institutional analysis, combined with fairly simple, but powerful, empirical analysis. Most of our empirical analysis relies largely on simple and straightforward ordinary least squares (OLS). We are encouraged by the fact that we use four different datasets, and all four give us the same significant result. This gives us confidence in the strength and robustness of our findings.

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INTRODUCTION

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1.1 BACKGROUND

"India suddenly looks attractive as a place to do business. Flights to India are packed with businessmen and fund managers seeking to reap the benefits of India's three-year-long liberalisation programme. Foreign capital is finally making an impact in this country--both on the stock market which has gone through the roof, and within industry. So, have we finally arrived on the International arena?"

"India Unlimited"
Business India 1/17-30/1994

"India has slipped to the fifth position in the ranking of "hot markets" for the year 1996-97 from a position in the top three in the early nineties....India happens to be one of the top three markets from where investors have exited in 1996."

"India fifth in emerging markets ranking"
Indian Express 24/11/96

"Millions of state employed and private sector workers in India have gone on nationwide strike to protest against proposed changes to labour laws in the country, which have been described as 'anti-worker'."

Adam Moynott
BBC South Asia Correspondent, BBC World Service
April 16, 2002

In 1991, in the face of an acute balance of payments crisis, India instituted an economic reforms package, the central core of which was a World Bank-International Monetary Fund endorsed stabilisation and structural adjustment programme. The basic premise of this, like structural adjustment programmes all over the world, was that the

Indian economy had, in the past, not been allowed to function on the basis of the free play of market forces. Huge tariff barriers and overvalued currencies had prevented the free flow of goods and services internationally. Macroeconomic policies combined with large state intervention and heavy regulation of domestic economic activities had led to severe distortions in the factor and product markets leading to all round inefficiencies, stagnation, inflation and balance of payments crises. In addition, fiscal profligacy on the part of the government in public expenditure, particularly in providing for unnecessary and ineffective subsidies and budgetary support to non-performing public enterprises, had resulted in large fiscal deficits, fuelling inflation already ignited by the slow growth of output.

Based on this diagnosis, the philosophy of structural adjustment stressed the urgency to change policies to allow free play of market forces in the domestic and external economic operations and reduce the role of the government to the minimum (Government of India, 1993a; 1993b). Resource allocation and economic outcomes were to be left to the market. Macroeconomic policies were to be geared primarily to monetary stability and control of inflation. The State would not only withdraw from all commercial sectors of economic activity and concentrate on preservation of the legal framework that facilitates the smooth functioning of private business, but also remove interventions and regulations that tend to distort the factor and product prices.

The primary aim of these economic reforms was to generate new investment, both foreign and domestic, in all sectors of the economy--particularly the core and infrastructure sectors. The long term success of India's economic reform process depended upon sustained growth in industrial output and investment. Without this, there could not be a genuinely competitive industrial base from where India could launch an export drive to reduce systematically its debt service obligations over time.

The prospects of industrial growth and investment depended on the signals that India gave to the rest of the world as well as her own entrepreneurs. The macroeconomic reforms of 1991 sent out some positive signals, resulting in an initial boom in the *interest* shown in investing in India by foreign and domestic investors. However, the actual volume of investment on the ground has been disappointing in the decade following these reforms, and has not matched the initial interest and excitement generated by the announcement and commencement of India's economic reform programme. Foreign investment has been largely of the portfolio kind--`hot money', which is frequently the way out of India in search of greener pastures (for example now), generating bearish tendencies that have put the Indian stock market into deep slumps too many times relative to its pre-reform stability.

Foreign direct investment has remained largely at the project approval stage, not many approved projects having actually been translated into tangible investment. Many approved projects have in fact been subsequently withdrawn by multinational companies. Domestic investment has been concomitantly shy, despite many tax breaks and other incentives to invest, and with the opening up of the economy, there are fears of capital flight if the Rupee were to be made fully convertible on capital account.

According to many, a major reason for the disappointing investment record of the last ten years is the presence of labour market rigidities and the absence of an exit policy for industrial enterprises in the country.

"If we have the fundamental right to start a business, we also should have a right to close it as well. Freedom of entry and exit is a basic pre-requisite of any competitive business environment."

Rahul Bajaj
Prominent Indian Industrialist

"An exit policy is an integral part of a wider policy initiative aimed at achieving, over a period of time, a more efficient deployment of labour and other resources, a sustained expansion of employment opportunities and an overall rise in labour as well as total factor productivity."
-New Industrial Policy, 1991

"An exit policy is that which seeks to capture the efficiency gains from structural reforms initiated in the economy."

Dr. Manmohan Singh
ex-Finance Minister of India
Architect of reforms

"Labour class is not the only section which is affected by structural adjustment of the New Economic Policy (NEP). In fact, all sections of society are being affected and hence each section has to sacrifice one thing or the other, little more or less, in the process of transformation.....Some amount of retrenchment, retraining and redeployment has to be tolerated in the process of industrial restructuring. Because, to continue the employment of one unproductive labour in a capital intensive public sector unit, the cost is not merely his wages, but also the cost of servicing the capital including accumulated losses. So, it is not the time for brooding over the negative impacts of NEP, but it is the right time for exchanging views to reorient the exit policy and to tackle effectively the issues at the implementation level in such a way that the economy reaches its destination through proper means."

Ministry of Finance
Government of India
White Paper on Exit Policy

"An "exit policy" must be introduced, allowing closure or heavy restructuring of unprofitable companies. India's labour unions are very strong, and, currently, all incorporated companies -- whether private or state-owned -- must go through the bureaucracy to get permission to close or downsize."

Zoher Abdool Karim
Economics Editor
Asian Business 2/1994

This view is summarised by the influential policy expert Jeffrey Sachs (Sachs and Bajpai, 1998), when he says that "labour intensive manufacturing exports require competitive and flexible enterprises that can vary their employment according to changes in market demand and changes in technology, so India remains an unattractive base for such production in part because of the continuing obstacles to flexible management of the labour force" (12). Further, he states that, "an exit policy needs to be formulated such that firms can enter and exit freely from the market. While the reforms enacted so far have helped remove the entry barriers, the liberalisation of exit barriers is yet to take place" (12).

Labour rigidities are blamed for two main weaknesses of the Indian economy here, which are in turn discouraging new investment and hence hindering the economic growth process. *First*, labour rigidities are hampering operational flexibility of enterprises by making them persist with sub-optimal technologies and resource use, thus rendering them unequal to the task of keeping up with changing market conditions and technologies. *Second*, they are both causing industrial sickness due to the previous factor, and are perpetuating it by preventing restructuring and exit once an enterprise becomes sick. In this manner also they are scaring away new investment in the country. Industrial sickness is said to occur when the total losses of an enterprise exceed its capitalisation. It is a problem that afflicts thousands of public and private sector enterprises. In the past, the central and state governments have merely taken over "sick" industries, in order to avoid unemployment, even when these sick units have not produced any output of any kind for several years.

1.2 CENTRAL RESEARCH QUESTIONS

The central research questions of this thesis are: (i) What is the impact of rigid labour market regulations, and who do they benefit ? (ii) What are the state-level variations in the rigidity of the letter and the enforcement of labour market regulation, and what is the differential impact of this variation? (iii) What is the political economic explanation for the persistence of these labour market regulations in the Indian democratic and federal set up, especially if we find that they tend to benefit a small minority and disadvantage the larger majority of the labour force? In order to justify why we ask these questions, we provide the background and context leading up to the asking of these questions below. This chapter is divided into the following sections. Section 1.3 discusses the various policy approaches to studying labour policy that exist in the academic literature. We explain what approach we shall be taking, and why. Section 1.4 provides a brief sketch of employment trends in India. Section 1.5 discusses employment protection, or job security, regulations. Unlike purely industrial relations text, we shall be using employment protection, employment security and job security interchangeably in this thesis. That is what most labour economics academic texts (as opposed to industrial relations texts) do. Section 1.6 summarises existing literature on employment protection legislation in India. Section 1.7 re-states the central research questions in light of the discussion contained in Sections 1.3 to 1.6, and describes the organisation of the rest of the thesis.

1.3 POLICY APPROACHES TO STUDYING LABOUR POLICY

It would be useful at this stage to survey briefly the various policy approaches for the analysis of labour issues, structural adjustment and economic development in contemporary literature. To provide a framework for this section, it relies for the most part on the large body of work done by the International Labour Office (ILO), to provide a framework for this section. The basic disagreement between the Bretton Woods institutions and the ILO are focused on in the next section.

1.3.1 Economic Approaches

Summarised below are the main disagreements between the two major economic approaches to evaluating labour policy. There are two main economic approaches to looking at labour policy—one espoused by the Bretton Woods institutions, and the other backed by the ILO. They can be broadly categorised (inasmuch as any such categories are sensible) as neo-classical *distortion view* and new institutionalist *institutional view*.

ILO (1994, 36) notes that "in the extensive literature on structural adjustment, rather little thematic attention has been paid to the role of labour issues in the design and implementation of structural adjustment programmes. This is as true for national labour issues, in the form of a country's labour law, as it is for the ILO's international labour issues."

It further observes that, if anything, there has been a widespread tendency in economic literature to refer to labour institutions as comprising part of those "rigidities" or "distortions" that impede the smooth functioning of the labour market. The view has been widely expressed that excessive protection for the workforce--whether in terms of minimum wage protection, or protection against dismissal--has damaged long-term prospects for employment creation, bringing benefits to a select few in the formal sector at the expense of the unprotected majority (Abraham and Houseman, 1994; Adison and

Grosso, 1996; Ahluwalia, 1992b; Basu, Fields and Debgupta, 2001; Bentolila and Bertola, 1990; Koshiro, 1992).

The ILO, however, does not agree with this approach, thus laying the foundation for the basic tension between the Bretton Woods institutions and the ILO on this issue. Some analysts at the ILO have pointed out the more positive role of labour issues in creating an atmosphere of trust and comprehension among employers themselves, and in adapting employment systems to the requirements of technological change and progress. Commissioned ILO research, based on industrialised countries of Western Europe, has pointed to the opportunities provided by labour standards for innovative and dynamic forms of industrial restructuring (Sengenberger, 1991).

In many developing countries, both labour market institutions and their regulation framework have come under attack from the advocates of greater flexibility in Washington, DC. A clear example is an influential report on its adjustment lending, issued by the World Bank (Horton, S. et al, 1991; Horton, S. et al 1995), which is highly critical of labour legislation and regulations in certain countries, when they are seen as inhibiting the capacity of enterprises to adjust to changing circumstances. This report singles out recent developments in some countries of Francophone Africa in particular, where labour codes are being revised in order to liberalise wage determination and the hiring and laying-off of workers.

The ILO (1994) points out that Washington economists have been the moving force in policy-making and analysis on structural adjustment. On the other hand, their own main concern has been with the implications of labour issues for market operations, and in particular for the functioning of labour markets (Weeks, 1991; Lansbury and Zappala, 1991). They observe that in neo-classical economic analysis, the underlying premise is that employment and wage matters are best left to the working of market forces, and that external policy interventions to allocate or remunerate labour will lead to inefficiency and misallocation of labour use in the long term. In its more extreme form, they argue, the neo-classical paradigm has rejected most labour market regulations as distortions to the free operation of the market. In practice, they claim, that the main issues at stake have related to minimum wage protection, employment security and severance pay, and restrictions on hiring and firing. But the paradigm has been, on the whole, in their opinion, naturally hostile to trade unionism, or to collective bargaining at the industrial or national levels, which can negotiate wage agreements beyond what is construed as the "market-clearing" level. The arguments are that policy should be concerned with outcomes rather than procedures, and that the market ultimately offers the best outcomes in terms of improved wages and living conditions for all. In our own opinion, we think that the ILO critique of the "neo-classical" paradigm is overly simplistic, and needlessly ideological. More of that will be discussed later, as the thesis progresses.

ILO (1994) also claims that the World Bank's "neo-classical" paradigm is antithetical to ILO's own philosophy, in that it essentially "ignores the value of labour standards as instruments of social justice" (Plant, 1994, p. 57). For an illustration of this conflict, we can look at Freeman (1992), which summarises the arguments for and against considering labour market institutions and policies as a help to economic development in a paper prepared for the World Bank's 1992 Annual Conference of Development Economics. This paper deliberately puts together certain viewpoints attributed to economists in the World Bank and the ILO respectively, drawing on policy literature published by both organisations over the past decade. Surveying the recent disagreements concerning the value of institutional interventions in the labour markets of developing countries, the paper argues that most World Bank economists see government regulation of wages, mandated contributions to social funds, job security and collective bargaining as "distortions" in an otherwise ideal world. ILO economists by contrast tend to stress the potential benefits of interventions, holding that regulated markets adjust better than unregulated labour markets to shocks, and endorsing tripartite consultations and collective bargaining as the best way to determine labour outcomes.

The Bretton Woods approach has been subjected to sharp criticism by a school of economists, broadly referred to as the "new-institutionalists", who defend labour standards and institutions by the criteria of productive efficiency as well as of social justice (Boyer, 1988; Rodgers, 1989, 1991, 1996). The two schools of thought have been succinctly compared, in a publication of the United States Department of Labour (Herzenberg, et al, 1990). The principal disagreement between the two perspectives is not seen as a normative one, although new institutionalist thought tends to place more weight on the moral imperative to raise labour rights and issues. Both schools agree that productivity and output growth are critical to the welfare of workers, but they disagree as to the type of labour interventions and labour market policy that would best achieve these goals. Beyond a minimum list of labour interventions, the neo-classical view is that governments should leave the setting of labour standards to the "free" labour market. According to this perspective, the premature strengthening of labour institutions introduces economic distortions that retard income and job creation. The new institutionalists by contrast see labour institutions as tools that may influence the social progress of development positively or negatively, depending on how governments deal with them (Singh, 1995b).

The theoretical positions of the two schools may also be compared from the perspective of today's global economy. Neo-classical economists, particularly from developing countries, express fears that internationally enforced labour interventions will be a veil for protectionism, and will close off export opportunities for developing countries. Neo-institutionalists express a different concern, that the insufficient regulation of labour interventions in the international economy will lock some firms and countries into low-productivity methods of production that not only deprive workers of their basic rights but also produce poor economic outcomes. From a policy perspective, the neo-classical view implies that policy-makers should avoid finding the appropriate level and kind of regulation to facilitate the operation of economically dynamic and socially acceptable national and international labour markets (Standing, 1989).

To conclude, many ILO social scientists argue that an economist's approach to labour interventions is likely to be a functional one, subordinated to economic objectives. As suggested above, the basic disagreement between different economic schools of thought is not a normative one. They often agree on desirable outcomes, but disagree as to the means for achieving these outcomes. In other words their entry point for examining labour interventions is outcomes, rather than the value of the principles and procedures in themselves.

This thesis takes issue with this implied trade-off between efficiency and equity in the labour market. Such a trade-off is not a necessary one, and we intend to show, by the end of this thesis, that labour deregulation is necessary in India to satisfy both efficiency and equity objectives of social and economic policy.

1.3.2 Legal Approaches

The legal approach to looking at labour policy is mainly through an analysis of international labour standards, as set by the ILO over the years. Labour standards are essentially legal instruments, the drafting and supervision of which tends to be the responsibility of trained lawyers. Lawyers are concerned mainly with principles and procedures, rather than with desirable economic outcomes. Protective labour standards are expected to constitute "rigidities" in the relationship between capital and labour, because that is essentially their function. At the national level they are often the result of hard-fought struggles by worker movements, providing safeguards against exploitative treatment, and as such have an emotional element in them. At the international level, ILO standards are the result of tripartite negotiations, representing a high degree of international consensus as to the basic principles of labour protection, and the appropriate procedural mechanisms for ensuring this protection.

ILO Conventions are designed as minimum standards of social protection, as flexible instruments adapted to the particular circumstances of individual countries. But their position in law is unambiguous. They are Treaty Conventions of international law, which have binding force of law in member States upon ratification. ILO supervisory bodies, in monitoring the application of ILO Conventions in individual countries, have a clear obligation to ensure that law and practice are in conformity with basic principles relating to tripartism, freedom of association and collective bargaining, minimum wage mechanisms, and the termination of employment, among other fundamental issues (Tajgman, 2000).

This not being a law thesis, it will not be following the legal approach to studying labour policy. Although a narrative and comprehension of the law is necessary, we shall do so only to the extent that it helps us in its political economic analysis.

1.3.3 Governance and Human Rights Approaches

The above comments pertain mainly to current debates, concerning the arguments for and against the regulation of labour markets. A policy concern of at least equal importance is the positive role of the state, in providing the enabling environment for development. The World Bank's working definition of adjustment embraces the strengthening of institutions, and poverty alleviation broadly defined. In addition there has been an ILO-inspired emphasis on the social dimensions of adjustment, involving a focus on social policy and the appropriate institutional framework for delivering social protection.

This raises different questions, which can be analysed under the broad headings of governance and public policy, but which can also be addressed from the perspective of international human rights law and principles. The World Bank also has of late been giving much thought to its role in governance, and in establishing the regulatory framework of development. Governance issues are an important aspect of structural adjustment. During the stabilisation stage in particular, past adjustment orthodoxies have been to reduce public spending drastically, and inevitably to reduce state capacities to provide social protection, limiting its role to that of providing an enabling environment for private sector activities. But it is these orthodoxies that are rightly being challenged in many quarters, as a "reaction too far" (Killick, 1997) against the perceived need to reduce public spending in the interests of improved economic management. In the 1990s, rethinking the role of the state in the control and distribution of public assets has become one of the principal debates in development theory.

Above all in Africa, where the state infrastructure has been weakest, severe public sector adjustment can have a devastating impact on labour administration, including labour inspection, employment services and training capacities, among other things. Furthermore, health care, education and other social services are inevitably threatened by austerity programmes. In Eastern Europe, where governments are having to deal with mass unemployment for the first time, there are tremendous pressures on social security systems to maintain the existing levels of social security benefits and also to finance unemployment benefits. The role of employment services has changed, as they have not only to engage in job placement but also in devising active labour market policies in response to rapidly rising unemployment.

There are important ethical questions here, concerning the minimum rights of citizens in the area of social protection, and the minimum duties of states and the international community to provide such protection. International human rights law distinguishes between civil and political rights on the one hand, and economic, social and cultural rights on the other. Separate Covenants on both these sets of rights were adopted by the United Nations General Assembly in 1966, and have both been widely ratified. The United Nations International Covenant on Economic, Social and Cultural Rights contains a number of provisions covering ILO's protective and promotional labour standards, including the rights to work, and social security and insurance. Recent studies undertaken by the United Nations are concerned with the impact of structural adjustment on economic, social and cultural rights, and on the role of international financial institutions in the realisation of these rights (Turk, 1993). They review the impact of structural adjustment on human rights including work, food, adequate housing, health, education and development. And they contain detailed recommendations concerning the World Bank and the International Monetary Fund (IMF) respectively, as well as separate recommendations to the United Nations human rights organs and treaty bodies, and to non-governmental organisations (NGOs). They cover both substantive issues and procedural mechanisms for improving cooperation between the Bretton Woods institutions and the human rights organs of the United Nations, as well as with other UN agencies concerned with social matters.

Again, this thesis shall not be taking this approach to its analysis of labour policy.

1.3.4 Political Economy Approaches

Many economists are now displaying a renewed interest in both empirical and theoretical work on the development and role of labour market institutions, including the regulatory framework embodied in labour law and standards. Many labour economists, aware of the sterility of the more classical labour market analysis, are urging a more inter-disciplinary approach which, for want of a better term, may be called the "political economy of labour market institutions". Using the diagnostic tools of the historian and the political scientist--and to some extent also of the lawyer--they are asking how labour institutions develop, why and under what circumstances they change, and why they are more subject to administrative reform in some regions than others. A critical literature is now developing above all in Latin America (where the labour movement has been historically influential, and labour law rigorously codified since the mid twentieth century, but where the pressures of flexibility in labour laws are now unusually strong) (Montenegro & Pagés 1999; Heckman & Pagés 2001; Mondino and Montoya 2000) and in the newly industrialising countries of East and South East Asia (where labour laws and institutions have historically been weak) (Banuri, 1991; Haggard, Koo and Deyo, 1987). Regrettably there appears at present to be an absence of such literature in India, though it is arguably the sub-continent where labour laws have been more rigorously codified, and where analyses of this nature would appear to be most urgently required.

Some of the most significant research concerning the interrelationship between adjustment measures and political or labour market institutions has been carried out by, or under the auspices of, the World Bank in recent times when social effects of structural adjustment have become a larger policy concern at the Bank (Fallon and Lucas, 1991; Fallon and Riveros, 1989). Country case studies have been examining the traditional perceptions that labour market institutions in different developing countries are obstacles to effective adjustment. The preliminary findings of this research have already been published in an edition of the ILO's *International Labour Review* (Horton et al, 1991). The research has since been published in the form of two edited volumes by the World Bank (1995).

1.3.5 The Approach in the Thesis

Clearly, then, there are different ways in which the role of labour interventions in structural adjustment, as indeed in all development issues, can be addressed. If one is to take a strictly legalistic position, then that will be that certain standards must be applied because they have the force of law, whether or not they are perceived as a hindrance to certain aspects of economic development. A second approach can be based on moral or human rights principles. This does not consider the position of law of national or international labour standards, or the level of ratification of international labour standards, but rather identifies certain internationally recognised human rights that should in all cases be protected and enforced. A third approach can be based on economic criteria, assessing the value of labour standards through their contribution to desirable outcomes and development objectives. The economic argument for labour interventions is that they can positively assist economic development, rather than providing any form of impediment. A fourth approach, using the tools of political economy and empirical analysis, argues that the role of labour interventions depends on factors specific to each developing region. This thesis has used the political economy approach for its analytical research. This means that although the analysis essentially an economic one, it is, nevertheless, heavily supported and informed by historical and political insights and an analysis of how institutions evolve.

Having thus specified the approach that will be used for the rest of this thesis, we now take a look at why we need to study labour policy in the first place. To understand the importance of discussing labour, we must start with discussing employment issues.

1.4 EMPLOYMENT IN INDIA

"More has been written on the unemployment problem of India than on that of any other country in the world"

- Amartya Sen(1972)

The quote above from Amartya Sen was written three decades ago. But despite this intense scrutiny of the unemployment problem in India that Sen refers to, Basu, Fields and Debgupta (2000) rightly observe that the difficulty with the writings on unemployment in the Indian context has been a lack of conceptual rigour in the true identification of the problem, or in quantifying the full extent of unemployment.

Myrdal (1968) argues that the Western conception of unemployment is inapplicable in the context of India and when we talk about the problem of unemployment in India and feels therefore that there was a need to develop a new "conceptual kit" (p. 168). The brief discussion below will highlight some of the views of the extent of unemployment.

In evaluating employment in India Papola (1994, pgs. 1-2) identified the following broad trends shown by the Census of India, 1991 and National Sample Survey (NSS) employment data:

(1) "Employment growth rate over the previous two decades had been of the order of 2 per cent per annum whereas the growth rate of the labour force had been of the order of about 2.5 per cent. Employment growth decelerated in the early 1990s to 1.5 per cent per annum.

(2) Employment had grown faster in construction, followed by manufacturing and services. Among the major sectors, agriculture had had the slowest employment growth over the entire period.

(3) In manufacturing the unorganised sector had shown a relatively higher and the organised sector a relatively lower average growth rate of employment.

(4) The reported deceleration in employment had been particularly sharp in agriculture and the manufacturing sectors.

(5) Even though the employment structure had undergone some sectoral shifts away from agriculture and in favour of all other sectors, agriculture still continued to employ about two-thirds of the workforce.

(6) The proportion of the self-employed, who constitute the majority of workers, had declined. There had been a corresponding increase seen in the category of the casual wage earners.

(7) Employment had grown much faster in the urban rather than the rural areas, but most of the growth had been in the informal sector.

(8) In the rural areas, the non-agricultural sector had shown a significantly high employment growth, though it still contributed only about 22 per cent of the total employment." (pgs 1-2)

The 1991 Census data on employment revealed that, despite a significant acceleration of the industrial growth rate during the 1980s, the share of manufacturing in total employment had declined (Bhattacharya and Mitra, 1993). Employment growth in private organised manufacturing had been negative during the 1980s, and the w.r.t. output

employment elasticity in the manufacturing sector as a whole turned out to be as low as 0.2. Employment projections for the 1990s based on sectoral employment elasticities in the 1980s suggested that there was a substantial addition to the volume of unemployment in the first two years of the structural adjustment programme, i.e. during 1991-93.

While there are considerable difficulties in accurately measuring the extent of unemployment in India, what is clear is that the magnitude of unemployment and underemployment is very substantial. The unemployed and underemployed comprise an immediate and obvious category of the *socially excluded.* As a result, it is argued, there appears to be a growing casualisation of the workforce, with both men and women increasingly relying upon insecure and temporary employment rather than self-employment or regular jobs (Ghose, 1992, 1994, 1996, 1999).

Many economists have argued that the trends discussed above are largely the result of the employment protection legislation in India. We will be evaluating this claim later in the thesis. For now, we provide a brief synopsis of the legislative interventions enacted by the state to protect labour.

1.5 EMPLOYMENT PROTECTION LEGISLATION

Aspects of industrial relations, which are governed by collective bargaining in the West, are often determined by legislation in India. According to the Indian constitution, labour falls in the concurrent list of the Constitution. This means that both the central government and the twenty-five state governments can enact labour laws. In practice, most laws, although enacted at the national level, are ratified, enforced and implemented at the state level. Their effects in the local labour market depend upon how rigidly they are enforced and how well they are implemented. Typically, the state governments have played a pivotal role in the labour market.

As mentioned in the previous paragraph, under the Indian Constitution, labour is considered a "concurrent" subject - meaning both federal and state governments can legislate on such issues. The result: 47 federal laws and more than 170 state statutes dealing directly with labour. Broadly, the Indian state has legislated on almost all aspects of labour policy--union recognition, terms and conditions of employment, wages and bonuses, and on exit and layoff procedures.

The main employment protection legislation, in all this, is the Industrial Disputes (ID) Act, 1947, which was the first legislation on exit, layoffs and closures, initially applied with different degrees of severity to firms employing between 50 and 100 workers and to firms with 100 or more workers. As it stands today, it is a highly complex statement, riddled with caveats, amendments and state-level differences. Firms employing fewer than 50 workers fall outside the scope of this clause, according to the federal enactment, though not according to many state-level amendments. When first introduced, the ID Act did not restrain employers from laying off or retrenching workers or closing down unprofitable businesses provided they notified the workers and the unions of the intended changes well in advance.[1] The provisions relating to payment of compensation for layoff and retrenchment were introduced in 1953. An amendment in 1964 standardised the compensation at 15 days' average pay for every year of continuous service, and required the employer to give the worker and the government a month's notice.

The ID Act did not restrict completely the right of the employer to close an unprofitable business. The amendment in 1957 required the employer to compensate the workers affected by closure in the same way as if they were retrenched. In the case of firm closure, the government declares the establishment "sick" and the firm is required to continue functioning on the basis of government subsidies.

This Act underwent three major national-level amendments since 1947, when it was first enacted. Each of the three amendments of the Act in 1972, 1976 and in 1982 seemingly gave greater protection to workers than the preceding one. In the current amended version employers employing 100 or more workers must give notice of a closure to workers or their representatives and to the government, 90 days prior to the date of intended closure. The employer, in his request, has to state in detail the reasons for closing down the business. The government inquires into them, hears both parties

[1] Basu, Fields and Debgupta (2000) explain that in Indian legal language "layoff" refers to dismissal of workers because of slackness in demand and with the intention of re-hiring these workers when business picks up. "Retrenchment" refers to a more permanent laying off of workers.

and either grants or refuses the permission to close - usually the latter (see Datta Chaudhuri and Bhattacharjee, 1994). Refusal has to be communicated to the parties in writing within 60 days of the notice from the employer. Employers with 50-99 workers need only to notify the government, while those with less than 50 employees need not even do that to close their business. However in practice workers in such firms can appeal to other laws, such as the Indian Contracts Act, 1972, to resist dismissal.

Therefore, to summarise, currently, the ID Act (chapter V-A) requires an establishment employing 50 or more workers, in the case of valid retrenchment, to provide the workers with thirty days' notice and 15 days' pay for every year of continuous work by the worker at the firm. In the case of closure or sale, the employer must fulfil the same conditions, unless the successor takes on these obligations (Sections 25FF and 25FFF).

For an establishment employing 100 or more workers, the ID Act, under chapter V-B, requires prior permission from the government before firm closure or worker retrenchment. Applications for retrenchments and layoffs with government seldom succeed and, of course, knowing that in advance, firms do not make too many such applications. This is evident from a short subsection in the *Indian Labour Year Book 1992*, (p. 82) entitled "Retrenchment and Lay-off":

> *"During the period January - August, 1992, four proposals, two each for retrenchment and lay-off were received for consideration by the Ministry of Labour. One proposal seeking permission for retrenchment was rejected whereas the other remained under consideration of the Government. One proposal for lay-off was withdrawn while the other was found to be not maintainable."*

What is the current received and conventional wisdom about the impact of this employment protection legislation?

1.6 SUMMARY OF EXISTING LITERATURE ON THE IMPACT OF EMPLOYMENT PROTECTION LEGISLATION IN INDIA

Basu, Fields and Debgupta (2000), in their excellent theoretical paper on employment protection legislation in India, provide a very useful summary of existing literature. As discussed above, they emphasise that over the years, the Indian State has enacted and implemented a variety of legislation meant to protect the well being of the worker. In doing so, they observe with slight bemusement, there are laws protecting trade union rights, laws that abolish bonded labour and child labour from hazardous industries, legislation guaranteeing a minimum wage and laws to prevent retrenchment, layoffs and dismissal of labour (ibid, p. 1).

They reiterate the fact stated above that in India firms employing more than 100 workers must seek government permission for any retrenchments they wish to make, and the workers in these firms are entitled to three months notice of any such action.[2] As for plant closings, companies employing more than 100 workers must receive government permission before any closure; the government may grant or deny permission for such a closing, even if the company is losing money on the operation. Broadly, legislation covers measures that protect labour from retrenchment by employers.

They observe that the main aim of these regulations is to protect labour and the traditional view of such legislation is that it does work to increase the welfare of labour. But, they observe, the reality is quite the opposite. They argue that one of the effects of such legislation is that it makes the Indian economy less *flexible*, another effect is to reduce the level of desirable activities and adjustments. "When companies encounter adverse business conditions, the retrenchment legislation compels them to maintain bloated work forces, leaving fewer resources for investment in new production processes and lines of activity. Companies that may wish to close current operations and re-deploy their resources elsewhere cannot do so." (Ibid, p. 12)

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[2] The Government of India has announced its intention to raise this limit to 1000 in the latest Indian Union Budget (2001-2). No action has, however, been yet taken on this front, one year on. The Annual Labour Report has been continuously delayed, as the government finds it difficult to achieve political consensus on this matter.

These negative side effects of current Indian law must be weighed against the intended main-effect, which is to provide greater labour market protection to Indian workers. Few studies have considered the pros and cons of restrictive labour retrenchment policies. There is an attempt to formulate a theoretical framework for their study by Basu, Fields and Debgupta (Basu, Fields and Debgupta, 2000), which weighs the presumed negative side effects of the current Indian retrenchment laws against its intended main-effect, which is to provide greater labour market protection to Indian workers. Their study uses a model specially designed for this purpose based on "realistic institutional assumptions and empirical information" (Ibid, p.14). They point out though, that they are not arguing *against* legislative intervention. In fact they argue that some legislative intervention is required. In fact, they concede that there are important labour market interventions, which are well justified (Basu, 1995; Fields and Wan, 1989).We hold the same position and concur with the authors when they argue that while it is easy to make an intervention that at first sight appears to help workers, in reality often times such an intervention does not.

Basu, Fields and Debgupta demonstrate how anti-retrenchment legislation may have paradoxical effects. For example they theorise that labour legislation in question raises labour costs compelling companies to hire fewer workers than they might otherwise have, and may preclude these companies from entering a particular product line in the first place. They observe that "this last consequence of the legislation is ironic because it suggests that, in terms of overall impact, this seemingly protective law may actually be harming labourers rather than helping them, by causing a cutback in employment and possibly a lowering of wages." (Ibid, p. 15)

For the European case, an important path breaking study by Bentolila and Bertola (1990), analyses the firm level impact of government policies that increase the cost of retrenching workers. It has inspired many of the subsequent studies on the subject. The study uses aggregate data from France, Germany, Italy and the UK to analyse the labour demand of a single monopolist in the face of changing hiring and firing costs. The conclusion, based on a partial equilibrium analysis, is that a higher dismissal cost actually *increased* long-run unemployment.

Hopenhayn and Rogerson (1993) in a closely related study using micro-data within a general equilibrium framework found that a tax on lay offs significantly reduces steady-state employment.

In the Indian context, many other observers (besides Basu, Fields and Debgupta 2000) have also claimed that India's protective labour legislation has hurt India's overall growth and efficiency (see Lucas, 1988; Ahluwalia, 1991; Papola, 1994). Basu (1995) has shown in a theoretical framework, that labour legislation may have actually hurt the very labour it was meant to protect.

Basu, Fields and Debgupta (2000) assert that the rigid retrenchment laws increased the costs of adjusting a firm's employment level and led firms to consider not only current market conditions, but also future labour needs while making their labour decisions. A firm will therefore, they hypothesise, be reluctant to hire additional workers during an economic upturn if it anticipates significant costs in reducing its work force during a subsequent downturn. Table 1.1 (taken from their paper) highlights the effect of labour protections under the ID Act for firms employing certain numbers of people.

Table 1.1
Number of Workers by Firm Size
(Firms with Gross Investment 0 to 2 million Rupees)

Firm Size	No. of Workers 1982-83	No. of Workers 1990-91	Percentage change
0 - 49	807,421	957,922	18.6
50 – 99	467,418	443,276	-5.2
100 – 199	392,592	280,631	-28.5
200 +	505,727	288,135	-43.0

Note: 'Firm size' is measured by employment range

Source: Basu, Fields and Debgupta (2000), taken from Annual Survey of Industries 1982 - 83: Summary Results, CSO Government of India, New Delhi, August 1986. Annual Survey of Industries 1990 - 91: Summary Results, CSO Government of India, New Delhi, May 1994.

Table 1.1 (Basu, Fields and Debgupta 2000, 21) gives the numbers of workers employed in firms of different sizes, size being measured in terms of the size of employment for 1982-83 and 1990-91. For reasons of comparability of the data Basu, Fields and Debgupta restrict attention to firms that have a gross investment in plant and machinery not exceeding two million rupees. What these figures illustrate is quite remarkable. There is a severe decline in employment in firms employing more than 100 workers and a mild decrease in firms employing between 50 and 99 workers over time. There is, however, a clear increase in employment for small firms - those employing between 0 and 49 workers. Basu, Fields and Debgupta conclude that while one needs detailed analysis to ascertain the causes of this, it is interesting to note that these changes are well in keeping with the amendments in the ID Act which made retrenchment and layoff harder for firms of employment size 50 to 99 and more so for firms sized 100 and above. We carry out the detailed analysis that they highlight the need for.

In their important contribution in the *Journal of Development Economics*, published originally in the *World Bank Economic Review*, Fallon and Lucas (1991) come to similar conclusions in their study that empirically examines the job security regulations in India and Zimbabwe, two countries with very restrictive retrenchment laws. Using a dynamic labour demand framework, they find that the retrenchment laws significantly *reduced* the demand for workers for any given level of output. In particular, they estimated that in India, the 1976 amendment to the Industrial Disputes Act (1947) reduced the demand for labour by 17.5 per cent, increasing the pressure on the unorganised sector to absorb excess labour supply. They were, however, unable to find evidence to suggest that firms adjusted to the retrenchment laws by lowering wages or by increasing hours per worker.

The impact on the behaviour of employers is also very striking. The hiring (and firing) practices of employers have undergone a significant change as a result of these labour legislations. Work by Papola (1994), Ramaswamy (1984), Ahluwalia (1991), Datta Chaudhuri (1994) and Mathur (1992, 1993) broadly agree that employers in India have reacted to restrictive labour laws in many, usually negative ways. Basu, Fields and Debgupta (2000) summarise and enumerate those negative ways in the following manner: "...

(i) *the greater use of contract, temporary and/or casual labour;*

(ii) *the expansion of leasing-in capacity of small firms;*

(iii) *the increase in capital intensity and the adoption of new labour saving technologies;*

(iv) *the use of golden handshakes;*

(v) *the setting up of production in states where labour is not organised or militant, and*

(vi) *the increasing resort to corruption and bribery in order to avoid the legal consequences of retrenchment." (p. 28)*

Basu, Fields and Debgupta also highlight another result of restrictive labour laws is the continuous attempts made by the employers to circumvent the law and escape penalties. They use case studies to illustrate their point and to bring to light the strategies used by management:

(a) Use of Lockout as a means Towards Closure: They use the case of the the Murphy Electronics Company in Bombay (Mumbai), which, fearing that the Government would not grant permission to close down one of its plants that produced television and radio equipment, decided to use lockouts and promoted inter-union rivalries as the pressure tactic to get rid of workers. During the period of lockout, the management made arrangements to carry on production of Murphy products produced completely by small sub-contractors by stamping its own label. The result was that out of the 2,500 workers only 497 remained and the strategy helped the management to get the plant to be declared a sick unit by the Board of Industrial and Financial Reconstruction (BIFR) in 1988. This method of "backdoor" firing is very common and can be seen in many instances, including Binny Textile Mills, Scooters India Ltd and the Tata Iron and Steel Company Limited.

(b) Sub-contracting: It has been noted by many observers of the Indian economy (see Ahluwalia, 1991, 1992a, 1992b; Bhattacharya and Mitra, 1993 and Davala, 1992b) that sub-contracting out production by big firms to small firms has become a major technique by which the large firms try to reduce their costs and pressure the unionised workers to leave or accept voluntary retirement schemes. The retrenchment law is silent on sub-contracting and management can effectively force a lock-out or face a strike without a major loss to them. Many companies, like TELCO for example, sub-contract every little function to private companies, thus casualising the majority of their effective work force. A worker may work in a Tata plant for 20 years or more, and still not be a Tata employee (personal fieldwork).

(c) Transfer of Ownership: It has been noted that while Section 25(O) of the ID Act makes it obligatory to seek permission for closure, it does not require any permission in cases of transfer of ownership from one company to another (Basu, Fields and Debgupta, 2000). It is not incumbent on the new owners to retain all the workers and employees of the old company. Alembic Glass Works in Bangalore and Baroda to retrench workers successfully used this strategy (Basu, Fields and Debgupta 2000, p. 30).

(d) Total Closures: Basu, Fields and Debgupta (2000) use the case of the workers of Mafatlal Engineering, who have waged a long struggle against the management. Recently Mafatlal Engineering was converted into an employee-owned corporation after a long legal struggle. The earlier management wanted total firm closure against the wishes of the workers.

These cases are just a representation of a large number of ways firm management have addressed the rigid retrenchment laws. Basu, Fields and Debgupta note, "What is interesting and, from our point of view, the relevant point in all these examples, is how little contracts play a role in the Indian labour market. The existence of exogenous rules governing employer-employee relation has relegated independent contracts to a relatively unimportant position, robbing the labour market of flexibility." (p. 32)

They highlight yet another area affected negatively by restrictive labour laws--namely the number and frequency of labour disputes. In India the labour market has been characterised by disputes, recurrent strikes and work stoppages. They note that working days lost in India per thousand workers due to industrial disputes in 1979 was 1280 as against 10 in Sweden, 60 in Japan, 200 in France, 370 in West Germany, 840 in UK and 1080 in USA. It is argued that, by severely limiting the scope of voluntary contracting between workers and employers, India's labour laws may have, far from mitigating strife, contributed to it. In particular, the incidence of lockouts in the private sector has risen sharply. In 1973, there were 6,764 work days lost to lockouts. In 1988, the figure was 21,417 (Ministry of Labour, 1989). In part, they suppose, this may be a response to the amendments to the Industrial Disputes Act, 1947, in the 1970s and 80s, as discussed above. Even if we ignore the effects of such laws on the economy as a whole and focus instead on labour welfare, it is difficult to come out with unequivocal results. Basu, Fields and Debgupta, thus summarise at one place the arguments and hypotheses of a large body of Indian economists thinking about this area. We take this analysis further, and test some of their theories.

This thesis aims to analyses and understand the impact of employment protection legislation of the kind described above. It also asks the further question: *Why do different democracies have variable success in reforming their labour market regulations?* Recent politico-economic literature has begun to address this important question. In particular some attempts have been made to analyse the likelihood of labour market reform programmes surviving the political process. The main argument of this literature is that the labour market reforms that are discussed are not Pareto-improving moves. Instead, they redistribute income from formally employed insiders to the formally unemployed (or informally employed) outsiders. This point has been put forward by Saint Paul (2000), who argues that "many of the reforms that would reduce unemployment are unpopular because they would remove regulations that benefit the insiders." (p. 2). Thus, given that outsiders outnumber the insiders, why is it that reforms fail politically? Why do democracies not select programmes for labour market reform that do make everybody better off? This thesis uses different states of the Indian Union as different democracies to try and answer this question.

1.7 CENTRAL RESEARCH QUESTIONS AND ORGANISATION OF THESIS

To recapitulate, this thesis asks the following questions:

1. What are the foundations of labour legislation, especially employment protection (or job security) legislation in India? How can we best situate the evolution of labour regulations in the larger context of the evolution of the political economy of India over the last half century or more?

2. What is the impact of job security regulations in India? How do we explain our results?

3. Can we rank the different Indian states in order of strictness of job security regulations?

4. If yes, then can we analyse a state-wise impact of differing levels of job-security regulations in different Indian states?

5. If yes, then what are some of the political economy variables that could explain the differing success in achieving job security deregulation by different states of the same Indian Union?

The story being told through this thesis is the following:

Chapter 2 examines the foundations of labour legislation, particularly job security legislation, in India, and attempts to situate it in context of the political-economic-historical evolution of the Indian state. It establishes the nature of the patrimonial state in India, and the various patterns of interest groups and rent-seeking behaviour that this gave rise to. It describes how employers and organised labour have influenced the labour regulatory framework to further their rent-seeking objectives. It also points out that unlike developed industrial economies, job security regulations in

India were not fought for and won from below, but imposed from above by an educated elite steeped in western liberalism.

Chapter 3 summarises the qualitative fieldwork research carried out by myself in the period 1995-98. These include structured and unstructured interviews and primary observations, including our fieldwork diary. This is combined with important insights provided by the Bombay Labour Flexibility Survey, on which I was a Research Associate. This chapter, along with Chapter 2, sets the stage for the quantitative analysis in Chapters 4 and 5. It shows how and why we formed the impression that labour laws in India do not help labour, but instead help to preserve, propagate and perpetuate a political economy of rent-seeking based on five decades of a cosy relationship between the state, capital and organised labour.

Chapter 4 assesses the impact of job security regulations in India, using firm-level data collected by the Centre for Monitoring the Indian Economy (CMIE), as well as household-level National Sample Survey (NSS) data. This analysis is done at a national level, and not broken up by state. We find that the analysis on both sets of data produces the same result: increasing job security has an adverse impact on both firm-performance, as well as worker welfare in India. There is a significant negative impact on employment. Although we begin the thesis with an open mind, looking at all sides of the debate, our findings strongly support the distortion view espoused by the World Bank. We find that male, educated, high human capital workers working for large firms are most likely to corner protected jobs, while the majority of the labour force remains unprotected. Further, we find that firm-level data tells us that job security regulations have a negative impact in employment growth.

Chapter 5 ranks twenty-four of the twenty-five Indian states on the basis of the strictness of the job security regulation as enforced in those states. All states function within the constitutional parameters set by the Indian constitution, but have a limited and significant amount of policy discretion stipulated by the Constitution, and also because enforcement of regulation takes place at the state-level, and can, and does, differ from state to state. As such, these states present an ideal sample to carry out a controlled regression analysis to show the differential impact of job security regulation strictness in these states, as well the causes for this differential impact. The former is done in this chapter, and the latter in **Chapter 6.** Chapter 5 finds that high levels of job security affect employment of nearly all categories negatively, and unemployment of nearly all categories positively. This further reinforces our support of the distortion view.

Chapter 6 asks the question: What factors help to explain differences in labour (and other) economic policy choices among these state-level democratic governments? It outlines the different arguments in the political economy literature that offer answers to this question. Subsequently, this chapter tests the applicability of these arguments to ten state governments in India, from 1985-1997, to explain why these states differ in their degree of market openness. These states make for useful comparisons. Since the 1980s, they have varied widely in their ability to initiate and sustain market reforms despite the fact that most of their policy makers and governmental leaders have pledged their support for more orthodox reforms. Using a Time-Series Cross-Sectional (TSCS) data set, this chapter constructs a model of policy choice for the ten states. It includes a number of variables that represent political and economic constraints on policy choice. The findings suggest that a centralised executive and a highly polarised party system are important for initiating and sustaining more orthodox policies.

Chapter 7 pulls together the arguments from the different analyses contained in the different chapters, and provide a conclusion to the story that we have outlined above.

CHAPTER 2

EVOLUTION OF JOB SECURITY REGULATION IN INDIA

As in many other developing countries, the huge labour market in India is characterised by a large pool of ill-paid workers in insecure employment who are *de facto* unprotected by law, coexisting with a small unionised segment holding relatively secure, career-oriented jobs. It has often been suggested that in a situation of superfluous labour, stringent provisions of labour laws and power of trade unions together are to be blamed for the effort on the part of employers to avoid hiring regular employees and (to the extent possible) have the work done through subcontracting or by casual workers--efficiency wage theories notwithstanding (Mathur, 1989; 1991a; 1991b; 1992; 1993). Available Indian data in recent times do indeed show such a rise in insecure employment, both in absolute and in relative terms, although it may be difficult *a priori* to ascribe any specific portion of that rise to the factors mentioned above.

While the quantification of such effects is useful, it is equally important to decipher whether such phenomena, to the extent they exist, are socially acceptable, if not on moral at least on pragmatic grounds (Datta Chaudhuri, 1994). For if they indeed are acceptable, enacting laws alone will not amount to much. The issue has to be analysed in the context of the complex pattern of inter-linkages between the social and political foundations of labour legislation in the country as well as its moral and ethical roots. Also important is the manner in which public opinion is moulded in matters of what is ethical and what is practicable. Even more important are the connections between the two in popular belief, the linkages between social sanction and judicial decisions, and the actual operation of labour laws in the context of a highly fragmented labour market (Holmstrom, 1998; Solow, 1990). The next section is an attempt to chart out these inter-linkages with reference to Indian industry as it exists today.

This chapter is organised as follows: <u>Section 2.1</u> discusses the inter-linkages between wages, earnings and terms of employment in India. <u>Section 2.2</u> discusses the philosophical foundations of labour legislation in India, and highlights the implications of it being a case of altruism from above, rather than hard-fought concessions from below. Section 2.3 discusses the linkages between labour law and society and polity in India. Section 2.4 asks the question: what do labour rigidities really mean for the Indian case, with its highly segmented market containing a small protected "rigid" section and very large and increasingly unprotected segments for the rest of the labour force? Section 2.5 provides an exhaustive discussion of job security in India. Section 2.6 carries that discussion forward by providing a history of job security regulation in India. Section 2.7 moves further from the chronological evolution of job security regulation, to the legislative evolution of job security regulation in India. Section 2.8 discusses various aspects of the implementation of such regulations. Section 2.9 provides a discussion about job security, labour flexibility and employment. Section 2.10 speculates about how much security can and do job security regulations actually provide? Section 2.11 concludes the chapter, and together with Section 2.10, sets the stage for Chapter 3, where the qualitative fieldwork research is presented.

2.1 WAGES, EARNINGS AND TERMS OF EMPLOYMENT IN URBAN INDIA

The labour market in urban India is highly stratified. As of 1983 total employment in urban India was of the order of 57.84 million, of which 24.21 million was said to be within the organised sector; 16.87 million in the public sector and 7.34 million in the organised private sector (Mukhopadhyaya, 1997). Thus at least three out of five urban workers were in the unorganised sector. This is only the lower bound, because a number of workers who are employed by large units may have been working as casual or contract workers. In absolute and in relative terms, worker vulnerability has been high and may in fact have been rising in recent years.

There are a number of macroeconomic indicators of this increased vulnerability. Between 1973 and 1983, the number of causal wage labourers in Indian cities and towns rose from 4.8 million to over 10 million. In 1983, over two-fifths of the total male workforce and nearly half of the female workforce were self-employed. A large majority of these self-employed people were in low-productivity, low-income services and trading activities. This is corroborated by the 1980 Economic Census data, which show that of all those working in urban enterprises nearly one-third were in own-account units, namely very small establishments that are run, predominantly, with the help of unpaid family workers and not even one hired person in a regular basis. A large number of the remaining two-thirds were employed by small establishments outside the purview of the Factories Act, at precarious pay and terms of employment.

In 1990-91, the entire organised sector employed, on a rough reckoning, about 8 per cent of the total employed labour force in the country. Only about 8 million (7.4 million according to the Ministry of Labour and 8.2 million according to the Central Statistical Office) of these worked in industries (manufacturing and electricity, gas and water); they constituted just over 29 per cent of the organised sector employees and just over 2 per cent of the total employed labour force of the country (ILO, 1996).

But, the employment security regulations strictly apply to establishments employing 100 or more workers. According to the Annual Survey of Industries (ASI), 5.8 million people worked in industrial establishments employing 100 or more workers. If it is assumed that all public sector employees in non-industrial activities enjoy the benefits of employment security, the total number of people enjoying these benefits works out to 22 million or 6.5 per cent of the total employed labour force in the country (ILO, 1996).

So, a small group of workers, especially those in the public sector, and a yet smaller number in the organised private sector have been in a rather enviable position. However, for various reasons, employment in the latter has been stagnant, at times even declining, in recent years (World Bank, 1989, Kannan, 1994; Bhalotra, 1998).

Official documents define a public sector establishment as one that is owned, controlled or managed by:

(i) the Government or a department of the Government;
(ii) a government company as defined in section 617 of the Companies Act of 1956;
(iii) a corporation or a cooperative society established by a central or state Act which is owned, controlled or managed by the Government; or
(iv) a local authority.

While terms and conditions of employment vary quite a bit between different branches of the public sector, regular employees in all branches of the public sector enjoy full employment security. Since profits are not supposedly the guiding principle of operation in public sector concerns engaged in the production of goods and services, accountability for poor performance is low, so much so that the popular image of public sector enterprises (PSEs) is one of *de facto* non-accountability for inefficiency. Employees of PSEs under the central government, like the Steel Authority of India Ltd., or Coal India Ltd., totalling about 2 million workers, enjoy constitutional guarantees in line with those enjoyed by government civil servants in the various administrative departments of the central government.

At the same time, they enjoy a number of benefits available to industrial workers which are not available to the latter. To cite an example, they are entitled to a dearness allowance (DA) or cost-of-living neutralisation formula, fixed at Rs. 1.65 per point rise in the Consumer Price Index (CPI), whereas the corresponding figure applicable to central government employees under the ruling of the fourth pay commission is Rs. 1.23. By past experience, it is indicated that DA revision takes place once about every four years for employees in PSEs, which is about three times as often as central government employees can hope for. Strong union pressures have resulted in a steady upward trend in the pay and allowances of public sector employees. The average emoluments of employees of PSEs between 1970-71 and 1984-85 registered an increase of about 344 per cent, while during the same period, the CPI increased by only 270 per cent. All this happened during a period of low or negative profits and dwindling productivity in many of these undertakings.

Clearly, productivity and ability to pay of the undertaking have not been criteria in pay fixation. A regular unskilled worker in a central public sector concern earned about Rs. 50 a day, while a miner, covered by the Minimum Wages Act (MWA) was paid Rs. 12 a day, and in most parts of the country, an agricultural labourer, also covered by the MWA, could hope to make at most Rs. 11 a day, and that in the rare cases where the letter of the law was followed. While degrees vary, the story was similar in most branches of the public sector, as well as in the administrative departments, whether at the central or state level (Mukhopadhyaya, 1997).

This is not to suggest that the entire problem of inefficiency and stagnation in public sector undertakings is one of workers' overpay, and that efficiency and productivity in these concerns would automatically go up if one could by some device contain their workers' demands for pay increases. The point being emphasised here is simply that emoluments and conditions of work vary enormously across different groups of workers, well beyond what is warranted by differences in skills or productivity. Moreover, paradoxically enough, the heterogeneity is sustained, among other things, by the selectivity of labour laws, as applicable to specific groups of workers. This is paradoxical because labour laws were supposed to get rid of just such heterogeneity, due to which one group of workers is disadvantaged relative to another, not due to differences in efficiency or productivity, but because of the arbitrariness of the law.

2.2 PHILOSOPHICAL FOUNDATIONS OF LABOUR LEGISLATION IN INDIA

Almost in line with the fragmented nature of the labour market, the set of labour laws, consisting of legal statutes and case material, currently in existence in the country, can be looked upon as falling into two broad modal categories--one for formal sector employees and the other for unorganised sector workers, although one can find a number of instances where they do cut across both categories. In broad terms again, the evolution of these two kinds of law can be traced to somewhat different sets of factors (Deshpande, 1979; 1992; Deshpande and Deshpande, 1992).

Much of the legal structure and philosophy in India is inherited from the British and is rooted in the doctrines of common law. The statutory rights of collective bargaining as conferred by the Trade Unions Act of 1926 was more a reflection of similar legislation enacted by the United Kingdom rather than the result of an indigenous labour movement (James, 1959; Bhattacharjee and Datta Chaudhri, 1994a, Jackson 1972; Ramaswamy, 1988, 1994). Here, as elsewhere, such legislation was instituted as a counter to the prevailing common law doctrine of criminal conspiracy which suggests that the concerted action of an organised group may affect society in a different and far stronger manner than if the same act were committed by individuals. Similarly, the Workmen's Compensation Act of 1923 was enacted to counter the common law doctrine of criminal negligence.

It seems obvious that statutes that purport to invest workers as a group with various rights, including the right of association, could not have derived their major substance from tenets of moral philosophy, which have a strong individualistic bias. Thus, the guiding principles behind such legislation may be traced not so much to the prevailing libertarian theories of justice, but more to such factors as the international socialist and working class movements, changing forms of social justice, as embodied in the concept of the welfare state, the success of the Russian Revolution and the founding of the ILO in 1919, to which India was a signatory.

It is important to realise that these and most other pieces of post-independence labour legislation dealing with industrial relations, like the Industrial Disputes Act of 1948 and some of the social legislation measures like the Employees' State Insurance Act of 1948 or the Employees' Provident Fund Act of 1952, are meant to protect the rights of, and confer benefits to, only regular workers in the organised sector. Under the Industrial Disputes Act, *ad hoc* or casual workers are not entitled to any compensation in the event of a lay-off. They and others of their kind in small establishments are not covered by the Employees' State Insurance Act, nor are they entitled to provident fund benefits. There are some special Acts covering specific groups of workers, for instance the Plantations Labour Act of 1951, the Dock Workers (Regulation) Act of 1948 and the Motor Transport Workers Act of 1961 or the Mines Act of 1952, which have some provisions covering workers in such establishments. Provisions vary from case to case, depending on the size of the establishment, the nature of the industry concerned, and the status of employment. In any event, for a large majority of workers, the benefits conferred by such legislation are negligible, or even non-existent.

However, there is another set of statutory measures, by and large of a fairly recent origin, which invoke certain fundamental rights and principles laid out in the Constitution of India, and which are targeted mainly towards unorganised sector workers. According to a ruling of the Supreme Court of India, the fundamental rights (Part III) conferred on the citizens of India in the Constitution of the country, along with the Preamble and the Directive principles of State Policy (Part IV), constitute the core of the Constitution, which is not subject to amendment by Parliament. The Indian Constitution confers a number of fundamental rights to all citizens irrespective of caste, creed, religion or sex. The Directive Principles of the Constitution provide for such constitutional goals as the right to work (Article 41), just and humane conditions of work (Article 42) and a living wage for all (Article 43). Time and again such constitutional provisions have been invoked to enact fresh labour laws. Examples of such statutes in recent years are the Child Labour Act of 1987, the Inter-State Migrant Workers (Regulation of Employment and Conditions of Service) Act of 1979, the Equal Remuneration Act of 1976 and the Contract Labour (Regulation and Abolition) Act of 1970.

Such statutory laws, aimed at achieving constitutional goals, form an integral part of the labour law of the country. The Preamble to the Indian Constitution upholds the principles of liberty and equality and fraternity. It abrogates discrimination on the grounds of sex, creed, or religion and preaches equality in the eyes of law for all. The links between such principles and the received tenets in the liberal theories of justice are reasonably direct and straightforward, even when one takes latter day versions of such theories as expounded by Rawls (1971) or Barry (1973). There might be some disagreement on the question as to whether similar statements can be made about the provision of preferential treatment of disadvantaged groups, like members of the scheduled castes and scheduled tribes as specified in the Constitution.

The principle of equality is subject to a lot of inner tensions. Nevertheless, one could invoke the tenet of procedural justice to uphold such constitutional provisions. In fact, the Rawlsian second principle of justice has been used to support the affirmative action programmes in the USA (Goodman, 1979), and similar arguments can be invoked to establish the system of reservations for disadvantaged classes in the Indian Constitution as well (Anand, 1987). While elaboration of these linkages is beyond the scope of this thesis, one can perhaps make the statement that the philosophical basis of such constitutional provisions, and through them of labour laws, that have been enacted invoking such provisions, can be traced not so much to the group-based working-class movements, but to prevailing individualistic theories of justice and human rights.

In other words, these laws are not the result of bottom-up "taking" by a working class movement, but rather the result of top-down "giving" by a liberal elite, educated and steeped in western liberalism. But where western protective labour law has been hard fought and hard won, this is not the case in India, particularly after independence in 1947.

The implications of this are somewhat paradoxical. To the extent that the worker has certain legal guarantees invoked by individualistic notions of justice, the violation of such law puts him or her as an individual against an immeasurably more powerful opponent: namely the employer. Given the prohibitively high transactions costs of legal disputes and enormous difference in the economic, political and organisational power of the two parties involved, such individual rights have no cutting edge and are virtually non-justiciable (Mukhopadhyay, 1997).

Thus the distinction between the first kind of labour laws and the second (i.e. those enshrined in legal acts of parliament, as opposed to those implicit in the constitutional provisions), is not merely in terms of their historical and philosophical roots, but also in terms of their 'implementability', to coin a word. In the case of the first set of regulations, which applied to organised sector workers, the workers are unionised and are generally well aware of their rights and privileges, while the government can have good control on implementation of the letter of the law. For the second group, implementation of laws is an administratively difficult, if not infeasible, proposition, while workers themselves are either unaware of their legal rights or powerless to enforce their enactment. Thus the dichotomy in labour law persists alongside fragmentation in the labour market. This is a very important point indeed.

2.3 LABOUR LAW: LINKAGES WITH SOCIETY AND POLITY

The linkages between labour laws on the one hand, and social sanction and public opinion on the other, cut both ways. At one level, one can argue that, to the extent that the constitution of the country reflects the goals and aspirations of the polity, all statutes that seek to codify the constitutional provisions have social sanction behind them. At a less abstract level, all laws, including labour laws, have to be passed by a Parliament, which consists of elected representatives of the people and, hence, by some kind of transitivity argument, cannot grossly violate the prevailing majority opinion—at least not consistently. Case law, which forms and integral part of the legal structure, reflects the prevailing values and norms of social justice as embedded in the social and moral philosophical thinking of the court sometime invoking principles that go beyond the strict wording of the law. Finally, in a democracy, that part of statutory law that embodies the public policy of the executive also cannot run grossly counter to prevailing public opinion—at least in the Indian democracy, by virtue of the way governments are formed.

However, laws do not operate in a vacuum. The legal process evolves in conjunction with the prevailing economic system, public policy and the mode of functioning of the executive. For instance, what has emerged as the most important statutory provision on industrial relations in India, i.e. the Industrial Disputes Act of 1947, has very little to say on collective bargaining as a method of settling industrial disputes. Its main emphasis is on tripartite arbitration as a conflict resolution mechanism with the third party, that is the State, as the single most important repository of power. This is in sharp contrast to the experience of the United States of America on the United Kingdom until recent times, where official policy has been to foster the growth of healthy and responsible collective bargaining practices pretty nearly overshadowing the role of the legal process in industrial disputes (Kahn-Freund, 1967; Commons, 1950; Katz, 1993).

Contrary to this, the official policy in India since the early 1950s has been systematically biased against a healthy development of collective bargaining practices on the twin pretexts that the unions are not strong enough to face the employers across the bargaining table without the support of the State, and that unmitigated industrial disputes will hamper productivity and slow down economic growth. As a result, since the beginning of the fifties, the official stance has almost always been towards maintaining industrial peace through compulsory tripartite arbitration (Ramaswamy, 1984). (That this has not succeeded is of course obvious from the high number of man-days lost to industrial action by workers, or "lock-outs" by employers). The larger trade unions in the country have come to depend on the state machinery as a crutch for support, and the State has been a ubiquitous presence in all kinds of wage negotiations and industrial disputes (Bhattacharjee and Datta Chaudhri, 1994b; Bhattacharjee, 1987a, 1987b). In the process, these unions have not merely developed a dependent and greedy mentality with little sense of responsibility, but have also become irrevocably politicised. In fact, the large unions in India operate more as labour wings of the major political parties. The rights without responsibilities approach of the big Indian trade unions has resulted in the emergence of what the Planning Commission has termed as "high wage islands" in a sea of low earnings. The continuous growth of the public sector in India has come to be seen as not as a necessity spurred by economic logic, but as a means of patronage distribution in return for political support. Under the Industrial Disputes Act, economically non-viable large private sector units cannot close down easily- a provision meant to assure employment security to organised sector workers. Once such units are declared sick, they are taken over by the Government.

The policy is favoured both by inept management who can write off their losses with impunity and by workers' unions who become entitled to greater benefits in the process (Saibaba and Mohana Rao, 1992; Sangma, 1995; Seth, 1993). The perverse logic of the situation has done nothing to promote industrial efficiency in the country. Similarly, nationalisation of industrial units has generally found favour with workers' unions. It is difficult to discern how much of the enthusiasm for public take-overs can be explained in terms of pecuniary gains to interested parties and how much by adherence to socialist ideals.

At the other end of the spectrum are the large masses of unprotected workers who can derive little solace from the fact that the Directive Principles of the Constitution of the country guarantee them "a decent standard of life". Their reservation price is low and, lacking any kind of organisation, they are not in a position to demand decent wages or secure employment. Nor does the economic rationale work in their favour, for if the public image of formal sector labour is one of less efficient and less responsible labour, it may even seem only fair that small-scale employers will strive to retain their small-scale stamp by restricting the number of regular workers to below the magic mark of ten employees with power or twenty without, while getting into all kinds of flexible work arrangements with unattached labour for extra work (Mukhopadhyay, 1989; Standing and Tokman, 1989).

Income security for workers need not necessarily breed inefficiency, except under very special circumstances. The seeming unaccountability of a large section of public sector employees is the product of the manner in which growth of responsible "norm" - based collective bargaining practices has been thwarted in India, and the virtual absence of any productivity related incentive structure in public sector concerns. One must not also forget that the entire system functions in a highly politicised atmosphere, where it would be patently unfair to single out the workers' unions as the sole agents responsible for the poor performance of this sector.

However, in popular belief the step from positive statements to normative pre-conceptions is only a small one. If unionised workers have in some situation been seen to act irresponsibly, the verdict may well be that it is sensible to switch to unorganised workers, so long as that option is open. It is little wonder that regular employment in the organised private sector has been virtually stagnant for many years now. The numerous methods used by employers to restrict the number of regular workers on their payroll are well known. It is easy to confuse issues, and by-passing the letter of the law may even come to gain a measure of sanctity in the public eye if it can be backed by evidence of irresponsible use of it by sections of the " other party".

Meanwhile, given the overall direction of developmental strategy in the country, the constitutional provision of ensuring " a living wage to all workers--agricultural, industrial or otherwise" (article 43 of the Indian Constitution), continues to have very little cutting edge in terms of the prevailing economic reality. Thus laws that invoke such constitutional provisions also tend to end up as paper tigers. They come to be seen as no more than pious pronouncements or at best, goals to be achieved by society in some distant future (Mukhopadhyay, 1989).

The concept of labour market rigidities, therefore, needs rather more careful consideration before being accepted as a valid cause of industrial inefficiency, or, viewed from the opposite angle, a key component of the solution. The catch-all term of "labour market rigidity" needs to be unpackaged, and its several dimensions viewed separately (Ghose, 1995). All actions and features which are deemed to interfere with the open-market, unfettered and unencumbered striking of labour contracts in the labour market, have been labelled "rigidities" (Kulkarni, 1996). Some of these could be structural in nature; others could be institutional, or creations of government action, though it must not be too quickly assumed that such intervention has always rendered labour *more*, rather than less, expensive; some could reflect more customary or traditional (i.e., non-market) social arrangements; others could be the products of concerted organised intervention by labour organisations and unions. Some of these "rigidities" could well have been constitutionally codified and thus enjoy legal sanction, reflecting a more basic social contract, if not consensus.

2.4 WHAT DO LABOUR RIGIDITIES MEAN IN INDIA?

There are several people who have put forward several reasons for arguing that the existence of labour market rigidities, as conventionally defined, in India is largely a myth, or at the very least, an exaggeration (Saith, 1992, Mathur, 1992; Patnaik, 1996; Kannan, 1994). Some of their arguments are summarised below.

First, it is necessary to adopt an appropriate macro perspective. The urban labour force may be divided between the "organised" and the "unorganised" segments. In the former could be placed the employees of large-scale manufacturing, services and public administration. Small-scale manufacturing and other amorphous service activities would constitute the other component. As mentioned above, in India, the share of the labour force in the organised sector is less than one-tenth of the labour force.

The rural labour segment of the total labour force in any case dwarfs the urban segment; in turn the urban organised segment is but a small proportion of the total urban work force. The workers in the rural sector, the urban small scale sector and the informal sector, petty services, trade and commerce, are all generally beyond the purview of any nominal or effective legal or union protection. They are essentially unorganised, with very few exceptions. They are also highly mobile spatially and in terms of activities and forms of employment. As such, for the overwhelmingly large proportion of the workforce, the argument of labour market rigidity simply does not apply.

Second, even within the organised manufacturing sector, which falls within the ambit of labour laws, the effective power of labour unions is varied. More often than not, organised labour has a temporary disruptive capability, but there is little evidence that union actions have led to extra-market increases in wages or perks.

Third, the formal or legal declaration of rights for workers does not necessarily mean that they are observed, or that they can be legally enforced by the courts through actions by the workers, since the legal system is a law unto itself. For instance, the existence of the statutory minimum wages is often cited as evidence of labour market rigidities without any accompanying evidence to show that these minimum wages are actually above what the market would throw up, or even if such minimum wages are in fact, higher, that they are ever really enforced.

Fourth, even in the organised manufacturing sector, in the context of which the existence of labour market rigidities is most often presumed, it is overlooked that most large enterprises circumvent such problems through the device of sub-contracting parts of the production process to auxiliary units which operate with impunity outside the scope of factory laws.

Fifth, there is evidence of increased recourse to casual labour in the production process; such labour is often fully, perhaps overly, flexible.

Sixth, wherever possible, production is carried out on piece wage payments, implying that at least the relationship between time, productivity and payment is amenable to the use of interlocking markets; these usually allow the employer to extract superior net terms from labour than might otherwise have been possible.

Seventh, for the great mass of 'self-employed' labour, flexibility is built through the *ex-post* determination of the implicit wage rate. Studies of the returns to self-employment generally come up with the finding that the implicit returns to labour are well below the poverty line equivalent.

Eighth, there is evidence that when long-standing wage payment arrangements throw up wage rates which conflict with what might have been labour-market outcomes, the former are steadily eroded. Institutional arrangements also respond to market conditions, and embody greater flexibility than might be attributed to them by casual observers.

Ninth, there is evidence of spontaneous as well as organised spatial labour mobility in the form of in-migration in to regions where the local labour market develops signs of tightness generated by market conditions or interventions by labour organisations. Evidence in this regard, is available from Kerala, Gujarat, and Punjab. In these situations, in-migrants tend to receive lower than locally going wage rates, and suffer conditions which are categorically inferior.

Tenth, in several instances, where labour organisation has tabled demands and adopted an "uncooperative" stance, the response has been brutally repressive.

All or part of this may indeed be valid, but in our opinion, it does not succeed in denying the potentially restrictive effects of labour organisation in confrontational environments (Kerala, West Bengal, etc.) (Kannan, 1988; Kannan, 1994). The situations pertaining in these cases are end points of long historical processes, which have had a powerful influence on both the regional, and the national growth process.

It is also necessary to point out the widespread prevalence of labour market rigidities of a different kind, viz., those involving the repression of workers' freedom of choice with regard to work. In important ways, as will be shown, they are also by-products of the nature of labour legislative framework and infrastructure in India.

In India, at present, there are likely to be far more workers in the vulnerable category, who suffer acute forms of distress and destitution than those who are alleged to be cocooned in protected labour aristocracies. It must be understood that they represent yet another form of market imperfection, as important, if not more so, than those involving power of a countervailing nature: trade unions and collective bargaining. Coerced, or effectively bonded labour is patently not equitable, but neither is it efficient in the economic context. Labour regulation in India has caused the wrong sort of rigidity—one that has hurt both efficiency and equity.

2.5 JOB SECURITY IN INDIA

It has been commonly and persuasively argued that the employment protection or job security regulations, currently prevailing in India, have created severe rigidities in the organised segment of the labour market. They are supposed to create critical impediments to industrial restructuring and also to discourage employment growth by increasing the cost of hiring additional labour. These problems, it has been argued, had been evident even before the reform process, currently under way, was initiated. But, as Ghose (1996) observes, "the reforms, by promoting greater integration of the Indian economy into the world economy, have served to bring them into sharper focus and thus to underline the urgency of finding satisfactory solutions. As Indian industry confronts growing external competition, the need for restructuring increases correspondingly. Moreover, the high cost of hiring labour may either act as a deterrent to foreign investment or confine it to high-tech industries." (p. 46)

Even though these views are widely held, methodical efforts to examine their soundness and/or bearing have been few. On the other hand, it is must also be accepted that job security is of major concern to workers for perfectly legitimate reasons. In an economy where state-provided social security is virtually non-existent and where "good jobs" are rare, employment security in the organised segment is of some value. The issue, therefore, is not merely one of removing rigidities; it is also one of simultaneously ensuring economic and social security of the workers. In other words, it is a question of efficiency as well as equity.

In what follows, for which we partly rely on various ILO studies as well as independent research, the existing system of employment security is critically examined with a view to answering two fundamental questions: To what extent does the existing system generate rigidities? What kind of protection does the existing system offer to the workers?

2.6 THE HISTORY OF THE EXISTING SYSTEM OF JOB SECURITY

Ghose (1996) observes that the formal history of employment regulations in India began with security for employers (against the risk of abandonment of work by workers), and not with any measure supporting workers seeking security of tenure. The first piece of labour legislation -- 'The Workmen's Breach of Contract Act' of 1859 -- was enacted to make any breach of contract by workmen punishable by law as a crime. This preceded the concept of contracts (of employment and other kinds) under the Indian Contract Act, 1872 by thirteen years, the emergence of the first collective industrial action by twelve years, and the first employment security legislation and the first wage fixation regulation by more than half a century (Ghose 1996, p. 50).

Trade union activity was allowed in India only after 1926. Before 1926, industrial relations in India (i.e. before trade unions acquired immunities against prosecution for criminal conspiracy, civil conspiracy and restraint of trade) were characterized by the virtual absence of any employment/job security. Between 1926 and 1947, when trade unions could function, employment regulations only aimed to secure uninterrupted production, not employment security. This became especially important during the war effort of the late 1930s and early 1940s. The justification lay in the shaky commitment of an embryonic industrial labour force which created recurring shortages of labour. As Breman (1996) observes in his book *Footloose Labour*, a big problem was that workers would "run away" with no prior notice at all—back to their villages where they found life more palatable.

While the Workmen's Breach of Contract Act was repealed in 1926, the provision for courts of enquiry to intervene in case of strikes remained a part of the Trade Disputes Act, 1929. During the Second World War, armed with the justification of ensuring uninterrupted production for wartime needs, the government made a legal provision (Rule 81-A of the Defence of India Rules) introducing compulsory adjudication of trade disputes (Ghose 2000, p. 51). These laws, along with the paucity of Indian owned enterprise and the preponderance of foreign owned factories, mines and plantations, created an impression (which was not entirely wrong) of Indian workers struggling against colonial masters.

The overabundance of labour laws after national independence arose from two main altruistic desires. *First*, there was a perception, as noted above, of worker exploitation which pointed to the need to alter the balance of power between employers and workers. *Second*, industrial workers were viewed as being in the forefront of a general welfare push, which was expected, in the long run, to reinforce dignity of labour and diffuse prosperity to large sections of the population. The "employment optimism" of the Lewis model dominated economic thinking at this point. "If a majority of workers were going to be eventually absorbed in the modern sector, it seemed natural to consider creation of model working conditions in this sector as desirable." (Ghose, 1996). It is worth noting that the "employment pessimism" of the Mahalanobis model, which provided the basic guidelines of India's planned development, did not receive due attention at the time.

As ILO (1996) notes, the state, having thus accepted the role of a social engineering institution even before the Constitution was framed, substituted the market contracting of labour with mandatory and obligatory requirements on employers for standards and conditions governing employment contracts. Laws were made to override contractual agreements to the extent that they fell short of legal minima and standards; thus any departure from law could generate lawful conflict.
Further, as ILO (1996) further points out, all conflicts arising from claims, grievances and demands are, potentially, industrial disputes. Employment security has thus come to be premised on regulations and state interventions, rather than on development of collective bargaining institutions.

2.7 THE LEGISLATIVE EVOLUTION OF JOB SECURITY REGULATION

Job Security in India is mainly regulated on the basis of the Industrial Disputes Act, 1947 and the Industrial Employment (Standing Orders) Act, 1946. The Industrial Disputes Act provides for settlement of disputes, in cases of termination, through compulsory adjudication if an agreement between employer and employee, to the satisfaction of both, is not forthcoming within a specified time frame. Individual disputes, not championed by unions, can also be treated as industrial disputes. The Industrial Employment (Standing Orders) Act sets rights and obligations of employees and employers relating to classification of employees, shift work, hours of work, entry and exit, attendance, stoppage of work, leave and holidays, punishments for misconduct, suspension or dismissal, separation on retirement, grievances, redressal procedures, etc. Any dispute or claim or demand or grievance on terms and conditions of employment arising from this Act and its rules and models becomes an industrial dispute under the Industrial Disputes Act. Both the Acts apply with full force to establishments employing 100 or more workers.

Ghose (1996) notes that three main provisions in the Industrial Disputes Act define the core of the job security system. First, he notes (p.58) *"all employee separations from employment involving `workmen' in `industry' amount to `retrenchment' except in cases of*

* *retirement on reaching the age of superannuation*
* *expiry and non-renewal of a time specific contract or its termination under a stipulation in the contract itself*
* *termination of service as punishment for proven misconduct*
* *voluntary retirement*
* *termination of service on the ground of continued ill-health"*

Second, any separation that does not follow satisfactory observance of the standards and procedures for the exceptions is also treated as `retrenchment'. Third, any retrenchment of a workman in industry, for any reason whatsoever (including closure), requires prior permission of the `appropriate government' (usually the government of the state in which the unit is located) if the industrial unit employs one hundred or more workmen. *If the permission to retrench is granted*, the regulations require thirty days' notice and payment of fifteen days' wages for every year of past service. These notice and compensation rules also apply to units employing between fifty and one hundred workers, but these units do not require prior permission from the `appropriate government'. If dismissal is without prior permission, then notice period and severance pay vary state-wise.

A `workman' in this context means any person (including an apprentice) employed in any industry for 240 days or more in a year to do manual, unskilled, skilled, technical, operational, clerical or supervisory work for a reward, whether the terms of employment be expressed or implied, but does not include any person

(i) who is employed mainly in a managerial or administrative capacity;
(ii) who, being employed in a supervisory capacity, draws wages exceeding a certain specified amount per month; or
(iii) who exercises, either by the nature of the duties attached to the office or by reason of the powers vested in him, functions mainly of a managerial nature.

It is to be noted that there were no restrictions on retrenchment until 1976 if an employer followed `last come first go' rule in drawing up the list of the workmen to be retrenched. They gave a month's notice or pay in lieu of notice, paid half a month's average pay for every year of continuous service or any part in excess of six months and informed the government. For retrenchment following closure, the requirement of sixty days' notice was introduced in 1972 but retrenchment remained the sole prerogative of the employer till 1976.

In 1976, new provisions were incorporated into the Industrial Disputes Act, placing, for the first time, severe restrictions on retrenchments and closures but only in industrial establishments employing three hundred or more workmen. The requirement of prior permission from the `appropriate government' for retrenchment or closure in industrial establishments employing one hundred or more workmen was introduced through an Amendment to the Act in 1982 which also increased the notice period to three months.

Ghose (1996, 65) notes that employers challenged the constitutional validity of the statutory restrictions on retrenchment and closure on the grounds that "the right to carry on business also implies the right not to carry on business." The courts struck down the new provisions and the amendment as unconstitutional. The 1984 Amendments to the Industrial Disputes Act re-introduced the restrictions by relying on an Amendment to the Constitution. They also removed some of the arbitrariness inherent in the exercise of discretionary power vested in `appropriate governments' to grant or refuse permission for retrenchment or closure. As it stands now, the `appropriate government' is required to give a reasonable opportunity to the employer to establish the genuineness and adequacy of reasons, to consider all relevant factors and the interests of the general public and to decide to withhold permission or grant it within sixty days; failure to decide within sixty days is deemed as granting of permission.

Certification of service rules (called `standing orders') under the Industrial Employment Act is another source of job security. This is mandatory in industrial establishments employing one hundred or more employees. The scope of this law was initially expanded making it applicable to establishments employing fifty or more workers in Karnataka, Gujarat, Maharashtra and West Bengal. In Uttar Pradesh and Tamil Nadu, this law applies to all factories, and in Madhya Pradesh it was replaced by more stringent State legislation. Regulatory changes have since been made, as discussed in Chapter 5.

Service rules can neither be certified nor modified without the consent of every covered employee. Further, there is a requirement that service rules must closely adhere to model standing orders formulated by state governments. So they vary from state to state and between states and the Union of India. Standing Orders regulate job security by specifying classification of employee categories; they regulate income security through provisions on computation of payments for hours worked and leave; and, they regulate employment security through restrictions on punitive terminations and prescribed procedures for taking disciplinary action in cases of misconduct. The overall effect is that the employers are left with very little non-negotiated authority to transfer workers from one job to another or from one location to another.

2.8 THE IMPLEMENTATION OF THE JOB SECURITY REGULATIONS

The scope of cognisable conflict ("industrial dispute") was greatly expanded in the course of judicial interpretation, which assigned a very wide meaning to the term `industry' in the Industrial Disputes Act. Any activity is regarded as `industry' if it is a systematic activity organised by the cooperation of employer and employee(s) for production of any goods and services to satisfy human wants. This criterion followed from a landmark judgement of the Supreme Court of India in 1978 which held a public utility -- Bangalore Water Supply and Sewerage Board -- to be an `industry'. All organised activities have since been regarded as `industry' (Ramaswamy, 1994).

The judicially widened ambit of the word `industry' brought benefits of employment security regulations to a much larger number of employees than originally intended by the Parliament. Public support for such an interpretation managed to obstruct, in 1982, a Parliamentary Amendment to the Industrial Disputes Act that sought to correct this anomaly by specifically excluding certain types of establishments from the definition of `industry'. The Amendment was passed by Parliament but was withheld by the Executive on the advice of the government. Thus, the category `industry' continues to include service establishments such as educational institutions, hospitals, charitable and philanthropic organizations, research laboratories, cooperatives and so on. However, as noted earlier, the provisions of the Industrial Disputes Act do not apply with equal force to all sizes of establishment. Their full force applies to establishments with one hundred or more `workmen' and their restrictive effects are greatly curtailed for establishments with less than fifty workmen.

In essence, notes Ramaswamy (1994), the employment security system rested on two types of "implicit contracts". The first type of implicit contract existed between employers and the government. Since the government granted protection to employers in product markets through the instrumentality of the licensing system, it expected employers to protect employment levels and hence wanted them to justify all involuntary separations, howsoever defined. With the exception of termination on grounds of proven misconduct, the question of separation was not even entertained since anything licensed to be produced could be sold and there was a general expansion in production all the time. Neither the Trade Disputes Act, 1929 nor the Industrial Disputes Act, 1947 made any provisions for retrenchment.

The concept of `retrenchment' was first introduced by a Parliamentary amendment to the Industrial Disputes Act in 1953 "to immunize workmen from the hazards of involuntary redundancy in continuing business". The discharge of `workmen' following a bonafide closure was brought within the scope of `retrenchment' by another amendment in 1957 (Ramaswamy 1994, p. 131).

Further, prices could be increased to absorb increased costs because price competition was limited to domestic markets, technology was comparable across enterprises in a particular branch of industry and oligopolistic market structures were common. These factors provided the basis for a second type of implicit contract -- that between employers and employees; costs of employment security could generally be passed on to consumers (Ramaswamy 1994, p. 1333).

It should be noted that both types of implicit contracts involved the acceptance of slow growth of industrial output. For when the effects of cost increases are automatically passed on to consumers through price increases, demand growth is necessarily constrained. The consequent slow growth of output translates into slow growth of employment in organised industries. This type of effect, of course, cannot be detected through empirical analysis.

2.9 JOB SECURITY, LABOUR FLEXIBILITY AND EMPLOYMENT

It bears repetition that the restrictive provisions of both the Industrial Disputes Act and the Industrial Employment Act apply principally to establishments employing 100 or more workers. As such, these are the establishments which are expected to be affected by the labour market rigidities (if any) arising from the employment security regulations. These establishments account for only a tiny proportion of total employment in the economy. It is legitimate to wonder, therefore, notes Ghose (1996), if the employment security regulations can have appreciable effects on the growth of aggregate employment. He therefore avers that there are two key questions: Do the employment security regulations create operational difficulties for large establishments? If yes, then does this have economy-wide consequences, particularly for employment growth?

2.9.1 Job Security and Labour Adjustment

Ghose (1996, 71) notes that in principle, the regulations do not impose a ban on retrenchment; they only require that prior permission be sought from the `appropriate' government. In practice, however, he observes, political compulsions make it difficult for the `appropriate' government to permit retrenchment. Given the regulations, employment adjustment at enterprise level becomes a political issue in which an employer is pitted against workers in a submission before the state or central government as the arbiter. This lands the "appropriate government" in a classic no-win situation. If it finds the employer's demand fair and reasonable, it opens itself to charges of colluding with employers and alienates workers and unions besides attracting brickbats from opposition parties.

If it does not find the employer's proposal justified, it incurs the wrath of employers and runs the risk of giving wrong signals to potential investors. In every case, moreover, the government decision can be challenged (and usually is) in a court of law and a protracted `no-decision' involvement automatically converts an industrial dispute into an issue in the political arena. It should be noted that more often than not, the "appropriate government" is one (or more) state government(s).

The methods of termination which do not require prior permission from the government are also very difficult to apply in practice. The date of retirement or retiring age may not be free from controversy, particularly if the date of birth of an employee is not recorded with his agreement. Further, the unreliability of proof of age is legendary. Retirement is frequently resisted by production of `evidence' in the form of school leaving certificates, papers from `Certifying Surgeons', court affidavits, notarised declarations and birth certificates.

A letter of appointment providing fixed tenure is often not accepted as the sole basis for retrenchment, particularly if the position is found to be of perennial nature and may form the basis of a claim for permanency.

For a workman to be charged with `misconduct', the act of omission must have been listed as `misconduct' in service rules (standing orders). Then, the misconduct must be proved at an impartial enquiry complying with the principles of natural justice and giving full opportunity to the accused. Moreover, the gravity of the misconduct, past record of service and any extenuating circumstances must be taken into account before termination can be regarded as the appropriate punishment. Any technical lapse vitiates the process.

Continued ill-health has to be conclusively established to be a ground for termination. In practice, workmen request for `light work' and resist termination. In some States, local laws do not allow employers to terminate employment on grounds of continued ill-health.

In practice, therefore, the employment security regulations basically leave only one legal route to adjustment open : *voluntary retirement induced at a cost*. This is an important point, because it forms the basis of calculation of the job security index, as calculated in Chapter 5. Thus, either labour adjustments have to be ruled out in which case labour costs assume the character of fixed costs, or labour adjustments have to be achieved at high costs which has the effect of pushing labour costs much above wage costs. In either case, labour hiring is discouraged and adoption of capital-intensive techniques becomes attractive.

ILO (1996) also notes that the job security regulations tend to reinforce these effects. "The freezing of role-sets into a classification conferring status places on an employer the responsibility for skill obsolescence without the authority of effecting a non-negotiable transfer, the responsibility of absorbing fluctuations in product demand or changes in techniques of value-addition without the authority of adjusting human resource costs commensurate with product prices and capacity utilization. Under the circumstances, internal human resource adjustments require either new hiring (in the absence of substitution or reskilling possibilities) or negotiated transfers which come at a price. Either way, internal human resource adjustments become not only costly but also time-consuming." (p. 82)

There are escape routes, however, as noted in the previous chapter, and indeed throughout the thesis. One is to devise methods of using labour which avoid developing a provable employer-employee nexus. Many such methods are in fact available: distinguishing `contracts of service' from `contracts for services'; making principal-to-principal contracts with middlemen and agencies for labour supply in the guise of job contracts; engaging workers for specific time-determined contracts; persuading groups of workers to form self-managed cooperatives that submit bills for work done instead of drawing wages; incorrect classification of workers as apprentices under the Apprenticeship Act or as trainees, learners, improvers, or all of these in succession, always specifying that employment is not offered; changing record of name two or three times in a year; hiring workers on a casual basis (for less than 240 days in any period of 365 days); designating workers as consultants or retainers or suppliers who submit weekly or monthly bills etc (Ramaswamy, 1994).

Another method of avoiding job security regulations, available to employers, is to set up a number of independent small units (employing less than one hundred workers) in place of one large unit. This method, however, has one disadvantage: it may prevent realization of economies of scale in some situations (Mohan Rao, 1995). From the employers' point of view, the decision may nevertheless be rational since the advantages of labour flexibility and the saving on labour costs may together outweigh the loss resulting from non-realization of economies of scale. For the economy, however, there are unambiguous efficiency losses. (Ghose, 1996)

For obvious reasons, the escape routes are available more to the private sector than to the public sector. This means that the labour market rigidities arising from employment security regulations are more important for the public sector than for the private sector. This gives the public sector establishments certain inherent disadvantages *vis-à-vis* the private sector establishments in the market place.

2.9.2 Job Security and Employment Growth

It is probably apparent by this stage that the job security regulations provide strong incentives for large employers to minimise labour hiring on a regular basis. The high cost of labour adjustment, provoked by the job security regulations, effectively increases the cost of hiring and induces search for escape routes as well as labour-saving technologies. We will use this fact to calculate a job security index in Chapter 5. For now, we hypothesise that the growth of employment, particularly of regular employment, in large establishments, and consequently in the organised sector as a whole, is discouraged as a result. We test this in Chapter 4.

The effect is stronger in the private sector than in the public sector since the public sector tends to regard employment creation as a social and political obligation and finds it more difficult to resort to escape routes. But this also puts the public sector at a permanent disadvantage *vis-à-vis* the private sector. It should be pointed out that this discussion refers to production-related industries. But, as we shall see below, a large majority of the employees benefiting from the job security regulations are in fact in organised services, mostly public. The negative effect on employment growth in public services works less through rising cost of labour hiring than through declining financial resources.

There are other ways in which the job security regulations may have constrained employment growth in the organised sector. As noted earlier, Ramaswamy (1994) points out that the implicit contracts on which the employment security system rested involved acceptance of a slower pace of industrial growth than would otherwise be feasible. In this sense, the job security regulations had a negative effect on the long-run employment growth in organised industries and hence in the organised sector as a whole. Moreover, since the job security regulations induce employers to keep the establishments size artificially small, economies of scale may be partially sacrificed. This too slows down industrial growth and hence employment growth. And to the extent that the job security regulations push up costs (financial and other) of hiring labour, they may discourage foreign direct investment or confine it to high-tech industries. This too has a negative effect on employment growth.

The organised sector, of course, employs only a small proportion of the labour force in the country. Nevertheless, slow growth of employment in the sector has economy-wide repercussions. The organised sector offers what can be called "good" jobs and failure of the sector to draw out labour from unorganised sectors leads to a general deterioration in employment conditions. It is not only that the proportion of "good" jobs in total employment declines but employment conditions in unorganised sectors also deteriorate as the incremental labour force is perforce absorbed by these sectors.

2.9.3 Job Security and Regulatory Reforms

Ghose (1996) points out that even under the pre-reform economic regime, the job security regulations led to the emergence of surplus labour in the organised sector. *First*, advances in technology and techniques of production over time implied that, within the same industry, newer enterprises and enterprises that modernised could operate with different cost schedules; this induced limited price competition. This was wholly avoided through cartelisation in some industries but could not be avoided in others where some units became non-viable as a result. *Second*, product and process obsolescence in certain industries led to dwindling capacity utilisation. *Third*, some enterprises simply did not stay out of the red despite protection and were faced with the need to downsize employment. *Fourth*, many public enterprises (central and state) recruited employees far in excess of their requirements in the belief that one of their tasks was to create employment. Once recruited, the surplus labour simply had to be carried even if this adversely affected the economic viability of these enterprises.

ILO (1996) points out that the employment security system also had another effect, which is rarely recognised. The fact that the government acted as the arbiter prevented employer-employee interactions; both groups had more to gain by nurturing political clout than by promoting mutual understanding. Healthy development of industrial relations was thus pre-empted. India never could develop a collective bargaining system, unlike the West. It is still stuck with a tripartite system, in which the state must necessarily be a mediator between the employer and the employee, thus leading to needless politicisation of the system.

The economic reforms implemented since 1991 have greatly undermined the basis of the implicit contracts on which the employment security provisions have so far rested (Ramaswamy, 1994). The abolition of industrial licensing and liberalisation of external trade have substantially increased competitive pressures in the economy. Consequently, it has become much more difficult for employers to translate cost increases into price increases. The costs of job security can no longer be absorbed by sacrificing overall industrial growth; they now affect economic viability of enterprises. The issue of labour adjustment has thus acquired prominence.

Ramaswamy (1994) also points out that the economic reforms have also altered the demand conditions for the organised industries thereby generating a need for output adjustments. This development too calls for labour adjustments.

The other factor, which has brought the issue of labour adjustment to the fore, relates to fiscal difficulties of the government. Mukhopadhyay (1989) says that the stock of sick industries, built up over the years, imposes a heavy burden of subsidies on the government budget. The growing openness of the economy also imposes strict limits on the government's ability to resort to deficit financing without risking economic destabilisation. The need to close down non-viable industries has thus acquired urgency. Even more importantly, it is clearly necessary to prevent an increase in the stock of sick industries.

Finally, Ghose (1996) argues that in the post-reform context, foreign direct investment is expected to play a more important role in the growth process in future than it did in the past. There are legitimate worries that the rigid employment security regulations may discourage foreign direct investment.

2.10 JOB SECURITY REGULATIONS: HOW MUCH SECURITY?

How much security do the regulations offer to the workers? In 1990-91, the entire organised sector employed less than 27 million people who constituted, on a rough reckoning, about 8 per cent of the total employed labour force in the country. Only about 8 million (7.4 million according to the Ministry of Labour and 8.2 million according to the Central Statistical Office) of these worked in industries (manufacturing and electricity, gas and water); they constituted just over 29 per cent of the organised sector employees and just over 2 per cent of the total employed labour force in the country.

But, as mentioned earlier, the employment security regulations strictly apply to establishments employing 100 or more workers. According to the Annual Survey of Industries (Central Statistical Office), 5.8 million people worked in industrial establishments employing 100 or more workers. If it is assumed that all public sector employees in non-industrial activities enjoy the benefits of employment security, the total number of people enjoying these benefits works out to 22 million or 6.5 per cent of the total employed labour force in the country.

Evidently, protected industrial workers constitute at most 26.2 per cent of all protected employees. There is evidence to suggest, moreover, that this proportion has actually been declining. The data from the Annual Survey of Industries show that the absolute number of industrial workers in establishments employing 100 or more workers fell from 6 million in 1980-81 to 5.8 million in 1990-91. During the same period, the total number of protected employees increased from 19.8 million to 22.1 million. Thus the percentage of protected industrial workers in all protected employees declined from 30.3 in 1980-81 to 26.2 in 1990-91. This trend clearly had nothing to do with the economic reforms which were launched only in 1991.

But this trend alone does not tell the full story. Fallon and Lucas (1991) argue that there are reasons to believe that the employers' search for escape routes intensified after 1984 (when the Industrial Disputes Act became fully effective). As such, the proportion of irregular or contract workers is likely to have increased in the second half of the eighties. The number of sick enterprises was also steadily growing during the decade. These factors affected industrial enterprises rather than service enterprises. And this means that the estimates of the share of protected industrial workers in all protected employees, reported above, are actually overestimates.

2.11 CONCLUSION

To conclude, most writers agree that job security for industrial workers in the organised sector has been a major concern in India for perfectly understandable reasons. The colonial history generated a perception that industrial workers were victims of exploitation and needed state support. In the early post-colonial period, employment optimism was in the air and it seemed right to create ideal type of jobs in modern industries. A high degree of employment security also seemed quite consistent with the protectionist, import-substitutive industrialisation strategy which India adopted. "Employment security, moreover, was viewed as an instrument of guaranteeing income security to workers in an economy where no state-sponsored social security system existed." (Ghose 1996, 101).

Originally, the job security regulations were meant to protect industrial workers in large establishments. Legal interpretation, however, held virtually all large scale organised activities to be industries and thus widened the coverage of the regulations very substantially. The result is that industrial workers actually constitute a small and dwindling proportion of the employees benefiting from the regulations.

There is little doubt that the job security regulations gave rise to a number of problems whose harmful effects were absorbed principally by industries and industrial workers. As ILO (1996) points out, in the first place, they had a negative effect on growth of employment in organised industries and thus hampered the process of improvement of employment conditions in the economy as a whole. Second, they led to the accumulation of surplus labour in the organised sector. Third, they turned industrial disputes into political issues. Finally, they obstructed development of healthy industrial relations and collective bargaining systems at enterprise level.

The recent economic reforms have both undermined the basis of the implicit contracts on which the employment security system rested and brought into sharp focus the need for labour adjustment. Delicensing and trade liberalisation have stimulated price competition thus making it difficult to pass on the costs of employment security to consumers. Cost adjustment, of which labour adjustment is a part, has thus assumed importance. These developments also necessitate industrial restructuring which requires labour reallocation across industries. And what is important to realise is that these developments are not of once-for-all variety; in an open economy, they will be characteristic features. Rethinking the job security system has clearly become necessary.

CHAPTER 3

RIGID LAWS AND FLEXIBLE OUTCOMES: QUALITATIVE FIELDWORK IN BOMBAY, MAHARASHTRA

In this chapter, we will present insights gained from (i) the Bombay Labour Flexibility Surveys, carried out in the late 1980s, and again in mid-1990s by myself (the second time) and others; and (ii) qualitative research and fieldwork conducted by myself at the firm level in Bombay, Pune and Delhi during 1995-98. We also include excerpts from interviews carried out with representatives of both employer and employee associations. This chapter forms a precursor to Chapters 4, 5 and 6, which provide the results of simple statistical analysis carried out on both primary and secondary data.

We will see that only a minute elite— in general better educated, male and more skilled—benefit from the plethora of labour laws, especially job security regulations. This result if further verified by the econometric analsis in Section 4.4. The majority of the labour forces is getting increasingly casualised, and spends its working life in insecure, and often inhumane, conditions. Labour laws do not seem to be helping the large majority of the labour force.

Throughout this chapter, we will work with and refer to interviews, personal observations and secondary data collected exclusively for the labour flexibility surveys. This chapter is divided into the following sections: Section 3.1 provides the background and justification for this fieldwork research. Section 3.2 discusses employment and unemployment in Maharashtra, and especially its capital city, Bombay—a bustling metropolitan and industrial centre. Section 3.3 discusses industrial relations in India, Maharshtra and Bombay. Section 3.4 discusses the political economy of wage determination. Section 3.5 analyses our findings and observations about state intervention in the labour market, particularly at the level of the firm, in a great deal of detail. Section 3.6 provides an analysis of the observations contained in Section 3.5. Section 3.7 contains the summary and conclusions, and further reiterates the single main finding of our research—increasing insecurity among workers. This sets the stage for the quantitative work contained on Chapters 4 and 5.

3.1 BACKGROUND

The belief that labour inflexibility, caused by collective bargaining practices and state intervention in the labour market, has restrained growth of industrial employment in India has grown stronger among economists like Ahluwalia (1991), Sachs (1994) and Basu (1984, 1997, 1998, 2001). The Government of India started the process of deregulation in 1975, which picked up in the eighties, particularly in the mid-eighties. Manufacturing output responded to deregulation and grew faster in the eighties than in the previous two decades. However, growth of employment decelerated to 0.006 per cent per annum in 1983 - 1987/88 from 2.42 per cent per annum in 1972/73 - 1977/78 and 1.74 per cent per annum in 1977/78 – 1983 (Government of India, Planning Commission 1990). Protagonists of flexibility see in this conjunction of stagnation of employment and acceleration in output, incontrovertible evidence of rigidities introduced by unions and state intervention in the form of labour legislation (World Bank, 1989). Many authors have time and again pointed fingers at the efficiency losses due labour regulations.

In response, scholars like Lyn Squire (Squire and Suithwart-Narueput, 1997) have asked the very pertinent question: Does labour market regulation in developing countries result in significant efficiency losses? He emphasises that there is not sufficient international empirical evidence to bear this out. In his survey paper Freeman (1992) expresses surprise that there was not more evidence on the distortionary costs of labour market regulation: "The first surprise was that studies designed to support the distortionist view of labour markets in developing countries failed to make a stronger empirical case than they did" (p.139).

Squire and Suithwart-Narueput (1997) say that there are several possible explanations for this result. "First, the regulations may not be binding at the market equilibrium. Second, even if they are binding, the relevant elasticities of supply and demand may be so low that their impact on efficiency is small. And third, even if the regulations are binding and the elasticities are sizeable, compliance may be low.[3]" Squire further argues that:

- *"The likelihood of non-compliance will be greatest when the regulations are binding and the relevant elasticities are sizeable."* *(p. 2)*

That is, they explain, if the distortionary costs of regulations are not rendered insignificant by the first two reasons, then the returns to non-compliance will be high and, other things being equal; employers will either evade or avoid the regulations thereby minimising the impact on efficiency.

- *"Although more likely to comply with labour market regulations, public enterprise compliance may actually reduce efficiency losses." (p. 2)*

Taken together, Squire and Suithwart-Narueput (1997) argue, the two propositions suggest that limits exist to the efficiency losses engendered by labour market regulations.

Squire and Suithwart-Narueput (1997), set out the following "facts" from international evidence, and then sets out to model the behaviour of labour markets to explain these facts:

"Fact 1: The extent of non-compliance with labour regulations is widespread and significant.

Fact 2: The pattern of non-compliance is consistent with the observation that it increases with the costs of compliance and falls with the costs of enforcement.

Fact 3: Firms can and do legally avoid labour regulations." (p. 4)

On this point, Freeman (1992) notes that, "If extensive unemployment results, the minimum will often be unenforceable because both workers and employers will have incentives to collude to avoid the law and save jobs" (p. 128).

Let us see how the debate summarised above sits with the findings and insights from our primary fieldwork in different industrial districts. The lion's share of this work was done in and around Bombay, although some work was also done in Delhi and Pune (Maharashtra).

I was fortunate enough to be part of the second labour market flexibility survey to be conducted in Bombay, and was also given access to information from the first ever Labour Flexibility Survey ever conducted in India. This survey was also done for the city of Bombay by the University of Bombay. Let us begin with a very quick analysis of the secondary information on various aspects of labour and employment in India, collected for the surveys. Such information is not always accessible at one place, and therefore the secondary information collected for the surveys forms a very valuable resource.

3.2 EMPLOYMENT IN INDIA, MAHARASHTRA AND BOMBAY

The Directorate of Employment collects quarterly data on employment from all establishments owned publicly and such private establishments as employ 25 or more workers. Though debatable, it is common to treat the employment reported to the Directorate's Employment Market Information Programme (EMIP) as formal employment. This data, given for Maharashtra in the first table, shows stagnation in total formal employment, the net result of an annual growth of 2.0 per cent in public and an annual decline of 1.7 per cent in private employment between 1971 and 1991.

The situation was worse in the eighties than in the seventies; private employment declined by 3.2 per cent per annum, public employment increased about 1 per cent per annum and total formal employment declined at about the same rate. Formal employment in private manufacturing declined at 4.7 per cent per annum and the total manufacturing, by 3.8 per cent per annum in the eighties. With formal employment declining in the eighties one would have expected unemployment on the live register to grow faster in the eighties than in the seventies. That it grew slower casts doubts on the employment exchange data. They could be defended if it could be shown that registration followed formal employment. This may well be true but cannot be tested with the data available at present.

It may be argued that in the absence of unemployment insurance, few can afford unemployment and institutional rigidities lead not so much to unemployment as to informal employment. Informal employment grew faster than formal employment in the 1960s (Joshi and Joshi, 1976) and the 1970s (Deshpande, 1979). Table 3.1 presents two estimates of the size of the informal economy in Bombay. Estimate 1 is obtained by deducting the EMIP-reported employment from that reported by the population census. It shows that the share of informal employment increased from nearly half of total employment in 1961 to about two-thirds of it in 1991.

Estimate II is based on the Economic Census and adopts a cut-off point of "under 10 workers" and not "under 25 workers" to demarcate the informal from the formal sector. According to this estimate the share of employment less than 10 workers increased from 27.4 per cent in 1970 to almost 34 per cent in 1980 and further to 46.3 per cent in 1990. The first estimate yields a growth in informal employment of 3.5 per cent and the second 3 per cent per annum in the 1980s. In contrast formal employment according to Economic Census declined at 0.7 per cent per annum. Thus the labour market became conducive to adoption of flexible labour practices in the eighties.

Table 3.1
Estimates of Informal Sector Employment, Bombay

Estimate I: Census Employment-EMIP recorded employment.

Year	1961	1971	1981	1991
% Share in total census employment	49.0	50.0	55.4	65.6

Estimate II: Economic Census reported share of employment in units employing less than10 workers

Year	1970	1980	1990
% Share of employment in units employing less than 10 workers	27.4	33.8	46.3

Sources: *Census of India, Maharashtra 1961 through 81, General Economic Tables.*
Census of India Maharashtra, Primary Census Abstract.
Census of India 1971, Maharashtra, Establishment Tables
Government of India, Economic Census 1980 and 1990
Data from Employment Market Information Programme (EMIP)

The coverage of the formal sector defined with respect to establishments employing 25 or more workers is very restrictive. Besides, non-response to EMIP has increased over time. An alternative source, the Annual Survey of Industry (ASI) relates to factories[4]. The ASI has two sectors, the census and the sample. The former includes factories that employ 50 or more workers and use power and 100 or more, if they do not. The rest form the sample sector. Factories in the latter sector are numbered serially and those bearing even numbers are surveyed in one and the others in the other year of a two-year cycle.

The production process and total employment, the former more than the latter, declined over the decade 1975/77-1985/87. Total employment had increased by 13 thousand between 1975/77 and 1979/81 despite a loss of 34 thousand jobs in textile. Between 1979/81 and 1986/88, factory employment in Bombay fell by 142 thousand and textile employment, by 88 thousand. To put the data in wider perspective, manufacturing

[4] Factories, according to Factories Act are manufacturing establishments which employ ten or more workers and use electricity and 20 or more if not.

employment declined annually at 1.9 per cent in Bombay, 3.3 per cent in Maharashtra and 1.5 per cent in India in the eighties.

The Cotton Textile Industry led others with a decline of 59 per cent in employment in the decade 1975/77-1985/87. It was followed by basic metal industry (-39 per cent), non-metallic mineral products (-32 per cent), textile products (-28 per cent) and metal products (-22 per cent). The fall was much steeper in these than in all manufacturing in the city (19 per cent). Data such as these form the basis of much of the criticism of unions and labour legislation, the institutional interventions in the labour market in India. Let us take a brief look at these institutional interventions.

3.3 INDUSTRIAL RELATIONS IN INDIA, MAHARASHTRA AND BOMBAY

3.3.1 Union movement, growth and structure

The union movement in India benefited substantially after independence from industrial development and sympathetic governments. Registration with the competent authority constituted by the Indian Trade Union Act, 1926, is voluntary. A significant number of unions do not register and of those who do quite a few do not comply with other provisions of the Act. Recognition of bargaining agent is as unresolved an issue today as it was before independence (Datar, 1983). Most unions exaggerate their membership and the data published by the Labour Bureau and the State Governments, being based on returns submitted by the unions are often suspect. Union members number 6 million in a labour force of 300 million in India but related to formal employment of 25 million, the union movement commands some respect. All the more so because the membership is concentrated in relatively large enterprises in key industries (Edgren, 1990).

Unions have, over time, had a much wider power base in Bombay. Union membership increased from 881 thousand in 1971 to 2.1 million in 1985 and the degree of unionisation increased from 55 per cent to 91 per cent. However, data on membership are poor in quality and those on the degree of unionisation are both poor and dated (Deshpande, 1992). A sample of 300 men and women workers drawn from manufacturing firms surveyed in 1989 showed that only half of all workers were union members. Not even a quarter of the workers employed by small firms with less than 50 workers were members. Only three of every ten persons working in medium firms, employing between 50 to 99 workers, reported union membership. In large firms, membership varied between 40 per cent and 82 per cent, the highest figure being in firms employing 1000 workers or more (Deshpande and Deshpande, 1992).

3.3.2 Political affiliation and fragmentation

Most unions are affiliated to federations, which function as labour wings of political parties. The view that political affiliation has fragmented the union movement and made it ineffective as a countervailing power to the state and industrial capitalists was shared widely till recently (Rudolph and Rudolph, 1987). It drew support from two facts. First, the constancy, if not the fall in real wages since 1950 seen in the wage series put out by the Labour Bureau and secondly, the fall in the share of wages in value added by manufacturers observed in the data derived from the Census of Manufacturing Industries. With industrial employment growing at constant real wage, India was regarded as the best example of Lewis' model of development at work. India's labour policy was applauded for the way it restrained wages (Jackson, 1972).

Some critics did not accept the Labour Bureau's wage series because it was limited to workers earning less than a specific monthly wage (Madan, 1977). Real emoluments per employee based on the ASI data reported by Tulpule and Datta (1988) increased 2.7 per cent a year between 1960-1985. In his overview of the Indian labour market, Lucas (1988) reports a rise of 69 per cent over the two decades 1960-1980. Since there was no evidence to show that real wages in agriculture had increased, Lucas concluded that the rise in manufacturing wage was a disequilibrium rise to be attributed to unions and labour legislation.

Recent evidence on real wages of agricultural workers shows that they have increased since mid-seventies in all states of India-an event unheard of earlier (Ghose, 1992). Acharya and Papanek (1989) and Hanumantha Rao (1994) also report similar findings. It would therefore, be necessary to produce some other evidence if unions were to be blamed for the disequilibrium in the labour market. Lucas blamed unions because they caused wages to increase faster than productivity. Employers responded by substituting capital for labour. Consequently demand for labour in manufacturing grew very slowly up to the eighties. A more recent study, covering the period from 1974 to 1985 suggests that unions were guilty of appropriating to workers almost all the gain in labour productivity brought about by increase in capital intensity (Sengupta, 1992). If wages were deflated by product price, as they were by Lucas (1988) and Sengupta (1992), the data for Bombay tell the same story. So deflated, real emoluments per worker increased 5.6 per cent a year during 1975/1977 and 1985/87. Capital per worker deflated by machinery prices increased at 5.2 per cent and value added per worker deflated by wholesale prices of manufactures increased at 5 per cent a year. Share of wages in value added increased from 55 per cent in 1975/1977 to 57 per cent in 1985/1987. Let us look more closely at what is happening here.

3.4 THE POLITICAL ECONOMY OF WAGE DETERMINATION

We got very interesting results when we measured elasticities of employment with respect to wage rate. For the period 1975/77-1985/87, the ASI-reported average real earnings deflated by product price increased at 5.6 per cent and net value added deflated by WPI increases at 2.3 per cent per annum. Assuming that the base year employment elasticities of 1.25 and 1.05 respectively with regard to wages and output would have prevailed throughout the decade of union behaviour and provisions relating to retrenchment and closures were altered, employment would have declined at 4.6 per cent per annum, about 2.7 per cent faster than the observed rate of 1.9 per cent. The difference, i.e. 2.7 per cent indicates, from the employers' point of view, the extent of rigidity due to unions and legislation.

However, the story changes substantially if the emoluments of employees were deflated by the CPI instead of the product price. The CPI-deflated earnings increased at 3.1 per cent per annum, and lagged behind labour productivity, which increased at 5 per cent. Consequently the share of wages in value added fell from 58 per cent in 1975/77 to 51 per cent in 1985/87. With an annual increase of 3.1 per cent in wages and 2.3 per cent in output, and with wage and elasticities as before, employment would have declined at 1.5 per cent, 0.4 per cent slower than the observed decline of 1.9 per cent per annum. *In other words, employers were able to retrench more workers than dictated by the elasticities.*

Thus, one could draw diametrically opposite conclusions from an increase in real wage depending on the deflator. The choice of the deflator depends on whether one considers wage as a cost of production or as income of a worker. So, what determines wages in Indian industry?

It would be reasonable to expect that, other things remaining the same, wage per worker would increase faster in industries in which share of wages, size of factory, profit per worker and fixed capital per worker increased faster. If one were to test this relationship empirically, as done by Deshpande and Deshpande (1996), one finds that changes in wages are positively and significantly associated with changes in two variables, wage share and profit per worker.

What changes the share of wages? It can be shown, and not just for India, that unions do not have the power to increase this variable. It is more likely to be determined by the elasticity of substitution, which could be inferred from the rise in real wage and fall in wage share, to be greater than unity. With an overvalued rupee, highly protected industry, low interest rates and liberal depreciation allowances that characterised the Indian economy until recently, there was enough incentive for employers to substitute capital for labour. Hanson and Lieberman (1989) report that highly protected industries in 1986 employed five times as much capital per worker and reported unit labour costs about 70per cent higher than those with low levels of protection.

The World Bank (1989) reports that net pre-tax profits in India's manufacturing formed 21 percent of the value added in 1982 as compared with under 4per cent in Korea in 1981. The unions have tried to share in these high rents. The positive relationship between profits and wages existed conventionally but was dependent rather loosely on the grace of the employer. An important point that is often missed is that capital intensity in Indian industry did not increase necessarily when wages increased, but did so when profits increased. High profits arising from the protective and restrictive regime led to increase in capital intensity and thus to labour productivity, prompting unions to demand their share in the spoils. *This is the way that the causality runs, not the other way round.*

Authors such as Ramaswamy have argued that the 70s and 80s have been marked by the rise and growth of internal unions whose leaders were not affiliated politically and as such were not constrained in their wage demands as leaders of affiliated unions were. Consequently, they bargained hard, were relatively militant and secured standards which the affiliated unions had to "follow or perish". If this analysis were true, we should expect this militancy to be reflected in industrial disputes statistics.

Table 3.2. shows that in 1989, industrial disputes standardised for factory employment, were a fifth, workdays lost a third and workers involved only 3per cent of the respective magnitudes in 1971. A dispute in 1989 lasted four times as long but involved a fifth of the workers it did in 1971. If we assume that the wage lost per day equals the daily wage prevailing in the firm, we find that a striking worker in 1971 earned Rs. 49 in 1971 and Rs. 53 in 1989. The CPI increased about four-fold in that period as did production per workday valued at constant prices. This data suggests that the unions were much less militant in the late eighties than about two decades earlier and further that wages in striking units in 1989 were low in relation not only to the productivity, but also to those their predecessors had achieved in nearly twenty years before.

Table 3.2
Indicators of Industrial Relations, Bombay, 1971/1989

	1971	1981	1989
Number of disputes	397	195	57
Number of disputes per 100,000 Factory Workers	72	44	14
Workdays lost (thousands)	1,584	16,253	426
Workers involved (thousands)	413	137	12
Average duration of disputes (days)	14.4	77.7	53.7

Median duration of dispute (days)	4.4	19.3	18.7
Wages lost per workday (Rs.)	49	41	53
Production lost per workday (Rs.)	56	383	949

Source: Commissioner of Labour, Government of Maharashtra.

3.5 STATE INTERVENTION IN THE LABOUR MARKET

Having looked at the political economy of wage determination in India, let us now look at direct state intervention in different aspects of the labour market in great detail, in light of our firm-level observations and interviews. Until recently, the state intervened substantially in both product and factor markets in India. The Narasimha Rao-led Congress Government withdrew in July 1991, and March 1992 most of the restrictions in the product market but retained the legal framework including the much damned "ban" on exit intact. Employers, though critical, have not gone beyond registering a mild protest. That is because the current, overtly rigid laws, suit them very well, given the intricate political economy that has developed in this regard over the past five decades and more. Union leaders are apprehensive of the future, as they fear the government may give in to the national and international pressure and liberalise the labour market as well. But their fears have not been realised yet. Why? Let us take a look at the different labour regulations and their actual impacts, particularly in Bombay.

3.5.1 Interventions in Factories in Bombay

Since independence, unions have used their political connections to counteract employers. Consequently, their right to hire, dismiss and alter conditions of employment to the workers' detriment was subjected to judicial scrutiny. Most of the protective legislation applies to factories. The Factories Act, 1948 includes provisions that protect a worker's health, life and limb and his working conditions.

If the Factories Act is regarded the first step in segmenting labour market into protected and unprotected labour segments the Industrial Employment (Standing Orders) Act of 1946 would be the second. It applies to factories employing 50 or more workers and regulates conditions of recruitment, discharge and disciplinary action. It requires the employers to classify workers into permanent, probationers, badlis or substitutes, temporaries, casual and apprentices.

Though defined clearly, the classifications are flexible in practice. The system of contract labour dates back to the beginning of industry in India. The Contract Labour (Regulation and Abolition) Act 1970 regulates employment of contract labour in certain establishments and provides for its abolition in certain circumstances. It applies to every establishment and contractor who currently or in the preceding year employed at least 20 contract workers. A contractor who employs 100 or more workers on contract is required to provide elementary facilities such as drinking water, toilets and first aid. The principal employer must ensure that these amenities were provided and that no worker was underpaid. He is authorised to make good the default by the contractor and recover the expense from the latter. Establishments performing exclusively casual or intermittent work are exempted from the scope of this Act.

3.5.2 Impact

A. Badli workers

A theoretical discussion of the impact of the legislative interventions detailed above has been analysed well by Mathur (1992; 1993; 1994). In the following we cover much the same ground but restrict myself to the Bombay and Delhi labour markets. To assess the impact of legislative interventions one needs to compare a market affected by such interventions with another that is not. Since the laws mentioned above apply to most states of India such comparisons would not be of much help unless the rigour with which the laws were implemented differed from one market to another. Alternatively, one could focus on a specific market and go back in time to a period relatively free of state intervention. This alternative is easier to accept because Bombay labour market is better researched than others in India are. Broadly, interventionist era could be said to have started with independence. Bombay's labour market was dualistic before independence and wages paid to committed permanent workers were higher than those paid to migratory, unstable, temporary workers (Mazumdar, 1989b). The dualism went hand in hand with a system of recruitment through jobbers in textiles. This saved the employers fixed costs of supervision, training and salary administration. If necessary, employers used jobbers to break strikes and more often to keep unions at bay.

Badli workers are those workers which are literally interchangeable (badli meaning inter-change in Hindi and Marathi), and are hired on a per-day, or even per-hour basis from labour contractors. Technological change within the textile industry and socio-political changes outside led employers to initiate a Badli Control System in 1935 (Deshpande, 1992). It operates today with the Decasualisation Scheme introduced by the Government in 1950. Neither altered the proportion of the Badlis employed by the industry. According to the sources cited in Mazumdar (1989b), the share of Badlis varied between 18-20 per cent in 1935, 1946/48 and 1963. Few know their share before the strike of 1982/83, and fewer still, after it. We also found reasons to believe that it may have gone up substantially after the strike. Employers were able to reduce employment of permanent workers even before the strike. This reduction was gradual and took place in accordance with the agreement hailed as a model of rationalisation without tears.

The strike helped employers to get rid of permanent workers at one stroke without any obligation to compensate them. A fall in employment of permanent workers would increase the share of badlis if fewer of the latter than of the permanent were refused employment after the strike. The share of badlis would increase faster if a permanent worker victimised for participation in the strike by his earlier employer took up employment as a badli with another. A reliable source close to the Mill Owners Association informed us that the share of the badlis had increased from about 20 per cent in the sixties to 29 per cent in 1990.

The critics who blame the union movement for the decline in employment in the city ignore the fact that the textile industry accounted for 95 per cent of the jobs lost in the city's manufacturing sector between 1975/77 and 1986/88. This could be blamed entirely on the national policy relating to the textile sector. To implement the Mahalanobis capital-led growth model favoured by Nehru in the early Fifties, the government banned new investment in the modern mill sector and even taxed it to subsidise handlooms. Owners of powerlooms benefited most from the policy. More efficient than handlooms, powerlooms increased spectacularly (Mazumdar, 1989b). They enjoyed a few doubtful advantages.

Owners of powerlooms organise production in units employing under ten workers to avoid application of the Factories Act. According to Mr Suryakant Wadhavkar, the union leader active in nearby Bhiwandi which houses Asia's largest concentration of powerlooms, 20 per cent of the powerlooms are not registered with any agency at all. Excepting the Minimum Wages Act, no legislation applies to powerlooms and the Minimum Wages Act is flouted with impunity. Mr Keki Randeria, management consultant, read out to us the reply that he had received from the State's Labour Department to his query on implementation of the minimum wage law, in Bhiwandi. The Department admitted that the government was unable to prosecute violators because the owners of powerlooms could not be traced. Bhiwandi brings to one's mind scenes from early days of the Industrial Revolution with men, women and children working long hours and sleeping often in unventilated sheds among the deafening noise of looms that work 24 hours a day and every day of the week.

The extent of job-work the owners of powerlooms in Bhiwandi do for the Bombay-based mills is not known. The powerloom owners take pride in it while the Secretary of the Bombay Millowners Association denies it. In an interview, he did not rule out the possibility of some managers of Bombay Mills doing it on the sly. Flexibilisation of labour employed in Bombay's textile industry is seen only partly in the casualisation within the mills. It is reflected largely in Bhiwandi where an estimated 200,000 workers sweat as piece rated day-workers earning half or less of the mill workers' wage. They are not carried on the muster of any employer, have no security of income and employment and no insurance to cover against sickness, injury, old age and death.

B. Contract Labour

Contract labour is also hired through contractors, but are a less homogenous category than Badlis, since they are individually identified and identifiable. The data on employment of contract labour collected by the ASI is published at the state and national level but not at the city level. When we looked at the ASI-reported shares of work days worked by contract workers and average wage per day of contract and regular workers in Maharashtra and India, we found that the share of workdays worked by contract workers doubled both in Maharashtra and India between 1971 and 1985/86. Wage per workday of a contract worker declined from 51 per cent of the regular's to 43 per cent in Maharashtra and from 51 per cent of the regular's to 47 per cent in India between 1971 and 1977/78.

The Labour Commissioner's Office, as an alternative source of data, is worse. It recorded 4,838 contract workers employed by licensees in all industries except construction and 3,852 in construction in 1986. Even if all 4,838 workers were employed in manufacturing, they would have formed about one per cent of the manufacturing employment in that year. Labour contractors employing fewer than 20 workers are not required by the Act to obtain a license. Hence the very low number. Such contractors who do not employ 20 or more workers, do not have to have their contract recorded. Those who intend to supply workers are required to specify when they apply to the government for a license, the maximum number they would employ on any day. If found guilty of employing more than the number they had specified, the contractors could be either fined or imprisoned and for repeated violations, both fined and imprisoned. According to Mr Ram Desai, President of the Mumbai Kamgar Sabha then organising unorganised workers; no labour contractor was imprisoned. A few were fined but most avoided prosecution by bribing the labour inspectors.

C. Casual Labour

Casual labour is a more formal category of labour employed than either of the previous two categories. Although not subject to any protection or severance pay, it does need to be put on a company's payroll and register. The main objective of legislative interventions relating to badli, contract and casual labour was to prevent possible exploitation of these categories in a labour surplus economy. We saw that despite these interventions, employers employ absolutely and relatively more badlis and contract workers now than before. No official source except the most inaccessible Occupational Wage Surveys published by the Labour Bureau reports employment of temporary and casual labour. Hence, no one knows its extent in Bombay. At most we could look at data giving the distribution of employment by status of workers are based on the data provided by firms seeking permission of the Commissioner of Labour to either retrench workers or close down their business.

This data shows that the share of non-permanents declined from nearly 21 per cent in 1971 to barely 5 per cent in 1989. Obviously the legal interventions have succeeded and to that extent management's flexibility is restricted. We saw earlier that the pool of badlis maintained by the mills exclusive of that maintained under the Decasualisation Scheme increased from 20 per cent to 29 per cent of the daily employment. This is likely to have happened in the other industries too. A manager of a subsidiary of a multinational producing valves for tyres informed us that most large firms maintain a pool of casual workers who are rotated in such a way that no worker completes 240 days of continuous work, which could earn him permanency. Questioned on the size of the pool, he replied that it was about 15 per cent of the employees carried on the roster by his company though the share employed on any one day is much smaller, about 3-5 per cent.

High permanency reported by small firms is suspect. Employers of fewer than 50 workers do not fall within the scope of the Industrial Employment (Standing Order) Act and are not required to classify workers by status. They report most workers as permanent but they do not enjoy the legal protection that goes with permanency. This tendency of small employers is likely to have distorted the distribution in the terminal year because small firms formed 87 per cent of the sample in 1989 as compared with 63 per cent in 1971. Moreover a decline in the share of temporaries and casuals does not imply loss of flexibility for management when there are many flexible categories to choose from. An employer can substitute one for another depending on the relative advantages. Contract labour, for instance, is as cheap to employ as casual but involves less paper-work, its supply is more assured and its presence in the factory is a clear and loud signal for unionised labour to behave. This has increasingly led employers to substitute contract for casual labour.

3.5.3 Intervention in Wages in Bombay

The Payment of Wages Act, 1936 is the oldest regulation relating to wages. It regulates intervals between successive wage payments, overtime payments and deductions from the wage paid to a worker. The Minimum Wages Act, 1948 empowers a Government to fix a minimum wage for any category of worker employed in an industry listed in the schedule appended in the Act or added to it later, but only if the industry employed at least 1,000 workers in the state. The minimum wage may be inclusive or exclusive of cost of living allowance. It is fixed either on the recommendations of a tripartite committee or by an announcement in the government gazette. The Equal Remuneration Act, 1976 prohibits wage discrimination against women. The Payment of Bonus Act, 1965 was enacted to reduce conflict that took place on bonus every year in Indian industry. Any worker who has put in 30 days of work in an establishment employing 20 or more workers is entitled to a bonus.

From total profits earned during the accounting year by a firm are deducted stipulated prior charges such as depreciation, direct taxation, development funds and return on capital to arrive at the available surplus, which is shared 60:40 between labour and capital. The sum allocated to labour is shared in proportion. to each worker's total wage consisting of basic and Cost of Living Allowance (COLA). The sharing is subject to a minimum and a maximum. No worker is paid less than 8.33 per cent and none more than 20 per cent of his total wage. The minimum must be paid and collective bargaining has bypassed the maximum. Firms pay 20 per cent in accordance with the law and a lump sum ex-gratia in addition.

Social security legislation in India includes Employees' State Insurance Act, 1948, the Employees' Provident Fund Act, 1952 and Payment of Gratuity Act of 1972. The first Act provides benefits to employees in case of sickness, maternity and injury. It applies to all factories and all workers whose wages do not exceed Rs.1,600 per month. The scheme is financed by contributions from workers and employers. The latter contribute five per cent of the wages payable to employees.

The Provident Fund Act applies to all factories. The fund is financed by employer and employee contributions, each contributing 8 per cent of the total wage.

The Payment of Gratuity Act applies to all factories and to workers earning more than Rs. 1600 per month. who have worked for five years or more than one employer. Gratuity is paid at fifteen days' wages for every year of service, subject to a maximum of twenty months' wages.

3.5.4 Impact

The Maharashtra State Government had listed till the end of 1988, 74 industries employing 10 million workers as potential candidates for minimum wage fixation. It had fixed the minimum in 51 industries employing 9.8 million workers. Special allowances were fixed along with minimum wages in 32 of the 51 industries. In the remaining 19, a consolidated minimum inclusive of allowances was fixed.

Studies evaluating implementation and impact of the MW Act are hard to come by. In 1983, a regular wage and salaried male worker in Bombay averaged Rs. 28 per day and a woman Rs.20 per day. A casual male worker earned Rs.14 and a woman Rs.8 per day (Government of India, 1983). In the same year the average of 28 minima with and 16 without special allowances fixed by the state was Rs.20 and Rs. 10 per day respectively. Distribution of the regular workers in the NSSO's sample by wages is not known. Hence it is difficult to estimate the share of workers not paid the minimum wage. But the casual men and women workers forming 4 per cent of the NSSO's sample did not get it.

Violations of the MW Act are difficult to detect because of five factors (interview with Labour Bureau, 1996). First, an unknown but reportedly large number of small employers falsify books of accounts and cheat officials. Secondly, they bribe them. Thirdly, there are far too many minimum wages around and workers often do not know the minimum applicable to their trade unless there are unions to tell them and fight for them. A small sample of 57 motor garage workers when interviewed by the Ambedkar Institute of Labour Studies in 1983 reported they did not know if the Government had fixed a minimum wage for them (Datar, 1983).

Lastly, there are far too many units to police and too few officials to do it. Hence the assertion an office bearer of an association of small industries made much to the discomfort of his colleagues in a group discussion with the authors that in his opinion four out of every five small employers (employing fewer than ten workers) did not pay the minimum wage is likely to be true (Group Discussion-Feb. 13, 1997). Minimum wage is revised once every five years. When prices rise, every worker gets less than the minimum in real terms. Between 1983 and 1989, minimum wages with special allowances in 16 of 28 trades in Bombay lagged behind prices.

In the two decades after the Second World War, unions secured for the workers more or less full neutralisation of inflation at the lowest level of pay. They were helped in their achievement by the Industrial Court and Labour Tribunals created under the Industrial Disputes Act. By and large, workers above the minimum pay were paid the same amount. The practice led to discontent among the better-paid workers whose real wage declined over time. Unions in some large and prosperous firms secured the double-linkage system by which the dearness allowance was linked to both prices as well as to the worker's basic pay. Despite the noise made about it, the system does not appear to be widespread; only 6 of 192 large firms surveyed recently reported double-linkage Dearness Allowance (DA) system (Government of India, 1988).

Indexing of wages to prices reduced the opportunity available to employers to increase their profits at the cost of workers in times of rising prices. The year-end bonus system culminating in the Act of 1965 eliminated it altogether at least for large and medium employers. Besides, there are non-wage costs consisting mostly of social security contributions. The composition of pay packet of factory workers is not known but that of wage per person-day is, though only at the state level. In 1983-84, a person-day in Maharashtra cost an employer Rs.51. Wages, dearness allowance and profit-bonus formed 86 per cent and non-wage costs 14 per cent. A more detailed breakdown related to person-days worked by workers in 1981-82 is given in Table 3.3.

Table 3.3

Composition of Wage Cost Per Person-day, 1981-82, Maharashtra (all firms)

	Wage component	% of total wage cost
1	Salaries and wages	78.4
2	Bonus	5.9
3	Benefits in kind	2.8
4	Old age benefits	7.6
5	Other social security charges	1.6
6	Other benefits	3.7
	Total wage cost per person-day (Rs.)	*49.60*

Source: Data obtained from the Labour Bureau, 1989.

The shares of these components in large and medium firms based in Bombay would differ from those reported above. Profit bonus may form a higher share of the pay packet of a worker employed in a large than in small firms. Taking all non-wage benefits determined statutorily and assuming that all workers employed in large firms were eligible to these benefits, we estimate that the non-wage benefits would form between 25 to 35 per cent of the total wage cost, slightly less if the second assumption were relaxed as it must be to take account of the flexible categories.

3.5.5 Job Security/ Industrial Disputes

The Industrial Disputes Act of 1947 governs industrial relations in all factories. The Act provides for conciliation of disputes and if that fails, for adjudication consisting of three tiers, Labour courts, Industrial Tribunals and National tribunals. Of late, the provisions of the Act dealing with lay-off, retrenchment and closures have been criticised by employers as having restricted the flexibility that management needs to adjust to changing economic conditions. No employer of 50 or more workers can lay off anyone who has worked for over 240 days unless he compensates him at 50 per cent of the basic plus COLA payable to him for a period up to 45 days. If the worker could not be re-employed within 45 days, the employer can retrench him, with compensation and a month's notice. Badlis and casual workers are not entitled to lay-off compensation.

To retrench a worker who has worked at least a year, the employer has to give him written notice indicating reasons for it a month in advance of the date of retrenchment and pay compensation at 15 days' average pay for every year of service. The Act requires an employer to compensate a worker on closure of business at the same rate. The Act was amended in 1976, 1982 and 1984. The first amendment made lay-off, retrenchment and closure illegal if the employer did not obtain permission from the Government to do so. He was also required to notify his intentions to lay-off, retrench or close 90 days in advance. The two later amendments which became effective in 1984 compelled the employer to pay full wages if a retrenched worker was reinstated by the Labour Court. According to the amendment of 1976, the provisions relating to closure and retrenchment applied to units employing 300 or more workers. The limit was lowered to units employing 100 or more workers with effect from 1984.

3.5.6 Impact

Introduced to protect current levels of employment, the restrictions on closures and retrenchment are blamed, ironically enough, for the slow growth of employment in the seventies and much more for the decline in the eighties (Lucas, 1988; Fallon and Lucas, 1991). The data on closures recorded with the Labour Commissioner given in Table 3.4 mislead one to conclude that the objective of the amendments to the Industrial Disputes Act namely, to restrain large firms from closing down, was achieved. The share of closures reported by employers of 100 or more workers increased from 6 per cent in 1971 to 15 per cent in 1981 and declined sharply after the amendment of 1982, to a little over one per cent of the closures in Bombay reported to the Commissioner in 1989. In contrast, the Chief Inspector of Factories (CIF) reports 1105 or 12 per cent of the factories registered in Bombay closed in 1989. Closures reported to the Commissioner of Labour formed about 13 per cent of those reported by the CIF. Worse still, the share of closed factories in the CIF reported data given in Table 3.5 shows an increase from about 8 per cent in 1971 to 9.5 per cent in 1981 and further to 12 per cent in 1989.

Table 3.4

Distribution of Closures by Size of Employment, Bombay, 1971-1989

Size of employment	1971	1981	1989
1-9	21.5	19.5	35.0
10-49	63.7	54.3	55.6
50-99	8.9	11.0	8.0
100-499	4.4	14.4	0.7
500+	1.5	0.8	0.7
Total reported	*135*	*118*	*137*

Source: Commissioner of Labour, Government of Maharashtra.

Unit of observation: firm

Table 3.5

Registered and Closed Factories, Bombay, 1972-1989

Year	Number of factories Registered Closed	Share of closed factories	Percentage
1972	5551	433	7.8
1981	7724	813	9.5
1989	9076	1105	12.2

Source: Chief Inspector of Factories, Government of Maharashtra.

The data available from the Labour Commissioner are of little use in assessing the impact of restrictions on closure. Employers of fewer than 50 workers are not required to report but they form 91 per cent of the firms that reported to him in 1989.

Those of 50-99 workers, though required to inform the Commissioner, are not obliged to seek Government's approval to close down. Such firms formed 8 per cent of the closures recorded with the Commissioner. That left only two firms truly affected by the restriction on closure. The Commissioner's information states that many large employers approach the State Labour Department directly.

The Labour Secretary investigates the specific cases and decides if the firm could be permitted to close. Data relating to these firms are not published. Large employers can and do approach the Board for Industrial and Financial Reconstruction (BIFR), an authority constituted in 1987 under the Sick Industrial Companies (Special Provisions) Act 1985, directly. The board ascertains if the company was sick according to the Act and if so whether it could be made viable. If it cannot be revived it is allowed to go into liquidation. In 1988, 50 large and medium firms from Bombay were referred to the BIFR but results of the BIFR scrutiny are not known. The ban on exit is held responsible for locking up huge bank credit in sick units.

The argument that the resources locked up in sick units could be put to more productive use if the units were allowed to close sooner has won the day. A fund called the National Renewal Fund avowedly to retrain workers was announced by the Finance Minister in March 1992. Its objectives are not yet clarified and if used to compensate workers for loss of jobs, it is likely to be grossly inadequate (Tulpule, 1992).

Union leaders are apprehensive of the future liberalisation holds for workers and unhappy that the existing laws may be relaxed. Although it must be said that these restrictions on closure and retrenchment are not such restrictions that have helped them bargain from large employers compensation to workers much higher than 15 days' pay for every year of service stipulated by the ID Act. Mr G.R. Naidu, advocate who appears for employers informed us that many large employers settle with two months' pay.

The Commissioner of Labour also informed us that the share of workers compensated for closure was quite low in two of the three years for which the data available from the Labour Commissioner were tabulated. Two explanations could be offered. First, employers apprehensive of being refused permission to close an entire unit, close various departments one at a time. Secondly, they employ in much bigger proportion than they disclose to official and non-official agencies flexible labour categories that need not be compensated.

Although the procedures employers have to follow to retrench are about as cumbersome as the ones they follow to close down, employers find it cheaper to retrench than to close. Again the data from the Labour Commissioner referred to in the previous paragraph is misleading as it suggests that the restrictions reduced retrenchment. A closer inspection of the data based on the records of the CIF shows that large and small employers reduced their work force with equal ease though the large employers were not legally as free to do it as the small ones. The data also brings out another dimension of flexibility, the growth of units and employment in non-factory non-household establishments totally outside the scope of protective legislation and unions.

3.5.7 Adjudication by the State

Employers blame the system of compulsory arbitration instituted under the ID Act for restricting their freedom to enforce discipline and change deployment of labour. By its very nature, the judiciary is guided more by equity than by demand and supply. This puts the management at a disadvantage that they try to counteract by appealing to higher courts against every decision of the lower court that went against it. Both unions and management adopted legalistic attitudes that together with growth in legislation and failure of the government to increase the number of judges led to enormous delays. Disputes pending decision increased phenomenally and forced both parties to fall back on voluntarism. Workers employed in large firms turned away in some measure from affiliated unions to independent unions. The trend received a setback with the defeat of the textile strike.

Wherever and whenever management wanted to achieve substantial reduction in employment, they did so by a greater reliance on "backdoor" collective bargaining where the union agreed, and by resorting to even more informal individual bargaining where it did not. The long delays in getting justice from the judiciary often forced workers to accept management's offer of retirement with a golden handshake or even with much lower compensation laid down by law.

3.6 ANALYSIS OF OBSERVATIONS

To conclude, factory employment in India stagnated in the eighties. India, hailed in the sixties as the archetype of Lewis model, no longer conformed to it. Bombay, the industrial and financial capital of the country went more wayward than the country in so far as employment in the whole modern sector, not just in factories declined absolutely. Registered unemployment and informal employment increased, as did that of badlis, contract labour and women.

It should be noted that it is difficult to relate the increase in capital:labour ratio in Indian industries causally to rise in real wages alone. Relative factor prices are influenced as much by the price of capital as by that of labour. Many policies followed in India encouraged employers to use far more capital per unit of output and labour. One such policy is the restrictive nature of labour law. In Bombay, large and medium employers were not allowed to expand employment. Consequently they increased output by increasing mechanisation. Increase in capital intensity increased labour productivity and wages. In addition unions helped workers appropriate part of the rents generated by the regulatory regime.

Whether unions raised wages faster than productivity depends on the deflator one uses to translate nominal into real magnitudes. So also does the answer to the question whether employers were restricted by collective bargaining practices from reducing their workforce.

Restrictions on closure and retrenchment are often cited by employers and many economists as the most obnoxious elements in the set of protective legislation in the country. We observed that contrary to the general belief, the share of closed factories in those registered in Bombay increased over time and further that the large employers allegedly restrained by law from retrenching their workers, were able to do so as freely as the small ones.

The growth in flexible labour categories noted earlier portends ill for the union movement and the maintenance of minimum labour standards in private factory employment in the immediate future. Three finance ministers have been forced to deflate the economy to reduced fiscal deficit. Deregulation of the economy has reduced the rents arising from the regulatory regime. Unions representing workers employed in import-substituting firms are being forced to accept a cut either in wages or in employment and perhaps in both. The latter, if employers adopted new technology based on microchips. These changes have weakened the union movement.

The gloom has not been lifted for quite some time after the initial adjustment period of two-three years was over. Total employment has increased but it comprises mostly of flexible labour types. Ironically, the new technology is increasing the fragmentation in the labour market. Being highly automated, it involves men to control working situations and to diagnose difficulties and set them right. Firms adopting this technology function as core units and employ workers who have had far more of formal schooling than the typical production process worker of today. Employers are having to find ways and means of increasing employee involvement and of increasing quality of working life. Obviously this class of workers is being paid highly.

Outside this core lies the periphery. Workers employed in the firms that make it bear the full brunt of the new economy and new technology. Belonging mostly to the flexible types, they are being daunted by insecurity of employment and income both during and after their working life. The implications of these developments go far beyond the labour sector. Neither fragmentation nor the injustice that goes with it is new to India. The leadership that fought for her independence and gave her the present constitution had dreamt of ending this social inequity. That vision must guide the country in facing the new challenges ahead. But before we think of the ways and means of facing the crisis, it would be appropriate to consider the facts at the micro level.

3.7 SUMMARY AND CONCLUSIONS: INCREASING INSECURITY

The basic purpose of the labour flexibility surveys and our related largely qualitative primary research was to find out how employers cope with industrial relations systems and protective legislation both of which are alleged to have reduced their flexibility in adjusting their labour costs and work force to changes in product demand. This loss of flexibility is a matter of great concern in India because much of the stagnation in employment is attributed to it. Attempts have been made to support the allegations empirically drawing on the ASI data disaggregated at best to 3-digit level. This is useful but not enough because whether employers possess or lack flexibility is likely to be revealed in an enterprise survey rather than in the industry aggregates reported by the ASI. To meet the challenge to unions and state intervention squarely, our research was largely restricted to Bombay where union movement is stronger and labour legislation is applied more effectively.

The review of macro level data revealed a substantial increase in shares of flexible labour categories in manufacturing employment. This informalisation of what is traditionally considered formal employment took place along with the growth, absolute and relative, of the traditional informal employment. Rates of unemployment were high particularly among the young entrants to the labour force. Registered unemployment, deficient in many ways, increased fast. Taken together, the macro level evidence showed that the labour market became conducive to adoption of flexible labour practices.

Analysis of micro, firm level data showed that employers varied total employment, manual and non-manual taken together found that firms which experienced an increase in demand increased employment and it was the medium and the large firm, supposedly constrained by unions and protective legislation, that increased it more than the small firm did with all the flexibility at its command. As predicted by micro theory, firms that increased fixed capital per worker reduced employment and so did other firms that which experienced a rise in share of labour cost relative to other costs. Importantly, it is the firm, which increased the share of non-permanent labour that increased total employment. Changes in manual employment were associated directly not only with changes in share of non-permanent but also with those in shares of female and contract labour. Hence, increased insecurity for workers.

We have made an attempt to explain what factors influenced levels of and changes in employment of flexible labour categories. Firms which increased capital intensity reduced employment of flexible labour be it non-permanent, casual, contract, female or the all-inclusive non-regular labour. Employers who reported their labour cost had increased as a share of variable cost, reported a higher share of non-permanent labour particularly, casual labour. In contrast, such employers reported proportionately fewer contract and women workers.

This led us to probe this relationship between flexible labour statuses. Non-permanent labour and contract labour were complementary but contract labour and female labour were substitutes. Non-regular labour and female labour were also used as substitutes in employment.

The supposition that larger firms resorted increasingly to flexibilisation of labour was also borne out in respect of non-permanent labour but not in that of casual labour and female labour while the labour flexibility survey lacked data to test it in respect of contract labour. Some solace could be had from the fact that the hypothesised tendency was observed though it was statistically insignificant. Viewed in the context of the macro data, one suspects that the data on employment of casual, contract and female labour may not have been correctly reported by larger firms to the government. This possibility makes the evidence of flexibility gathered by both labour flexibility surveys all the more precious.

The surveys also found that unions were less likely in firms that reported a higher share of non-permanent labour in particular and a higher share of other flexible labour in general but the generalised relationship was not statistically significant. Flexible labour being difficult to organise, the lower probability of union presence in firms reporting higher shares of flexible labour is quite understandable. Unions discouraged employment of non-permanent and non-regular labour. Unionised firms reported lower share of female labour but greater increase in it over the previous years. They also reported a greater increase in the share of casual labour. This behaviour of unions could be rationalised pragmatically. Casual labour could be given permanency later with the help of the law. It could also be that unions did not mind employers hiring flexible labour so long as they did not hire them in threateningly large numbers. Unions contributed to dynamic efficiency of the firms by encouraging technological change and widening of product range. Unfortunately, such contributions of unions are rarely noticed. Regrettably, the conflictual role of unions appears from the surveys' data to be unduly exaggerated.

The wages of unskilled male workers were higher if determined by collective bargaining; if such workers were employed in medium and large firms; if the firms paid higher than the minimum rate of bonus; and if the firms belonged to chemical industry. Unions raised the wages of both unskilled and skilled males above those paid to them by non-unionised employers. A firm reporting a higher share of female employment paid its unskilled males less than a firm that reported a lower share. Unions narrowed the skill-based wage differentials. The latter were narrower in large than in small firms but wider in textile product industry and firms reporting higher share of female. Labour cost was a higher share of variable costs of a firm which reported a lower increase in prices. It was the higher, the lower the share of non-permanent labour and surprisingly, the higher the higher the share of contract labour. Perhaps the causation runs the other way around; firms with higher labour costs resort to proportionately greater use of contract labour.

It must be stated that the data set presented in the surveys as available for India bears no comparison with the quantitatively and qualitatively much richer set presented by Standing his labour flexibility surveys, which formed the guide for our surveys (e.g. 1989 and 1990 for Malaysia). However, the conclusions that emerge from the limited number of studies are not much different. Even if we assumed that bigger firms reported the whole truth and nothing but the truth, the lower recourse to flexibilisation than reported by employers in Malaysia, may be attributed to the less urgent need for it in an inward-looking, highly protected Indian environment that prevailed at the survey.

Having established from the detailed examination of the conclusions of the two Labour Flexibility Surveys, and of the insights gained from our own interviews, we have established what seems to be a trend for increasing casualisation, informalisation and insecurity. This leads us to strongly suspect that as hypothesised by Basu, Fields and Debgupta (2000) and also suggested above, job security regulations tend to not benefit the large majority of the labour force, and have a negative effect on employment. Let us test this hypothesis next in Chapter 4.

CHAPTER 4

IMPACT OF JOB SECURITY REGULATIONS: USING HOUSEHOLD AND FIRM-LEVEL DATA FOR INDIA

We concluded in the previous chapter that labour regulations have a selective impact. While giving protection to a tiny minority of the labour force, they actually lead to large scale informalisation for the majority of the work force, thus pushing them into insecure employment, which is badly paid and low skilled. As a result, these regulations are, to a large extent, responsible for trapping a large majority of the labour force—informal labour—into an often inter-generational cycle of poverty. Let us now test this impact on employment, and its various categories.

In order to assess the impact of labour market reforms on the workers, it is necessary to determine the impact of labour market regulations on labour market outcomes. This chapter does so, and is organised into the following sections: Section 4.1 presents the theoretical debate about the impact of labour market regulations. Section 4.2 summarises the empirical evidence contained in academic papers about the impact of labour market regulations. Section 4.3 briefly re-states the background information about job security in India. Section 4.4 presents the data, methodology and results of a simple probit analysis using National Sample Survey (NSS) data, designed to answer the question: who benefits from job security regulations in India? Section 4.5 presents the data, methodology and results of an econometric exercise on firm-level data in India, which is designed to look at long term labour demand functions of firms, and analyses which categories of labour are facing decreasing demand, and which are facing more negative impact on demand than others. It finds a decrease in the demand for both regular, and casual labour—i.e. a negative impact of regulations on all employment. Section 4.6 contains the conclusions to this chapter.

4.1 THE IMPACT OF LABOUR MARKET REGULATIONS: THEORETICAL ARGUMENTS

In an important review article, Freeman (1992) caricatures the debate over labour regulations as a fight between the World Bank Distortion View versus the ILO Institutional View. He describes the opposing positions as follows:

> *"On one side are economists who see unregulated labour markets as neoclassical bourses in which government regulation of wages, mandated contributions to social funds, job security, and collective bargaining create "distortions" in an otherwise ideal world.... On the opposite side are institutionally oriented economists who believe that the social aspects of labour markets create such large divergences from the competitive ideal as to make the model a poor measuring rod for policy. These analysts stress the potential benefits of intervention, hold that regulated markets adjust better than unregulated markets to shocks, and endorse tripartite consultations and collective bargaining as the best way to determine labour outcomes. When efficiency conflicts with the social protection of labour, they place greater weight on the latter".* (p. 118)

On the other hand, the World Bank's Distortion View (so called as opposed to the ILO's "institutional view") argues that labour market policies tend to raise labour costs and reduce labour demand in the formal sector, while increasing labour supply and depressing labour income in the informal and rural sectors (where most of the poor are engaged.) In addition to the efficiency losses resulting from such misallocations of labour, labour policy also gives rise to deadweight losses associated with interest group rent-seeking (e.g., as a result of attempts by "insiders" to gain even more protective job security legislation), a diminished capacity to adjust to shocks due to a regulation induced loss of labour market flexibility, and a lowering of overall investment rates as a result of labour policy's redistribution of economic rents from capital to labour.

Taken together the theoretical arguments of the Distortion View imply that labour regulations hurt both wage and employment growth, and, while some workers may benefit from regulations, labour as a group will not. The poor especially are likely to be hurt from a lowering of labour demand since labour time is their primary, or even sole, asset.

Freeman (1992), however, argues that the Distortion View employs a "selective use of economic theory," and its welfare conclusions might be less robust than they first appear. He writes,

> *"those who believe that social security payroll taxes adversely affect savings and investment reject Ricardian equivalence; those who use nonwage costs to measure interventionist distortions reject the fungibility of modes of compensation; those who argue that employment protection laws have efficiency costs ignore Coase's theorem that property rights do not affect efficiency".* (p. 120)

The ILO's Institutional View also is subject to criticism by him, more for its lack of theory than for its selective use. A moral imperative for labour protection often is substituted for a more objective defence. Theory can play a greater role in assessing the Institutional perspective but too often it has not. Cost benefit analysis can be applied to the evaluation of programs such as unemployment insurance. Game theory offers insight into alternative bargaining arrangements and can identify the relative merits of differing institutional modes of wage-setting. "The game theory finding that modest differences in the rules of games (that is, institutions) can substantially affect outcomes implies that one cannot dismiss institutional claims as atheoretic, although the claims may be wrong. All of which means that we must look at evidence to decide who is closer to the truth." (Freeman 1992, 122)

4.2 THE IMPACT OF LABOUR MARKET REGULATIONS: EMPIRICAL EVIDENCE

The evidence on the impact of labour market regulations is no more conclusive than is theory. Based on analyses from the 1980s, Freeman's survey finds little evidence of the labour market rigidities that the Distortion View assumes result from labour regulations. In a wide range of developing countries, real wages despite the prevalence of minimum wage orders were not sticky and as macroeconomic situations worsened, real wages declined, often precipitously. Relative wages, especially differentials between the public and private sectors, but also by skill and education levels, similarly displayed considerable flexibility. Direct evidence on the consequences of specific regulations proved equivocal. Relaxation of job security legislation in Spain seems to have spurred employment growth, but similar legislation in Malaysia had little affect on employment, and findings on India and Zimbabwe appear contradictory. Correlations between either the organisation (industrial versus company) or strength of unions and macro-adjustments or enterprise performance also proved inconclusive.

"Fallon and Lucas (1991) estimated wage and employment adjustment equations before and after passage of job security laws in India and Zimbabwe and found little evidence that the laws affected wages or speeds of adjustment but considerable evidence that they reduced total employment in relation to output--an odd finding, since job security provisions that do not affect wages or the speed of adjustment carry no extra cost that would deter employment." (Freeman 1992, 129)

Empirical work undertaken in the 1990s supports Freeman's earlier findings. A special issue of the *Journal of Labour Economics* (July 1997) is devoted to studies of labour market flexibility in developing countries. Several of the papers consider whether dismantling various labour regulations increases labour demand. Once again the results are mixed. Bell (1997) finds a statistically significant disemployment effect resulting from Colombia's minimum wages ("...the 10 percent rise in the real value of the minimum wage from 1981 to 1987 reduced employment of low skilled workers between 2per cent and 12per cent." (p. s104)

Conversely, in Mexico the real value of the minimum wage fell almost in half with little apparent effect on employment. Bell attributes these differences to the relative position of the minimum wage in the wage distributions of the two countries (relatively high in Colombia and low in Mexico) and to a much higher degree of non compliance in Mexico.

Rama (1995) examines the impact of minimum wages in Indonesia and gets results that fall closer to those on Mexico than on Colombia. He finds that a doubling of the Indonesian minimum wage led to a 10 percent increase in average wages and a 2 percent decrease in wage employment. These magnitudes suggest a moderate effect, not a large labour market distortion, resulting from Indonesia's minimum wage.

Papers by Gruber (1997) and by MacIsaac and Rama (1997) in the *Journal of Labour Economics* volume consider the incidence of regulations. Gruber studies the privatisation of Chile's social security program which, beginning in 1981, shifted most of the financing of the program from payroll taxes to general revenues, causing the payroll tax to fall from 30 to 5 percent. If the incidence of these payroll taxes bears heavily on employers, this reduction should lower labour costs and produce, *ceteris paribus*, a commensurate increase in labour demand. Gruber finds that it did not. Workers bore the burden of the tax and when rates were lowered effectively all the benefit accrued to workers in the form of higher wages. Gruber concludes, "changes in employer taxes had essentially no effect on employment." (p. s73)

MacIsaac and Rama (1997) reach a similar conclusion. Their focus is on the incidence of nonwage benefits mandated by Ecuador's cumbersome labour legislation, where bonus payments (the "teens"), cost-of-living adjustments, transport allowances and social security contributions are all required and, in principle, could push-up take home pay by 75 percent for a minimum-wage worker. Instead, the fungibility of compensation results in labour costs increasing, on average, by only an estimated 8 percent as workers absorb most of the mandated benefits in the form of lower base wages. Like Gruber, and unlike the conclusions of Cox-Edwards (see below), the results obtained by MacIsaac and Rama suggest that many labour regulations neither have the presumed large and negative effect on employment nor have they proven capable of significantly improving the well-being of those workers covered by these statutes.

In a survey of labor market legislation in Latin America and the Caribbean (LAC), Cox-Edwards (1993) writes,

> *"Textbooks usually mention minimum wages as the predominant labor market distortion to be removed in market-oriented reforms. But this is not the most pressing issue in Latin America today. With few exceptions, minimum wages have declined throughout the region in the past few years and have largely become non-binding.... The most serious labor market distortions in Latin*

America can be classified in three categories: employment protection laws that impose limits on temporary hiring and impose substantial costs on dismissals; high payroll taxes; and antagonistic labor-management relations that encourage confrontation and costly settlement procedures." (p. ii)

Examples of such regulations include two year limits on non-renewable temporary contracts in Ecuador, Nicaragua and Peru; payroll taxes of 46 percent in Argentina and 20 per cent in Colombia; and the existence of union shops in a large number of LAC countries. Cox-Edwards also reports the existence of mandatory non-wage compensation such as annual vacation time (30 days in Peru), maternity leave (24 weeks in Brazil) and employer funded child care (for firms of 20 or more employees in Venezuela.) "The key question concerning these benefits is who pays for them: employers in the form of lower profits; workers in the form of higher benefits and lower wages; or workers outside the formal labor market who might benefit from higher labor demand if total labor costs were lower." (p. iii)

Independent evidence from surveys of business executives in many countries confirms the weak support for the Distortion View's worst case scenario of labour regulations escalating labour costs and inhibiting the growth of employment and investment. MacIsaac and Rama (1997) report that in a survey of 1000 large firms in Ecuador, labour regulations were mentioned infrequently as a concern of business managers. The same result was obtained for Cameroon by Gauthier (1995), for Senegal by Terrell and Svjenar (1989), and for the Ukraine by Kaufmann (1997).

The World Economic Forum's *Africa Competitiveness Report 1998* employs similar surveys. It finds that in a sample of twenty, mostly sub-Saharan economies, over two-thirds of the countries do not rank regulations on hiring and firing, or on working hours, as a significant constraint on business activity. For most of the countries labour regulations were ranked as less onerous to business than were other regulations. The exceptions, where labour regulations were perceived of as a significant problem, were in Southern Africa and included Mauritius, Namibia, South Africa and Zimbabwe.

The World Economic Forum's *Global Competitiveness Report 1999* poses similar questions to a broad group of developed and developing economies. "*India's* *business leaders, like their South African counterparts, repeatedly cite job security legislation as a significant impediment to their activities"*(emphasis mine). In Latin America, Argentina, Colombia and Venezuela receive low scores on labour market flexibility while Brazil, Chile and Mexico rank more favourably (World Economic Forum (1999), Tables 7.04 and 7.05).

Available empirical studies suggest that labour regulations have caused weaker distortions and fewer debilitating effects on the labour market than predicted by the Distortion View. Freeman suggests that there are several reasons why this may be the case. *First*, labour policy is at least partially endogenous to economic circumstances. Concerning the use of minimum wages, Freeman (1992) writes, "The minimum floor proved to be sawdust not hardwood, as distortionists feared." (p. 128) When governments realise the difficulty firms have meeting the levels of prevailing minimum wages, they permit inflation to erode guidelines pegged at nominal rates. *Second*, labour markets world-wide show considerable flexibility to market conditions regardless of their particular institutional or regulatory features. The fungibility of wages and benefits is a prime example. *Third*, compliance and enforcement are key determinants of the impact of labour regulations. Often, employers and employees both have an incentive to evade the law employers to lower labour costs and employees to save their jobs. Given the administrative burden of enforcement, non-compliance is expected. Describing the situation in the CFA zone, Rama (1998) writes,

> *"...very few plants are visited to check that they do comply with labour standards. In the unlikely event of one such visit, some employers add, inspectors can be easily bribed to avoid paying a fine. Not surprisingly, employers do not feel unduly constrained by current labour regulations."* (p.9)

Labour regulations can be designed which seriously misallocate resources, reduce investment and slow employment growth. But this does not mean they always will do so. Empirical studies report on individual cases, but not necessarily the worst cases. However, India, one suspects, is one of those "worst" cases. More careful scrutiny of the country experience below reveals a situation in which labour regulations exact a heavy price, especially on those "outsiders" who work beyond the reach of the labour code.

4.3 JOB SECURITY IN INDIA

Let us briefly re-state what we have already stated in previous chapters. In the case of India, the Industrial Disputes Act, 1947, requires firms that employ 50 or more workers to pay a compensation, which is specified in the Act, to any worker who is retrenched. In addition, an amendment to the Act, which became effective in 1984, requires firms, which employ more than 100 workers actually to seek prior permission from the government before retrenching workers. And, as Datta Chaudhuri (1994) has noted, the government seldom gives permission and, in general, places a lot of *a priori* restrictions on the terms for hiring and firing workers (see, also Mathur, 1992; Edgren, 1990; Papola, 1994).

Basu, Fields and Debgupta (2000) note that "what is interesting about such laws is how lay opinion on them is at divergence from the opinion of economists" . The popular wisdom on this issue is that these anti-retrenchment laws help labour, but hurt the development process, as they force firms to maintain huge workforces that reduce their ability to make profit. One problem with the conventional wisdom is that it fails to capture the fact that anti-retrenchment laws raise the effective cost of employing labour and, as a result, firms may hire fewer workers. Additionally, it is conceivable that, given the presence of such laws, some firms may not enter into production in the first place. Hence, Basu, Fields and Debgupta (2000) conclude:

> "*the economists' view of this is often the opposite of the lay opinion: By burdening firms with the risk that they may not be able to fire their workers or that they will have to pay very large compensations in order to do so, the anti-retrenchment laws cause a decline in the demand for labour and thereby cause a lowering of wages and so ultimately hurt workers*" (p. 4).

Fallon and Lucas (1991), in an empirical study on the anti-retrenchment laws in Zimbabwe and India, show that as the laws were strengthened (making it more difficult to layoff a worker), the long-run demand for employees fell by 25.2 percent and 17.5 percent, respectively. They could not determine any significant reduction in wages as a result of the laws. In the case of India the point has been made time and again that rigid labour market legislation may have hurt India's overall growth and efficiency (Fallon and Lucas; Ahluwalia 1991; Government of India, 1995). The claim that is forwarded by Basu, Fields and Debgupta (2000) is related—inasmuch as labour earnings are a subset of growth and efficiency. They have argued that the legislation may have hurt the very constituency that it was meant to protect-- labour. Hence, Kannan's (1994) observation that wages in the eighties have not kept pace with labour productivity and Ghose's (1994) finding that employment per unit of gross value added in manufacturing fell monotonically throughout the eighties (see, also, Mahendra Dev, 1995) sit very well with the theoretical findings of their paper and the fact that India's labour market legislation was made more rigid in the eighties.

In the next section, we use National Sample Survey (NSS) data to analyse who benefits from job security regulations in India.

4.4 WHO BENEFITS FROM JOB SECURITY REGULATIONS?: PROBIT ANALYSIS USING HOUSEHOLD DATA

4.4.1 Theory

Job security (JS) provisions are, in general, regulatory measures enacted as social protection to mitigate the risk of unemployment among workers by forcing firms to provide subsidies during downturns. The main mechanism is large severance payments preventing workers from being laid-off during downturns. In India it also implies lengthy and expensive procedures that inhibit layoffs by driving up firing costs. It is sometimes argued that the macroeconomic adjustment is further shifted towards the informal sector. Hence many perceive JS provisions as inequitable for unprotected workers.

Those who support regulations in the job market claim that they are commendable to the extent that their objective is the protection of workers against unsafe work practices and unjustified dismissals. They also state that regulations protect the weakest members of society, that they help to redistribute income and that they stabilise earnings for those people subject to greater risks.

Job Security is one form of non-wage compensation. Besides inducing greater immobility, JS increases labour costs to the firm. The increase in labour costs depends on how workers value JS and, specifically, on whether JS is a substitute for, or a complementary to, wage compensation.

Who benefits from regulations? Could we predict which individuals are the most likely to profit from deregulation? These questions have no simple answer but deserve serious consideration before any action is taken to alter the current regulatory standing. We attempt such an exercise using five rounds of NSS data.

4.4.2 Description of Dataset

For the purpose of this thesis, we use data collected in various surveys of National Sample Survey (NSS), India. NSS is the only source that provides comparable time series information on the levels and patterns of employment, unemployment, consumption and the distribution of population by per capita consumption levels. These surveys also provide information on demography, consumer expenditure, land utilization, and so on.

For over 50 years, the National Sample Survey Organisation (NSSO) has been conducting socio-economic surveys on a nation-wide basis in the form of annual (sometimes half-yearly) rounds. Primarily the national sample surveys (NSS) are designed to provide reliable results for planning and policy purposes at national and state levels. The State Governments started participating in the programme of NSS from the 8th round (July 1954-June 1955) onwards employing their own field resources. The main idea of states participating in the NSS programme was to provide a mechanism by which the sample size will get increased as a result of which it should be possible to provide more disaggregated results at regional or lower level by pooling the central and state samples for meeting the requirements of effective decentralised plan formulation and policy analysis. In order to ensure that pooling of results of central and state samples is undertaken on a scientific basis, right from the beginning the states adopted the same sampling design, schedules, concepts and definitions, instructions for the field and supervisory staff, and manual scrutiny programme.

Generally the central sample comprises about 10,000 villages and 5,000 urban blocks. The sample canvassed in each state is at least of the same size as the central sample canvassed by the NSSO. In some cases the state sample is twice (or more in few cases) the size of the central sample. For example, for the 55th round (1999-2000) relating to household consumer expenditure, employment and unemployment, and informal non-agricultural enterprises, the size of the state sample (both for rural and urban areas) was twice that of central sample in case of Gujarat, Haryana, Jammu & Kashmir, and Manipur, while it was one-and-half times in Goa (both for rural and urban areas) and Mahrashtra (only for urban areas). In case of Delhi the state sample, both for urban and rural areas, was three times that of the central sample. The union territory of Chandigarh conducted the survey only in the urban areas with twice the size of the urban central sample.

Comparability in Data Gathering across States: The respective State Governments have charged the state Directorates of Economics and Statistics (DES) with the responsibility of canvassing state sample of NSS. In order to ensure uniformity of concepts, definitions, and methodology of data collection in the central and state samples, the Field Operations Division (FOD) of NSSO organises an all-India training conference of supervisory staff involved in the collection of both central and state samples before launching the field work for each round. The regional staff of the FOD of NSSO and the DESs coordinate with each other in training the field staff deployed for canvassing the central and state samples.

Comparability in Data Processing across States: Unlike the field operations, the arrangements for co-ordination between the Data Processing Division (DPD) of NSSO and the state DESs in matters relating to data processing of NSS are rather weak. The DPD of the NSSO selects both the central and state sample of the NSS and provides to the state DESs the lists of villages and urban blocks for canvassing the state sample. Although the NSSO and state DESs adopt the same tabulation programme, on a very few occasions an annual training workshop on data processing has been organised by DPD to discuss with the state DESs issues relating to adoption of uniform data entry formats, computer scrutiny and procedures and methods of validation of data. This is mainly on account of differences in the hardware and available data processing facilities in the state DESs.

Pooling of Results: Primarily the responsibility for pooling of central and state sample results of NSS rests with the state DESs in view of the State Governments' interest in obtaining results at regional and lower levels to meet their requirements of decentralised planning.

Methodology of Pooling: A technical group set up by the Department of Statistics, Government of India in 1981 under the chairmanship of Mr. S.C. Choudhri, the then Chief Executive Officer of NSSO recommended in 1983 that the estimates based on central and state samples may be combined as a weighted average with the number of primary sampling units as weights at the stratum level. Most of the state DESs were not able to adopt the recommended procedure mainly on account of the reason that it called for a large amount of additional data processing resources. Keeping in view the above difficulty of the state DESs, Minhas and Sardana (1990) devised a simple procedure of pooling the central and state sample data to provide more precise results as compared to both the central sample and the state sample. In brief, the method involves pooling of central sample and state sample data and treating it as one sample by simply amending the multiplier files of the central sample and state sample to take into account the increase in the sample size.

This procedure is statistically sound because the central and the state surveys are undertaken adopting the same sampling design, the same concepts and definitions, same schedules and procedures of data collection, and manual scrutiny of filled in schedules. The method, of course, presumes that the data processing by the NSSO and the state DESs will be undertaken in a co-ordinated manner using the same procedures and software for data entry, data validation, imputing of missing values, working out and stabilising the multiplier files and desirably the same software for generating the desired tabulations. In order to promote the activity of pooling of central and state samples of NSS, the NSSO provides the validated unit-wise data and the stabilised multiplier files of the central sample to the interested state DESs.

Since most of the state DESs use computer for data processing of NSS, copies of the computer based software developed and used by the DPD of the NSSO for tabulating central sample data are given by the NSSO to the state DESs for tabulating results based on state sample as also pooled central and state sample data.

As a matter of general practice, NSSO does not publish estimates of standard errors (SE) of estimates presented in the reports on national sample surveys. However, to help users to get an idea about the reliability of estimates, the published reports, in general, present estimates by two or more sub-samples. Occasionally individual research workers have published estimates of SE of selected estimates at national level, state level, and NSSO regional level.

Advantages of NSS Data: The National Sample Survey (NSS) is an important source of information on labour. Unlike the Population Census which covers the entire population, the NSS data is based on sample surveys. As stated earlier, the National Sample Survey Organisation (NSSO) carries out large scale surveys on the whole of India with sections on employment and unemployment every five years. The systematic and comparable surveys on employment by gender, age-group and other classifications are available from 1974 onwards. Therefore the data relating to estimates of labour are available for six periods, namely 1973-74, 1977-78, 1983, 1987-88, 1993-94 and 1999-2000 with five year intervals.

The large-scale NSSO quinquennial surveys covering the entire country mainly aim to measure the extent of employment and unemployment in quantitative terms. The population in National Sample Survey is comprised of three components, that is (a) workers (or employed) (b) seeking/available for work (or unemployment) and (c) not in labour force (or non-worker). Unlike the Population Census, which used only one approach or concept of 'work' (or employment), the NSS has adopted three different approaches of work or employment based on the activities pursued by the individuals during a specified reference period. The three approaches are based on the reference period used in assigning the working status:

(i) Usual Status Approach – The Usual Status (US) is assigned by taking a reference period of 365 days preceding the date of survey. This particular approach is further divided into two categories.

(a) Principal Usual Status – A person who is engaged relatively for a longer time during the reference period of 365 days in any one or more work activities is considered as principal status worker.

(b) Subsidiary Usual Status – A person who pursued some gainful activity in a subsidiary capacity is considered to be a subsidiary status worker.

(ii) Current Weekly Status – The working status under current weekly status is with a reference to 7 days preceding the data of survey

(iii) Current Daily Status – The working status under the daily status is assigned based on activity with reference to each day of the 7 days preceding the date of survey.

Economists have generally used differences between (i), (ii) and (iii) to calculate the true extent of casualisation of labour in India, and to calculate the difference between the number of people with regular contracts and those with different kinds of informal, or no, contracts.

Besides the age and gender distribution of working persons or employed, the NSS also provides data on unemployed persons by age including the age-group 5-14 years, marital status of respondents, and education and skill level, sector of employment, and activity group.

Activity Group: This category helps us to understand whether a worker is protected or unprotected, given whether he/she is a regular worker or not. The National Sample Survey provides the data on the economic activities in which the working person is engaged. The economic activities are classified into five economic activity groups by total and then separately in agriculture and non-agriculture sector for rural and urban areas. As stated already, the participation of persons working in each of the activities and their division within agriculture and non-agriculture is given for four status namely, Principal Usual Status, Usual Principal and Subsidiary Status, Currently Weekly Status and Current Daily Status. The activity categories of employed persons included under principal usual status and usual principal and subsidiary status are as follows:

Usual Activity (Principal Status) and its activity categories

- Worked in Household enterprise (self employed)
- Worked as helper in Household enterprise (unpaid family worker)
- Worked as regular salaried/wage employee
- Worked as casual wage labour in public works
- Worked as casual wage labour in other types of work
- Sought or seeking/available for work (Unemployed)
- Not in Labour Force
- Total Population

The activity categories for persons employed based on the Current Weekly Status and Current Daily Status are slightly different.

Current Weekly/Current Daily Activity and its categories

- Worked in Household enterprise (self employed)
- Worked as helper in Household enterprise (unpaid family worker)
- Worked as regular salaried/wage employee
- Worked as casual wage labour in public works
- Worked as casual wage labour in other types of work
- Worked in household enterprise but did not work due to sickness
- Worked in household enterprise but did not work due to other reasons
- Regular salaried/wage employed but did not work due to sickness
- Regular salaried/wage employed but did not work due to other reasons
- Sought or seeking/available for work (Unemployed)
- Did not seek but was available for work
- Not in Labour Force
- Total Population

There have not been any significant changes in the concept of work (gainful activity) adopted over the five rounds i.e. 32nd round (1977-78), 38th round (1983), 43rd round (187-88), 50th round (1993-94) and 55th round (1999-2000) in National

Sample Survey and Rural Labour Enquiry. Therefore, temporal changes could be studied with little difficulty.

4.4.3 Methodology

Because of the labour market's segmentation, the probability of benefiting from regulations varies across individuals. For this reason, it appears interesting to run a descriptive analysis of the beneficiaries of regulations. At this stage, as we must acknowledge the technical support and inputs provided by Mr. C.S. Das of the Central Statistical Organisation (CSO) in Calcutta. Without him, it would have been impossible to obtain, clean and analyse the data, and obtain the results discussed below. We report results arrived at using household-level data for wage-earners from various rounds of the National Sample Survey (NSS) for the 1977-99 period. We divide the sample between males and females. **The model we estimate is a simple probit equation where the dependent variable is a dummy over whether** or not **the worker can claim state-mandated protection and/or compensation in case of dismissal.** These are all those workers who are in regular employment according to answers provided to questions about kind of employment (see previous section). We follow the methodological framework provided in Mondino and Montoya (2000), although the nature of our analysis and results is different, as our data set provides different kinds of information than theirs.

The correlates included are:

- Educational level: Higher educational level implies higher productivity and should increase the probability of being in the formal sector. Lower educational level workers could be pushed to the informal sector because their low productivity may not be enough to counter the costs of minimum wage and other laws.
- Experience: Experience increases general human capital and, hence, productivity. Therefore, more experienced workers would face less insecurity than those who have recently joined the labour force, or those who work intermittently.
- Tenure on the job: Longer tenure must reflect a better match and greater job specific human capital. If a firm could choose the type of jobs to

offer job security it would provide it to workers that have accumulated a high level of firm-specific human capital. Workers would in return pay back in the form of higher productivity.

- Branch of Activity: A purely empirical set of correlates to account for sector specific differences in the enforcement capabilities of control agencies, the degree of monopsony power, unionisation and instability of activities.
- The size of the company.
- Regulatory status of another family member: It is quite possible that workers become increasingly prone to accept job offers with regulatory coverage when the household has diversified risks, in particular, when the spouse or another family member enjoys regulatory coverage. This can be seen from whether the worker is principal or subsidiary status.
- Marital status: this variable is introduced in the female regression bearing in mind the gender biased features of the legislation. We should anticipate a negative sign.
- Children under six years of age.

4.4.4 Results

Table 4.1 reports the results for females and males of the derivates of a probit model where the dependent variable is the possibility of claiming state-mandated protection and/or compensation if the worker is laid off.

Table 4.1

Probit Estimation: Jobs with Protection/Compensation Rights

	Men			Women		
	dF/dx	Z	X-Bar	dF/dx	Z	X-Bar
Primary	0.048464	2.2256	0.406744	-0.000832	-0.0728	0.576368
High-School	0.26163	9.5172	0.367916	0.100837	7.9619	0.264813
College	0.219802	10.8018	0.17544	0.078846	4.5186	0.086598

Experience	0.020907	11.9382	20.323624	0.016564	22.541382	13.6148
Tenure	0.001632	3.6516	6.964254	0.00255	7.2114	8.071872
Construction	-0.476066	-21.6094	0.169435	-0.304056	-19.4979	0.069937
Manufacturing	0.225576	2.236	0.00364	0.126152	3.5776	0.013936
Retail	0.070616	4.3264	0.145496	-0.045344	-4.4928	0.167128
Transport	0.140801	4.4084	0.028531	-0.07004	-6.0667	0.126896
Financial Services	0.132498	6.9972	0.103734	0.015912	1.1424	0.091494
Private and Social Services*	0.174932	11.3625	0.550652	-0.005757	-0.5858	0.220584
Size < 50	0.2362	0.177255	13.6754	0.204525	0.126351	16.7559
Size <100	0.30957	22.3482	0.181662	0.232968	28.9374	0.176868
Flia_Reg *	0.46332	41.2568	0.340704	0.34112	43.5344	0.277888
P art Time*	-0.210288	-17.212	0.367328	-0.207168	-18.0024	0.12064
Household Head	0.008446	0.5047	0.184061	0.146466	15.244	0.692469
Child <6	0.00012	0.002	0.21378	-0.00551	-0.51	0.198696
Married	0.1245	2.3467	0.3417	-0.0509	-3.6158	0.477427
Observations		*371620*			*296053*	

(*) dF/dx is for discrete change of dummy variable from 0 to 1. z is the test of the underlying coefficient being 0.

Interpretation of Results: The results are interesting, and support the Distortion View argument. It is easy to see that educated male workers are the most privileged lot, and benefit most from these regulations. It appears that regulations are increasingly prevalent the higher the human capital of the individual. It shows that the level of regulations, i.e. jobs with protection of tenure and working conditions, are at present growing with educational level, especially for males. Males also show, however, that for those with a college education the probability decreases a bit. Those with a university level education select themselves out of wage-earning jobs and into self-employment to avoid the impact of high taxation.

Let us look at the correlates one by one. First off, it is obvious that male workers fare consistently better than female workers. The most convincing results are obtained for *educational level.* The higher the education level, the greater the probability of having a protected job. Similarly, the greater the *experience level* and *tenure*, the higher the probability of having a protected job. Both of these imply greater insecurity for those entering the labour market (mainly youth), and those working intermittently (seasonal labour). Coming to the branch of activity, the least number of protected jobs are found in the construction sector, which uses the maximum number of unskilled manual labour. The more technical the branch of activity, the greater the probability of a worker having some protection. Also, the more specialised the activity, i.e. the more specialised the human capital required for it, the more probability of protection offered exists.

Coming to the size of the company, the smaller the company, the lower the probability of a worker having any protection with his or her job. The larger the company, the more the probability of such protection being afforded. Regarding regulatory status of another family member, it results are more convincing for male workers than for female workers. This sits well with the empirical fact that fathers with regular jobs find it easier to get access to regular jobs for their sons. This does not hold true for wives and daughters. Moreover, if the husband has a regular job, wives can often work as casual workers. This can be seen from whether the worker is principal or subsidiary status.

Coming to marital status, married men are far more likely to have protected jobs than married women. This could be accounted for by the fact that women often move in and out of supplying labour outside the household. As such, given our findings for experience and tenure, they are less likely to have job protection. For, children under six years of age, the possibility of any protection is very remote. This sits well with the legal fact of child labour being illegal. As such, all such labour is either "invisible", or classes as "house work".

Hence, summarising the results, the probit analysis confirms that regulations tend to segment the market and provide protection to those male workers with greater human capital, working for large firms. Workers with greater human capital belong to the upper and middle socio-economic and educational categories. In other words, the regulatory structure is regressive and, whatever protection it might provide, it does not appear to benefit those people who are objectively worse off. It provides protection to people who have greater power in the labour market anyway, by virtue of their education and skill backgrounds. The most vulnerable sections—trapped in low skill, insecure jobs--are left largely unprotected. At the same time, the results show the natural response one would anticipate from rational private decision making. Sectors more vulnerable to supervision and control (namely larger firms) are more compliant with regulations. Smaller firms tend to get away with offering a lot less security of tenure, wage of working conditions. In this respect, they echo the view held by Squire and Suthiwart-Narueput (1997), as quoted in the previous chapter.

4.5 THE IMPACT OF JOB SECURITY REGULATIONS ON LABOUR DEMAND: ECONOMETRIC ANALYSIS USING FIRM-LEVEL DATA

In this section we use the database of 4,230 firms contained in the Prowess database of the Centre for Monitoring the Indian Economy (CMIE) to show that tightening job security regulations over time have a negative impact on employment, thus supporting the distortion view held by the World Bank, and showing that job security regulations have a negative equity impact.

4.5.1 Theoretical Background

One can argue that most of the regulatory impact of employment protection would operate through the demand for labour. Theoretical arguments suggest that regulations in the form of taxes will have a negative impact on employment and/or wages. Contributions to social security are typically thought to affect negatively the demand for labour as well since the effects through labour supply are probably modest. Theory, however, provides relatively less guidance over the effects of severance payments and other protective measures, on employment. While they are likely to change the ease with which payroll is managed, it is not clear that they reduce the aggregate demand for labour. That is why one needs to test this proposition empirically, as we do below. It appears crucial to have an empirical estimate of how firms respond, in their labour demand decisions, to the presence of regulations.

Hamermesh (1986), summarising the literature, provides empirical estimates of the employment/labour cost elasticities for various industrial countries. He found the parameter to be low in the sample (0.1 to 0.5) suggesting that policies that increase the fixed cost of employment may reduce the employment-hours ratio only slightly. However, these elasticities could be biased downward as they may reflect the effect of prevailing JS since these regulations would have induced a substitution away from labour.

Less controversial than the effect of JS on the adjustment process is its effect on the employment level. An increase in JS increases the cost of hiring due to the change in the expected future severance payment and the cost of foregone output due to potential mismatches. In the context of shocks to output, labour-demanding firms must strike a balance between hiring more workers or waiting a few periods to forego the high potential future severance payment.

This section follows the work done by Fallon and Lucas (1991), and presents the results of the estimation of a homogeneous labour equation with a previously unexploited balanced panel of 4,230 Indian manufacturing firms put together by the Centre for Monitoring the Indian Economy (CMIE) in a manufacturing survey database called Prowess. Our empirical analysis considers the adjustment of regular and casual employment over the 1980/1999 period.

4.5.2 Data

Prowess, put together as a commercial product by CMIE, is the most reliable and powerful corporate database in India. It contains a highly normalised database built on a sound understanding of disclosures in India on over 8094 companies. However, we use only 4,293 of those companies for the analysis below in order to have comparability of the 1980 to 1999 time period of analysis. This database provides detailed information about all aspects of costs and revenues for each firm, including labour costs, break-up of those costs, and the categories of labour employed. In addition, it provides information on financial statements, ratio analysis, funds flows, product profiles, returns and risks on the stock markets, and so on.

The database is complemented with powerful analytical software tools to enable extensive querying and research. With Prowess, information access and research is unproblematic. Prowess exploits the detailed disclosures, which are mandatory in the annual accounts of companies in India. Besides it provides information from scores of other reliable sources, such as the stock exchanges, employer associations, trade unions, and so on. The coverage includes the detailed profit & loss account and balance sheet statements and ratios and funds flows based on these, half yearly results, products and plants, labour employed, and its categories (for example regular and casual, blue and white collar, and so on), raw materials, history of capital changes, bonus and dividends, stock prices and related information, expansion plans etc.

Comparability Issues: Different companies present accounting information differently. Inter year comparison, growth rates, inter-company comparisons and industry aggregates are all compromised by the uncritical use of raw data from annual accounts. CMIE's methodological framework for database normalisation addresses this problem. Databases are also subjected to rigorous formal validation and quality control.

Coverage: There are hundreds of thousands of industrial firms in India. But the eight thousand odd companies in Prowess account for more than seventy per cent of the organised industrial economy of India. In the case of most of the capital intensive industries, Prowess covers nearly the entire industrial sector. This large coverage is the result of the inclusion of all kinds of companies independent of its ownership, listing or size characteristics.

Prowess permits the intelligent selection, comparison, aggregation, etc. of industry groups. This intelligence built into the system makes Prowess the most scientific and transparent means to study an industry. Industry analysis in Prowess enables the generation of industry-wide income and expenditure statements, balance-sheets, ratio analysis, bench marking of industry averages and inter and intra industry comparisons.

Prowess comes packaged with about 140 industry groupings. More importantly, it permits the creation of user-defined industry groups or any set of groups. One of the rich features of the dataset is the availability of employment data for both regular and casual workers. One must note that this database provides us with the numbers of casual workers in the organised sector only, and does not cover the unorganised sector. This means that we are able to assess the impact of job security regulations on workers in the organised sector—not all of whom are regular, as we know. Since one of the effects of stiffening regulations is likely to be a more intense use of unprotected casuals, we are likely to uncover features here that papers with more aggregate data sources cannot. Of particular interest is the adjustment in the intensive margin that can follow an increase in the perceived cost of labour. For instance, increases in the demand for goods accompanied by higher severance costs are likely to lead to a reasonably constant level of employment but a more intense use of more unprotected labour.

4.5.3 The Model

We adapt the model developed by Mondino and Montoya (2000) to study the relationship between employment (number of jobs) and hours worked, and the way this relationship changes with enforced labour regulations. Their empirical approach models labour demand through a fairly general setting. We adapt their model to characterise employment choices as the dynamic interaction of formal and informal employment adjusting to fluctuations in output, factor prices and regulations. They, on the other hand, analyse the smooth substitution between number of jobs available, and number of hours worked. We find it more realistic to go with the formal-informal option for India, as, given high over-time rates, it is much more economic for employers to adjust between regular and casual workers, than making regular (especially unionised) workers work longer hours. While the system that will be estimated is unconstrained, the specifications for the demand system correspond to a substantial number of production structures.

The system is summarised by the following two equations that we have adapted from Mondino and Montoya's (2000) model:

$$\mathrm{LnR}_t = \alpha_1 + \alpha_2\mathrm{LnR}_{t-k} + \alpha_3\mathrm{LnRegs} + \alpha_4\mathrm{LnC}_{t-k} + \beta\mathrm{Lnw}_t + \gamma\mathrm{LnP}_t + e_{1t} \quad (1)$$

$$\mathrm{LnC}_t = \alpha_1 + \alpha_2\mathrm{LnC}_{t-k} + \alpha_3\mathrm{Ln\ Regs} + \alpha_4\mathrm{LnR}_{t-k} + \beta\mathrm{Lnw}_t + \gamma\mathrm{LnPt} + e_{2t} \quad (2)$$

Where *R* is regular employment, *C* casual employment, *P* is industrial production. *Regs* measures the "cost equivalence of regulations, which presumably affect not just the level of demand but also the dynamics" (Mondino and Montoya 2000, 24). Finally *w* captures the product wage.

Measuring the Effect of Labour Regulation: Mondino and Montoya (2000) calculate LnRegs using payroll taxes pensions, family allowances, health care and other benefits. They also includes expected severance payments. However, we use a different way of calculating LnRegs, as the nature of our data is different. We use benefits, which are not available to casual workers, as well as expected severance payments, but more importantly, we use the difference in wages between regular and casual employees doing the same job, as a measure of the cost of regulations. This implies that our analysis applies only to those jobs for which both regular and casual workers are employed. This excludes most white collar jobs, and hence the lion's share of our observations apply to blue collar jobs only.

Mondino and Montoya's (2000) model assumes that employers seek to maximise the expected value of current and future profit and that the costs of adjusting labour input are a quadratic function of the size of the adjustment made. The specification is quite flexible, as we mentioned above. It is consistent with a number of production structures with smooth substitution between new hires of regular and casual workers, including varying degrees of returns to scale or, what is even more likely, the presence of imperfect competition in goods markets. In other words, the Mondino-Montoya model does not restrict the source of curvature of the profit function. They write:

> *"Given this generality, care must be taken to make explicit the maintained hypotheses if the coefficients are to be identified as technology parameters. It is important to consider the theoretical model on which the specification is based so as to understand the true significance of the parameters. If the production*

process is assumed to have the features of a Cobb-Douglas production function, labour costs and production parameters are interpreted as labour and return to scale parameters, respectively. If, on the other hand, it is assumed that a CES production function explains the model better, the corresponding coefficients represent the capital-labour substitution elasticity and the scale parameter, respectively. In any case, in the estimations presented here, no restrictions on production function or underlying cost structure will be imposed." (p. 26)

4.5.4 Methodology: Panel Data Analysis

The term "panel data" covers a variety of data collection designs, but historically has referred to the repeated observation of a set of fixed entities (people, firms, nation states) at fixed intervals (typically, but not necessarily, annually). Classic panel analysis requires each unit to be observed at each time point, but more recent approaches permit unbalanced designs and tolerate both missing data and irregular intervals.

Unbalanced and Balanced Panels: An unbalanced panel data set, is a data set with missing observations over time (holes in the data set - so different group size over time) or different groups (e.g. of people or industries) participating over time or behaving differently across sections. Regarding the latter, such different groups have different specific qualities, which gives individual effects or impact when they are applied within estimations. We can adjust with Dummy Variables ('Fixed effects' or 'Slope effects'). Regarding the former – one will have to adjust your data set by guessing missing data or by dropping other observations until you have a consistent data set. A balanced data set is a data set where this is not the case i.e. no missing variables or different groups participating over time or behaving differently across sections.

Estimation Methods: When analysing cross sections over time it is common to use Dummy variables. They are used to adjust for the individual effect (Fixed Effect), which sections (individuals, groups, etc.), or periods (e.g. seasons, historical epochs) have on the general relationship between the independent and the dependent variables. For a system like $y = \alpha + \beta x + u$, if we do not adjust for the individual effects we may bias the results of both α and β. Within the fixed effect framework, we assume that the differences across units can be captured in the difference of the constant term α, assuming β is the same across all groups. (i.e. it is only α which is group specific). The purpose is to remove the bias in the estimates of β (as α becomes more difficult to interpret. Combined effect of α and β can be estimated via use of both 'fixed effects' and slope effects.

Drawbacks: Mondino and Montoya (2000) point out that panel data estimations, such as those pursued here, present some drawbacks. To begin with, the relatively short period of time spanned restricts the variability of regulations. In particular, as mentioned before, there were relatively few regulatory changes in the period under consideration, and those that took place happened towards the beginning of the sample. In any event, as we will see, the effects of regulations come out strongly and are highly significant. A second limitation they point to could have arisen, since the period was one of extraordinary change in a number of dimensions. These included a large number of firm births, and some amount of industrial sickness too. Fortunately these were adequately captured by the sampling technique used to create the CMIE panel, and therefore avoid the negative bias that otherwise might have resulted, unlike Mondino and Montoya (2000). Also, the period covered was a period of much firm re-structuring, so that it raises concerns over the value of long run elasticities. On the other hand, they point out, the high variance in some of the independent variables allows a more efficient estimation of the parameters.

The system represented by (1) and (2) presents a number of econometric problems that must be addressed. We shall continue to follow the guidance provided by Mondino and Montoya (2000). First, the model, being based on a panel, will be estimated with fixed effects to control for firm idiosyncratic factors. We will also introduce a quarter dummy to correct for any seasonality in the data, which was not previously adjusted. For this section, as for the previous one, we acknowledge the assistance provided by Mr. C.S. Das in carrying out the panel data analysis.

The model specification introduces an unrestricted dynamic adjustment. This is motivated via a cost of adjustment technology that depends in part on the hurdles imposed by regulations. The specification they chose was to introduce up to three lags to capture all seasonal as well as inertial factors. To allow for a richer interaction between the two forms of labour,we also introduce lagged terms of casuals in the regulars equation and vice versa (regular_1, regular_2, regular_3, casual_1, casual_2 and casual_3).

As stated above, the dataset includes a sample of 4,230 private manufacturing firms. The panel provides much useful information on the type of firms included. For instance, unlike Mondino and Montoya (2000), we actually know whether the employment relations are formal or not. The panel presents some problems too. Not all firms systematically answer all questions. Similarly, many firms drop out of the sample and the replacement criteria are not clear. The panel is stable, as it does not include newly created firms, (thus using only half of the total number of firms in the latest Prowess series. We report results from estimating a restricted balanced panel and an unbalanced one. The balanced panel drops all those firms that do not answer the relevant questions or that have dropped out of the sample, leaving 2,544 firms in the data set with all the complete answers for the whole period. The unbalanced panel, on the other hand, clears out those firms that do not answer the relevant questions in all quarters. This leaves 3,102 firms in the unbalanced panel.

4.5.5 Results

Table 4.2 presents the results of estimating through OLS. Our first specification treats output as exogenous. Estimates for regulars and casuals are reported for the unbalanced and the balanced panel, respectively. We estimated introducing individual firm fixed-effects correcting for serial correlation. The reported z score is heteroskedasticity consistent.

Table 4.2

CMIE Prowess Survey--OLS Results

	Unbalanced Panel		Balanced Panel	
	Regulars	Casuals	Regulars	Casuals
	1	2	3	4

Normal Wage	-0.21	-0.41	-0.11	-0.38
	(32.62)**	(18.41)**	(14.40)**	(29.63)**
Output	0.083	0.25	0.16	0.31
	(15.18)**	(28.27)**	(12.21)**	(21.11)**
Output_1 (lagged one)	0.03	0.09	0.06	0.16
	(25.12)**	(9.52)**	(11.84)**	(10.71)**
Regular_1 (lagged 1)	-0.041	0.31	0.17	0.27
	(12.83)**	(31.56)**	(21.32)**	(16.95)**
Regular _2 (lagged 2)	-0.06	-0.26	-0.08	0.05
	(12.79)**	(11.24)**	(21.82)**	(12.37)**
Regular _3 (lagged 3)	0.002	0.12	0.08	0.09
	(12.24)**	(15.21)**	(31.29)**	(14.23)*
Casual_1 (lagged 1)	-0.005	0.024	-0.007	0.06
	(18.63)**	(10.95)*	(8.23)**	(25.98)**
Casual_2 (lagged 2)	-0.001	0.03	-0.0007	0.011
	(33.32)*	(7.89)**	(8.57)**	(3.12)**
Casual_3 (lagged 3)	-0.0004	0.026	-0.0005	0.039
	(5.46)*	(11.34)**	(8.62)**	(13.21)**
Second Quarter	0.002	0.033	0.004	0.04
	(21.45)**	(12.93)**	(11.72)**	(31.21)**
Third Quarter	0.008	0.036	0.0006	0.092
	(11.32)**	(21.21)**	(16.57)**	(12.21)**
Fourth Quarter	0.0028	0.05	0.0011	0.055
	(9.38)**	(14.26)**	(12.94)**	(15.95)**
Regulations	-0.019	-0.39	-0.012	-0.48
	(1.98)*	(2.82)**	(4.62)**	(1.82)**
Constant	0.58	2.94	0.88	1.36
	(3.87)**	(15.91)**	(14.32)**	(22.12)**
AR-Squared	0.78	0.81	0.77	0.78

Absolute value of z-statistics in parentheses; significant at 5% level; * significant at 1% level*

The results show that all variables are statistically significant. A 1 per cent increase in real wages decreases the level of regular employment 0.21 per cent while casuals go down 0.41 per cent—almost double—a result much more striking than the one obtained by Mondino and Montoya (2000) from their panel. (These numbers become even more striking once state-level analysis is done in the next chapter.)

This result is in accordance with a common pattern in the literature, which is that casual workers appear more responsive to changes in costs or scale factors. When arises the need for adjustment, it is this category of workers that faces the most changes. This is most likely the effect of costs of adjustment. Theory indicates that with costly changes in manpower, a firm is much more likely to rely on adjustments in casual workers than on the number of regular jobs offered.

Casual workers therefore face much more insecurity of tenure, and also find it difficult to attain higher wages. This situation is unlike that in the industrialised countries of the West, where it is easier to adjust workers with regular contracts, especially in countries like the United Kingdom (UK) and the United States of America (USA).

Both regular workers and casual workers appear sensitive to fluctuations in output. As mentioned in Chapter 1, one of the surprising features of India's job market has been the apparent low responsiveness of employment to output. In fact if output grows 1%, casuals increase almost 0.25% while regular workers increase only by 0.08%. If this could further be broken down into white and blue collar workers, then we would most likely find that blue collar workers vary more with changes in output than do white collar workers.

This would be so, say Mondino and Montoya (2000), because white collars work can only be increased through overtime hours (which are costlier), while blue collar regular workers can just be replaced by and placed with more casuals. The same would apply to unionised versus non-unionised workers. Firms take this into account when making hiring decisions. Unfortunately we do not have enough white collar workers in the sample to verify that. Moreover, we have no information from the dataset on the extent of unionisation in our sample.

A feature of the results is that output and wage elasticities are higher in the unbalanced panel than in the balanced one. Fortunately, the selection rule to stay in the panel is clear. Firms that die or "sicken" are included, and not those that simply do not answer in some periods. Thus, there is some basis to conclude that regulations do have an impact in pushing firms into bankruptcy or sickness.

When we consider the effect of regulations, which is the central objective of our analysis, the results are the most striking. Both regular and casual employment is sensitive to changes in regulation costs. However, the impact on the employment of casual workers is much more drastic as a result of increasing costs of regulation on casual workers than on regular workers. For a 1 per cent rise in the cost of regulations, regular employment falls by 0.019 %, while casual employment falls by 0.39%. In both the unbalanced and balanced panels, fairly similar trends in the results obtained. So, to sum up, the cost of regulations always appears to affect significantly the demand for workers, but casual workers are affected much more than regular workers.

Let us add this finding to the finding of Section 4.4, which was that male, educated workers, working for large firms, are usually the ones with regular or protected jobs. That means that not only are the most vulnerable workers not likely to have any job protection, but also as the cost of regulation increases, they are more likely to lose their (even) casual jobs in the organised sector.

Given the wages in the organised sector, for even casual work, are significantly higher than wages in the unorganised sector and agriculture, and given that demand for casual work in the organised sector falls significantly every time the cost of regulations goes up, it is very clear from the two pieces of empirical analysis in this chapter that job security and protection regulations cause a worsening in the standards of living of the poorer, low skilled and more vulnerable workers.

Mondino and Montoya (2000) point out that "when using micro-data the simultaneous problems of output determination and employment are typically avoided. The reason is simple: under perfect competition, demand is given and hence firms only choose how many workers to hire." Unfortunately, in the case of India, as in Argentina, the assumption of competitive markets may be a bit unrealistic, at least for the first few years of the sample, when the economy was quite closed and a few firms ruled the domestic market. Under imperfect competition the decision to hire workers and sell goods is closely intertwined and disturbances that affect one will probably affect the other.

For this reason Mondino and Montoya (2000) instrument for movements in the final goods demand. We however do not have the econometric arsenal required to carry out an instrumenting exercise rigorously. We do not, therefore, attempt to carry out an instrumental variable (IV) analysis, and note that omission here. However, the simple OLS analysis does provide us with powerful results.

4.6 CONCLUSIONS

India's experience in the 1980s and 1990s raises serious questions about the adjustment of the labour market. While output was growing strongly, employment was lagging behind—often called the phenomenon of "jobless growth", which many have tried to explain. Many observers blame this behaviour on an increasingly binding lack of market flexibility. One source of such stiffness could well be the important number of JS regulations governing labour market relations. As the economy demanded greater flexibility to adjust to a more competitive business environment, labour regulations were becoming ever more binding. The issue, however, is that there were no estimates of how important these increasingly tighter regulations were.

We have shown that India's JS regulations do not quite do what they are intended to do. They reverse discriminate, providing protection to those workers with greater human capital, from more privileged backgrounds. Regulations appear regressive, limiting the opportunities of those worse off and protecting the jobs of those endowed with higher human capital.

These findings strongly support the case put forward by the World Bank and other proponents of the Distortion View. Regulations, and in particular employment protection, represent a cost for business. Firms rationally respond to them by lowering their demand for labour. Indeed, in the short run, but mostly in the long run, there is a strong negative effect of regulations on the level of labour demand. This downward shift of labour demand is at least partially (and we would argue mostly) responsible for the drop in employment that is found to be associated with regulatory coverage. Any downward shift of a demand curve increases the potential for employment reduction.

Let us now study this at greater detail by going below the national level to the state level in India in Chapter 5, and see whether we get similar results for that.

CHAPTER 5

JOB SECURITY RANKING OF INDIAN STATES: THE JOB SECURITY INDEX AND EFFECTS OF JOB SECURITY REGULATION

In the previous chapter, we established that job security regulations in India only help a small labour aristocracy, while disadvantaging the large majority of the labour force through decreasing labour demand and lack of coverage. In this chapter, we study this phenomenon in greater detail. We first rank the states of the Indian Union by the strictness of their job security regulations, and then analyse the differential state-wise impact of job security regulations across these states. The chapter is organised in the following manner: In Section 5.1, we give a brief background about the division of powers between the central and state governments—both in the constitution, and in practice. In Section 5.2, we give details of our data, and describe the differences in job security regulations across states. In Section 5.3, we describe the construction of a job security index, based on the information provided in the previous section, and rank the states according to the Job Security Index, and discuss its implications. In Sections 5.4 and 5.5, we assess the differential impact of these differences in strictness of job security regulations. Section 5.6 provides the summary and conclusions.

5.1 THE CENTRE-STATE RELATIONSHIP IN THE INDIAN UNION

" Indian States are the drivers of Economic Reforms, stated Mr. Chandrababu Naidu, Chief Minister of Andhra Pradesh, at the India Economic Summit, organised by the Confederation of Indian Industry (CII), and the World Economic Forum, here today. He was speaking about the reform process in the state of Andhra Pradesh and the ensuing success of the state in achieving progressive growth rates........ On the labour and Public sector reforms initiated in the state, Mr. Naidu said that the government was encouraging VRS (Voluntary Retirement Scheme), of the 25 Public Sector Units (PSUs), in the

State, four had already been privatised, ten were in advanced stage of being privatised, eight sick units had been closed and three were being restructured. He had advised the PSUs that they must compete with the private sector, to remain in profitable business. Labour reforms, said Mr. Naidu, had been introduced vigorously in the state."

The Hindu
October 21, 2001

India is a union of states with a strong centre. Over time, in the first three decades after independence, power had been increasingly concentrated in the central government, particularly in the Prime Minister's Office, in opposition to the spirit of the constitution. But over the last two decades or more, power has finally begun to devolve to state governments, and economic and other policy is increasingly being formulated and implemented at the state level. In fact, the centre has grown progressively weaker relative to states, due to a combination of political and economic factors that are discussed below.

By the early 1980s an array of regional, ethnic and caste groups had become increasingly assertive, demanding a redistribution of political power and economic resources. Some areas where the issues have a complex historical background - Kashmir and the North East - remain intractable. But elsewhere India's changing political landscape in the 1990s has given regional parties more of a stake in central government, while economic liberalisation has benefited emerging regional elites. In practice, even in the absence of major constitutional reform, the balance of centre-state relations has shifted from centralisation to a greater acceptance of regional autonomy. In this context, it becomes increasingly vital that an economic analysis of any aspect of Indian development, especially something like the political economy of regulatory reform, *must* be done at the state-level, and not just at the All-India level, as has been the practice for the majority of independent India's five decades of development.

5.1.1 Background: Indian States and The Centre

In a narrow sense, centre-state relations concern the allocation of powers between the Union government in New Delhi and the twenty-five states plus six Union Territories and the National Capital Territory of Delhi (which have more limited powers). More broadly it encompasses many aspects of Indian political life: the interplay of national power and local politics; competing ideologies of nationalism and ethnic/minority rights; central political and economic decision-making versus local empowerment; problems of regional imbalances and redistribution; adjudicating disputes between states over access to resources; law and order and police powers; and educational and cultural policy. It is less a static institutional arrangement than a complex dynamic between and within the different levels of India's political system.

Although the term federation appears nowhere, India's constitution-makers defined the nation as a *union of states* and provided the states with their own national chamber, the Rajya Sabha (upper house of Parliament). Legislative powers are divided between the Union Parliament, which retains the cardinal functions of finance, communications, defence and foreign affairs, and the state legislatures which are given exclusive powers over subjects which include land and agriculture, education, police and public order, welfare, health and local government. On a further range of subjects either the centre or the states may legislate, although in the case of conflict the centre is pre-eminent.

Labour falls into the third, or concurrent list. It is important to note that labour laws are altered and implemented according to the particular state, within the ambit of the larger Central Act—in this case the IDA 1947. However, states are free to accept or not accept the central law. Further, they are free to amend the central law—the only restriction being that the amendment cannot go against the spirit of the law. Further, all implementation and enforcement of such laws is purely at the state level—and controlled by the state-level legislature, executive and judiciary.

The division of financial resources between the centre and the states is overseen by a constitutional body, the Finance Commission and, in the case of development funds, by the Planning Commission. Broadly, the centre collects 60 per cent of all revenue, while the states spend about 60 per cent of total expenditure. State finances are supervised by the central government through the Comptroller and Auditor General.

5.1.2 Central Power And State Politics

For the first twenty years or so after independence in 1947, the Congress Party under Nehru and, briefly, Shastri, was dominant at the centre and in the states. Union-state relations were essentially an intra-party affair of the Congress, based on elite consensus and accommodation. Following the extensive redrawing of state boundaries on linguistic lines in the 1950s the states increasingly emerged as the focus for the expression of regional language and culture. As democratisation proceeded they formed the arena for popular demands for economic development and against the imposition of a national culture. Elections in 1967 saw the Dravida Munnetra Kazhagham (DMK) in Tamil Nadu come to power on an "anti-northern" platform while in Punjab the Sikh Akali Dal party managed to form a coalition government.

But once Nehru's daughter Indira Gandhi had consolidated her position, she increasingly concentrated power in her own hands and in a number of central institutions, including the Prime Minister's Office, at the expense of state governments and local Congress politicians. During her two tenures as Prime Minister (1966-77 and 1980-84) President's Rule was invoked 41 times in order to dismiss state governments (compared to ten times under Nehru and Shastri).

This high-handedness contributed to the rise of regional parties. The early 1980s saw a period of increasing political turmoil. In Punjab, Sikh extremists turned an autonomy movement into an armed secessionist struggle which took years to suppress, with heavy loss of life. In Jammu and Kashmir the dismissal of the local government contributed to Kashmiri disaffection. In Andhra Pradesh a new regional party swept to power in 1984 on a platform of local pride. In 1985 a regional Assamese party gained power after years of bloody strife in the state. At the sub-state level ethnic and cultural movements also emerged, for example among the Nepali-speaking population of northern West Bengal and among tribal peoples in Assam and elsewhere.

The decay, under Indira Gandhi and later her son, Rajiv Gandhi, of the Congress party organisation - once an efficient transmission belt between local politics and national power - saw the emergence of a plethora of other parties. As essentially local phenomena they are sometimes bracketed with regional parties, although their basis is usually caste allegiance rather than linguistic or ethnic identity. Often they represent farming castes, numerically large but traditionally low in the social scale, who felt that their interests were neglected by the elite-dominated Congress and other national parties. Dalits (former untouchables) are also beginning to organise politically in some areas.

A significant effect of Congress's decline as a national electoral force (it has not won a majority since 1984) is that regional and caste parties are now in a position to bargain for a place in national government. In 1996 most gathered around the Janata Dal (itself effectively a regional party) to form a national government, supported from the outside by Congress. In 1998 many gravitated to the Bharatiya Janata Party (BJP) when it became clear that Janata Dal had little prospect of returning to power. The need to attract such support has made the BJP, strongly associated with a nationalist agenda, more willing to countenance regional demands. It also creates a complex balancing act for the majority party in such a coalition, since over-generous concessions to one group will inevitably trigger protests or demands from others.

Much of the BJP's first 13 months in office was spent fending off excessive demands from its main Tamil partner, leading to the rift which brought down its government. In October 1999 the BJP led a new coalition (minus its Tamil nemesis), the National Democratic Alliance, to power on a manifesto which set aside contentious nationalist issues and made further commitments to regional interests. Currently, the BJP government is ransom to leaders from many states, most notably Chandrababu Naidu of Andhra Pradesh, who use each political crisis to "negotiate" more and more concessions for their own states.

In general the 1990s has seen a greater acceptance that decentralisation does not threaten Indian unity. Not only the central government, but states themselves (several as big as major European powers) are undertaking a modest degree of devolution with their boundaries. For example, the devolution of powers to panchayat (village) level institutions is being taken more seriously. There has been greater willingness to grant demands for regional entities within states (autonomous councils in, e.g., Ladakh, Darjeeling) or to consider further sub-division of states as a means of defusing regional sentiment. Proponents of decentralisation argue that national politics now better reflects the diversity of Indian society.

At the same time, the rise of the BJP suggests there are powerful countervailing forces which regard issues of national identity and national unity as pre-eminently important. Some observers suggest that hard-line nationalists may see limited decentralisation as no more than an interim tactical ploy until they are able to consolidate power.

5.1.3 The Impact Of Economic Liberalisation

Although the Constitution assigns major responsibilities to the states and grants them access to resources through taxation and borrowing, as well as through resource sharing with the centre, in practice their freedom of action has been circumscribed. The Centre retained overwhelming control over invisible resources in the economy through its control over fiscal, monetary and foreign exchange resources. Moreover, centralised planning allowed it to gain greater control by intervening on the grounds of national interest, and of maintaining common standards of services across the states, and through determining administered prices of many products produced by public sector enterprises.

By June 1991, when Narasimha Rao's Congress Party took office, the highly regulated, largely closed Indian economy was on the verge of what the Ministry of Finance called "a calamitous economic precipice". In return for IMF assistance the government embarked on a programme of reforms and liberalisation, seeking to encourage foreign direct investment, technology transfers and a growth in foreign trade. The Indian economy retreated from the precipice. Although the pace of reforms has since been uneven all subsequent governments have reaffirmed their commitment to the principles.

Economic reforms assigned greater powers to state governments and provoked greater competition for control over them. Crucially, industries previously reserved for the public sector or private Indian companies, particularly in key areas of infrastructure, were opened up to foreign investors. The 1995 decision to allow state governments to retain foreign exchange income was a landmark. State governments were now free to identify the industries in which they wanted investment and to negotiate independently, although final clearance still has to be obtained from the Foreign Investment Approval Board or the Reserve Bank of India, depending on the size of the investment. Controls were progressively lifted from a number of industries, although aviation, defence industries, atomic energy, and railways remain off-limits to foreign investors.

State governments have also been allowed to exercise increased autonomy to negotiate reform programmes with International Finance Institutions. For example, Andhra Pradesh has secured support from the World Bank, which is also negotiating extensive support for Uttar Pradesh. The Asian Development Bank is seeking to support reform in Gujarat and Madhya Pradesh. The British Government's Department for International Development (DfID) is also working to support state level reforms in Andhra Pradesh, West Bengal, Madhya Pradesh and Orissa.

At the same time as these relaxations - readily grasped by several states, which became active in seeking foreign investment in infrastructure - the centre also tightened up on lending conditions. State finances had deteriorated significantly in the 1980s as states overspent on subsidies at a time of declining revenues; their capital expenditure also stagnated and declined. Their debt burden increased as they resorted to deficit financing. In the 1990s the deterioration in state finances accelerated. The situation has been exacerbated by the implementation of generous pay awards following the Fifth Pay Commission on civil service pay (which the states were not obliged to follow for state employees, but generally have). The states' deficit is now equivalent to around 4.5 per cent of GDP.

The Union government has since tightened up the conditions for lending to state governments, giving them added incentives to attract investment and reduce subsidies. Nine states have signed Memoranda of Understanding with the centre to obtain additional resources in return for policy reforms. These states have effectively sacrificed a measure of autonomy on policy because of their fiscal profligacy. Moreover, some 700 of India's 1,000 public sector enterprises- accounting for nearly 70 per cent of jobs in the organised sector - are owned by the states. There are obvious advantages to central government in encouraging the states to bear the brunt of resistance to the closure or privatisation of industries notorious for their poor financial performance and pervasive inefficiency but with strongly entrenched workforces.

Greater financial autonomy has generally been welcomed by emerging regional elites. Businesses with a high degree of regional concentration prefer to deal direct with foreign multinational corporations rather than through the many additional layers of central bureaucracy. Regional politicians appreciate that foreign investment in their state creates fresh employment and helps free up resources for social welfare purposes. Encouraging though this modest devolution is much remains to be done to remove the distortions in centre-state financial relations.

5.1.4 Regional Imbalances And Uneven Development

Even before the 1991 reforms states varied widely in their economic performance, reflecting their particular geographical, historical and political circumstances. Since 1991 interstate disparities of income have increased. Per capita income in the richest states - Punjab, Haryana, Maharashtra, Gujarat - is nearly three times as great as in the poorest - Bihar, Madhya Pradesh, Orissa and Uttar Pradesh. This has affected the latter's ability to apply and benefit from the reforms.

Economic reforms have had complex effects on the pattern of regional development. Some states, such as Maharashtra, have retained their competitive advantage of (relatively) efficient infrastructure and power supplies. Private investment and public expenditure alike tend to gravitate to such states. Others, such as the small North-Eastern states - isolated, politically unstable and socially backward, have seen few if any benefits from liberalisation. They remain almost wholly dependent on subventions from the centre. But Orissa, one of the poorest, has been one of the more successful in attracting foreign direct investment, particularly to the power sector and for extraction of its massive mineral resources. Punjab, the wealthiest state but only recently emerging from prolonged political unrest, has attracted very little. For different reasons neither has Kerala, despite having India's highest level of literacy and other social indicators approaching those of Western European countries. Patterns of economic development depend on a mix of political stability, bureaucratic competence, efficient infrastructure, particular sectoral advantages and a flexible labour market with the appropriate skills.

In terms of foreign investment the southern and western states have been the most successful - Tamil Nadu, Maharashtra and Karnataka in particular, attracting US$ 6-10billion each (investment approvals) over the 1991-98 period. The second tier is made up of Gujarat, Andhra Pradesh, West Bengal and Uttar Pradesh (between $3.6 and $4.6 billion each). Madhya Pradesh and Kerala came next, with $2.4billion and $1.4 billion respectively. Investment in Punjab, Haryana, Himachal Pradesh and Bihar was tiny, while eleven States received no foreign investment at all.

5.2 LABOUR REGULATION AND INDIAN STATES

Labour market regulations are usually introduced with stated objective of increasing workers' welfare. To put it in more "economic" terms, it is believed that labour regulations promote equity, even at the cost of some efficiency, and that such a trade-off is justified. We have shown thus far in this thesis that these regulations, in the way they pan out in India, have high efficiency *as well as* equity costs, and that labour law reform is urgently needed to promote both efficiency and equity.

Job security provisions, in particular, are designed to reduce a worker's odds of losing his job and livelihood. Do these benefits come at a cost? Yes. Do these benefits reduce employment? Yes. Do these job security provisions protect some workers at the expense of others? Yes. Let us see this at a greater state-level detail now.

As we have noted before, work on inter-state comparisons of job security and its impact have been carried out in Latin America and East Asia, but never in India. We follow excellent work done on Latin America by James Heckman, Carmen Pagés, James Montenegro and others at the Inter-American Development Bank (IADB) for this thesis. They make use of the fact that Latin American states have a wide range of labour market policies that provide natural experiments with which to evaluate the impact of these polices. We feel that the same potential is provided by the different states of the Indian Union, with one crucial difference—while the Latin American states are sovereign nations with their own foreign and trade policies, these and some other policies are exogenously determined for Indian states.

We establish in this chapter that job security policies have a substantial impact on the level and the distribution of employment in Indian states. Our evidence suggests that like Heckman and Pagés (2001), regulations promoting job security reduce covered workers' exit rates out of employment. However, it also indicates that demand curves are downward sloping, that regulation reduces aggregate employment and that the greatest adverse impact of regulation is on vulnerable groups marginal to the mainstream workforce.

Insiders and entrenched workers gain from regulation in the short run, and in a partial equilibrium or individual sense. But on a general equilibrium, `big picture' level, both insiders and outsiders suffer as employment falls for both categories, as the former stock of jobs becomes smaller and smaller, and as the latter also both in absolute as well as relative terms. Therefore, as a consequence, job security regulations reduce employment *and* promote inequality across workers. In order to see how we arrive at these results, let us look at these regulations state by state.

5.2.1 Job Security Regulation across Indian States

We follow Montenegro and Pagés (1999) for this part of the analysis, i.e. the construction of a job security index. However, there is one important difference. While they construct a job security index by modelling the variation in job security regulations in Chile *over time*, we confine ourselves to one point in time (1998-99), and study the variation in job security regulations *across states.* Like Montenegro and Pagés, we define job security (JS) legislation to include all those provisions that increase the cost of dismissing a worker. We quantify the costs of abiding by the legislation, in terms of wages, in order to address the questions: (1) How high are the implied costs of JS provisions in Indian states? (2) Which states have costlier termination provisions and which are more deregulated?

In India, like in Latin America, labour laws and statutes favour full-time indefinite employment over part-time, fixed-term or temporary contracts. These types of contracts differ not only in the length of the employment relationship but also in the conditions for termination. While indefinite contracts carry severance pay obligations, temporary contracts can be terminated at no cost provided that the duration of the contract has expired. Many states do not regulate the range of admissible contracts. Instead, such decisions are left to the parties involved in what is effectively collective bargaining, even though the official system of industrial relations in India is a tripartite one.

There are important differences as well in the conditions for termination of contracts. In the more regulated states, the termination of a contract is severely restricted. Thus, labour laws mandate a minimum advance notice period prior to termination, determine which causes are considered "just" or "unjust" causes for dismissal, and establish compensation to be awarded to workers for each possible cause of termination. In some states, firms must also request permission to dismiss more than a certain fraction of their labour force.

Finally, some states allow the reinstatement of a worker to his post if the dismissal is found to be "unjustified" by the labour courts and tribunals, although this provision has been eliminated in a few states.

Thus, termination laws require firms to incur four types of costs: advance notification, compensation for dismissal, seniority premiums for dismissed workers and foregone wages during any trial in which the worker contests dismissal. It is the range of differences in these costs which has been used to calculate the Index of Job Security (JS) below. This data was gathered painstakingly through communications between myself and state labour departments. Please note that we could not obtain any data for Jammu and Kashmir. Please note also, that the following rules apply only to "visible" workers; i.e. those on regular contracts or those formally employed as temporary or casual workers. As such, they already miss out on the vast numbers who work as totally informal workers. There is no cost to dismissing those workers.

Andhra Pradesh

<u>Advance Notification</u>: 15 days

<u>Compensation for Dismissal</u>: Fifteen days salary for each year worked if regular worker, otherwise at the discretion of employer

<u>Seniority Premiums for Dismissed Workers</u>: No seniority premium

<u>Foregone Wages during Contestation</u>: full pay if worker reinstated, nothing otherwise

Arunachal Pradesh

Advance Notification: 120 days

Compensation for Dismissal: Three months salary for each year worked

Seniority Premiums for Dismissed Workers: Lump sum payment of Rs. 8,000 if worked beyond ten years

Foregone Wages during Contestation: full pay if worker reinstated, half pay if not

Bihar

Advance Notification: 180 days

Compensation for Dismissal: Three months salary for each year worked up to eight years, four months salary for every year beyond that

Seniority Premiums for Dismissed Workers: Rs. 5000 for each year worked beyond ten years

Foregone Wages during Contestation: full pay if worker reinstated plus legal costs, half pay if not

Delhi

Advance Notification: 30 days

Compensation for Dismissal: One month salary for each year worked if regular worker; otherwise lump sum payment of Rs. 30,000

Seniority Premiums for Dismissed Workers: No seniority premium

Foregone Wages during Contestation: full pay if worker reinstated, nothing otherwise

Goa

Advance Notification: 90 days

Compensation for Dismissal: One month salary for each year worked

Seniority Premiums for Dismissed Workers: Lump sum payment of Rs. 7,500 if worked beyond fifteen years

Foregone Wages during Contestation: full pay if worker reinstated, lump sum gratuitous payment if not

Gujarat

Advance Notification: 15 days

Compensation for Dismissal: Fifteen days salary for each year worked if regular worker, otherwise employer has no obligation

Seniority Premiums for Dismissed Workers: No seniority premium

Foregone Wages during Contestation: full pay if worker reinstated, nothing otherwise.

Haryana

Advance Notification: 45 days

Compensation for Dismissal: One month salary for each year worked, only if on permanent contract; otherwise 20 days salary

Seniority Premiums for Dismissed Workers: Lump sum payment of Rs. 5,000 if worked beyond ten years

Foregone Wages during Contestation: full pay if worker reinstated, nothing otherwise

Himachal Pradesh

Advance Notification: 60 days

Compensation for Dismissal: One month salary for each year worked, only if on permanent contract; otherwise 20 days salary

Seniority Premiums for Dismissed Workers: Lump sum payment of Rs. 5000 if worked beyond ten years

Foregone Wages during Contestation: full pay if worker reinstated, lump sum gratuitous payment if not

Karnataka

Advance Notification: 15 days

Compensation for Dismissal: Fifteen days salary for each year worked since worker was made regular; no compensation for years worked a temporary or casual worker; employer under no obligation to compensate temporary workers.

Seniority Premiums for Dismissed Workers: No seniority premium

Foregone Wages during Contestation: full pay if worker reinstated, nothing otherwise. Employer has the right to demand legal costs if employee's claim judged malicious or frivolous.

Kerala

Advance Notification: 240 days

Compensation for Dismissal: Six months salary for each year worked, calculated at the latest wage rate or salary level

Seniority Premiums for Dismissed Workers: Rs. 10,000 for each year worked over three years.

Foregone Wages during Contestation: Full pay for worker during contestation plus legal costs if reinstated. Increments added and inflation indexed.

Madhya Pradesh

Advance Notification: 180 days

Compensation for Dismissal: Three months salary for each year worked

Seniority Premiums for Dismissed Workers: Rs. 5000 for each year worked beyond ten years

Foregone Wages during Contestation: full pay plus half of legal costs if worker reinstated plus legal costs, half pay if not; inflation indexed

Maharashtra

Advance Notification: 30 days

Compensation for Dismissal: One month salary for each year worked if regular worker, otherwise any amount at the discretion of the employer

Seniority Premiums for Dismissed Workers: No seniority premium

Foregone Wages during Contestation: full pay if worker reinstated, nothing otherwise

Manipur

Advance Notification: 180 days

Compensation for Dismissal: Four months salary for each year worked

Seniority Premiums for Dismissed Workers: Rs. 5000 for each year worked beyond ten years

Foregone Wages during Contestation: Full pay if worker reinstated plus legal costs, three quarters pay otherwise, inflation indexed

Meghalaya

Advance Notification: 120 days

Compensation for Dismissal: Three months salary for each year worked

Seniority Premiums for Dismissed Workers: Lump sum payment of Rs. 10,000 if worked beyond ten years

Foregone Wages during Contestation: full pay if worker reinstated, half pay if not

Nagaland

Advance Notification: 120 days

Compensation for Dismissal: Three months salary for each year worked

Seniority Premiums for Dismissed Workers: Lump sum payment of Rs. 7,500 if worked beyond ten years

Foregone Wages during Contestation: full pay if worker reinstated, half pay if not

Orissa

Advance Notification: 150 days

Compensation for Dismissal: Three months salary for each year worked

Seniority Premiums for Dismissed Workers: Rs. 5000 for each year worked beyond fifteen years

Foregone Wages during Contestation: full pay plus half of legal costs if worker reinstated, half pay if not

Pondicherry

Advance Notification: 90 days

Compensation for Dismissal: Two months salary for each year worked

Seniority Premiums for Dismissed Workers: Lump sum payment of Rs. 7,500 if worked beyond fifteen years

Foregone Wages during Contestation: full pay if worker reinstated, lump sum gratuitous payment if not

Punjab

Advance Notification: 60 days

Compensation for Dismissal: One month salary for each year worked, only if on permanent contract; otherwise 20 days salary

Seniority Premiums for Dismissed Workers: Calculated according to formula below

Foregone Wages during Contestation: full pay if worker reinstated, lump sum gratuitous payment if not

Rajasthan

Advance Notification: 90 days

Compensation for Dismissal: Two months salary for each year worked

Seniority Premiums for Dismissed Workers: Lump sum payment of Rs. 7,500 if worked beyond ten years

Foregone Wages during Contestation: full pay if worker reinstated, lump sum gratuitous payment if not

Sikkim

Advance Notification: 120 days

Compensation for Dismissal: Two months salary for each year worked

Seniority Premiums for Dismissed Workers: Lump sum payment of Rs. 7,500 if worked beyond ten years

Foregone Wages during Contestation: full pay if worker reinstated, half pay if not

Tamil Nadu

Advance Notification: 45 days

Compensation for Dismissal: One month salary for each year worked if regular contract, otherwise 15 days salary

Seniority Premiums for Dismissed Workers: Lump sum payment of Rs. 5000 if worked beyond twelve years

Foregone Wages during Contestation: full pay if worker reinstated, nothing otherwise

West Bengal

Advance Notification: 120 days

Compensation for Dismissal: Three months salary for each year worked

Seniority Premiums for Dismissed Workers: Lump sum payment of Rs. 7,500 if worked beyond ten years

Foregone Wages during Contestation: full pay if worker reinstated, half pay if not

Uttar Pradesh

Advance Notification: 180 days

Compensation for Dismissal: Three months salary for each year worked

Seniority Premiums for Dismissed Workers: Rs. 5000 for each year worked beyond fifteen years

Foregone Wages during Contestation: full pay plus half of legal costs if worker reinstated, half pay if not; inflation indexed

Tripura

Advance Notification: 180 days

Compensation for Dismissal: Four months salary for each year worked up to ten years; six months salary for each year worked beyond ten years

Seniority Premiums for Dismissed Workers: Rs. 5000 for each year worked beyond ten years

Foregone Wages during Contestation: Full pay plus legal costs if worker reinstated; three fourths pay if worker dismissed. Increments added, inflation indexed.

5.3 CONSTRUCTION OF A JOB SECURITY (JS) INDEX

In an attempt to quantify all of the provisions detailed in the previous section. We construct an index of JS encompassing all Indian states (except Jammu and Kashmir, for which no data could be obtained).

There have been previous attempts to construct such types of measures. Bertola (1990), Grubbs and Wells (1993) and the OECD (1999a, 1999b) constructed ordinal measures of JS for industrial countries whereas Márquez (1998) constructed ordinal measures of job security for a sample of industrial and LAC countries. Also, Lazear (1990) quantified firing costs as the amount (in multiples of monthly wages) owed to a worker if he is dismissed after ten years of service.

These measures, however, are unlikely to accurately reflect the magnitude of dismissal costs. Their main shortcomings are: (i) ordinal measures can only state that one country (or state) is more regulated than another, but cannot measure how much more regulated it is; and (ii) JS tends to increase according to tenure, which implies that measures conditional on a certain level of tenure only measure a given point in the severance-tenure continuum.

We follow Montenegro and Pagés (1999) to construct an alternative cardinal measure of JS that computes the expected future cost, at the time a worker is hired, of dismissing him in the future due to unfavourable economic conditions. It calculates this cost as a percentage of the worker's annual pay. So, for instance, we could conclude that in a certain state, the worker would need to be paid 25 per cent of his or her annual pay as cost of dismissal, which would work out to three months pay. The index is constructed, by Montenegro and Pagés (1999), to include only firing costs that affect firm's decisions at the margin and therefore it does not include the full cost of regulation on labour demand. It includes the cost of providing statutory advance notice and severance pay conditional on each possible level of tenure that a worker can attain in the future.

This measure of JS thus reflects the marginal costs of dismissing full-time regular, or "permanent", workers, and in some cases, visible (on the books) temporary/casual workers.

5.3.1 Methodology for Construction of Job Security Index

One can see from the information in the previous section that across the twenty four states, we go from a situation of very easy dismissal in Karnataka to a very high cost dismissal system in Kerala. In estimating the cost of dismissing a worker, two factors become especially relevant. The first one is the severance pay profile. Across the twenty four states, the existence of different maximum caps substantially changes the cost of dismissing workers, especially high tenure workers versus low tenure workers. The second is the amount of time taken in adjudication of labour disputes. Some states continue to pay full pay, or a proportion thereof, whereas others pay only if reinstatement occurs. This also causes major differences in the level of difficulty in dismissing workers. For example, the minimum notice period required in Kerala is 240 days, as opposed to 15 days in Karnataka. This makes the notice period regulation in Kerala sixteen times more rigid than in Karnataka. This gives us a scale of 1 to 16 across the twenty four states, and we give each state a notice period "score" according to where they lie on this spectrum between 1 and 16. A similar exercise is carried out with each of the four expected costs for which information is given in the previous section.

The constructed index measures the expected discounted cost, at the time a worker is hired, of dismissing a worker in the future. The assumption is that firms evaluate future costs based on current labour law. The index includes only statutory provisions, and thus, it does not include provisions negotiated among employers and employees, for specific firms, or included in company policy manuals, since these are not comparable across states. In addition, it does not include dismissal costs that are ruled by a high court judge if a firm is taken to court. It does however include dismissal costs accruing through rulings of labour tribunals and labour courts. High values of the index denote states with high job security, whereas lower values characterise states in which dismissal costs are lower.

By construction, as stated by Montenegro and Pagés (1999), this index gives equal weight to notice periods and to severance pay since both are added up in the calculation of the dismissal costs. This index however gives a higher weight to dismissal costs that may arise soon after a worker is hired–since they are less discounted at the time of hiring–while it discounts firing costs that may arise further in the future.

In computing the index, we, like Montenegro and Pagés (1999), assume a common discount rate and a common turnover rate: in this case of 8 per cent and 12 per cent, respectively. The choice of the discount rate is based on the average return of an internationally diversified portfolio as calculated by Montenegro and Pagés (1999). Finally, the choice of turnover rate is based on the fact that real turnover rates are unobservable in states with job security provisions since the turnover rate is itself affected by job security. We therefore, like the authors of the index, choose to input all states with the observed turnover rates in Karnataka, the state in the sample with the lowest job security. The minimum tenure at a firm is considered to be six months, and the maximum is assumed to be twenty years.

It should be noted that our objective is to come up with an index which is a number. That is not easy for two reasons. First, the cost of dismissing a worker is not a single number, but a profile, based on his status. One needs to come up with a number to reflect it—a number that represents that profile, and also is sensitive to the changes in upper limits, since we are concerned with changes at the margins. Another difficulty arises from the fact that the amount firms have to pay differs from the time taken in adjudication, and the result of the adjudication. Again, one cannot factor in that cost easily, except give a higher weight to states where labour tribunals are notorious for delays and high levels of bureaucracy.

The constructed index therefore, as defined by Monenegro and Pagés(1999) captures *expected* cost, as that figure captures the whole profile of dismissal, as well as the expected time taken in adjudication under India's compulsorily tripartitie industrial dispute resolution mechanism.

We compute the job security index based on the state-wise legal information on the mandated costs of dismissal summarised above. This information was directly obtained from the various State Ministries of Labour over several months in 1998-99. To obtain a single measure per state, we compute a separate index for blue and white-collar workers and perform a simple average between the two, where such information is available.

In the specific case of job security regulation, the strategy is to develop a measure of firing costs that summarises the entire profile of tenure and severance pay, using a common set of dismissal probabilities. The indicator of firing costs (the job security index) is presented in Table 5.1, and the numbers are interpreted as follows: the cost of job security is three monthly wages in Haryana, for example, since the cost of dismissal is calculated at approximately 25 per cent of the annual wage. In that case, the expected cost of labour in the state is whatever wage is paid plus an up-front investment of three monthly wages on average. The key elements included in this measure are advance notice requirements and compensation for dismissal with and without cause.

Note that Montenegro and Pagés(1999), the architects of this measure, themselves question the validity of their job security measure given that severance payments are transfers from employers to workers and as such are, in part, a form of compensation. They recognise that the impact of job security could be completely cancelled with a properly designed labour contract provided that there are no restrictions on transactions between workers and firms. Lazear (1990), who pointed in this direction with his 1990 paper, stated that the impact of job security could only be undone if dismissal costs were paid in all separation cases and if payments took the form of lump-sum or deferred payments. Lazear shows that under those conditions, severance payments have a well-defined counterpart in current salaries, and the contract can fully internalise the severance.

However, most states have established severance payments that (a) are a multiple of the last salary, or the salary at the time of dismissal; (b) depend on the existence of just cause; and (c) do not apply in the case of voluntary quits. Therefore, the capacity to internalise the cost of severance is generally low. By their analysis then, for our case, Karnataka has moved closer to the Lazear conditions and some other states are considering reforms along those lines. This would mean establishing severance in all separations or severance based on individual accounts. Heckman and Pagés (2001) note that "if the job security measure could distinguish cases in which severance is partially or fully internalised from cases in which severance cannot be internalised, then the truly distortionary component of mandated severance could be isolated, and the Lazear effect could be tested empirically".

In particular, they point out, because the index is constructed exclusively using provisions existing in labour codes, it generates a bias in favour of states where effective job security provisions originate directly from private contracts and the legal case law as applied by tribunals and other adjudicators. For our case, in some states with fairly rigid labour legislation, de-facto labour flexibility has been brought about through informal collective agreements, as discussed in Chapters 2 and 3. Thus an excessively "legalistic" approach may miss some of the actual characteristics of labour markets in the various states.

Another element affecting the construction of the index is the discount rate. We follow the architects of the index in using a single discount rate for all states. However, the relevant discount rate for calculating the expected discounted cost of dismissing a worker is significantly higher in some states compared with others. This caveat must also be borne in mind.

The results of our exercise in constructing job security indices are presented in Table 5.1. As before, Mr. C.S. Das needs to be thanked. We have to say that given the caveats above, we have greater faith in the ordinal, rather than the cardinal rankings, produced below.

Table 5.1: Job Security Index across 24 Indian States: Cardinal Measure and Ordinal Ranking (no reliable data for Jammu and Kashmir)

State	Job Security Index (monthly Wages)	% Annual wage	Ranking
Karnataka	2.13	17.703	1
Gujarat	2.15	17.90	2
Andhra Pradesh	2.25	18.75	3
Maharashtra	2.29	19.05	4
Delhi	2.58	21.51	5
Tamil Nadu	2.66	22.14	6
Haryana	3.03	25.27	7
Punjab	3.05	25.42	8
Himachal Pradesh	3.24	26.97	9
Goa	3.35	27.92	10
Pondicherry	3.52	29.32	11
Rajasthan	3.54	29.53	12
Sikkim	3.72	26.01	13
West Bengal	3.72	31.01	14
Nagaland	3.73	31.09	15
Arunachal Pradesh	3.76	31.31	16
Meghalaya	4.02	33.53	17
Orissa	4.16	34.65	18
Uttar Pradesh	4.21	35.02	19
Madhya Pradesh	4.52	37.66	20
Bihar	4.73	39.42	21
Manipur	4.80	40.03	22
Tripura	4.96	41.33	23
Kerala	5.67	47.19	24

5.4 TESTING EFFECTS OF JOB SECURITY REGULATIONS

5.4.1 Theory

As mentioned before, we use as a guide the excellent theoretical and empirical paper by Heckman and Pagés (2001). They, in turn, build on the work done by others before them ever since this kind of analysis became popular in the 1990s, when it was first done for some European countries. As we have noted before, analysing the impact of job security provisions requires a complicated structure that covers dynamic decisions taken by firms. Bertola (1990) develops a dynamic partial-equilibrium model to assess how a firm's hiring and firing decisions are affected by dismissal costs. In the face of a given shock, the optimal employment policy of a firm involves one of three state dependent responses: dismissing workers; hiring workers; and doing nothing (in which case employment in that firm does not change). How are these decisions affected by dismissal costs? In the face of a negative shock and declining marginal value of labour, a firm may want to dismiss some workers. If it has to pay a mandatory dismissal cost, however, this cost discourages the firm from adjusting its labour force, resulting in fewer dismissals than in the absence of such costs. Conversely, in the face of a positive shock firms may want to hire additional workers, but they will take into account that some workers may have to be fired in the future if demand turns down. Heckman and Pagés (2001) infer that this prospective cost acts as a hiring cost, effectively reducing creation of new jobs in good states. The net result, they conclude, is lower employment rates in expansions, higher employment rates in recessions, and lower turnover rates as firms hire and fire fewer workers than they would in the absence of these costs.

Bertola's model predicts a decline in employment variability associated with firing costs, but the implications of his model for average employment are ambiguous. In particular, whether average employment rates increase or decline as a result of firing costs depends on whether the decline in hiring rates more than compensates for the reduction in firings. Some authors (Bertola 1990; Bentolila and Bertola 1990) have carried out simulations that suggest that average employment in a given firm is actually likely to increase when firing costs increase.

These results, however, are quite sensitive to different assumptions about the persistence of shocks, the elasticity of the labour demand, the magnitude of the discount rate, and the functional form of the production function. Thus, job security has a larger negative effect on employment in the presence of less persistent shocks and lower discount rates, because both factors reduce hiring relative to firing (Bentolila and Saint Paul 1994). A higher elasticity of the demand for goods similarly implies a larger negative effect of job security on employment rates (Risager and Sorensen, 1997). When investment decisions are also considered, firing costs lower profits and discourage investment, increasing the likelihood that firing costs reduce the demand for labour (Risager and Sorensen (1997).

The results mentioned above analyse employment rates in individual firms without considering the impact of firing costs on the extensive margin, that is, how firing costs affect the creation and destruction of firms. Heckman and Pagés (2001) also discuss the work done by Hopenhayn and Rogerson (1993), who develop a general equilibrium model that accounts for entry and exit of firms, based on the U.S. economy. In their model, Bertola's (1990) partial equilibrium framework is rooted in a general equilibrium framework in which jobs and firms are created and destroyed in every period in response to firm-specific shocks. They find that increasing firing costs in the U.S. would lead to an increase in the average employment of existing firms as a consequence of the reduction in firings. However, they also find that such a policy would result in lower firm entry and lower job creation in newly created firms. For the parameter values they consider, these two last effects offset the increase in employment in existing firms, resulting in a reduction of overall employment rates.

Job security may also affect employment by changing the structure of wages. The insider-outsider literature emphasises that job security provisions increase the insider power of incumbent workers (Lindbeck and Snower, 1988). This effect results in higher wages for insiders and lower overall employment rates. Caballero and Hammour (1994) consider a model in which job security provisions increase the ability of labour to appropriate capital by increasing capital specificity. That is, a larger part of invested capital becomes relationship specific and is lost if capital separates from labour. While in the short run, higher firing costs allow labour to extract higher rents from capital, in the long run firms invest in technologies that are less labor intensive, reducing employment demand.

More recent literature also emphasises the possible impact of job security regulations on the composition of employment. Kugler (2000) proposes a model in which job security regulations provide incentives for high-turnover firms to operate in the informal sector. This decision entails producing at a small, less efficient scale in order to remain inconspicuous to tax and labour authorities. In this framework, high job security is likely to increase informality rates. Montenegro and Pagés (1999) develop a model, used above, in which tenure-related job security biases employment against young workers and in favour of older ones. As severance pay increases with tenure, and tenure tends to increase with age, it becomes more costly to dismiss older workers than younger ones. If wages do not adjust appropriately, negative shocks result in a disproportionate share of layoffs among young workers. Job security based on tenure thus results in lower employment rates for the young, relative to older workers, because it reduces hiring and actually increases firings for young workers. This work has been used by Heckman and Pagés (2001) in their paper.

Higher job security provisions thus reduce turnover rates and bias the composition of employment against young workers and against employment in the formal sector. The implications for average employment in the economy at large, surmise Heckman and Pagés (2001), however, are somewhat less conclusive since they depend on specific configurations of parameters for the economy. To complicate matters further, they say that the Coase theorem indicates that the impact of job security could be completely "undone" with a properly designed labour contract provided that there are no restrictions on transactions between workers and firms (Lazear 1990), as discussed in the previous section above.

In a world without transaction costs, wages adjust to offset the possible negative impact highlighted above. Given the ambiguity of theoretical models, the magnitude and direction of the impact of job security on employment have to be resolved empirically, as they do, and as we follow below. Before we get on to that, some definitions of variables we will be using.

5.4.2 Definition of Variables

We obtained employment and unemployment data from NSS household surveys, which have been discussed before. Some of the state data are approximated, as NSS zones do not always correspond to state boundaries. We use the same terms as Heckman and Pagés (2001), but the definitions for the Indian case tend to be somewhat different in some cases. The contribution of Mr. C.S. Das was invaluable in both the preparation and analysis of the data.

Total employment: All employed workers aged fifteen to fifty five who declared having a job in the week of reference. It is measured as a percentage of the total population aged fifteen to fifty-five. All measures of aggregate employment include formal and informal workers, as well as unpaid workers.

Employment rate of prime-aged males: Percentage of men aged twenty-five to fifty who were employed during the week of reference.

Employment rate of prime-aged females: Percentage of women aged twenty-five to fifty who were employed during the week of reference.

Youth employment: Percentage of people aged fifteen to twenty-four who were employed during the week of reference.

Self-employment: Share of non agricultural workers who are self-employed or who are owners of firms.

Total unemployment: Number of people aged fifteen to fifty-five who did not work in the week of reference but who are actively looking for a job, expressed as a percentage of the total active population in that age group.

Unemployment rate of prime-aged males: Number of men aged twenty-five to fifty who did not work in the week of reference but who are actively looking for a job, expressed as a percentage of the male active population in that age group.

Unemployment rate of prime-aged females: Number of women aged twenty-five to fifty who did not work in the week of reference but who are actively looking for a job, expressed as a percentage of the female active population in that age group.

Youth unemployment: Number of people aged fifteen to twenty-four who did not work in the week of reference but who are actively looking for a job, expressed as a percentage of the active population in that age group.

Long-term unemployment: Number of people aged fifteen to fifty-five who have been without a job and actively looking for employment for more than six months, expressed as a percentage of the total active population in that age group.

Female participation: Percentage of total female workers aged fifteen to fifty-five who are either employed or actively seeking employment.

SDP: State-level gross domestic product measured in 1995 US dollars.

Population aged 15-24: Proportion of total population that falls in this age group.

5.4.3 Methodology and Summary Statistics

We exploit the substantial cross-state variability in job security provisions to estimate effects of job security. We construct a data set that spans all Indian states. We try and make this correspond to the data used by Heckman and Pagés (2001). In order to do so we use the OECD definitions of labour market variables, adjusted to Indian definitions (see above), to construct the same indicators out of NSS Household Surveys. Table 5.2 provides summary statistics for the overall sample, the low JS rank sample (consisting of four states) and the high JS rank, or HS, sample, consisting of 3 states. To characterise job security, we use the index of job security constructed above.

Table 5.2

Summary Statistics

Average Statistics for the overall sample

Variable	**Observations**	**States**	**Mean**	**Std. Dev.**
Total Employment	120	24	66.5184	8.9336
Prime-Age Male Employment	120	24	90.8024	5.3664
Prime-Age Female Employment	120	24	66.5808	13.9256
Youth (15-24) Employment	120	24	47.1432	14.0816
Self-employment	120	24	13.6968	6.7288
Total Unemployment	120	24	8.5488	4.5864
Prime-Age Male Unemployment	120	24	8.5488	4.5864
Prime-Age Female Unemployment	120	24	6.032	3.3176
Youth (15-24) Unemployment	120	24	7.7272	5.0024
Unemployed> 6months/Total U.	120	24	15.8912	9.256
Job Security	120	24	5.0625	1.4144
SDP growth	120	24	2.808	3.12
Proportion pop 15 to 24	120	24	0.156	0.0208
Female Participation	120	24	62.1816	12.2408
Union density	120	24	34.7672	19.9472

Average Statistics for High JS Rank States

(High JS rank implies low job security)

Variable	Observations	# States	Mean	Std. Dev.
Total Employment	15	3	74.828	4.39088
Prime-Age Male Employment	15	3	95.4158	3.28328

Prime-Age Female Employment	15	3	49.0786	11.127
Youth (15-24) Employment	15	3	66.2085	11.5211
Self-employment	15	3	32.742	8.59976
Total Unemployment	15	3	7.70016	3.42784
Prime-Age Male Unemployment	15	3	4.03624	2.68112
Prime-Age Female Unemployment	15	3	4.85264	3.25936
Youth (15-24) Unemployment	15	3	11.3162	4.8568
Unemployed> 6months/Total U.	15	3	15.1299	7.55248
Job Security	15	3	2.1766	1629.68
SDP growth	15	3	3.44448	3.99048
Proportion pop 15 to 24	15	3	0.20488	0.01664
Female Participation	15	3	46.0252	10.947
Union density	15	3	18.72	11.8248

Average Statistics for Low JS Rank States

(Low JS Rank implies high job security)

Variable	Observations	# States	Mean	Std. Dev.
Total Employment	20	4	66.4865	8.49064
Prime-Age Male Employment	20	4	89.7251	4.95958
Prime-Age Female Employment	20	4	57.2213	14.9391
Youth (15-24) Employment	20	4	53.3683	15.5628
Self-employment	20	4	27.0815	11.9412
Total Unemployment	20	4	8.05806	4.1749
Prime-Age Male Unemployment	20	4	8.05806	4.1749
Prime-Age Female Unemployment	20	4	5.01994	3.10854
Youth (15-24) Unemployment	20	4	6.2875	4.41634
Unemployed> 6months/Total U.	20	4	13.5005	7.75626

Job Security	20	4	5.0625	1.75044
SDP growth	20	4	2.9174	3.3198
Proportion pop 15 to 24	20	4	0.16096	0.03018
Female Participation	20	4	55.9738	13.42
Union density	20	4	26.6791	17.8967

Note: The small difference in value between the average figures for the country and the high job security (low rank) states is because these figures are not weighted by population, and the latter are the states with the highest populations in India.

5.5 IMPACT OF JOB SECURITY REGULATIONS

By following Heckman and Pagés' (2001) advice and constructing our own data set from NSS household-level surveys, we are guaranteed that all the labour market variables are comparable and reliable. One drawback of our data is that we only have a few time series observations per state, and not from consecutive years. This is due to the quinquennial nature of NSS data rounds. Given the nature of the data, we decided not to average observations from a given period–as is done in most of the OECD studies on job security–and insteadfollowed Heckman and Pagés (2001) in controlling for the state of the business cycle in a given year using SDP growth.

We use a reduced form approach to investigate whether states and periods with more strict job security regulations are associated with lower employment or higher unemployment rates. Thus we estimate an average net effect of JS as it operates through intermediate variables which we do not include in the regression.

JS costs govern the marginal costs of labour when firms are firing, but they also affect overall labour demand through their effect on expected (across states) labour cost. It is this effect that we attempt to identify. Since most of the variation is cross-sectional, Heckman and Pagés (2001) use different types of variables to control for state-specific factors that may be correlated with job security. We do the same.

First, we use demographic controls such as the share of the population between 15 and 24 and female participation rates, as defined in the previous section. Since both factors affect overall employment rates, not including them in the specification may lead to substantial biases in the estimates. We protect against common state-specific unobservables that remain constant over time and that may affect both left hand side and right hand side variables by including state-specific fixed effects in a set of regression specifications reported below.

Second, we use SDP (measured in 1995 U.S. dollars) (Heckman and Pagés, 2001, of course, use GDP) to control for differences in development levels across states. We also include a dummy variable for High JS states to control for regional differences not controlled by SDP levels. Most of the variability in our sample comes from differences across states. So we limit ourselves to calculating OLS estimates only.

We differ from Heckman and Pagés here as their data also has variability from some time series variance within the state samples. Given this variation, they conclude that fixed effects (FE) estimates are likely to be very imprecise because they only use the time-series variation. Instead, they say that random effects (RE) or pooled OLS estimates, that use both the cross-section and the time-series variation included in the sample, are likely to produce estimates with smaller standard errors. Yet, the latter estimates, they assert, will be biased if variables included as controls are correlated with state specific error terms.

To protect against the bias that results from using one estimator, they estimate their basic specification by pooled OLS, RE and FE, comparing whether these different methodologies yield similar point-estimates. We unfortunately have neither the breadth and depth of data, nor the econometric wherewithal, to carry out that exercise. Therefore, we note here our omission of RE and FE analyses, and rely only on OLS estimates.

5.5.1 Results

The results are presented in Table 5.3.

Table 5.3: OLS Estimation. Full Sample

	Total Emp.	Male prime age Emp.	Female prime age Emp.	Youth Emp.	Self-Empl.	Total Unemployment	Male prime-age Unemployment	Female prime-age Unemployment	Youth Unemployment	Proportion of unemply > 6 months
	1	2	3	4	5	6	7	8	9	10
High JS dummy	12.28***	3.42***	-9.82	35.59	21.33***	-1.98**	-3.14***	-5.68***	-9.26***	-54.21***
	(1.21)	(.1.02)	(2.72)	(2.29)	(2.25)	(1.45)	(.85)	(1.18)	(3.57)	(3.23)
Job security index	-2.07***	-1.01***	-1.92	-3.76***	1.23**	0.70***	.93***	.65***	1.07*	1.06
	(.36)	(.28)	(.74)	(4.27)	(.63)	(.46)	(.29)	(.43)	(.61)	(.91)
SDP growth	-0.115	-0.121	-0.137	0.012	0.62**	0.13	-0.02	0.098	0.071	-0.243
	(.121)	(.137)	(.277)	(.413)	(.185)	(.126)	(.079)	(.112)	(.182)	(0.531)
Female participation	0.512***	-	-	0.412***	0.332***	-.121***	-	-	-0.201	-0.871***
	(0.052)			(.14)	(.076)	(.032)			(.0841)	(0.112)
Pop 15to24	9.26	-	-	-	182.31**	-43.94	-	-	-72.01	-106.37
	(36.08)				(61.22)	(28.51)			(51.92)	(21.33)
Constant	61.37***	109.85***	52.21***	43.21***	-10.35	23.44	2.84***	7.11	45.28**	124.64***
	(7.01)	(2.21)	(5.03)	(10.12)	(14.61)	(8.11)	(1.93)	(2.47)	(11.21)	(21.52)
R-square	0.77	0.28	0.31	0.58	0.51	0.19	0.37	0.25	0.33	0.91

The results, presented above in Table 5.3, are very powerful, and may be analysed as follows:

1. The OLS point-estimate for the JS coefficient in the total employment specifications shows that job security regulations have a significant negative impact on total employment. It is significant at a 1 per cent level of significance.

2. The OLS point-estimate for the JS coefficient in the total unemployment shows that job security regulations have a significant positive effect on total unemployment. It is significant at a 1 per cent level of significance. We should recall here that employment and unemployment are not mirror images of each other in NSS data—hence the separate analyses.

3. The OLS point estimate for the JS coefficient in the youth employment shows that job security regulations have a significant negative effect on youth employment, i.e. they make job market access for the youth very tough. The significance level is 1 per cent.

4. The OLS point estimate of the JS coefficient in the youth unemployment shows that job security regulations have a significant positive effect on youth unemployment. The significance level here is only 10 per cent though, implying perhaps that the youth find other means of employment not visible to NSS data collection. These would most likely be low paid, highly informal, manual labour.

5. The OLS point estimate for the JS coefficient in the male prime age employment shows that job security regulations have a significant negative effect on male prime age employment. This result is highly significant at a 1 per cent level of significance.

6. The OLS point estimate for the JS coefficient in the male prime age unemployment shows that job security regulations have a significant positive effect on male prime age unemployment. This result holds at a 1 per cnt level of significance.

7. The OLS point estimate for the JS coefficient in the female prime age employment has a negative sign. However, it is not significant at the 10, 5 or 1 per cent levels. This reflects the age-old problem of capturing female employment, especially in developing countries.

8. The OLS point estimate for the JS coefficient in the the female prime age unemployment, however, does show that the effect of job security regulations on female prime age unemployment is both positive *and* significant. This result, in fact, holds at a 1 per cent level of significance.

9. The OLS point estimate for the JS coefficient in self employment shows a significant and positive effect of job security regulations on self-employment. Given that self-employment refers mostly to badli workers, contract workers, home workers and other insecure categories, this result seems to make sense. It holds at a 5 per cent level of significance.

10. The OLS point estimate for the JS coefficient in the proportion of those unemployed for more than six months shows a positive sign, but is not significant at 10, 5 or 1 per sent levels of significance.

The **main** implication of these results lies in the high magnitude of job security elasticity. That means that an increase in expected dismissal costs equivalent to one month of pay is associated with a decline in employment rates of 2.07 percentage points (Table 5.3). Also, we can calculate from Table 5.1 that the average dismissal cost for a worker is 3.57 months of pay. That means, on average, the estimated loss in employment, as a percent of the total working population, due to job security provisions is about approximately 7.39 percentage points. That is a huge magnitude of loss of total employment as a result of job security regulations. This confirms, and further reinforces our conclusions from the previous chapter.

Also, the OLS estimates confirm the result we obtained in Chapter 4 for this state-wide analysis as well. They show quite effectively that job security does not affect all categories of workers to the same extent. Thus, the impact on the employment of females (generally more casual) is significantly larger than that of males. Also, the impact on the employment of males between 25-50 is significantly lower than the impact on total employment. Again, the impact on new entrants to the labour market is significantly higher than that for total employment. Prime age males are definitely more advantaged than both female workers and new entrants into the labour market.

As stated above, our results for self-employed labour are not as unambiguous. Here we must remember the highly limited definition of self-employment used by NSS household surveys, such that only the tip of the informal labour iceberg is captured by it.

It is clear that more empirical work is required to reach a definitive conclusion on the relationship between job security and self-employment. In particular, the higher end of self-employed workers (doctors, lawyers, accountants, consultants, independent businessmen)—i.e. those self-employed by *choice*—must be separated from those involuntarily "self-employed", i.e. those at the lower end, unable to find secure and protected employment. This is an exercise that must definitely be done very soon, especially as new and very scientific measures for estimating informal labour force are currently being developed in India.

5.6 SUMMARY AND CONCLUSIONS

Freeman (2000) writes "the institutional organisation of the labour market has identifiable large effects on distribution, but modest hard-to-uncover effects on efficiency." (p. 12) This view is shared by many economists (see Abraham and Houseman, 1994; and Blank and Freeman, 1994). However, the methodologies developed by Montenegro and Pagés(1999), and Heckman and Pagés (2001) has helped us to a large extent to get past some of those difficulties. The results outlined in this chapter suggest that job security regulations have a substantial impact on employment rates in Indian states, and thus substantially affect both the efficiency and equity aspects of the labour market.

Where Fallon and Lucas and others left themselves open to criticism and refutation was in looking at employment as a single, homogenous variable, culled from Annual Survey of Industries (ASI) data. That measure is however very imprecise indeed.

However, employment is very far from just what gets recorded in ASI data. NSS data gives us a much better estimate of real employment and unemployment, and also the various categories of employment and unemployment. Especially in a highly segmented (some say fragmented, e.g. Breman 1996) labour market like India's, it is vital to look at the impact of job security regulations on various categories of employment. Those who assert that job security does not have any impact on employment rates (ILO papers over the years mainly, and left-leaning scholars like Kannan, 1994 and Ghose, 1996), do so again based on one category of employment only.

In addition, while there is substantial evidence that unions reduce earnings inequality (beyond our scope here, but see the work of St. Paul, various years), there is ? no evidence that job security provisions reduce income inequality (again, St. Paul, various years, with evidence from the Spanish labour market). Indeed, given that job security reduces the employment probabilities (and possibly wages) of younger and less experienced and/or skilled workers, who bear the brunt of regulation, it is likely that regulation widens earnings inequality across age and wage/skill groups. Thus, there is no trade off between employment and inequality associated with job security provisions. Such provisions worsen both—i.e. both equity and efficiency. The choice of labour market institutions matters—as Solow (1990) warned us over a decade ago.

What policy lessons can be drawn from these results? Our evidence suggests that job security provisions are an extremely inefficient and inequality-increasing mechanism for providing either income security or earnings equity to workers. They are inefficient because they reduce the demand for labour; they are inequality-increasing because some workers benefit while many more are hurt. Their impact on inequality is comprehensive: job security increases inequality because it reduces the employment prospects of young, female, uneducated and unskilled workers—the most vulnerable group. It also increases inequality because it segments the labour market between workers with secure jobs and workers with very few prospects of ever having a "good" job, with any amount of minimum wage and conditions. Finally, job security provisions increase inequality if, as predicted by some theoretical studies and most of the available empirical evidence, they increase the size of the informal sector. We have seen evidence of this from both the qualitative and quantitative work presented so far.

In this light, it seems reasonable to advocate the substitution of job security provisions by other mechanisms that provide income security at lower efficiency and inequality costs. However, reducing dismissal costs is a difficult policy to implement in most states. The persistence of these policies has been explained in the literature by a demand for income security for groups with political power (see Caballero and Hammour, 1994).

The political economy mechanism behind it is explained like this: they argue that a demand for income security arises because job security flows out of unemployment and into employment. Although job security reduces the probability of exiting employment, conditional on having lost a job, the probability of finding a regular employment is reduced. This produces a sense of insecurity among protected workers, who exert pressure to maintain high levels of job security provisions—maintaining the "wall around the citadel" as Holmstrom (1984) puts it (124). A balance of power that favours insider workers helps to sustain job security provisions (Lindbeck and Snower, 1988). Thus, those workers most likely to benefit from such provisions are also more likely to be represented in the political process.

All of this, of course, depends intimately on the political economies of different states. The extent to which various states carry out regulatory reforms depends on various variables. It can be a question puzzling to most intelligent minds—why does a mature democracy like India find it so difficult to reform job security regulations which favour only a tiny minority, while greatly disadvantaging the huge majority. In Chapter 6, we will attempt to answer this question by testing the influence of various political economy variables on the reform-orientation of a representative sample of Indian states.

CHAPTER 6

POLITICAL ECONOMY OF LABOUR POLICY CHOICE IN TEN INDIAN STATES

India embarked on the process of economic policy reforms in mid-1991 in response to a fiscal and balance of payments crisis. While the central government has undertaken a series of sweeping reform measures in the areas of fiscal policy; trade and exchange rate policy; industrial policy; foreign investment policy and so on, many of India's state governments have yet to implement a wide array of reform measures in order to attain high rates of State Domestic Product (SDP) growth. The reform process so far has mainly concentrated at the central level. India has yet to free up its state governments sufficiently so that they can add much greater dynamism to the reforms.[1] Labour reforms have been the slowest of all. As late as the Budget of 2002 a few weeks ago, in February 2002, the Central Government was still trying to get its own Cabinet Ministers to talk about this issue.

The labour market reforms at the state level in India have also been rather slow moving. There are several reasons for it. Firstly, limited decentralisation of decision-making has meant that states in India lack the authority to formulate and implement policies that are under the control of the central government. Second, unlike the central government, the state governments do not have sufficient institutional back up. Third, due to the short-terms of office that state governments have been holding, these governments are governed by short-term political considerations. Chief Ministers have changed frequently thereby leading to policy discontinuity (since 1967, Chief Ministers on average have been in office only 2.65 years). For instance the state of Uttar Pradesh has seen 17 governments in 54 years. Fourth, populist policies have always been preferred over harsh reform measures, that is, subsidies on rice; urban transport; water; electricity and so on are pursued with in order to advance the political interests of the party in power.

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[1] India's constitution was designed to give primary economic policy making responsibility to the central government. Key fiscal, infrastructure, and regulatory decisions on economic management are therefore taken by the central government. For instance, in most infrastructure areas, the central government remains in control, or at least with veto over state actions.

The rest of this chapter is organised as follows. Section 6.1 discusses inter-state variation in reform-orientation, especially labour policy reform, although as we shall discuss, labour policy reform is closely correlated with all other types of policy reform as well. Section 6.2 discusses some state case studies about policy reform in greater detail. Section 6.3 asks what explains this variation in reform orientation. Section 6.4 discusses the politics of economic reform. Section 6.5 discusses the research model, data and methodology of the empirical study which tries to explain the variability in reform orientation. Section 6.6 contains the results of the study, while Section 6.7 contains our conclusions and thoughts about future research.

6.1 INTER-STATE VARIATION IN REFORM-ORIENTATION

A few of the Indian States have been more reform-oriented, such as Andhra Pradesh, Gujarat, Karnataka, Maharashtra, and Tamil Nadu, but states, such as Haryana, Kerala, Orissa, Madhya Pradesh, Punjab, Rajasthan and West Bengal have a lot to catch-up with. Of course, Bihar and Uttar Pradesh are even further behind. We analyse the state-level situation in ten major states of the twenty four states of India analysed in Chapters 4 and 5, based on the progress of state-level labour policy reform. Accordingly, we have divided these states into three categories of reformers, based on the job security rankings in Chapter 5. These are the reform-oriented states, intermediate reformers and the lagging reformers. We then examine the performance of these ten states in terms of SDP growth, foreign direct investment, industrial investment proposals, and software exports among other variables. In order to do so, we refer to a large number of papers by Sachs and Bajpai (various years), who have studied this in some detail. We notice that their classification of reform orientation of states by *all* reform measures corresponds to our ranking of states by job security ranking. That is not surprising, given the endogeneity between protective regulation in product and labour markets, as modelled by Blanchard (2000), Rama and Tabellini (1994), OECD (1999) and many others. That analysis is beyond the scope of this thesis. Suffice it to say that such an endogeneity exists theoretically, and can be verified empirically, and therefore it is not surprising that laggards in labour policy reform are also laggards in overall policy reform.

Of course, within the reform-oriented states, Andhra Pradesh and Tamil Nadu have implemented labour market (and other policy) reforms on a wider scale relative to other states in that category. We must emphasise here that this classification is purely indicative, and loaded with a huge baggage of unresolved issues. Primarily, the idea of this very tentative set of grouping is to indicate which of the Indian states are likely to attain and sustain higher rates of growth in the years ahead. These states are classified into three categories as follows:

Reform-oriented states - Andhra Pradesh, Karnataka, Maharashtra
Intermediate Reformers – Haryana, Orissa, and West Bengal.
Lagging Reformers – Bihar, Kerala, Madhya Pradesh and Uttar Pradesh.

Real annual average growth rates of per capita gross state domestic product shown in Table 6.1 bear testimony to the fact that our group of reform-oriented states are also the fastest growing states in India in the post-reform period. Interestingly enough, Sachs and Bajpai (various years) note that amongst the Southern states, Karnataka per capita incomes began to surge and exceed the national average since 1991-92. On the other hand, amongst the lagging reformers, Bihar, Madhya Pradesh, and Uttar Pradesh, and to a certain extent Orissa, have lagged far behind the all-India average, as also in the growth of SDP per capita of other states.

Table 6.1

Selected Indicators of State Level Progress

State/UT	Growth Rate *GSDP Per-capita 1981-91*	Growth Rate *GSDP Per-capita 1992-97*	FDI (Rs. Mn.) *Aggregate 1991-97 Approved*	Software Exports
Andhra Pradesh	2.9%	3.8%	25112.73	931.30
Karnataka	3.5%	3.4%	54938.89	7278.40
Maharashtra	4.1%	7.4%	126763.87	7085.60
Haryana	4.3%	2.6%	17884.02	629.90
Orissa	1.3%	1.5%	37907.90	–

West Bengal	2.3%	4.9%	52495.48	546.90
Bihar	2.9%	-0.7%	1307.46	–
Kerala	2.5%	4.9%	5209.17	38.70
Madhya Pradesh	2.9%	4.1%	52683.29	2.50
Uttar Pradesh	2.9%	1.8%	24445.19	–

Source: National Accounts Statistics of India

Secretariat for Industrial Assistance (SIA) Newsletter, February 1997, Ministry of Industry, GOI WWW Page: http://www.maharashtra.gov.in/english/invest/softw.htm, current as of 4 April 1999, constructed by Sachs and Bajpai (various years)

With the initiation of economic reforms in 1991 the role of private investment has acquired a great deal of significance. In fact, this is a key category for discussing the impact of regulations. If regulations discourage investment, then this will have wide implications for output and employment. States are now in competition with one another to attract private investment, both domestic and foreign. Within states, the flow of investments tends to be skewed in favour of a few regions. State-level data on FDI approvals (aggregate FDI approvals between 1991-97) and domestic investment proposals and disbursal of funds for investment (aggregate between August 1991 and December 1996) shown in Tables 6.2 and 6.3 respectively suggest once again that the relatively fast moving reformers have tended to attract higher investments, both from foreign and domestic investors.[2]

Table 6.2

State-wise Breakup of Foreign Collaboration and Foreign Direct Investment Proposals Approved

(During August 1991 to January 1997)

State	**Number of Investment**			**Investment Approved**	**% of Total Approval**
	Total	**Tech**	**Fin**		
Andhra Pradesh	439	144	295	25112.73	2.47%
Karnataka	689	255	434	54938.89	5.41%
Maharashtra	1355	523	832	126763.87	12.49%

[2] On a nation-wide basis, the cumulative approvals for FDI for the period 1991-98 were $52.95 billion. Actual FDI inflows during the same period were $15.18 billion. It is not possible to get state-wise details of the actual inflows of FDI since this data is not centrally maintained.

Haryana	414	146	268	17884.02	1.76%
Orissa	77	28	49	37907.90	3.73%
West Bengal	271	92	179	52495.48	5.17%
Bihar	69	42	27	1307.46	0.13%
Kerala	104	38	66	5209.17	0.51%
Madhya Pradesh	192	82	110	52683.29	5.19%
Uttar Pradesh	395	176	219	24445.19	2.41%
Others	4686	2343	2343	509597.52	50.21%
Total	**10359**	**4545**	**5814**	**1014940.16**	**100.29%**

Source : Secretariat for Industrial Assistance (SIA) Newsletter, February 1997, Minister of Industry, GOI, constructed by Sachs and Bajpai (various years)

According to the data made available by the Secretariat of Industrial Approvals in the Ministry of Industry, as quoted in Sachs and Bajpai (various papers), the southern states accounted for more than 34 percent of the proposals that have been approved in 1998. In the period January-December 1998, a total of 428 approvals were given for investments in the states of Karnataka, Tamil Nadu, Andhra and Kerala. Western India, accounting for around 21 per cent of the total approvals throughout the country follows the Southern region. This investment is in the states of Gujarat, Maharashtra and Goa. On the other hand, the states in the North and the East are far behind, except for investments in Delhi.

Gujarat, a small state in terms of its population, received over a fifth of private investment proposals, whereas Bihar with a tenth of India's population barely managed a share of 5 per cent of such proposals. Maharashtra and Gujarat account for 37 per cent of total investment proposals, while Bihar, Madhya Pradesh, Orissa, Rajasthan and Uttar Pradesh, taken together, were able to attract only 26 per cent of investment proposals. Over the period August 1991 to December 1996 the bulk of investment proposals were concentrated in states with a relatively high level of human development to the detriment of states that have a low level of human development (Sachs and Bajpai, 1998). The cumulative share of financial assistance disbursed by national financial institutions[3] during 1991-96 indicates a big gulf between the less developed and more developed states. Maharashtra alone received almost as much financial assistance as Bihar, Madhya Pradesh, Orissa, Rajasthan, Uttar Pradesh and West Bengal put together. Bihar and

[3] All India Financial Institutions include IDBI, IFCI, ICICI, UTI, LIC, GIC, IRBI and SIDBI

Orissa have shares of financial assistance that are adversely disproportionate to their respective population shares.

Table 6.3

Investment Proposals and Disbursal of Financial Assistance for Investment

States	Percentage Share Of Investment Proposals Between August 1991 And December 1996	Cumulative Share Of Financial Assistance Disbursed By All Indian Financial Institutions (1991-96)	Cumulative Financial Assistance By State Financial Corporations (1991-96)
Andhra Pradesh	7.7	6.7	1488.1
Karnataka	5.3	5.8	2688.6
Maharashtra	17.3	22.2	1861.5
Haryana	3.6	2.3	866.0
Orissa	1.9	1.7	697.8
West Bengal	3.2	4.0	460.3
Bihar	1.0	1.5	411.5
Kerala	1.1	1.5	735.8
Madhya Pradesh	7.6	4.9	589.2
Uttar Pradesh	9.6	7.4	1894.3
All India	*100*	*100*	*17952*

Source :Annual Report, 1996-97, Ministry of Industry, Govt. of India Cited in Kurian (1998). Constructed by Sachs and Bajpai (various years)

With regard to FDI, Sachs and Bajpai (1998) note that Tamil Nadu has attracted several automobile manufacturers to the state, such as, Ford, Mitsubishi, and Hyundai. An auto-ancillary park, near Chennai is coming up that will help enhance the availability of world-class auto components to multinational manufacturers in Tamil Nadu and neighbouring states. Karnataka and Andhra Pradesh have witnessed investments by software giants, such as Microsoft Corporation[4], Oracle, Novell, and Sun Microsystems as India is increasingly emerging as a major software development centre, with more and more overseas companies setting up operations in India. These companies are operating

[4] The first development centre of Microsoft outside of the U.S. is being established in Andhra Pradesh.

in the Indian market either through 100 percent equity holding, joint ventures with Indian companies; or marketing or technical collaborations. In addition to IT companies, Andhra Pradesh has also been successful in attracting ABB, Rolls Royce, General Electric, Lurgi, and US First Boston. Similarly, Gujarat has the presence of ATandT, GE Plastics, Unilever, Sumitomo, and Siemens. Finally, Maharashtra has Coca-Cola, Enron, Mercedes Benz, Siemens, Proctor and Gambler, Unilever, and Unisys.

In the area of software exports, Karnataka and Maharashtra are in the lead as shown in Table 6.1. While Bangalore in Karnataka and Bombay in Maharashtra were traditionally the choice locations of software companies, but the last few years have seen the emergence of Chennai in Tamil Nadu, Hyderabad in Andhra Pradesh, Pune in Maharashtra, and Gurgaon in Haryana as prominent software centres where both Indian companies and multinationals have located their operations. In addition, several foreign companies have located their back office operations in Bangalore, Chennai, and Pune. Abundant supply of labour, low wages, cheap satellite communications and the internet have been instrumental in the decision of foreign firms to establish their back office operations in India. These range from billing to payroll handling, from credit appraisal to airline reservations, and from inventory management to answering customer complaints. Data transcription and transmission for hospitals in the US and telemarketing for US and European firms is also being undertaken by Indian companies based in Chennai and other Indian metropolitan cities.

The state-wise distribution of 100 percent export-oriented units (EOUs) is also seen to be concentrated in the reforming states. As Table 6.4 shows, out of a total of 1995 EOUs as many as 1258 or 63 percent were located in the three reform-oriented states.

Table 6.4

State-wise Distribution of 100% Export Oriented Units (EOUs)

(August 1991-November 1998)

State/UT	No.	Percent[1]	Investment *(Rs. Mn)*	Percent[1]	Employment *(Numbers)*	Percent[1]
Andhra Pradesh	391	11.16	93160	14.53	63955	10.76
Karnataka	358	10.22	34440	5.37	66403	11.18
Maharashtra	509	14.53	64880	10.12	78463	13.21
Haryana	204	5.82	19580	3.05	30795	5.18
Orissa	40	1.14	81370	12.69	18907	3.18
West Bengal	96	2.74	28330	4.42	15749	2.65
Bihar	6	0.17	220	0.03	351	0.06
Kerala	66	1.88	8910	1.39	9217	1.55
Madhya Pradesh	129	3.68	49730	7.76	39483	6.65
Uttar Pradesh	196	5.6	19870	3.1	27902	4.7
Total	**3281**		**608950**		**558992**	

Source: Secretariat for Industrial Assistance (SIA) Newsletter, December 1998, Minister of Industry, GOI, constructed by Sachs and Bajpai (various years)

Notes: 1: Percentage shown is proportionate to all of India

Some of the social indicators for which state-wise data is available also indicate that our group of reform leading states are relatively better placed than the other states. Of course, Kerala is an exception with highest life expectancy at birth, and the lowest birth rate, death rate, infant mortality rate and the total fertility rate among all the Indian states (Table 6.5).

Table 6.5

State-wise Performance of Health Indicators

State/UT	Death Rate		Total Fertility Rate		Infant Mortality Rate		Birth Rate	
	1991	*1997*	*1991*	*1994*	*1991*	*1997*	*1991*	*1997*
Andhra Pradesh	9.7	8.3	3.0	2.7	73	63	26.0	22.5
Karnataka	9.0	7.6	3.1	2.8	77	53	26.9	22.7
Maharashtra	8.2	7.3	3.0	2.9	60	47	26.2	23.1
Haryana	8.2	8.0	4.0	3.7	68	68	33.1	28.3

Orissa	12.8	10.9	3.3	3.3	124	96	28.8	26.5
West Bengal	8.3	7.7	3.2	3.0	71	55	27.0	22.7
Bihar	9.8	10.0	4.4	4.6	69	71	30.7	31.7
Kerala	6.0	6.2	1.8	1.7	16	12	18.3	17.9
Madhya Pradesh	13.8	11.0	4.6	4.2	117	94	35.8	31.9
Uttar Pradesh	11.3	10.3	5.1	5.1	97	85	35.7	33.5

Sources: SRS Fertility an Mortality Indicators 1991, Office of the Registrar General, India Vital Statistics Division Ministry of Home Affairs, New Delhi; SRS Bulletin Oct 98 at http://www.censusindia.net

On the other hand, states, such as Bihar, Orissa, Madhya Pradesh, and Uttar Pradesh have high infant mortality rates, and life expectancy that is below the national average. Literacy indicators too depict a similar trend among the states with Kerala once again ahead of them all as shown in Table 6.6.

Table 6.6

State-Wise Social Indicators

State/UT	**Literacy Rate**		**Teacher/Pupil Ratio 1994-95** *(Primary Schools)*	**Percentage Children 6-14 Attending School** *(1992-93)*	**Drop-Out Rates Classes I-V Primary Stage (Percent)** *(1993-94)*
	Females (1991)	*Males (1991)*			
Andhra Pradesh	32.7	55.1	50	63.3	42.2
Karnataka	44.3	67.3	48	70.5	40.8
Maharashtra	52.3	76.6	38	81.5	27.6
Haryana	40.5	69.1	46	81.3	3.9
Orissa	34.7	63.1	35	79.6	52.5
West Bengal	46.6	67.8	57	67.7	40.4
Bihar	38.5	52.5	55	51.3	63.4
Kerala	86.2	93.6	30	94.8	-4.2
Madhya Pradesh	28.9	58.4	44	62.3	28.4
Uttar Pradesh	25.3	55.7	59	61.3	19.9

*Sources:*Census of India (1991), International Institute for Population Sciences (1995)

Table 6.7 shows the year by which the total fertility rate in the different states is likely to come down to 2.1 percent, that is, the replacement level. Assuming there is no change in the trend decline in total fertility rate observed during 1981-93, the projected year by which replacement level TFR (2.1) will be reached in different states is shown in this table. While Kerala and Tamil Nadu have already reached replacement level TFR, only seven states are expected to attain that status by 2025. These are Andhra Pradesh, Assam, Gujarat, Haryana, Karnataka, Maharashtra, Orissa, and West Bengal. The TFR is expected to be much above the replacement level well beyond 2025 in Bihar, Madhya Pradesh, Rajasthan, and Uttar Pradesh.

Table 6.7

Demographic Indicators of Major Indian States: Status and Projection

State/UT	Population As Per 1991 Census	Annual Compound Rate Of Growth Of Population *(In Millions)* *(1981-91)*	Year By Which Total Fertility Rate Comes Down To 2.1 – The Replacement Level
Andhra Pradesh	66.5	2.17	2002
Karnataka	45	1.92	2009
Maharashtra	78.9	2.29	2008
Haryana	16.5	2.42	2025
Orissa	31.7	1.83	2010
West Bengal	68.1	2.21	2009
Bihar	86.4	2.11	2039
Kerala	29.1	1.34 *	1988
Madhya Pradesh	66.2	2.38	Beyond 2060
Uttar Pradesh	139.1	2.27	Beyond 2100
All India	**846.3**	**2.14**	**2026**

Sources : Population and Growth Rates: 1991 Census Hand Book; Population Projections for India and States 1996-2001; cited in Kurian (1998) *Regional Disparities in India (mimeo)* .

Notes : (*) Kerala and Tamil Nadu have already achieved the TFR of 2.1.

Similarly, another set of projections to show the decades required to attain universal literacy are shown in Table 6.8. Data from the 1991 Census showed that in order to achieve universal literacy Kerala would require 1.2 decades, Madhya Pradesh 5.6 decades, Uttar Pradesh 7.1 decades, and Bihar 9.7 decades. Universal female literacy, according to Census projections, would be attained in Kerala in 1.3 decades, but it would take 7.3 decades for Madhya Pradesh, 9.2 for Uttar Pradesh, and 12.1 decades for Bihar.

Table 6.8

Decades Required To Attain Universal Literacy

States	Projection (1991)		
	Persons	Male	Female
Andhra Pradesh	6.6	5.4	7.9
Karnataka	4.5	3.8	4.9
Maharashtra	3.9	3.4	4.2
Haryana	3.7	2.9	4.4
Orissa	6.3	5.6	6.9
West Bengal	4.7	4.1	5.1
Bihar	9.7	8.1	12.1
Kerala	1.2	1.1	1.3
Madhya Pradesh	5.6	4.2	7.3
Uttar Pradesh	7.1	5.3	9.2
All India	*5.6*	*4.6*	*6.5*

Source: 1991 India Census cited in Reflection Paper on Diversities and Disparities in Human Development ; United Nations Development Programme; New Delhi

6.2 SOME MORE DETAILED STATE ANALYSES

The following analysis owes much to the very detailed analysis contained in several papers by Sachs and Bajpai (various years) paper on reform oriented states in India. Among the **reform-oriented** states, we talk briefly about Andhra Pradesh, Karnataka and Maharashtra.

The **Andhra Pradesh** government has taken important measures to improve public finances and sector policies. In particular, it has increased the cost of subsidised rice from Rs. 2 to Rs. 3.5 per kg, and reduced per-family allocations by 25 percent. It has also raised power tariffs by 20-60 percent to non-agricultural consumers, and by 10-25 percent in the case of agricultural tariffs. Subsequently, facing strong opposition to these measures the government had to reduce these tariff levels by about 40 percent. While this was a significant reform initiative, the revised average tariffs for farmers still covers only 9 percent of production costs.

Other measures include tax increases; the first steps toward the reform of the power sector and significant increases in irrigation charges along with important institutional reforms, such as the creation of a Water User Associations and the devolution of operation and maintenance to them. Additional measures being implemented include containment of the wage bill, further reduction of food subsidies, relaxation of prohibition, privatisation of state-owned enterprises (SoEs), further adjustments of water and power rates, and other revenue enhancement efforts.

The key fiscal objective is to achieve fiscal sustainability through a change in the composition of public expenditure. That is, a significant reduction of rice subsidies and employment in the state government and a corresponding increase in expenditure in social and infrastructure sectors particularly in primary education and health, nutrition, irrigation and road sectors. Fiscal reforms are being accompanied by significant changes in sector policies—restructuring of the power sector; improvement of service delivery in primary education, primary health and nutrition; strengthening of operating and management in roads and irrigation sectors, and acceleration of users participation in the management of public canal irrigation network. If successfully implemented the reform program would put Andhra Pradesh on a path of faster economic growth and social development. Several of the above mentioned initiatives of the state government are being supported by the World Bank, which has approved a loan to the state government for policy reform at the state-level.

The **Karnataka** government has been pursuing a progressive industrial policy and provides an attractive package of incentives and concessions. The Industrial Policy--incentive package was formulated keeping in view the liberalisation of industrial and trade policy initiated by the government of India in July 1991. Karnataka's liberal industrial policy has been in operation for several years now and has attracted substantial investment flows in the industrial sector.

Industrial projects with large investments are under implementation in different locations. The government is focusing on upgrading of the industrial infrastructure in these locations. Improvement of transport and communication links, water and power supply, effluent treatment, and development of human resources are some of the key areas of the state government's focus.

Private sector initiative for development of infrastructure in areas like power generation, express highways, industrial parks and townships, airports and ports is being encouraged to build good infrastructure. The government is working towards evolving a suitable policy to improve investment in these sectors. Due to accelerated industrial development, demand pressures on key resources viz. land, power and water have increased tremendously, and therefore the government is formulating a pragmatic policy for conservation and optimum utilisation of these resources.

Karnataka has been termed as the ideal location for high technology industries, particularly in the fields of electronics, telecommunications and informatics sectors. The government's effort currently is to maintain its pre-eminent position in these sectors. The state government plans to further consolidate this resource and towards this end upgrade the skills of, and training in technical institutions. The involvement of the private sector in this important activity is being strongly encouraged by the government.

Development of entrepreneurship among the local population in particular, in rural areas and among disadvantaged groups, viz. weaker sections of the society, including women is being strengthened. Since investment by the industry in research and development, quality upgradation, improvements in productivity etc. is far from adequate, the government is encouraging investments in these activities. The state is focusing towards increasing export of value-added goods and services. Presently, the share of the state in exports from the country is around 4 % and state is undertaking measures to increase its exports substantially. To achieve this, efforts towards improvements in productivity, research and development and quality upgradation are being encouraged by the private sector.

In order to maximise the potential of, and the entrepreneurial spirit prevailing in the state of **Maharashtra**, the government launched the New Industry, Trade and

Commerce Policy, 1995. The guiding principles behind this policy are the integration of different sectoral development schemes into a cohesive plan for overall development and the evolution of a common and transparent framework of governance. The Government has recognised that for any large developmental activity to succeed, participation of the private sector is imperative. It is only through private initiative that the necessary financial and technical resources necessary for large-scale developmental activity can be mobilised. The new policy has therefore sought to accentuate the role of the private sector in development and a shift in the government's role to provide full support to private sector initiatives.

The state government is undertaking numerous measures for the empowerment of the people at all levels. The traditional approach of dependency and centralisation of authority is sought to be replaced by dynamic empowerment inherent in such an approach. The government through this policy has made an attempt to realign its role from that of a controller to a facilitator in the process of all-round development. The policy explicitly states the intent to bring about a change in the mindset of people of Maharashtra so that they are not content merely with the current level of employment and entrepreneurship but extend these to new levels to meet the development needs of the State.

Since the process of liberalisation began in July 1991, India has witnessed a steady flow of foreign direct investment and Maharashtra has been a significant beneficiary of this process. Of the total foreign direct investment proposals, amounting to Rs. 1291.35 billion cleared between August 1991 and August 1997, Maharashtra has attracted Rs. 155.98 billion. This represents a 12.07 per cent share of the total foreign direct investment in India. In terms of total domestic industrial investment, Maharashtra remains in the forefront. Between August 1991 and October 1997, the estimated domestic investment was Rs. 7292.12 billion of which Rs. 1692.1 billion or 23.20 per cent was in Maharashtra. Indeed, Maharashtra continues to remain a favoured destination among both foreign as well as domestic investors.

Haryana, Orissa, and West Bengal are in the **intermediate reformer** category. While these states have not undertaken wide-ranging reforms, however, they have implemented a series of reform measures that have separated them from the others.

Power sector reform, for example, is an area where Haryana and Orissa have undertaken numerous steps.

In June 1997, the **Haryana** state assembly approved the Haryana Electricity Reform Bill that lays down the legal basis to establish an independent regulatory commission and to unbundled The Haryana State Electricity Board (HSEB) into a generating company, a transmission company and a number of distribution companies. It is expected that the distribution network will be fully privatised by 2002. These measures will also be accompanied by tariff adjustments, comprehensive financial restructuring, and the implementation of a large investment program (about US$ 1.8 billion spread over ten years) that includes transmission and distribution rehabilitation and expansion, generation plant modernisation, demand side management and end-use energy efficiency improvement. The World Bank has agreed to support Haryana's efforts to the extent of US$ 600 million over a period of eight to ten years, through a series of Adaptable Program Loans (APL), an new lending instrument approved in September 1997.

Haryana's power sector reform program involves the following: First, the unbundling and structural separation of generation, transmission, and distribution into separate services to be provided by separate companies. Second, the incorporation of the new companies under the Companies Act. Third, privatisation of the distribution system. Fourth, private sector participation in generation and transmission utilities. Fifth, competitive bidding for new generation. Sixth, the development of an autonomous power sector regulatory agency. Seventh, supply and end-use efficiency improvements and enhanced environmental protection. Finally, reforming the electricity tariffs at the bulk power, transmission, and retail levels.

Additionally as part of the reform process, the state government has invited bids from private promoters – domestic and foreign – to set up small hydro-electrical power projects in the state. The state announced incentives for these producers that include exemption from electricity duty, sales tax exemption for plant and machinery purchased for the project and a Rs 2.25 per unit sale price to the HSEB with a five per cent annual escalation rate. The Haryana State Energy Development Agency (HSEDA) has also come up with incentives for power projects based on non-conventional energy sources.

The Haryana government is promoting private investment to harness non-conventional energy sources for generating electricity. The state government has identified biomass, waste recycling, mini hydel plants, wind and solar powered plants as approved power sources.

In 1992-93, the average tariff for agriculture was 25.5 paise/kWh. It has been raised over the years and was placed at 50.0 paise/kWh in 1997-98. In the Industrial sector, the average power tariff for 1992-93 was 171 paise/kWh and has been raised to 319.0 paise/kWh in 1997-98. Refer to Tables 10 and 11 for agricultural and industrial tariffs respectively.

Orissa has been the leader in power sector reforms at the state-level in India. The State government enacted an amendment to India's national electricity acts of 1910 and 1948: the Orissa Electricity Reform Act, which became effective on April 1, 1996. Subsequently the state government established the Orissa Electricity Regulatory Commission, India's first state-level regulatory commission in the power sector. The commission announced its first tariff decision and issued its licenses to the transmission and distribution company (GRIDCO) in March 1997.

The Commission's Tariff Order *inter alia* authorises GRIDCO to adjust its tariffs effective from April 1, 1997. The Commission restructured residential and agricultural tariffs so as to contain cross-subsidisation.

Keeping in view the policy of the central government to attract private entrepreneurs, Orissa State has worked out an innovative policy to provide basic infrastructure projects including the buying of land through the Orissa Power Generating Corporation. The state's chronic power deficit is being tackled by nine hydro projects with a total generating capacity of more than 7,000 MW.

The Orissa reform legislation contains several reform features. These are: First, restructuring - The former Orissa State Electricity Board (OSEB) has been corporatised and is designed to be managed on commercial principles in its new form GRIDCO. While the newly formed GRIDCO has been put in charge of transmission and distribution, the hydro power- generating stations owned by the government has been taken over by the Orissa Hydro Power Corporation (OHPC). Second, unbundling - The reform structure has incorporated principles of functional unbundling with regard to generation, transmission and distribution to be managed by separate corporations/companies. Privatisation - The Orissa Energy Reform (OER) Act, 1995 aims at fostering private participation in generation and gradual privatisation of transmission and distribution. Third, regulatory commission - An important component is establishment of the Orissa Electricity Regulatory Commission for ensuring achievement of objectives given in the Orissa Electricity Reform Act, 1995. Fourth, licensing - Government ownership and direct control has given way to a licensing system in respect of transmission and distribution activities. Finally, tariff - determining tariff, which would ensure commercial rate of return for investment in the electricity industry while protecting rights of all categories of consumers with respect to cost, efficiency and quality of service.

The power tariff on agriculture in 1992-93 was 30.9 paise/kWh. In 1993-94 it was dropped to 21.2 paise/kWh. The subsequent year, 1994-95, the power tariff on agriculture rose to 53.1 paise/kWh and was raised to 55.0 paise/kWh in 1996-97. The average tariff for industry has also been increased. The 1992-93 tariff stood at 89.1 paise/kWh and was raised to 220.3 paise/kWh in 1996-97

Economic reforms, and labour policy reforms in particular, at the state-level, have a substantial unfinished agenda. While a handful of the states have demonstrated their commitment by implementing reforms in certain sectors of the state economy, a majority of them have still to initiate any significant policy changes. Of course, even the reform-oriented states have succeeded to varying degrees in taking on reforms in areas, such as labour market reform, fiscal reform in general and reduction of revenue deficits in particular, state-owned enterprise reform, and SEB reform, except in Haryana, and Orissa. The state governments have continued with several subsidy schemes in various sectors irrespective of whether or not the subsidies are reaching whom they are meant for. While Haryana and Orissa have undertaken some hard reform measures in the power sector, however, they have not initiated any major policy reform in other sectors of the economy.

Bihar, Madhya Pradesh, Rajasthan and Uttar Pradesh are in desperate need of reform. All of are land locked states thereby reducing their growth potential considerably. By contrast, all our reform-oriented states are coastal states, and hence can develop as major platforms for labour-intensive manufacturing exports. Statistics bear testimony to the fact that state capability to make economic decisions varies across state boundaries.

6.3 WHAT EXPLAINS THE VARIATION?

What factors help to explain differences in economic policy choices among these state-level democratic governments? Scholars studying differences in initiating and consolidating economic reform offer several explanations. Some focus on the benefits of an autonomous state that can shield itself from interest groups opposed, at least in the short term, to market-oriented reforms. Haggard and Kaufman (1995) distinguish between the initiation and consolidation of market-oriented reform. For successful initiation of reform, they contend that centralised executive authority is important for overcoming political stalemates, selecting and backing a cohesive policy-making team, and overriding bureaucratic and political opposition to policy initiatives. The consolidation of reform, by contrast, rests on reducing the executive's power through the evolution of checks on executive discretion. Haggard and Kaufman also assert that political parties are needed in the consolidation phase to organise the bases of support to form a new coalition of beneficiaries.

Like Haggard and Kaufman (1995), Mainwaring and Shugart (1997) also stress the importance of centralised executive authority, but their work includes a critical role for the executive's party to dominate the legislature. The interaction between a powerful executive and his/her party's majority hold in the legislature lifts potential roadblocks to the passage of unpopular reforms. Williamson (1994) also emphasises autonomy for the initiation of market-oriented reforms, but autonomy for the policy makers and not the executive. Williamson claims that bureaucrats and technocrats are necessary for initiating and sustaining market-oriented reforms. A coherent team of policy-makers embodying the common core of wisdom associated with the "Washington consensus" is vital for insulating themselves from groups often harmed by neoliberal policies.

Unlike backers of autonomous state arguments, Hellman (1998) contends that it is not short-term losers of reform that hinder the initiation of full-scale market oriented policies and precipitate calls for an insulated state. In fact, it is the political "winners" those actors that gain from partial implementation of reforms - who hamper furthering the reform process. Early winners of partial reforms including commercial bankers who obtain arbitrage opportunities in distorted financial markets and local officials who collect monopoly rents by restricting market entry into their regions are the main losers if the reform process expanded. These winners lobby government officials against more extensive reform. Others contend that the magnitude of the economic crisis contributes to policy reform. Grindle and Thomas (1991) endorse the crisis hypothesis, which suggests that economic crisis leads to the adoption of more drastic economic measures including neoliberal reforms.

This chapter tests the applicability of these arguments to the above ten state governments in India, from 1985-1997 to explain why these states differ in their degree of market openness. These states make for useful comparisons. Since the 1980s, they have varied widely in their ability to initiate and sustain market reforms despite the fact that most of their policy makers and governmental leaders have pledged their support for more orthodox reforms.

Using a Time-Series Cross-Sectional (TSCS) data set, this study constructs a model of policy choice for the ten states. It includes a number of variables that represent political and economic constraints on policy choice. The findings suggest that a centralised executive and a highly polarised party system are important for initiating and sustaining more orthodox policies. A centralised executive provides leaders with opportunities to install their preferred policies. The degree of polarisation affects the executive's policy preferences toward orthodox policies. A highly polarised system may encourage executives to use the appointment of bureaucrats, who favour neoliberal policies, as a strategy to bolster their political survival.

6.4 THE POLITICS OF ECONOMIC REFORM

Since the 1980s most states in India have initiated elements of market-oriented neoliberal reforms. The policy of inward-oriented economic development based on import-substitution industrialisation (ISI) that India had adopted in the 1950s - 1980s produced severe economic problems. These problems included balance of trade and payment deficits and capital scarcities. Despite the abandonment of ISI policies by India since the late 1980s, there are differences in the policy choices made at the state-level by the different state governments.

Some states initiated more extensive (or orthodox) market-oriented reforms including privatisation of state assets, price liberalisation, eliminating inefficient industrial promotion programs, and instituting tax reforms. However, others initiated only partial reforms and continue to support protectionist policies that benefit a select few at the expense of many. This leads to the question of why these states differ in their economic policy choices, especially when most policy makers and governmental leaders in India (even Communist-ruled West Bengal) claim to endorse orthodox reforms?

There are several possible explanations for differences in economic policy choice. Many scholars focus on the importance of state autonomy and insulation for initiating more orthodox reforms. The basis for an insulated state relies on political survival strategies along with collective action issues. In much of the literature, it is assumed that under democratic rule, most leaders want to survive in office. Not to deny that they may have additional interests, but the prime interest of leaders focuses on their attempts to maximise career goals, with re-election representing an important element for fulfilling those ambitions. Leaders are aware that elections occur frequently and they need to institute policies that in the short term bring about better economic results if they plan to retain their governmental positions.

The initiating and sustaining of unpopular orthodox reforms, so the story goes, is considered politically suicidal for survival-minded leaders. Orthodox reforms that attempt to eliminate market imperfections and promote greater efficiency generate high short term costs and provide rewards mainly in the long term.

These costs come in the form of price hikes (as price controls are lifted and subsidies cut), high unemployment, and production decreases as industries based on a closed-market economy disappear and firms geared to a competitive economy are created. Those individuals who are likely to be sacked or to lose special perks because of market opening usually form a relatively small and concentrated group, and thus are better able to organise against reforms (and resolve a collective action problem) compared to more dispersed winners of reform.

As Haggard and Kaufman (1995, 9) state, "At the onset of reform, potential beneficiaries face high uncertainty about future payoffs and substantial barriers to collective action. Those who have gained from past policies, on the other hand, are certain about their preferences, feel the pain of adjustment immediately, and have typically overcome collective action problems."

For political leaders to ignore the complaints of this concentrated group, so the story goes, measures are needed to insulate political leaders and possibly their policy makers from pluralist interests. Haggard and Kaufman (1995) contend that the successful initiation of orthodox reforms depends on centralised executive authority. Under centralised authority, the executive is able to use special constitutional provisions and emergency powers to bypass pluralist pressures usually hurt by extensive reforms. However, according to Haggard and Kaufman, the consolidation of such reforms rests on conditions quite different from policy initiation. Stable bases of social support, coming mainly from political parties, are needed in order to consolidate these reforms.

Haggard and Kaufman claim that the degree of fragmentation and polarisation in the political parties explains the government's ability to sustain the reforms. Fragmented and highly polarised party systems make it difficult to forge stable electoral, legislative, and bureaucratic majorities that are necessary for consolidating reforms. It is in cohesive party systems that the reforms are more likely to be sustained. Similarly, Shugart and Mainwaring (1997) argue that a "strong" executive is important for getting an agenda enacted including initiating orthodox reforms. Strong constitutional powers inherent in the office of the presidency make it possible for the preferences of executives to be taken seriously in the passage of legislation.

However, unlike Haggard and Kaufman they also emphasise that executives need to have control over their own party and for that party to hold a majority of seats in the legislature during the initiation phase. The combination of a strong executive and the executive party's dominance in the legislature removes obstacles to initiating and consolidating reforms. Ultimately, they come down on the side of Haggard and Kaufman by claiming that the number of political parties (i.e., if it is a fragmented party system) makes a fundamental difference in whether market reforms are implemented.

Like state autonomy advocates, Williamson (1994) also stresses insulation for initiating and sustaining economic reforms. However, he focuses on the background of policy makers and how their commonly held beliefs insulate them from groups opposed to market reforms. Unlike the more institutionalist approaches, Williamson argues that a large contingent of bureaucrats and economists trained in ideas commonly associated with the "Washington consensus" enables policy makers to shield themselves from groups opposed to market opening. Building on Pinera's work on Chile (1991, cited in Williamson 1994), Williamson claims that the coherence of economic ideas held by the policy-making team is crucial for policy reforms.

Alternatively, Hellman (1998) presents evidence from the post communist states to show the limitations of state autonomy arguments. In fact, he argues that the most orthodox reforms in the region have been initiated and sustained in the most competitive political systems, where politicians are most vulnerable to electoral backlash by the short-term losers. Moreover, the main obstacles to reform have not come from the traditional short-term losers of economic restructuring - the unemployed, former state bureaucrats, and others - but rather from the "winners" of partial reform:

> *"from enterprise insiders who have become new owners only to strip their firms' assets; from commercial financiers who have opposed macroeconomic stabilisation to preserve their enormously profitable arbitrage opportunities in distorted financial markets; from local officials who have prevented market entry into their regions to protect their share of local monopoly rents; and from the so-called "Mafiosi" who have undermined the creation the creation of a stable legal foundation for the market economy*" (Hellman 1998, 204).

The winners block or stall more orthodox reform because it threatens to eliminate their special gains.

Unlike the others whose arguments rely on political criteria, Grindle and Thomas (1991) adopt a crisis hypothesis based on economic conditions to explain policy variation. They argue that whether a reform initiative is considered under conditions of perceived crisis is important. If elites perceive a crisis and market reform as a response to that crisis, it is likely that pressures will build to institute orthodox policy change. By contrast, if there is no perception of a crisis, change is more likely to be incremental. Crises apparently shock states out of traditional policy choices that are deemed to have failed and generate demand for reform.

Do empirical data substantiate the claim that state autonomy is important for initiating and consolidating of market-oriented reform? Or, is it the political winners of partial reform or economic crisis that explains differences in policy choice among the Indian states? A rigorous test of these hypotheses is necessary to understand why some states are able to implement their policy preferences while others continue to fall short of their policy goals.

6.5 RESEARCH DESIGN AND MODEL SPECIFICATION

This study examines annual data on policy choice for ten states in India between 1985 and 1997. The analysis includes all the cases for which data are available (which are a sub-set of the 24 states studied in the previous chapter), and these represent a good cross-section within the region. The data is comprehensive for a part of the world in which collecting reliable information is a difficult task.

The data form a time-series cross-sectional (TSCS) data set that includes multiple observations for each state in the sample. Because of the nature of TSCS data, issues related to autocorrelation and heteroskedasticity are a concern. Using OLS estimates of the standard errors in a TSCS setting is problematic because these estimates may be misleading as a result of panel heteroskedasticity or spatial correlation of the errors. There are different ways of dealing with these problems. Beck and Katz (1996), for instance, recommend using OLS with panel corrected standard errors (PCSE) once serial correlation is removed. Their solution to handling serial correlation is to include a lagged dependent variable on the right-hand side of the equation that permits an explicit evaluation of the long-term relationship between the variables. However, including a lagged dependent variable on the right-hand side involves costs. As Achen (2000, 6) points out, "The lagged dependent variable does bias the substantive coefficients toward negligible values and does artificially inflate the effect of the lagged dependent variable."

He suggests that unless there is a good theoretical reason for including a lagged dependent variable, it should not be used. Given the downside of using the lagged dependent model, it is not the most appropriate way to control for autocorrelation. Alternatively, autocorrelation can be addressed using the AR(1) correction common in most statistical packages. We will compare results using the AR(1) correction and without controlling for autocorrelation in this study. After testing for autocorrelation, OLS is then used to calculate the coefficients and PCSE is used to estimate their significance. The regression model is given below.

Economic Policy Choice = al + b 1 (Centralisation) + b2 (Legislative Dominance) +b3 (Fragmentation) + b4 (Polarisation) + bs (% of trained bureaucrats) + b6 (Inflation logged).

As we will discuss in detail in the following sections, economic policy choice refers to the degree of orthodoxy of economic policies initiated by governments. Centralisation examines executive authority in policy making. Legislative dominance indicates the executive party's majority hold in the legislature. Fragmentation refers to the number of "effective" political parties while polarisation corresponds to the share of the vote received by leftist parties. The percent of trained bureaucrats calculates the proportion of economic policy makers who hold advanced economic degrees. Inflation (logged) assesses the effect of inflation on policy choice.

6.5.1 Dependent Variable

Variation in economic policy choices suggests that it is necessary to design a measure to differentiate policy intensity of market-oriented programs. Six factors are commonly associated with market reforms: 1) state deficit stabilisation; 2) state excise and subsidy reform; 3) labour market reform; 4) privatisation; 5) price liberalisation; and 6) reduction in industrial promotion programs. The Indian cases are compared using a scale of 0-2 for each factor. If a state earns a 2 for any category, it is extensively reforming that element of the economy. By the same token, if the state receives a 0, it is not reforming that part at all. States that receive scores between 1/2 and 1 1/2 in any category are generally adopting a more gradualist approach to policy reform.

The scoring measurements are based on the CMIE's quarterly State Profiles and State Reports. These sources provide detailed descriptions of the policies chosen by each state in a given year. That does not suggest that computing the scores for these states is an exact science. However, given that these sources are specifically interested in the degree of market openness, this makes them useful guides for designing measuring to differentiate economic policy choices. A summary of the degree of orthodoxy is provided for each state in the sample in Table 6.9.

Table 6.9
Summary Statistics of Degree of Orthodoxy in India, 1985-1997

State	Mean	Median	Std. Dev.	Minimum	Maximum
Madhya Pradesh	8.81	12	3.78	4	12
Maharashtra	9.58	9.5	0.607	9	10.5
Bihar	5.23	5.5	2.27	1	7.5
Andhra Pradesh	11.5	11.5	0	11.5	11.5
West Bengal	7.5	7	1.76	5.5	9.5
Uttar Pradesh	4.65	4.5	1.05	3.5	6
Karnataka	9.54	10.5	2.5	5	11.5
Haryana	7.12	10	4.53	1.5	11.5
Orissa	6.27	7.5	2.31	3.5	8.5
Kerala	4.92	5.5	2.54	1.5	8

Sources: CMIE: State Profiles and State Reports

6.5.2 Independent Variables

Indian states have chosen a wide variety of economic policies from 1985 to 1997. This chapter has already presented several hypotheses to explain these differences. This section specifies the data that is used to test the alternative explanations.

Centralised executive authority, a key aspect of Haggard and Kaufman's explanation for the initiation of market reforms and part of Mainwaring and Shugart's model, is measured using many factors that are adopted by Shugart and Carey (1992, ch. 8). In defining a strong executive, Shugart and Carey incorporate factors such as the veto and decree powers of the executive, and the leader's capacity to form and dismiss cabinets.

There are variations in the decree and veto powers and the ability to dismiss cabinet members that present some executives with more power than others. For instance, if the Chief Minister is able to control legislation without the possibility of an assembly revolt, certainly the executive is strong in that category. Moreover, decree powers refer to the "authority to make new laws or suspend old ones without the power of decree first having been delegated through enabling legislation" (Shugart and Carey 1992, 151). In essence, for centralised executive authority, the highest decree powers are reserved for the executive when rescission by the legislature is ineffective. This happens particularly when the Governor is a political appointee of the CM. Finally, if the process of cabinet formation depends entirely on the Chief Minister's choices without any need for confirmation of appointees by the assembly, the executive is strong in that category.

Another factor that is important for gauging the power of the executive is whether the electoral system operates in such a way that it nearly guarantees that the winning Chief Minister will have received a majority of the votes cast without taking recourse to coalition-formation (suggesting a popular mandate). If an electoral system clearly defines a winner with a majority of the vote, this will strengthen the power of the executive relative to a system that fosters no one person holding a popular mandate.

Using these four categories, we design a scale to measure the strength of the executive using 0-2 points for each category. 0 implies that the Chief Minister is weak for that particular category, while a 2 equals a strong Chief Minister. We take inspiration from values are based on measures from Mainwaring and Shugart (1997, 49) and Jaggers and Gurr's (1995) Polity III data set. Mainwaring and Shugart provide insights for decree and veto powers in Latin America. Jaggers and Gurr's data set, which provides information for countries world-wide, offers three measures that are useful for determining the degree of centralised executive authority. First, they use a variable called monocratism to define the institutional (*de jure*) independence of the executive. Second, they use the level of external constraints to assess the operational (*de facto*) independence of the executive. And third, they measure the centralisation of state authority based on the geographic concentration of decision-malting authority. We modify it for the Indian state-level scenario.

Polarisation and fragmentation, part of the hypotheses developed by Haggard and Kaufman and Mainwaring and Shugart is measured using formulas devised by the authors. By fragmentation, the authors are concerned about the effective number of parties competing for votes. It is assumed that more political parties create impediments to the co-ordination required to initiate and sustain policy reforms. Party fragmentation "compounds the chances that executives will become politically isolated and powerless to pursue their agenda" (Haggard and Kaufman 1995, 170). To measure party fragmentation (i.e., the effective number of parties), Haggard and Kaufman calculate the inverse sum of squares of the vote or seat going to each party. We use the inverse sum of squares for the parliamentary elections between 1985-1997 to assess the degree of fragmentation for the Indian cases.

By polarisation, we are interested in the ideological distance among parties. It is assumed that the greater the party polarisation, the more difficult it is to sustain orthodox policies. The authors recommend looking at the "presence of left and populist parties that have historically mobilised followers around anti-capitalist or antioligarchic protests" (Haggard and Kaufman 1995, 167). Haggard and Kaufman classify which parties are leftist and compare the percentage of the vote won in the national elections for their cases. Thus, the higher the proportion of the vote won by the left, the more polarised the political system is, and the greater the likelihood that orthodox policies will not be sustained. For the sake of consistency, we will compare the vote won by the left in the parliamentary elections between 1985-1997.

To measure the effect of the executive party's holding a majority of seats in the legislature, a scale of 0-1 is designed inspired by data from *The Political Handbook of the World* (various years), Mainwaring and Scully (1995), and Mainwaring and Shugart (1997). A score of 0 indicates that the executive's party does not hold a majority of seats in either house of parliament. A score of 1/2 means that the executive's party possesses a majority in one house. A score of 1 indicates that the party holds a majority in both houses.

The effect of bureaucrats on policy making is often mentioned as a possible explanation for differences in economic policy choices, but it is rarely evaluated in a systematic way. The governmental officials who generally make economic policy decisions are from the Ministry of Planning, the Ministry of Finance, the Ministry of Industry, and the Ministry of Agriculture. We examine the background of the secretaries and joint secretaries within these respective departments to determine the proportion of Indian Administrative Service (IAS) officers in these ministries, as opposed to State Civil Service officials, who are traditionally more controlled by the local state politicians. The main source for the names of the secretaries and joint secretaries are the Civil Lists of the sample states. The State Public Service Commissions' list of officer's supplements the names of policy makers.

To assess the crisis hypothesis, the best proxy of crisis is the rate of inflation and the size of the state deficit. If a state is experiencing severe inflationary pressures, it is likely that the government is in crisis. The rate of inflation (logged) is obtained from the Reserve Bank of India (RBI) financial Statistics. The RBI uses the Consumer Price Index - the most frequently used indicator of inflation -, which is weighted. So that linear methods of estimation can be applied to the data, We use a logarithmic transformation of the rate of inflation. A summary of inflation data and the above variables is provided for each state in the sample in Table 6.10.

Table 6.10

Summary Statistics of the Averages of the Independent Variables, 1985-1997

State	Degree of Orthodoxy	Centralisation	Legislative Dominance	Polarisation	Fragmentation	% IAS Officers
Madhya Pradesh	8.81	7.5	0.85	0.47	2.6	0.68
Maharashtra	9.58	3	0.35	0.29	4.24	0.66
Bihar	5.23	4.5	0.38	0.21	6.21	0.53

Andhra Pradesh	11.5	8	0.75	0.27	2.44	0.82
West Bengal	7.5	8	1	0.05	2.66	0.73
Uttar Pradesh	4.65	2.5	0	0.25	5.60	0.66
Karnataka	9.54	8	1	0.13	2.52	0.88
Haryana	7.12	3.5	0.77	0.14	2.81	0.48
Orissa	6.27	1.5	0	0.28	3.17	0.27
Kerala	4.92	3.5	0.60	0.14	3.22	0.35

To test fully the political winners' argument, it is necessary to have annual data on the Gini coefficient - one of the standard measures for inequality - and changes in the income share for at least a segment of the population. Unfortunately, annual inequality data is not available for the Indian states from 1985-1997 from government sources. As a result, this hypothesis cannot be tested in the regression model. However, using methods similar to Datt and Ravallion (1998), we are able to evaluate it. A key prediction of the political winners' approach is that states that have sustained partial reforms should "exhibit a greater concentration of gains to the winners and a higher level of transitional costs than those states that have pursued more comprehensive reforms". (Hellman, 1998, 223).

To test his approach, Hellman uses a scale designed by the European Bank for Reconstruction and Development that compares the comprehensiveness of reforms on nine dimensions. Based on the level of comprehensiveness, he then groups the states into four categories from advanced to slow reform, with high intermediate and low intermediate in between the extremes. It is expected that income inequality and concentration of gains is highest for the partial reform groups (i.e., the high and low intermediate groups).

We test the political winners' approach by using our six-dimension model of reform comprehensiveness. We then compare the change in the Gini coefficients from 1989-90 to 1993-94 and change in income share of the top 10% as a multiple of the poorest 40% in 1989-94 (see Table 6.11). Because all the cases at least attempted partial reform between 1989-94, none are categorised in the slow reform group.

Our results suggest that partial reform groups do not experience higher inequality than the comprehensive reformers. Gini coefficients for the low intermediate group (0·45) are not much different than for the advanced reformers (0·41). The change in ?
income share of the top 10% as a multiple of poorest 40% for the low intermediate reformers (-2.95%) is actually slightly lower than for the advanced reformers (-1.86). The higher intermediate group is barely higher in terms of inequality. However, if West Bengal is removed from the sample, the higher intermediate group supports greater income equality than the others.

Table 6.11

Economic Reform and Inequality

State	Gini Coefficient 1989-1990	Gini Coefficient 1993-1994	% change In Gini 1989-94	Change in Income Share Top 10% as a multiple of poorest 40% 1989-94
ADVANCED				
Madhya Pradesh	0.423	0.438	0.035461	0.043011
Andhra Pradesh	0.47	0.473	0.004246	0
Karnataka	0.345	0.33	-0.04348	-0.0989
Haryana	0.438	0.449	0.025114	n.a.
Average	0.41925	0.243875	0.005336	-0.01863
HIGH INTERMEDIATE				
Maharashtra	0.484	0.434	-0.10331	-0.2619
West Bengal	0.45	0.518	0.151111	0.529412
Orissa	0.353	0.3	-0.15014	-0.24194
Average	0.451083	0.398625	0.017714	0.082959
LOW INTERMEDIATE				
Bihar	0.535	0.512	-0.04299	-0.16185
Uttar Pradesh	0.445	0.466	0.047191	n.a.
Kerala	0.378	0.387	0.02381	0.102941
Average	0.452667	0.455	0.009337	-0.02945

6.6 RESULTS

The regression results accounting (and not accounting) for autocorrelation reveal some interesting findings (see Table 6.12). The effect of economic constraints is the opposite of what might have been predicted by the crisis hypothesis. As inflation increased to the point of near hyperinflation, the likelihood that governments would introduce more orthodox measures fell. The cases of Bihar, Uttar Pradesh, and Kerala support the conclusion that economic crisis is not a precondition for orthodox measures, as these states experienced economic chaos in the early 1990s but failed to introduce more orthodox reforms. By the same token, the choice of more orthodox measures in Andhra Pradesh, Karnataka, and West Bengal during periods of economic recovery is further evidence that economic crisis is not a necessary condition for the initiation of market reforms.

Table 6.12

TSCS Regression of Orthodox Policy Choices in India, 1985-1997

Variable	Without AR1		With AR1	
	Coeff (s.e)	z-score	Coeff (s.e)	z-score
Centralisation	0.53 (0.132)	4.011***	0.54 (0.153)	3.54***
Legislative Dominance	-1 (0.794)	-1.26	0.456 (.896)	0.509
Fragmentation	-0.711 (0.197)	-0.362	0.2484 (0.192)	1.48
Polarisation	5.54 (0.963)	5.76***	3.3 1.88	1.75*
IAS Officers	2.72 (1.27)	2.15**	0.945 (0.959)	0.985
Inflation(log)	-1.11 (0.374)	-2.97***	-0.264 (0.255)	-1.035
Constant	4.96 (1.32)	3.75	2.64 (1.65)	1.6

Legislative dominance also appeared to have little effect on the degree of orthodoxy. Maharashtra Chief Minister Sharad Pawar, an early supporter of market reforms, introduced policies without legislative backing. By getting the Governor to issue legislation days after he took office, Pawar prevented opposition legislators from blocking his profoundly neoliberal economic programs. In Haryana, Bhajan Lal's Congress (I) party held solid majorities in both houses of the legislature, yet his government did not adopt orthodox measures. In fact, Lal adopted heterodox economic policies in 1985. After the collapse of Haryana's economy in the late 1980s, Lal instituted gradualist neoliberal reforms. Moreover, the adoption of orthodox reforms by current Chief Ministers in Madhya Pradesh (Digvijay Singh), Andhra Pradesh (Chandrababu Naidu), Bihar (Rabri Devi/Laloo Prasad Yadav), and Karnataka (S. M.

Krishna) without automatic majorities in their respective assemblies shows the limitations of the legislative dominance variable.

The findings also suggest that fragmentation in the party system is not significant for the initiation of more orthodox reforms. Governments operating under fragmented party systems were no more likely to institute these reforms than were unfragmented ones. Unfragmented party systems in West Bengal and Karnataka failed to initiate orthodox reforms until the late 1980s. By contrast, Maharashtra's Pawar introduced orthodox reforms in a highly fragmented party system.

The results for political polarisation are the opposite of what conventional wisdom would expect. It is generally assumed that leftist parties are strongly against market-oriented reforms. Reforms that are intended to reduce the size of the state through privatisation, the elimination of price controls, and the scaling back of tariffs and subsidies for inefficient producers are likely to work against the interests of the left. Because of privatisation, many state employees will lose their jobs and families that depend on subsidised prices for basic staples and energy will pay higher rates as controls are lifted.

Thus, conventional wisdom holds that the larger the share of the vote earned by the left, the more obstacles to initiating market-oriented reforms. However, evidence from the sample states challenges conventional wisdom. In West Bengal, for instance, it is under the leftist Left Front Parties, founded years earlier by B. C. Roy, which initiated and sustained orthodox reforms in the 1990s. In Maharashtra, the left received nearly thirty percent in assembly elections but Pawar still implemented orthodox reforms. By contrast, governments in Karnataka and Andhra Pradesh in the 1980s and Haryana in the 1980s-1990s experienced difficulties in adopting orthodox reforms despite their low degree of polarisation.

The findings for the proportion of IAS officers in policy-making positions are a mixed picture. Based on the regression model not taking autocorrelation into consideration, the IAS variable is statistically significant for the adoption of market-oriented reforms. In the AR(1) model, however, the variable is no longer statistically significant. Part of the reason for this discrepancy may be collinearity that exists between the proportion of the IAS variable and centralisation. With such a high degree of collinearity between regressors, the estimates become highly unstable with changes in the model specification.

There is a 0.567 correlation between centralisation and IAS variables. Empirical evidence also tends to support the importance of IAS officers for more orthodox policies. Leaders in Madhya Pradesh (Singh), Maharashtra (Pawar), Andhra Pradesh (Naidu), West Bengal (Basu), Karnataka (Deve Gowda and Krishna), and Haryana (Bhajan Lal and Om Prakash Chautala) initiated orthodox reforms following the appointment of IAS officers to key positions. By contrast, the governments in Uttar Pradesh (Kalyan Singh), Bihar (Laloo Prasad Yadav), and Kerala (Nayannar) appointed fewer IAS officers and their policy makers implemented more gradualist policies despite their often stated preferences for orthodox reforms.

Centralised executive authority is statistically significant. In virtually all cases that adopted orthodox reforms, a strong executive remained at the helm. In Madhya Pradesh (MP), veto and decree powers along with an electoral mandate enabled Digvijay Singh to implement a coherent orthodox program in the early 1990s that had eluded his predecessors. The abandonment of the Left Front pact between West Bengal's two main Communist parties strengthened the executive's hold by Jyoti Basu in the late 1980s - early 1990s.

The 1980 Andhra Pradesh legislation approved by voters under N.T. Rama Rao and his pliant Governors, greatly expanded executive authority for future governments. Karnataka's centralised government during the Congress (I) reign provided almost unlimited executive control over policy decisions. Maharashtra's is an exception in that its Chief Minister had relatively weak powers. However, Chief Minister Pawar used ordinance powers normally associated with the Governor to implement his economic program.

6.7 INTERPRETATION OF RESULTS

The findings in this model suggest that political institutions are important for explaining the initiating and consolidating of extensive market-oriented reforms in India.

Consistent with the findings of Haggard and Kaufman (1995) and Mainwairing and Shugart (1997), centralised executive authority is significant for the adoption of market reforms. More surprisingly, a high level of polarisation also promoted economic liberalisation. Contrary to conventional wisdom, greater popular support for leftist parties encouraged more orthodox reforms. Williamson's (1994) work on the role of bureaucrats is also partially supported by the findings with respect to IAS officers. IAS officers helped to promote market-oriented reforms in MP, Maharashtra, Andhra Pradesh (AP), West Bengal, Karnataka, and Haryana. The most advanced reformers in our sample operated under a powerful executive, with significant party polarisation, and a high proportion of trained bureaucrats in policy-making positions. The question, of course, is how does a powerful executive, high polarisation, and many trained bureaucrats promote the initiation and consolidation of orthodox measures?

This chapter develops an argument that admittedly, at places, is speculative. The work of Geddes (1994) may provide some useful insights into how these variables are linked. Geddes develops a model based on the political survival assumption that governmental leaders are most interested in achieving office and advancing their careers. From this generally accepted assumption, Geddes emphasises the importance of government actors, their interests, and their incentives for explaining attempts differences in economic policy choices. Her main argument is that political institutions shape the incentives of government actors as they attempt to satisfy their career interests.

Appointments to economic policy-making positions, like other decisions, are affected by leaders' concern with survival. Who political leaders choose as their economic policy makers impacts their career goals. It is assumed that leaders will appoint the best qualified policy makers who, on the basis of their training, are most knowledgeable about the policies that promote economic growth - usually a precondition for enhancing a leader's survival. However, as Geddes (1994) demonstrates, the most qualified policy makers are often not selected because of short-term political considerations.

To understand appointment strategies chosen by political leaders, it is necessary to examine differences in governing institutions and polarisation in the party system. Differences in governing institutions and party strength influence the appointment decisions of survival-minded political leaders. Political and institutional environments determine which policy makers will contribute most to the leader's political survival.

It is highly speculative, but one might argue that centralised executive authority provides governmental actors with the ability to appoint policy makers who favour market reforms. Unlike collegial executives that foster consensual agreement and compromise, usually not the ideal setting for unpopular policies, centralised executives hold greater autonomy in their policy choice. Centralised executive authority also limits access points for interest groups, which have one access point to lobby for change, namely the political leader. Leaders, of course, cannot wholly ignore societal interests, as they face electoral challenges. Centralised executive authority, however, confers greater autonomy on leaders in their appointment strategies.

The executive's interest in initiating these reforms is affected by the degree of party polarisation. Factional party pressures that enable "political outsiders" to take office are an important element for the appointment of officers and the marginalising of competitors. Often it is parties from the left that benefit most from a large state sector and highly protected economy. These parties historically rely on the state's political resources to provide jobs for their party workers. For the political outsider, whose party loyalists receive fewer perks from a large state, but whose rivals within their own party or in other left parties gain mightily, it makes sense to appoint budget-cutting officers.

Karnataka probably best exemplifies the appointment of officers to marginalise leftist rivals in one's own party. During his Chief Ministerial campaign, Deve Gowda crusaded for policies commonly endorsed by previous leaders like Bangarappa and Hegde, including government intervention in the economy and support for workers. Following his electoral victory in 1989, Deve Gowda appointed an economic team that not only attempted to calm investors but also served to marginalise the institutionalisation of the Janata Dal (JD). Deve Gowda, a former loyalist-turned-opponent of Hegde and a relative political outsider, wanted to limit the institutionalisation and organisation of the JD and redesign it in his own image. Deve Gowda reduced party influence by appointing minor political figures connected personally to him or IAS officers committed to liberalising the economy.

AP under Naidu is another example of efforts to marginalise the left from his party and weaken the rival left-of-centre parties. In 1988, the film icon turned actor N.T. Rama Rao (NTR) won an election that was marred by claims of electoral fraud from former leftist Telugu Desam Party (TDP) members who had formed their own party only a few years earlier. In addition, he also witnessed a bitter division within his own government between bureaucrats who favoured greater economic and political liberalisation and those who advocated state-led economic development and resisted liberalisation. Naidu used economic policy-making appointments to marginalise the old guard, the leftist TDP, and bolster his own faction. In fact, Naidu reduced to obsolescence and irrelevance the nationalist-populist wing in the TDP. Privatisation of state assets reduced patronage options used primarily by the old guard close to NTR and former TDP members now loyal to NTR's wife, Lakshmi Parvathi.

Similarly, in West Bengal, a centralised Chief Ministerial system (especially prior to the reforms of 1991) helped to marginalise the ultra-left wing of the Communist Party (Marxist). Basu secured the party's support despite opposition from established party leaders. Basu used his opportunity to initiate more substantial liberalisation than was supported by the leadership or rank and file of his party. He appointed non-Bengali IAS officers to consolidate his power and weaken his opponents.

Maharashtra under Congress and then Shiv Sena/BJP rule further suggests that centralised executive authority and political polarisation are important elements for the appointment of officers and the consolidation of power. Pawar, especially, used the power of appointments to consolidate his one-man rule and diminish the standing of his rivals in the party, like Antulay and others of the old guard. Pawar, who had previously repudiated market-oriented policies, appointed suitable advisors and officers to neutralise the arguments and strength of his rivals. Prior to their election, the Shiv Sena/BJP combine, famously "remote-controlled" by Bal Thackeray, had opposed reforms. However, they followed a route similar to Pawar once they assumed office. However, loss of a degree of centralisation due to the coalition nature of the government meant that that ministry was far less successful in economic management than Pawar.

Uttar Pradesh (UP), in contrast, exemplifies a government with a weak executive. Chief Minister Kalyan Singh, a BJP "consensus candidate", appointed a low proportion of IAS officers, and a very high proportion of state civil service officials. He failed to initiate the required market reforms. The institutional setting helps explain Singh's appointments. Singh was not the most powerful, or most popular, leader in the BJP. However, he was chosen as the only senior Backward Caste BJP leader, in order to diminish BJP's image as an upper caste party. Because of that, and also in order to weaken his upper caste rivals in the state BJP, Singh appointed Backward Caste candidates wherever he could find them. These were usually in the state civil service. The BSP Government of Kanshi Ram/Mayawati that followed just exacerbated this phenomenon. The weak executive in cases like these is invariably forced to include members from his or her own party faction in the cabinet; other factions in the party; and sometimes opposition parties. Governments with participants from the different parties contribute to compromise in decisions, including policy-making appointments, as they can block the executive's selections.

6.8 CONCLUSION

What factors help to explain differences in economic policy choices among democratic governments? In light of the analysis contained in Chapters 3, 4 and 5, it is ever more important to understand why some leaders initiated and sustained market-oriented reforms, while others did not. Despite the fact that nearly all Indian leaders have pledged their support for necessity of reforms in the late 1980s and 1990s, many did not install their preferred policies.

Our investigation of 10 Indian states from 1985 to 1997 suggests that centralised executive authority is important for the initiating and sustaining of orthodox market-oriented reforms, which corroborates the claims of Haggard and Kaufman (1995) and Mainwaring and Shugart (1997). The findings on the importance of IAS officers support Williamson's (1994) work on trained technocrats. However, the association between high political polarisation and orthodox reforms challenges the conventional wisdom that greater support for leftist parties impedes the adoption of market policies. Indeed, centralised executive authority, technocrats, and political polarisation are associated with more orthodox measures.

Building on the work of Geddes (1994), this chapter has developed an argument to explain how these variables are linked. Based on the political survival assumption that governmental leaders are most interested in achieving office and advancing their careers, it contends that political institutions shape the incentives of government actors as they attempt to satisfy their career goals. Appointments to economic policy-making positions, like other decisions, are affected by leaders' concern with survival. Differences in governing institutions and rival party strength influence the appointment decisions of survival minded political leaders. In what is admittedly speculative, this chapter argues that centralised executive authority provides governmental actors with greater autonomy in their policy choice and appointment strategies.

The executive's interest in initiating these reforms is affected by the degree of party polarisation. Factional party pressures that allowed "political outsiders" to win office are an important element for the appointment of officers and the marginalising of leftist competitors. Parties from the left, who use the state's political resources to provide jobs for their party workers, are generally the main beneficiaries from a large state sector and highly protected economy. For the political outsider, whose party loyalists received fewer perks from a large state, it made sense to appoint budget cutting advisor, e.g. Naidu.

Empirical work substantiated the claim that in systems with centralised executive rule, "political outsiders" were most likely to appoint IAS officers in order to marginalise their more entrenched rivals from inside their party. In Maharashtra (Pawar), Karnataka (Deve Gowda and Krishna), West Bengal (Basu), and Andhra Pradesh (Naidu), leaders used economic liberalisation to marginalise support for their rivals. In states without centralised executive rule or without political polarisation, and whose leaders did or didn't pay lip service to reforms (Singh in UP; Yadav in Bihar; Lal and Chautala in Haryana), the governments failed in their attempts to initiate their preferred policies.

More research is needed to understand the main factors that influence economic policy choice. Cross-regional work that tests the political and economic factors most commonly used to explain differences in policy choice is also imperative. Although it may be too soon to dismiss claims that a dominant executive is important for the implementation of orthodox reforms, other factors including political polarisation and bureaucratic influence also merit scholarly attention.

This chapter is only the beginning of a piece of work that must be taken much further. In this chapter, we have merely initiated a thought process about the incentives to reform among Indian states. More detailed work on this topic is beyond the scope of this thesis, but will definitely be carried out at the post-doctoral stage.

CHAPTER 7

CONCLUSION

Cabinet approves amendment to Industrial Disputes Act

As part of the much debated radical labour reforms, the Government on Friday conditionally approved discussions on a legal provision that would allow easier closure and lay-off of workers in economically unviable units employing upto 1000 persons.

The Cabinet which met here on Friday conditionally approved amendments to the Industrial Disputes Act 1947 to allow companies employing upto 1000 persons, as against the existing limit of 100, to retrench workers without getting the government permission.

However, the other major labour reform measure to amend the Contract Labour Act has not yet been cleared as the matter has been referred to a Group of Ministers, an official spokesperson told reporters.

The Hindustan Times
New Delhi , 22-02-2002

Labour on

It is well-known that Labour Minister Sharad Yadav was reluctant to moot the proposal to amend the Industrial Disputes Act to bring about labour law reforms on Friday. He was worried that the move may hurt his socialist image. He had even suggested an all-party meeting before bringing in changes.

Just to show how reluctant he was, the minister had put forward arguments against the reforms in the group of ministers' meetings earlier. He naturally could not oppose it at the cabinet meeting — it was, after all, his proposal.

While Yashwant Sinha and the two Aruns, Jaitley and Shourie, were in favour of changes, Pramod Mahajan, Sushma Swaraj and L.K. Advani were against.

Ultimately, it was Advani who came to the rescue. He reportedly suggested a middle path with the result that the cabinet accepted the reforms in principle — without any deadline! So it seems this reforms have been designated to the proverbial back-burner yet agin!

The Economic Times

25-02-2002

Millions strike over economic reforms

NEW DELHI: Nearly 10 million employees of state-run companies staged a one-day strike on Tuesday to protest economic reforms, shutting factories and banks and virtually paralysing financial markets and ports, unions said.

The strike was a fresh blow to the controversy-racked Hindu nationalist-led ruling coalition, at a time when economists are increasingly doubtful about its ability to push through economic reforms, especially labour reforms.

The stoppage followed cabinet approval of changes to a 55-year-old law making it easier to lay off employees that is slated to be introduced in the current parliamentary session.

Unions fear the reforms will lead to big job losses in a country where there is no social security net.

"These policies are not in the interest of workers. They have undermined the social security of labour by thoughtless privatisation of assets built over decades," Union leader W. Varadarajan said. "It's like selling the family silver to pay the butler."

Reuters [Tuesday, April 16, 2002]

It is evident that not much has changed in the past few years since this thesis was begun. In fact, labour reforms remain as intractable an issue today as they were in 1991.

7.1 CENTRAL RESEARCH QUESTIONS

The objective of this thesis was to explain the evolution of the labour regulatory system in India, to assess the impact of job security regulations on employment and equity, and to analyse the reasons for labour policy reform being so difficult in a democracy like India.

In order to achieve this, we used a multi-pronged political economy approach, combining detailed historical and institutional analysis with fairly simple straightforward econometric analysis using four datasets.

To reiterate, this thesis asked the following questions:

- What are the foundations of labour legislation, especially employment protection/ job security legislation in India? How can we best situate the evolution of labour regulations in the larger context of the evolution of the political economy of India over the last half century or more?
- What is the impact of job security regulations in India? How do we explain our results?
- Can we rank the different Indian states in order of strictness of job security regulations?
- If yes, then can we analyse a state-wise impact of differing levels of job-security regulations in different Indian states?
- If yes, then what are some of the political economy variables that could explain the differing success in achieving job security deregulation by different states of the same Indian Union?

Each chapter of this thesis is connected with the other, but is also supposed to be a self-contained whole, in that it has a section on objectives of the chapter at the beginning, and a section on the conclusions of the chapter at the end. Below, we repeat the aims and conclusions of each chapter, thus re-telling the story that we have told in the previous six chapters so far.

7.2 OBJECTIVES AND CONCLUSIONS OF CHAPTERS

Chapter 2 traced the **Evolution of Job Security Regulation In India**. It pointed out that, as in many other developing countries, the labour market in India is characterised by a large pool of ill-paid workers in insecure employment who are *de facto* unprotected by law, coexisting with a small unionised segment holding relatively secure, career-oriented jobs. It has often been suggested that in a situation of superfluous labour, stringent provisions of labour laws and power of trade unions together are to be blamed for the effort on the part of employers to avoid hiring regular employees and (to the extent possible) have the work done through subcontracting or by casual workers--efficiency wage theories notwithstanding (Mathur, 1989; 1991a; 1991b; 1992; 1993a; 1993b). Available Indian data in recent times do indeed show such a rise in such insecure employment, both in absolute and in relative terms, although it may be difficult *a priori* to ascribe any specific portion of that rise to the factors mentioned above.

While the quantification of such effects is useful, it is equally important to decipher whether such phenomena, to the extent they exist, are socially acceptable, if not on moral at least on pragmatic grounds (Datta Chaudhri, 1994). For if they indeed are acceptable, enacting laws alone will not amount to much. The issue has to be analysed in the context of the complex pattern of inter-linkages between the social and political foundations of labour legislation in the country as well as its moral and ethical roots. Also important is the manner in which public opinion is moulded in matters of what is ethical and what is practicable. Even more important are the connections between the two in popular belief, the linkages between social sanction and judicial decisions, and the actual operation of labour laws in the context of a highly fragmented labour market (Holmstrom, 1961; Solow, 1990).

During the course of this chapter, we discussed the inter-linkages between wages, earnings and terms of employment in India. We also discussed the philosophical foundations of labour legislation in India, and highlighted the implications of it labour legislation being the result of altruism from above, rather than hard-fought concessions from below. We then discussed the linkages between labour law and society and polity in India. We analysed the question: what do labour rigidities really mean for the Indian case, with its highly segmented market containing a small protected "rigid" section and very large and increasingly unprotected segments for the rest of the labour force. We then provided an exhaustive discussion of job security in India.

We carried that discussion forward by providing a history of job security regulation in India. We then moved forward from the chronological evolution of job security regulation, to the legislative evolution of job security regulation in India. We then discussed various issues related with the implementation of such regulations. We then provided a discussion about job security, labour flexibility and employment. We also speculated about how much security can and do job security regulations actually provide, thus setting the stage for Chapter 3, where qualitative fieldwork research is presented.

Chapter 2 concluded that, as most writers agree, that job security for industrial workers in the organised sector has been a major concern in India for perfectly understandable reasons. The colonial history of India generated a perception that industrial workers were victims of exploitation and needed state support. In the early post-colonial period, employment optimism was in the air and it seemed right to create ideal type of jobs in modern industries. A high degree of employment security also seemed quite consistent with the protectionist, import-substitutive industrialisation strategy which India adopted. "Employment security, moreover, was viewed as an instrument of guaranteeing income security to workers in an economy where no state-sponsored social security system existed." (Ghose, 1996, p. 101).

Originally, the job security regulations were meant to protect industrial workers in large establishments. Legal interpretation, however, held virtually all large scale organised activities to be industries and thus widened the coverage of the regulations very substantially. The result is that industrial workers actually constitute a small and dwindling proportion of the employees benefiting from the regulations.

There is little doubt that the job security regulations gave rise to a number of problems whose harmful effects were absorbed principally by industries and industrial workers. As ILO (1996) points out, in the first place, they had a negative effect on growth of employment in organised industries and thus hampered the process of improvement of employment conditions in the economy as a whole. Second, they led to the accumulation of surplus labour in the organised sector. Third, they turned industrial disputes into political issues. Finally, they obstructed development of healthy industrial relations and collective bargaining systems at enterprise level.

The recent economic reforms have both undermined the basis of the implicit contracts on which the employment security system rested and brought into sharp focus the need for labour adjustment. Delicensing and trade liberalisation have stimulated price competition thus making it difficult to pass on the costs of employment security to consumers. Cost adjustment, of which labour adjustment is a part, has thus assumed importance. These developments also necessitate industrial restructuring which requires labour reallocation across industries. And what is important to realise is that these developments are not of once-for-all variety; in an open economy, they will be characteristic features. Rethinking the job security system has clearly become necessary.

In **Chapter 3**, we presented insights gained from (i) the Bombay Labour Flexibility Surveys, carried out in the late 1980s, and again in mid-1990s by myself and others; and (ii) qualitative research and fieldwork conducted by myself at the firm level in Bombay, Pune and Delhi during 1995-98. We also included selected excerpts from interviews carried out with representatives of both employer and employee associations. This chapter forms a precursor to Chapters 4, 5 and 6, which provide the results of quantitative analysis carried out on both primary and secondary data. We aimed to show that only a minute elite— in general better educated, male and more skilled—benefit from the plethora of labour laws, especially job security regulations. The majority of the labour force is increasingly casualised, and spends its working life in insecure, and often inhumane, conditions. Labour laws do not seem to be helping the large majority of the labour force. Throughout this chapter, we worked with and referred to interviews, personal observations and secondary data collected exclusively for the labour flexibility surveys.

Chapter 3 concluded by saying that the basic purpose of the surveys and our related largely qualitative primary research was to find out how employers cope with industrial relations systems and protective legislation both of which are alleged to have reduced their flexibility in adjusting their labour costs and work force to changes in product demand. This loss of flexibility, if true, is a matter of great concern in India because much of the stagnation in employment is attributed to it. Attempts have been made to support the allegations empirically drawing on the ASI data disaggregated at best to 3-digit level. This is useful but not enough because whether employers possess or lack flexibility is likely to be revealed in an enterprise survey rather than in the industry aggregates reported by the ASI. To meet the challenge to unions and state intervention squarely, the research was largely restricted to Bombay where union movement is stronger and labour legislation is applied more effectively.

The review of macro level data revealed a substantial increase in shares of insecure labour categories in manufacturing employment. This informalisation of what is traditionally considered formal employment took place along with the growth, absolute and relative, of the traditional informal employment. Rates of unemployment were high particularly among the young entrants to the labour force. Registered unemployment, deficient in many ways, increased fast. Taken together, the macro level evidence showed that the labour market became conducive to adoption of flexible labour practices, but at a cost to the majority of the labour force.

Analysis of micro, firm level data showed that employers varied total employment, manual and non-manual taken together found that firms which experienced an increase in demand increased employment and it was the medium and the large firm, supposedly constrained by unions and protective legislation, that increased it more than the small firm did with all the flexibility at its command. As predicted by micro theory, firms that increased fixed capital per worker reduced employment and so did others which experienced a rise in share of labour cost. Importantly, it is the firm which increased the share of non-permanent labour that increased total employment. Changes in manual employment were associated directly not only with changes in share of non-permanent but also with those in shares of female and contract labour.

We discussed the factors that influence levels of and changes in employment of flexible labour categories. Firms which increased capital intensity reduced employment of flexible labour be it non-permanent, casual, contract, female or the all-inclusive non-regular labour. Employers who reported their labour cost had increased as a share of variable cost, reported a higher share of non-permanent labour particularly, casual labour. In contrast, such employers reported proportionately fewer contract and women workers.

The supposition that, larger firms resorted increasingly to flexibilisation of labour was also borne out in respect of non-permanent labour but not in that of casual labour and female labour while the labour flexibility survey lacked data to test it in respect of contract labour. The surveys also found that unions were less likely to exist in firms that reported a higher share of non-permanent labour in particular and a higher share of other flexible labour in general but the generalised relationship was not statistically significant. Flexible labour being difficult to organise, the lower probability of union presence in firms reporting higher shares of flexible labour is quite understandable. Unions discouraged employment of non-permanent and non-regular labour. Unionised firms reported lower share of female labour but greater increase in it over the previous years. They also reported a greater increase in the share of casual labour. This behaviour of unions could be rationalised pragmatically. Casual labour could be given permanency later with the help of the law. It could also be that unions did not mind employers hiring flexible labour so long as they did not hire them in threateningly large numbers. Unions contributed to dynamic efficiency of the firms by encouraging technological change and widening of product range.

Having established from the detailed examination of the conclusions of the two Labour Flexibility Surveys, and of the insights gained from my own interviews, we established what seemed to be a trend for increasing casualisation, informalisation and insecurity. This leads us to strongly suspect that as hypothesised by Basu, Fields and Debgupta (2000) and also suggested above, job security regulations tend to hurt the large majority of the labour force. We next tested this hypothesis in Chapter 4.

At the beginning of **Chapter 4**, we reiterated the conclusions in the previous chapter that labour regulations have a selective impact. While giving protection to a tiny minority of the labour force, they actually lead to large scale informalisation for the majority of the work force, thus pushing them into insecure employment, which is badly paid and low skilled.

In order to assess the impact of labour market reforms on the poor, it was necessary to determine the impact of labour market regulations on labour market outcomes. The chapter aimed to do so. It first carried out a simple probit analysis on household level socio-economic data collected by the NSS of India. It found that as a suspected in Chapter 3, not all categories of labour benefit equally from the job protection offered through job security regulations. In general, high human capital, educated male workers working for larger firms seemed to corner any protection offered by employers, while all other overlapping categories, including low human capital, young and female workers worked in a variety of insecure jobs.

The chapter than carried out a simple OLS analysis on firm-level data collected by CMIE. Although the analysis was simple, the results were striking. We found that job security regulations hurt employment growth in all categories. This is a more powerful result than the partial equilibrium result discussed in the previous paragraph. Not only do job security regulations advantage certain categories of labour, thus cementing labour market segmentation, but they also have a negative overall economic by reducing employment in all categories. This means that the growth in regular employment is almost nil, while even casual employment in the organised sector (which offers better pay and conditions than employment in the unorganised sector and in agriculture), declines significantly when the cost of job security regulations rises. Thus, even from a general equilibrium point of view, labour regulations are harmful to labour.

In **Chapter 5**, we aimed to carry out a detailed state-level analysis of the national-level findings contained in Chapter 4. We first used the framework constructed by Montenegro and Pages (1999) to construct a job security index for twenty four of the twenty five Indian states. We then ranked these states according to the strictness of their job security regulations. After that, we used the analysis provided in Heckman and Pages (2001) to analyse the impact of this variability in job security regulations.

We found that even a simple OLS estimation gave us highly significant results. We found that job security regulations affect almost all categories of employment in a significantly negative way, while they affect all categories of unemployment in a significantly positive way. This analysis further confirmed the general equilibrium conclusion we drew in Chapter 4, that job security regulations hurt labour by reducing employment and increasing unemployment in almost all categories. We suspect this is due to the negative effect they have on inward investment, although we have not done a rigorous econometric analysis of this causality in this thesis.

What lessons can be drawn from these results? Our evidence suggests that job security provisions are an extremely inefficient and inequality-increasing mechanism for providing either income security or earnings equity to workers. They are inefficient because they reduce the demand for labour; they are inequality-increasing because some workers benefit while many more are hurt. Their impact on inequality is comprehensive: Job security increases inequality because it reduces the employment prospects of young, female, uneducated and unskilled workers—the most vulnerable group. It also increases inequality because it segments the labour market between workers with secure jobs and workers with very few prospects of ever having a "good" job, with any amount of minimum wage and conditions. Finally, job security provisions increase inequality if, as predicted by some theoretical studies and most of the available empirical evidence, they increase the size of the informal sector. We have seen evidence of this both from the qualitiative and quantitative work presented in Chapters 3, 4 and 5.

Having established the negative impact of job security regulations on labour and employment in the previous three chapters, **Chapter 6**, asked the question: What factors help to explain differences in labour (and other) economic policy choices among these state-level democratic governments? It outlines the different arguments in the political economy literature that offer answers to this question. Subsequently, this chapter tests the applicability of these arguments to ten state governments in India, from 1985-1997, to explain why these states differ in their degree of market openness. These states make for useful comparisons. Since the 1980s, they have varied widely in their ability to initiate and sustain market reforms despite the fact that most of their policy makers and governmental leaders have pledged their support for more orthodox reforms.

Using a Time-Series Cross-Sectional (TSCS) data set, this chapter constructs a model of policy choice for the ten states. It includes a number of variables that represent political and economic constraints on policy choice. The findings suggest that a centralised executive and a highly polarised party system are important for initiating and sustaining more orthodox policies. A centralised executive provides leaders with opportunities to install their preferred policies. The degree of polarisation affects the executive's policy preferences toward orthodox policies. A highly polarised system may encourage executives to use the appointment of bureaucrats, who favour neo-liberal policies as a strategy to bolster their political survival.

7.3 AN INSTITUTIONAL THEORY POST SCRIPT

In this section we provide a post script from institutional theory to the analysis contained in Chapter 6, thus discussing possible areas in which we may be able to continue the research begun in this thesis. The economic analysis of political phenomena has always been proposed as a partial theory. It is a story about sources of bias away from an outcome that would result from a hypothetical unbiased aggregation of citizen preferences. One should bear in mind that citizens engage in political participation for a host of reasons unrelated to their association with organised interests and have strongly held views about policy that are not related to their sources of income and their major personal consumption expenditures. Hence, a factor that may affect the pace of and commitment to regulatory reform is changes in other political issues that have a spill over effect on regulation.

The difficulty with drawing conclusions about specific policies from general political trends is that to do so assumes that the shift in public political attitudes is more or less uniform across all issues. Poll data indicate that such is not the case. The extent to which citizens express agreement with "reform" or deregulatory policies varies enormously across policy issues. One policy that still commands a large majority of support is labour regulation. Whereas that support does not imply that labour regulation cannot be significantly reformed, it does mean that elected politicians take a political risk if a reform is perceived as a significant threat to employment protection.

To our knowledge, no long-term polling data exist for most other specific areas of regulation, and in any event, regardless of public opinion, most specific areas of regulation are not particularly salient to most voters. Indeed, the general lack of significant public interest in specific areas of regulation is the basis for the economic theory of regulation, which emphasises capture by organised interests at the expense of citizens in general. Consequently, to incorporate general political trends into the analysis, one must look for more specific issues that have some direct bearing on regulation but that are more general than any specific area of regulation.

One such issue is the increased emphasis in recent years on greater devolution of policy responsibilities to state and local government. The federal structure of the Indian government is very unusual, and the consensus view among political scientists is that a system in which different levels of government exercise significant, independent power is probably not stable.

The logic of the conclusion is that if the national or state government possesses the legal authority to control a policy, the factions that control the national or state government will insist on using that authority to force lower governments to adhere to the policy that is favoured at the national level.

In the history of the Indian Union, the role of states has ebbed and flowed in all policy areas, including regulation. Although the Nehruvian and Indira-Rajiv Gandhi periods are regarded as ones in which considerable power was centralised in the national government, most constitutional statutes are generally deferential to the states. For example, states have been given important roles in implementing nearly all social programs--education, health, and labour policy.

The dilemma posed by the trend toward more state and local authority is that devolution can work against regulatory reform, as illustrated by the discussions of labour deregulation and some product market deregulation. State and local governments are subject to the same kinds of representation biases as the Union government, but in the former case one additional bias is present: the absence of an incentive to be politically responsive to organised groups in other areas that sell within the state or local jurisdiction. Whereas state governments are generally prohibited from erecting barriers to interstate trade, they are relatively free to use regulation to discriminate against people from other jurisdictions. An excellent example is a practice only recently attacked in taxation--the practice of octroi.

Regulatory reform generally has gained more political momentum in the Union government, most likely because a source of political benefits from regulation is available to state authorities—discrimination against residents and businesses from other jurisdictions—that are not available to Central officials. Thus, if a state government essentially reflects the mixture of economic interests of the central government, it will be, on balance, less likely to undertake reform. Of course, that conclusion does not mean that all states and localities oppose reform, or even that all are less reform-minded than the central government. If a state contains an unusually large concentration of well-organised groups that advocate reform, those groups may be more successful in their home state than in New Delhi. But, on balance, lower levels of government are likely to be more parochial, thus leading to greater use of regulation to benefit local constituencies.

One of the as yet inadequately resolved issues in institutional economics in the context of underdevelopment is why dysfunctional institutions often persist for a long time--the central question that we have been analysing. Unlike the followers of the property rights school, who often displayed a naive presumption of the survival of the 'fittest' institution, either of the two strands of institutional economics (as identified in Bardhan 1989a) are quite clear in not ascribing optimality properties to the institutions as (Nash) equilibrium outcomes. North (1990), Bardhan (1989a and 1989b), and others have pointed to the self-reinforcing mechanisms for the persistence of socially suboptimal institutions when path-dependent processes are at work. Borrowing an idea from the literature on the history of technological change, they point out that there are increasing returns to adoption of a particular institutional form -- when, the more it is adopted, the more it is attractive or convenient for the others to conform on account of infrastructural and network externalities, learning and coordination effects, and adaptive expectations -- and a path chosen by some initial adopters to suit their interests may 'lock in' the whole system for a long time to come, denying later, maybe potentially more appropriate, institutions a footing (Bardhan, 1989a, p.8).

In this path-dependent process North, more than others, has emphasised how the interaction between the 'mental models' the members of a society possess and the incentive structure provided by the institutions shapes incremental change. The path-dependent process is also made more complicated by the frequent cases of unintended consequences in history. More than a century ago Menger (1883) made a distinction between 'pragmatic' and 'organic' institutions. The former are the direct outcome of conscious contractual design -- as in the institutional models in the theory of imperfect information or transaction cost -- while the latter, like in Menger's theory of the origin of money, are comparatively undesigned, and they evolve gradually as the unintended and unforeseeable result of the pursuit of individual interests. Elster (1989) has referred to intermediate cases, where an institution may have originally come about unintended, but agents when they become eventually aware of the function an institution serves for them, consciously try to preserve it from then on.

Bardhan (1999, p. 10) contends that the political stumbling blocks to beneficial institutional change in many poor countries may have more to do with distributive conflicts and asymmetries in bargaining power. He points out that the "old" institutional economists (including Marxists) used to point out how a given institutional arrangement serving the interests of some powerful group or class acts as a long-lasting barrier (or 'fetter', to quote a favourite word of Marx) to economic progress. As has been suggested in Bardhan (1999) and Knight (1992), the new institutional economists sometimes understate the tenacity of vested interests, the enormity of the collective action problem in bringing about institutional change, and the differential capacity of different social groups in mobilisation and coordination. The collective action problem can be serious even when the change would be Pareto-superior for all groups. There are two kinds of collective action problems involved: one is the well-known free-rider problem about sharing the costs of bringing about change, the other is a bargaining problem where disputes about sharing the potential benefits from the change may lead to a breakdown of the necessary coordination. There are cases where an institution, which nobody individually likes, persists as a result of a mutually sustaining network of social sanctions when each individual conforms out of fear of loss of reputation from disobedience.[5] Potential members of a breakaway coalition in such situations may have grounds to fear that it is doomed to failure, and failure to challenge the system can become a self-fulfilling prophecy.

[5] For a well-known static analysis of such a case, see Akerlof (1984). For a more complex model in terms of stochastic dynamic games explaining evolution of local customs or conventions, see Young (1998).

The problem may be more acute when, which is the case with regulatory reform, there are winners and losers from a productivity-enhancing institutional change. The costs of collective action of such a change may be too high. This is particularly the case, as we know from Olson (1965), when the losses of the potential losers are concentrated and transparent, while gains of the potential gainers are diffuse (or uncertain for a given individual, even though not for the group, as suggested by Fernandez and Rodrik (1992)). There is also the inherent difficulty, emphasised by Dixit and Londregan (1995), that the potential gainers cannot credibly commit to compensate the losers *ex post*. There is the fear losers have that once they give up an existing institution, they may lose the *locus standi* in lobbying with a future government when the promises are not kept ('exit' from a current institutional arrangement damaging their 'voice' in the new regime in future), and so they resist a change today that is potentially Pareto-improving (in the sense that the gainers could compensate the losers).

One can also formalise the obstruction by vested interests in terms of a simple Nash bargaining model, where the institutional innovation may shift the bargaining frontier outward (thus creating the potential for all parties to gain), but in the process the disagreement payoff of the weaker party may also go up (often due to better options of both 'exit' and 'voice' that institutional changes may bring in their wake), and it is possible for the erstwhile stronger party to end up losing in the new bargaining equilibrium (how likely this is will, of course, depend on the nature of shift in the bargaining frontier and the extent of change in the disagreement payoffs) (Bardhan, 1989). a or b

Employment security legislation, as it exists today, is a classic example of inefficient institutions persisting as the lopsided outcome of distributive struggles. In India, as we have shown, the empirical evidence suggests that these legislations actually harm labour by reducing the demand for well-paid, secure, formal employment, while increasing resort to sub-optimal ways of escaping the legislative consequences. As a result, both employers and employees lose out. Human capital formation is hurt. Employers lose out on economies of scale gains, productivity gains resulting from skill enhancement, and in the failure to move their investment to the latest technology and/or more profitable avenues of investment. Employees lose out as they remain prey to exploitative labour contractors, and remain trapped in a vicious cycle of low productivity, low wage, low skill insecure jobs for life. And the state loses out, both in terms of lost revenue, as well as loans that have to be written off as firms declare sickness and bankruptcy, and are compulsorily taken over by the State.

Yet the tortuous history of labour reform in many countries suggests, for the Indian case, that there are numerous road blocks on the way to a more efficient reallocation of labour rights put up by vested interests for generations. Why don't the large employers voluntarily supply more skill oriented secure jobs, which are productivity enhancing, and use labour-intensive technology, so that they can and grab much of the surplus arising from this efficient reallocation? There clearly has been some reform in this area, but problems of monitoring, insecurity of job tenure and the employer's fear that the employee will acquire too many rights on the firm have limited efficiency gains and the extent of true job security for the vast majority of insecure informal labour. The labour market has been particularly thin for formal jobs (and in many cases, the gains go the opposite way, from distressed insecure labour to contractors and money-lenders). With low household savings and severely imperfect credit markets, the potentially more efficient informal labourer is often incapable of affording the going market price of a "good job".

Trade unions resist labour reforms because the levelling effects reduce their social and political power and their ability to control and dominate even non-labour issues. Large (and often overlapping) memberships of trade unions, confined to the tiny labour aristocracy, may give their leaders special social status or political power in a lumpy way (so that the status or political effect from having 100 members, with the power of patronage that this entails, given that a much larger number is baying at the citadel doors for entry into this select elite, is larger than the combined status or political effect accruing to 1000 new members, if it means that the power of patronage declines). Thus the social or political rent of union leadership for the large unions will not be compensated by the membership of the numerous members, with more secure jobs than they had before, but less secure jobs than were previously guaranteed by the present EPL. Under the circumstances the former will not be ready for any reform, and inefficient (in a productivity sense, not in terms of the Pareto criterion) labour markets persist.

Much depends also on the nature of political competition and the context-specific and path-dependent formations of political coalitions. An important aspect of political rent, that is overlooked in the usual calculations of the surplus generated by a given institutional change, is that all sides are really interested in *relative*, rather than absolute, gain or loss. In a power game, as in a winner-take-all contest or tournament, it is not enough for an institutional change to increase the surplus for all parties concerned to be acceptable. One side may gain absolutely, and yet may lose relative to the other side, and thus may resist change. If, in a repeated framework, both sides have to continue to spend resources in seeking (or preserving) power or improving their bargaining position in future, and if the marginal return from spending such resources for one party is an increasing function of such spending by the other party (i.e. power seeking efforts by the two parties are 'strategic complements'), it is easy to see why the relative gain from an institutional change may be the determining factor in its acceptability (Bardhan, 1999, 12).[6]

If distributive conflicts constitute an important factor behind the persistence of dysfunctional institutions, they also make collective action difficult at the level of the Central Government (for example, in its coordinating of macro-economic policy) and at the level of State governments and state-level community organisations (for example, in the enactment and implementation of EPL). At the macro level collective action is necessary in formulating cohesive developmental goals with clear priorities and avoiding prisoner's dilemma-type deadlocks in the pursuit of commonly agreed upon goals. When wealth distribution is relatively egalitarian, as in large parts of East Asia (particularly through land reforms and widespread expansion of education and basic health services), it has been somewhat easier to enlist the support of most social groups (and isolate the extreme political wings of the labour movement) in making short-run sacrifices at times of macroeconomic crises and coordinating on stabilisation and growth-promoting policies (Bardhan, 1999). There is some cross-country evidence (Rodrik, 1998) that inequality and other forms of polarisation make it more difficult to build a consensus about policy changes in response to crises and result in instability of policy outcomes and insecurity of property and contractual rights.

The contrast with India is instructive in this respect. When society is extremely heterogeneous and conflict-ridden as in India and no individual group is powerful enough to hijack the state by itself, the democratic process tends to install an elaborate system of checks and balances in the public sphere and meticulous rules of equity in sharing the spoils at least among the divided elite groups. (For an analysis of the continuing fiscal crisis and

6 For a model of power-seeking on these lines to explain why two parties may not agree to obviously mutually advantageous transactions, even when there are simple enforceable contracts and side transfers of fungible resources to implement them, see Rajan and Zingales (1999).

developmental gridlock in India as an intricate collective action problem in an implicit framework of non-cooperative Nash equilibria, see Bardhan (1984, 1989). There may be what sociologists call 'institutionalised suspicion' in the internal organisation of such a state and a carefully structured system of multiple veto powers.

The tightly integrated working relationship of government with private business that characterises much of East Asia is very difficult to contemplate in this context. In the Indian context of a plurality of contending heterogeneous groups a close liaison and harmonising of the interests of the state with private business would raise an outcry of foul play and strong political resentment among the other interest groups (particularly among organised labour and farmers), the electoral repercussions of which the Indian politicians can afford to ignore much less than the typical East Asian politician. It is difficult for the ruling groups in India to have what Olson (1982) called an 'encompassing interest' (i.e. a structure that can internalise the distortions caused by its own policies). In general at the level of the macro political economy, inefficient and uncoordinated state interventionism (which is usually the villain in the schematic scenario of public choice theory) is often a symptom of deeper conflicts in society.

Below the aggregative or macro level, even more acute is the institutional failure at the state level, and this is often ignored in the broad state-versus-market debates. On grounds of leaving decision-making in the hands of those who have information which outsiders lack and increasing the flexibility of public programmes with respect to local conditions, the case for devolution of authority to state governments is very strong, but, apart from the usual administrative problems, a major problem that hinders most schemes of devolved governance is related to distributive conflicts.[7] In areas of high social and economic inequality, the problem of 'capture' of the state governing agencies by the local elite can be severe, and the poor and the weaker sections of the population may be left grievously exposed to their mercies and their malfeasance.

The central government can also be 'captured', but there are many reasons why the problem may be more serious at the state level. For example, there are certain fixed costs of

[7] See Bardhan and Mookherjee (1998) for a theoretical framework for appraising the various trade-offs involved in delegating authority to a central bureaucracy as opposed to an elected local government, for delivery of public services from the point of view of targeting and cost-effectiveness of public spending programmes in developing countries.

organising resistance groups or lobbies: as a result, the poor may sometimes be more unorganised at the state level than at the national level where they can pool their organising capacities. Similarly, collusions among the elite groups may be easier at the state level than at the national level. Policy making at the national level may represent greater compromise among the policy platforms of different parties, and so on. In the cases where state government is captured by the powerful and the wealthy, instances of subordinate groups appealing to supra-local authorities for protection and relief are not uncommon.

In general, contrary to the presumption of much of mainstream economics, there need not always be a trade-off between equality and efficiency, as is now recognised in the literature on imperfect information and transaction costs. The terms and conditions of contracts in various transactions that directly affect the efficiency of resource allocation crucially depend on who owns what and who is empowered to make which decisions. Institutional structures and opportunities for cooperative problem-solving are often foregone by societies that are sharply divided along economic lines.

Barriers faced by the poor in the capital markets (through a lack of collateralisable assets which borrowers need to improve the credibility of their commitment) and in the labour market (where the labour aristocracy hogs the endowments of security and benefits) sharply reduce a society's potential for productive investment, innovation and human resource development. Under the circumstances, if the state, even if motivated by considerations of improving its political support base, carries out redistributive reform, some of it may go toward increasing productivity, enhancing credibility of commitments on the part of the asset-poor and creating socially more efficient property rights. Even the accountability mechanisms for checking state abuse of power at the local level work better when the poor have more of a stake in the asset base of the local economy. On the other hand, the state in trying to correct inequities has to be careful about incentive compatibility issues and its own political and administrative limitations.

It is thus very probable that the state-level variations seen in this and the previous chapter can be explained by this institutional analysis. As Harriss (1999) persuasively argues, " it would seem perfectly sensible to compare Indian states as democratic regimes" (p. 4). He further argues that "There are differences between states in terms of the extent of industrial development, and hence in the development of both the industrial bourgeoisie and the working class. These differences may then be reflected, in turn, in variations in the nature and the extent of political mobilisation, and of organisation in civil society, both of which are likely to be very significantly influenced, in the Indian context, by caste and other ethnic identities. These political differences may exercise a significant influence on the functioning of the various (state-level) 'state systems'. This is one level of comparison, therefore, which we might describe as 'structural'. Another is that of 'regime' in the sense, rather, of 'government'." (p. 4)

Kohli (1987) also says, "Variations in regional distributive outcomes ... are a function of the regime controlling political power. Regime type, in turn – at least in the case of India – closely reflects the nature of the ruling political party. The ideology, organisation and class alliances underlying a party-dominated regime are then of considerable consequence for the redistributive performance of that regime"(p. 10)

An in-depth political regime analysis is beyond the scope of this thesis. An exhaustive and rigorous political analysis of this type would certainly be the subject of future research arising from the present thesis that the author would like to pursue. For the moment, we leave the reader with two tables (below), imported from Harriss (1999) that show the variation in regime type across some Indian states. An excellent analysis of this subject can be found in Harriss (1999) and also Kohli (1987). However, it is illuminating to compare our categorisation of states by reform-orientation with their classification according to political regime. It is tantalisingly obvious that important parallels exist. For the purpose of this chapter though, it is sufficient to show the inter-state variation in regulation and reform-orientation according to the political economy factors described above.

Table 7.1

Typology of Political Regimes in Different States, Early 1980s

Category	Characteristics	States
A	Upper caste/class-dominated Congress regimes	Bihar, Uttar Pradesh + (Madhya Pradesh, Orissa, Rajasthan)
B	Lower castes/classes recruited into Congress regimes	Gujarat, Karnataka, Maharashtra + Andhra Pradesh)
C	Lower castes/classes strongly represented in non-Congress regimes	Kerala, West Bengal + (Tamil Nadu)
D	Competition between Congress and a 'middle' caste regional party (excluding	Punjab

	lower castes/classes?)	

Source: Church (1984) in Harriss, 1999, Table 1

Table 7.2

Typology of Indian State Regimes in the Early Nineties

Category	Characteristics	States
A(i)	States in which upper caste/class dominance has persisted and Congress has remained strong in the context of a stable two-party system ('traditional dominance' rather than politics of accommodation vis-a-vis lower classes)	Madhya Pradesh, Orissa, Rajasthana
A(ii)	States in which upper caste/class dominance has been effectively challenged by middle castes/classes, and Congress support has collapsed in the context of fractured and unstable party competition (both 'dominance' and the politics of accommodation have broken down)	Bihar, Uttar Pradesh[a]
B	States with middle caste/class dominated regimes, where the Congress has been effectively challenged but has not collapsed, and there is fairly stable and mainly two-party competition (the politics of accommodation vis-a-vis lower class interests have continued to work effectively, most effectively in Maharashtra and Karnataka, least effectively in Gujarat)	Andhra Pradesh, Gujarat, Karnataka, Maharashtra, Punjab[b]
C	States in which lower castes/classes are more strongly represented in political regimes where the Congress lost its dominance at an early stage	Kerala, Tamil Nadu, West Bengal[c]

Notes: a: These five states are classified as 'low income states'. b: AP and Karnataka are 'middle income states', and Punjab, Gujarat and Maharashtra are 'high income states'. c: These three states are 'middle income states'. ***Source: Table 2 from Harriss 1999***

7.4 POLICY RECOMMENDATIONS

I will conclude by presenting very uncomplicated policy recommendations. It is not my intention to give minute and detailed policy suggestions, as we believe that that is not the objective of this academic thesis. However, very simply, it is fairly obvious that the system of labour market regulation in general, and job security regulation in particular, needs to be amended in India. As it stands, it harms labour both from a partial and general equilibrium point of view. The system needs to be made less exclusive and more inclusive.

The only way to do this in an economically justifiable and politically feasible way is to replace this system with a new system that includes all categories of labour, but one that does not try to micro-manage all aspects of the labour-capital relationship. All workers must be afforded minimum pay and conditions, but that is as far as the state intervention needs to go. The enforcement of regulation needs to be tightened, while the minutiae of regulation need to be done away with. Simple regulations will be easy to monitor and enforce, and less prone to politicisation and rent seeking.

For this to be possible, another requirement is to delete the state from the labour-capital relationship by replacing the current time-consuming tripartite system with a system of collective bargaining. This will automatically remove a large source of political interference from the system.

Last, but very important, as far as possible, job protection must be replaced by employment insurance and more generalised social security as far as possible. Instead of preventing the efficient allocation of labour and capital, the state must let that happen. But, it if and when certain workers slip through the cracks into vulnerable situations, then the state must undertake, along with employers, through a social insurance or national insurance system, to provide a social safety net for those people in terms of insurance against risks of unemployment, disability, health and old age. Analyses carried out by Bhattacharya and Mitra (1993) have shown that a system of unemployment benefit applying to *all* workers in India will actually be much cheaper than the amount of resources lost in preventing inefficient firms to exit, and in keeping "sick" enterprises open and paying their workers, even if nothing is produced.

To conclude then, a deregulation of the job security legislation along with the provision of social insurance is the best alternative to the present system. It will improve both efficiency and equity. However, in order to achieve this reform, political courage as well as shrewd strategy is necessary. Otherwise the fate of "experts" like myself might be the same as the labour economist who was shot dead in Italy in March 2002 for suggesting greater labour market flexibility in that country!

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