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## The costs of employment protection

India has some of the more restrictive labour laws in the world. However, these laws cover only the organised sector. Thus, firms thinking of growing in size and becoming formal must weigh the advantages of size against the disadvantages of regulation. This keeps Indian firms small and informal unless they have a lot to lose by staying small, that is, when they are very good indeed. This, it is argued, results in a disproportionately large share of smaller, less productive firms, many of which operate in the informal sector, which employs nearly 90% of the Indian workforce. This makes sense given the uneven protection of employment across formal and informal sectors, with the latter being virtually unregulated. Strict labour laws may also result in very few large firms concentrating most of the total market production, as these regulations act as a barrier to becoming large.

### Labour laws and firm productivity

How large are the effects of such laws? In a recent paper, we provide some idea of these costs in terms of their impact on productivity (Dougherty, Frisanchi, and Krishna, forthcoming). We use state-level variation in labour market reform and firm-level data on the performance of industrial establishments in recent years to tease out the effects of such reforms. Using plant-level data between the late 1990s and the late 2000s, we find evidence of the impact of reforms of employment protection legislation (EPL) and related labour market policies on plant-level productivity in India. To measure the effect of EPL reforms we basically compare industries with high and low levels of labour usage, across states with different degrees of labour reforms. The fundamental assumption is that EPL is more likely to restrict firms operating in industries with higher labour requirements. Thus, we should see important productivity losses in labour-intensive industries located in states with fewer reforms relative to these same industries operating in states with greater degree of EPL flexibility. On the other hand, industries that rely less on labour should suffer less from inflexible EPL so we should not observe important productivity gaps among them across states with different levels of EPL reform.

A key strength of our work is that the labour reform measure (Organisation for Economic Co-operation and Development (OECD) 2007) covers 50 specific subjects of possible reform in seven major areas of labour regulation in addition to the Industrial Disputes Act IDA1, taking into account both formal and informal amendments at the state level<sup>2</sup>. An additional

strength is the use of plant-level information from the Annual Survey of Industries (ASI) to evaluate the direct effect of EPL in India. We take advantage of the ASI panel data to obtain plant-level measures of multi-factor productivity; that is, the amount of total output that is not explained by labour, capital, and intermediate inputs<sup>3</sup>.

We find that the modest easing of regulations in Indian states that has taken place in recent years was enough for firms in states with higher levels of pro-employer reform to benefit substantially through gains in productivity. Our analysis indicates that, on average, plants in labour-intensive industries and in states that have transitioned towards more flexible labour markets, such as Uttar Pradesh or Gujarat, are 25.4% more productive than their counterparts in states that have experienced lower levels of EPL reform (West Bengal or Chattisgarh, for example). However, no important differences are identified among plants in industries with low labour intensity when comparing states with high and low levels of EPL reform.

We also find that the different strategies used by plants to overcome the constraints imposed by labour regulations generate varied effects of state-level labour reform both by plant size and type of ownership. Given the extensive use of contract labour in large plants, which is a way around labour regulations, and voluntary retirement schemes among public plants, which is another way of relaxing restrictions on firing, smaller plants and private plants could accrue the largest productivity gains from state-level labour reforms.

### Accelerating labour reforms

Our analysis shows that state-level actions have already led the way in labour reform, both on paper and in practice. Nevertheless, these reforms could be taken much further. Out of the 20 states surveyed, only three had conducted more than half of the potential procedural or administrative changes they were surveyed about, suggesting that there is still much room to ease the burden of labour regulations at the state-level. Given the difficulty in carrying out reforms at the central level, states may be in a better position to accelerate their own labour reform processes while prioritising reforms according to the characteristics of their home industries. However, the central government urgently needs to resolve ambiguities in the Supreme Court's ruling and provide clear general guidelines, particularly in areas such as contract labour and fixed-term contracts.

Until recently, labour reform had taken a backseat in discussions of structural reforms in India. However, recent contract labour cases have split the Supreme Court's bench and have forced the issue of labour market deregulation back into the policy debate. In addition, the government has expressed a newfound desire to [“seiz\[e\] the demographic dividend”](#) increasing chances that labour law reform will be back on the reform agenda.

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Economic Co-operation and Development (OECD), the Inter-American Development Bank (IDB), nor their member countries or partners.

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**Notes:**

1. The IDA came into force in 1947. Its objective is to enable the investigation and settlement of industrial disputes by negotiation. It extends to the whole country but applies only to the organised sector.
2. Most previous studies for India have relied on the Besley-Burgess (2004) index, which captures state-level reforms to the IDA between 1949 and 1992. Besley and Burgess (2004) and several other studies relying on their index find similar results: pro-worker regulation has a negative impact on output, investment, employment, and productivity among registered manufacturing firms. However, their index deems unsuitable to evaluate the effects of EPL on industrial performance after 1992 since most recent changes in state-level practices have resulted from judicial interpretations of the laws by the Supreme Court. See Dougherty et al. (forthcoming) for more details.
3. Multi-factor productivity is obtained as a residual once all the other inputs are netted out of total output. See Dougherty et al. (forthcoming) for more details on the methodology we follow to estimate these residuals.

**Further Reading**

- Ministry of Finance, (2012), [‘Economic survey 2012-13’](#).
- Dougherty, Sean, Veronica Frisancho, and Kala Krishna, ‘State-Level Labor Reform and Firm-Level Productivity in India’, Forthcoming in India Policy Forum.
- Besley, Timothy, and Robin Burgess (2004), “”Can labor regulation hinder economic performance? Evidence from India””, The Quarterly Journal of Economics, 119(1), 91-134.