By Invitation

Reforming the Industrial Dispute & Trade Union Acts

Tushar Poddar

This paper looks at how labor laws in India may have slowed down employment growth. It estimates how much growth is being foregone due to the lack of labor mobility from agriculture to industry. It then focuses on Industrial Disputes Act and Trade Unions Act. The paper discusses specific provisions which may have negatively impacted employment growth, including the provisions for employment termination in India, requiring the permission of the government and consultations with trade unions. It examines how they need to be reformed, by looking at lessons from within India and other countries. Finally, it examines the case of Korea as a success story in generating labor-intensive manufacturing growth.

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Introduction

India's employment growth in recent years has been anemic. The economy added only about 2 million jobs each year in FY05-FY12, compared to 12 million a year in the five years before that. Moreover, increasing numbers of workers are leaving the workforce – the labor force participation rate fell by 3 percentage points over the same period. As a labor-abundant country, India should be generating jobs in labor-intensive manufacturing. However, the manufacturing sector saw a net decline of 5 million jobs in FY05-FY10 at a time when industrial growth was very strong at over 9% during this period. The industries that are losing jobs are in the most labor-intensive sectors – textiles, electronics, and apparel. Firms are substituting capital for labor.

This paper begins by looking at structural problems in India's labor market, and how they have hindered employment. We estimate how much growth is being foregone due to the lack of movement of surplus labor from agriculture to industry. We then focus on labor laws – two in particular that we believe could reap large dividends if they are reformed. We look at labor laws in other countries in order

to distill lessons from how those labor laws have been revised. We conclude by looking at employment growth examples from some of the more successful manufacturing countries in Asia, Korea in particular.

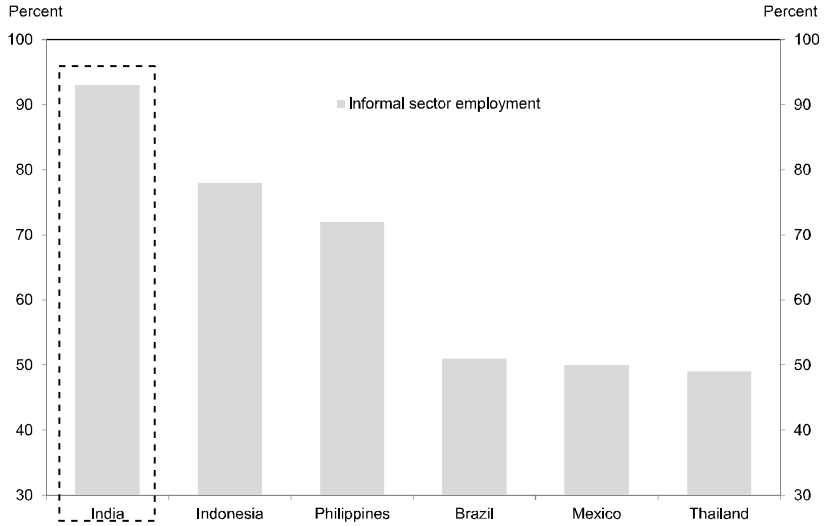
The Labor Problem

In theory, India can realize significant labor market gains from its favorable demographics due to: 1) increases in labor input from the young; 2) economies of scale in operation – as a firm grows, it can initially have increasing returns to scale – whereby adding more labor and other inputs leads to a more than proportional increase in output; and 3) urbanization – moving labor from low-productivity agriculture to high-productivity industry and services.

Employment growth has been anemic, and this is reducing the gains from labor input from the young.

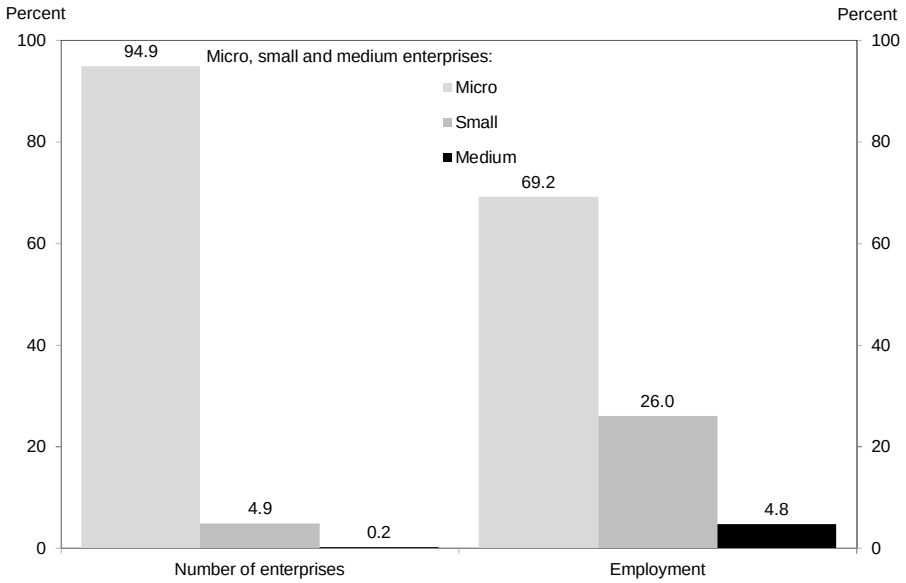
In practice, the gains have been much smaller than they could have been. Employment growth has been anemic, as discussed above, and this is reducing the gains from labor input from the young. India's employment profile is remarkable for its small scale and informality. To escape stringent laws, entrepreneurs keep the scale of their operations small. Most workers are in small enterprises, with their share in enterprises employing less than six people at 65.6%. Self-employed workers constitute half the workforce.

Exhibit 1 Informal employment is highest in India



Source: Planning Commission (2013): *Twelfth Five Year Plan (2012-2017)*,Volume III,22. Employment and Skill Development

Exhibit 2 Scale of employment is very small



Source: Fourth All India Census of Micro, Small and Medium Enterprises, 2006-07: Registered Sector; Planning Commission, 12th Five Year Plan Draft

According to research by the World Bank, the value added per worker in the informal sector is less than half of the value added per worker in the formal sector. Further, employers have no incentive to invest in skills of contractual workers or in providing insurance.

Complex labor laws incentivize firms to remain small and stay in the informal sector.

Complex labor laws incentivize firms to remain small and stay in the informal sector. This allows them to remain under the radar of labor officials and escape stringent provisions. The large number of laws leads to inspection visits by different officials under different laws, which increases transaction costs and opens up opportunities for rent-seeking. There is also no standardization of documentation required or time periods for which records have to be kept. The inflexibility of labor laws has prevented large-scale employment growth in manufacturing. Moving workers from the informal to the formal sector can unleash productivity growth. In addition, formal workers in the formal sector pay taxes, so revenue collections can rise.

Labor mobility has also been hampered, as labor laws have reduced the demand for manufacturing labor. We use a simple framework to estimate the impact of labor mobility on growth rates. We broke down GDP growth into three components: 1) the contribution from sectoral increases in labor productivity, suitably weighted by the sector's share

of GDP; 2) the contribution from growth in the labor force in the sector, in the absence of labor mobility, again weighted by the sector's share of GDP; and 3) the impact on GDP growth from inter-sectoral labor mobility, in the presence of differences in sectoral labor productivity levels.

These are summarized in the equation (1) below:

$$g = S^A\pi^A + s^I\pi^I + (1-S^A-S^I)\pi^S + S^An^A + s^In^I + (1-S^A-S^I)n^S + \left(l^A \times \frac{\prod^I - \prod^A}{\prod} \times m^{AI}\right) + \left(l^A \times \frac{\prod^S - \prod^A}{\prod} \times m^{AS}\right) + \left(l^I \times \frac{\prod^S - \prod^I}{\prod} \times m^{IS}\right)$$

where:

superscript A stands for agriculture, I stands for industry, S stands for services.

g: GDP growth

s: share of a sector in GDP

n: natural rate of growth of labor force in the sector

l: share of a sector in total employment

Π: level of labor productivity

π: growth rate of labor productivity

m: the net movement of labor between sectors (e.g., m^{AS} stands for labor movement from agricultural to industry).

The contribution of inter-sectoral labor mobility on overall GDP growth is represented by:

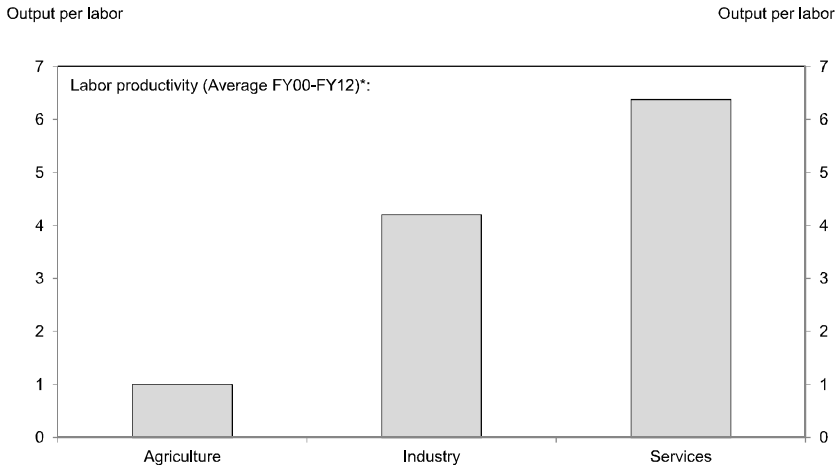
$$\left(l^A \times \frac{\prod^I - \prod^A}{\prod} \times m^{AI}\right) + \left(l^A \times \frac{\prod^S - \prod^A}{\prod} \times m^{AS}\right) + \left(l^I \times \frac{\prod^S - \prod^I}{\prod} \times m^{IS}\right) \quad (2)$$

We find that labor is four times more productive in industry and six times more productive in services compared to agriculture (Exhibit 3). We measured the impact on GDP of urbanization by looking at productivity differences between agriculture and the manufacturing and services sector. We find that in recent years the increase in GDP due to the shift from rural to urban areas has not increased significantly. The increase in GDP from the migration of workers from agriculture to other sectors was 0.87 percentage points of GDP, according to our estimates, in FY05-FY12. This was not significantly higher than the contribution of migration in FY00-FY05 of 0.73 percent points of GDP. Moreover, the contribution of moving from agriculture to industry has actually fallen over this period. Compare this with China, where we estimate urbanization is contributing 2-3 percentage points to GDP growth.

The Straitjacket of Labor Laws

India has some 44 labor laws, which are enacted by the Central Government and enforced by both the Central as well as state governments. In addition, there are also labor laws enacted and enforced by the various state governments. Some laws date from the colonial era. The Trade Unions Act is from 1926, the Workmen's Compensation Act is from 1923, and the Factories Act is from 1948. We focus on two acts in particular, that

Exhibit 3 Labor is much more productive in industry & services compared to agriculture



Source: "India: Adding 110 million jobs", *Goldman Sachs Asia Economics Analyst (2014)*, Issue No: 14/13

have some of the most restrictive provisions and where we believe labor reforms can have the largest impact on manufacturing employment and growth.

The Industrial Disputes Act (1947)

The law deals with the firing of workers, strikes, and the closure of firms. We believe this law has done more to hold back the growth of India's manufacturing sector than any other policy. It keeps most of the labor force in the informal sector, primarily in temporary jobs, preventing employers from investing in their training.

We believe the most consequential part of the Industrial Disputes Act is Chapter Vb, which deals with special provisions relating to lay-off, retrenchment and closure in certain establishments. This chapter is applicable to all firms that have more than 100 workers. "Lay-offs" denote being out of work temporarily, though still remaining on the employer's payroll, while "retrenchment" implies permanent loss of job.

Sections 25M and 25N deal with procedures to be followed for lay-offs and retrenchment, respectively. Under both sections, the prior permission of the government is required on an application made in this regard. For retrenchment, the workman has to be given three months' notice in writing indicating the reasons for the retrenchment. Importantly, the government consults with the workman before giving permission: "The appropriate government, after making such enquiry as it thinks fit and after giving a reasonable opportunity of being heard to the employer, the workmen concerned and the person interested in such retrenchment, may, having regard to the

genuineness and adequacy of the reasons stated by the employer, the interests of the workmen and all other relevant factors, …grant or refuse to grant such permission…"

Section 25O deals with the procedure for closing down an undertaking.The employer has to apply for permission at least 90 days before the date of closure.Workmen are entitled to receive compensation equivalent to 15 days' average pay for every year of service.

Section 25Q of the Industrial Disputes Act lays out the penalty for lay-off and retrenchment without previous permission: "Any employer, who contravenes the provisions of section 25M section 25N shall be punishable with imprisonment for a term which may extend to one month, or with fine which may extend to one thousand rupees, or with both."

Section 25R, which deals with penalty for closure, argues that any employer that closes down an undertaking without complying with the procedure of getting permission from the government shall be punishable with imprisonment for a term that may extend to six months or with a fine that may extend to five thousand rupees, or with both.

In addition, there is Section 25G on procedure for retrenchment: "the employer shall ordinarily retrench the workman who was the last person to be employed in this category." The principle followed is last come, first go. There is no consideration of merit.

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These provisions, which have seen some more pro-worker amendments by the states, essentially mean that the government is involved with every lay-off and retrenchment of workers. A factory job is not a voluntary contract between an individual and an employer, but a tri-partite arrangement with the government. Moreover, whenever a worker needs to be fired, the government would consult with the workers and their representatives, thereby bringing in the approval of the trade unions in the case. As a result, Indian employers looking to lay-off or retrench workers are presumed to be acting improperly until they can prove otherwise. India stands virtually alone among countries in having such stringent norms for employment termination. This sort of government permission is not required in any developed country and almost none of the emerging markets requires the permission of the government and consultations with trade unions. Even countries with restrictive labor regulations (for example, Bangladesh, Philippines, and Malaysia), do not require consultation and approval from trade unions.

There are few, if any, countries that require government permission to fire

workers. In China, to dismiss a worker does not require prior authorization from the government though the labor administration must be informed. In Malaysia, the courts do not interfere with the employers' decision to retrench workers provided the decision is bona fide and not taken to victimize the employee.

Comparing Gujarat & West Bengal

An interesting case study is a comparison between Gujarat and West Bengal on state amendments to the Industrial Disputes Act. The Gujarat government amended the Industrial Disputes Act in 2004 to allow for greater flexibility in the labor market for Special Economic Zones (SEZ). It allowed firms within the SEZ to lay off workers, without seeking the permission of the government, by simply giving one month's notice to the worker. To allow for firm exit, the law was amended such that the employer can close an undertaking by giving two months' notice to the government. Contrast this with the normal legal requirement of getting permission from the government, with the latter giving an opportunity for the employees to be heard on the issue. The Gujarat Act 12 changed the definition of "industrial dispute" to exclude the termination of service of an employee in an SEZ, thereby significantly reducing the scope for litigation.

The West Bengal Government, in contrast, made several pro-worker changes. The IDA was amended to be applicable to more firms – those employing above 50 workers. It changed the laws to make it virtually impossible to shut down a loss-making factory. The employer with the application for closure must contain the particulars of the quantum, mode, manner and time of payment of compensation to the workmen. The owner is also required to furnish a guarantee to discharge liability for payment of compensation to the workmen. Most factory owners thus prefer to keep their loss-making units barely viable, but strip their assets. Not only this, the West Bengal amendment says that where an application for closing down an undertaking is made, the appropriate government may issue such directions as may be necessary for maintaining normalcy and continuity of work during the notice period. This allows the government to keep a loss-making enterprise afloat even after the employers are unable to do so. This prevents the churn of capital and labor, which is at the heart of modern enterprise.

The results are quite clear-cut. While Gujarat saw a 60% growth in manufacturing employment in 2000-2012, West Bengal saw only a 22% increase.

There is a strong case for adopting an entirely new law to govern industrial relations.

Given the issues detailed above, and considering that the Industrial Disputes Act dates back to 1947, we believe there is a strong case for adopting an entirely new law to govern industrial relations. Due to several state amendments over the decades, the law has become unwieldy, apart from the strict measures

mentioned above, which we believe are clearly in need of revision. However, a new law may take several years in order to get a consensus among the states. In the meantime, the Gujarat amendment shows one way forward. The most stringent conditions, especially regarding retrenchment, may be excluded for the SEZs. This would allow these zones to be havens of employment and allow market forces to work in the labor market. With the government no longer involved in every employment decision, employers would be encouraged to increase formal employment and expand manufacturing, thereby taking advantage of economies of scale and investing more in the training of their workers.

The Trade Unions Act (1926)

We believe there are at least three key aspects of this act that merit retooling. First, the act allows for a multiplicity of trade unions. The Trade Unions Act stipulates that any seven or more workers can form a trade union and apply for registration. Further amendments allow the formation of at least ten unions in an establishment with a size of 70 workers. This means multiple trade unions in an establishment, which can reduce harmony, increase conflict, and promote competition between them.

Second, members enjoy immunity from criminal and civil liability when furthering the interests of the trade union. This immunity allows them to call strikes, which can hinder the smooth functioning of industrial units. This includes breaching terms of the employment contract.

Third, the law provides the scope for outsiders to the tune of 50% of the office bearers. This is undesirable as it opens the door to outsiders who can capture the unions and may not have the interest of firm employees as their priority.

It is instructive to see how other countries have reduced the role of trade unions. Bangladesh reformed its labor laws in 2006 and now requires a minimum membership of 30% of workers to form a trade union. In Sri Lanka, at least 40% of workers on whose behalf the trade union seeks to bargain with the employer should be members of such a trade union. In Pakistan, 20% of workmen should be members of a union to be entitled for registration. However, for collective bargaining, the union with at least one-third of workers employed in an establishment will be eligible for collective bargaining.

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In the US, to curtail the power of unions, the Taft-Hartley Act was passed in 1947. It declared closed shops as illegal. A closed shop is where the employer agrees to hire only union members and an employee who resigns from the union must be dismissed. The act forbade strikes in order to assign particular work to the employees. For a strike or lay-off, an 80-day notice had to be given by either side. Further, the president could

obtain an 80-day injunction to stop the continuation of a strike. This has been used often by US presidents to forestall industrial strikes. The act strengthened the employees' rights relative to the established union in several ways, including that an employee's membership of an established union is not required for him to work. The landmark act helped correct the balance in industrial relations and led to reduced industrial action and strikes as the US economy entered its historic post-war economic expansion.

In the UK, Margaret Thatcher's Government passed six pieces of legislation in 1980-1993 to reduce union bargaining power. Initially, the permissible grounds to refuse to join a union were extended. The definition of a trade dispute was narrowed to cover only disputes between workers and their employer, and the applicability of unions' immunity for civil and criminal liability was reduced. Inter-union disputes and all others lost immunity. Unions became financially liable to employers by unlawful industrial action. Industrial action outside the authorized terms could lead to the union being sued for damages and result in injunctions being granted against the union. Contracts specifying that only union labor was to be employed were outlawed. All unions were required to ballot members before engaging in industrial action. Absent such a ballot, the union automatically lost immunity and could be sued for breach of contract. Individual union members had the right to take their union to court when industrial action had not been the subject of a lawful ballot. Further, union members could not be disciplined for failing to participate in a strike. These pieces of legislation changed the nature of industrial relations in the UK, and they were followed by a period of strong economic growth and job creation.

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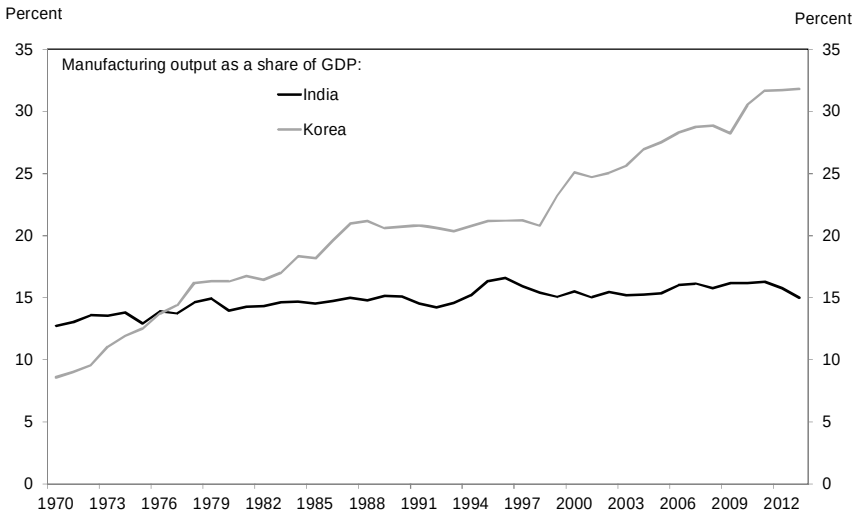
Given how outdated the Trade Unions Act has become, there is a clear need to overhaul to act to make it more applicable to the modern era. Legislation in the US and particularly the UK provide examples of how this can be done with sufficient political will. A modern act could promote better relations between employers and unions, encourage greater formal sector employment and economies of scale, and lead to less conflict.

Lessons from Korea

India has one of the lowest shares of manufacturing in GDP in Asia, at about 15%. An interesting comparison is with Korea, which has one of the highest shares of manufacturing in output at over 30%. India and Korea's share of manufacturing in output was similar until the early 1970s at about 14% of GDP. However, the trajectory since then has diverged dramatically. While Korea's share of manufacturing in GDP has acceler-

ated, India's share has stagnated at about 15%. Korea's per-capita income was 2.5 times that of India's in the early 1950s. Today it stands at eight times.

Exhibit 4 India and Korea manufacturing as a share of GDP has diverged since the 1970s



Source: "How India can become the next Korea", *Goldman Sachs Asia Economics Analyst (2014)*, Issue No: 14/15

Korea's labor laws during 1970s-1990s were liberal, allowing considerable flexibility in employment decisions. Until the mid-1970s, Korea's labor markets were in a state of permanent excess labor supply on rapid urbanization and demographic tailwinds. About 3% of the population was aged over 65 years in 1970 compared to 11% in 2010, with the working age population growing at around 3% per annum in the 1970s. Against this backdrop, labor regulations focused on job creation and training, and the formation and activities of labor unions were restricted until the late 1980s, especially for foreign-invested companies. The minimum wage was introduced only in 1988, and Korea did not join the ILO until 1991.

Korea's manufacturing growth began with labor-intensive industries. In 1970, the main export items were textiles, plywood and wigs, representing 40%, 11% and 11% respectively. Given that these are labor-intensive sectors, exports drove job creation. The main items changed to garments, steel plate, and footwear in 1980. Garments remained the top export item in 1990, with a 12% share but followed by semiconductors, footwear and TVs. By 2000, however, the top export items were transformed to capital-intensive items; the top five items were semiconductors, computers, automobiles, petroleum products, and ships. Industrial sectors, of which most are manufacturing, have stopped adding to their share of total employment since the peak of 28.5% in 1988.

The experience of other success stories in manufacturing in the region is similar. In China, in its high-growth phase starting from 1998, computers, electronics, electrical machinery, and textiles added the most jobs in manufacturing. Similarly, Taiwan saw similar increases in computers, electronics, electric parts, and leather products from the 1970s. Thus, in the initial growth phase, the labor-intensive sectors see the most rapid growth. As growth gets more broad-based, more technology-based sectors become the key drivers of job creation. This provides valuable lessons for the sectoral composition of growth in India.

There is little doubt from the Asian examples that the initial phase of growth has to come from intensively using the factor that is the most abundant: labor. India's growth strategy has to rely on labor-intensive manufacturing, and to do that requires urgent attention on laws governing labor. India's labor laws are currently not geared to encourage large-scale labor-intensive manufacturing, and we believe the Industrial Disputes Act and the Trade Unions Act should be changed to make them more supportive of job creation. Such a retooling of India's labor laws would also be in line with the new government's stated priority of ensuring sufficient jobs for India's youth.

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