Business Standard

Alok Sheel & Sean Dougherty: Constraining labour gains

Alok Sheel & Sean Dougherty / New Delhi October 28, 2007

India's per capita GDP growth since 2000 has averaged just under 5 per cent per annum, which is almost three times higher than in the first three decades following independence. The long-term implication is that after widening over the last few centuries, the gap in per capita income between India and OECD countries is at last showing a converging trend. Improvement in labour productivity, which doubled over the last two decades, is a major factor underlying this convergence. A recent OECD Survey* has found that since 1995 labour productivity growth in India has exceeded that for all OECD countries except Korea, even though it was lower than for China.

This productivity improvement has occurred despite indications in the latest full NSSO round (61st) of 2004-05 that the entire incremental job creation was in the less productive informal and unorganised sectors. Employment in the organised sector has remained unchanged at around 26 million between 1990 and 2005. Unorganised sector employment has meanwhile expanded by about 53 million, its share in total employment rising from 92 per cent in the early eighties to 94 per cent in 2004-05. In manufacturing, over 90 per cent of employment is in firms with less than 10 employees, compared to about 5 per cent in China. Despite their overwhelming preponderance, these small firms account for just about a third of manufacturing output. Indeed, the greatest incremental job creation (about 50 per cent) and employment elasticity (1.52) was in agriculture and allied services, which is the slowest growing and least productive segment of the economy. While per capita labour productivity increased on average by 5.5 per cent per annum in real terms between 1993-94 and 2004-05, in agriculture it grew by just 1.5 per cent. The OECD Survey estimates that productivity in the formal sector is 19 times and formal private company sector 27 times higher than in the agricultural sector. Even after controlling for technology, industry, region and firm’s age, total factor productivity in firms with more than 250 employees is almost double that in firms with only 10 employees.

It appears that while robust economic growth and productivity gains over the last two decades has more than halved the proportion of the population living below the poverty line since the early eighties, the employment bias in favour of the less productive sectors of the economy has constrained median income growth. It is unsurprising, therefore, that both the National Commission for Enterprises in the Unorganised Sector (NCEUS) and the World Bank have recently estimated that about 80 per cent of the population have incomes below $2 at PPP, compared to under 50 per cent in China.

Most of the productivity gains of the last two decades are on account of a modest shift of employment out of agriculture within the informal sector, modest gains in total factor productivity through expansion of education, and better technology in the formal sector. The OECD Survey found that in the organised sector, industries are becoming more capital intensive. Between 1998 and 2004 constant price fixed assets per employee rose by 21 per cent in firms with 100 or more workers, while it fell by 14 per cent in smaller firms. What has constrained labour productivity growth in India is the weakness of labour intensive manufacturing despite labour costs being as competitive as in China.

It is pertinent to note that while firm size has remained small, a substantial portion of India's manufacturing is in sectors that usually benefit from economies of scale. China has a much better record than India in labour-intensive manufacturing and has shown faster decline in poverty rates.

To what extent the anaemic performance of employment in organised manufacturing is on account of rigidity of labour laws is arguable. While net job creation in the organised sector is flat, the OECD Survey finds that rates of job creation and destruction are surprisingly as high as plant-level job flows in the US, which has much more flexible labour laws. These job dynamics indicate that the regulatory stance of employment protection legislation (EPL) in India should be weak, although India's labour market regulations are actually much more stringent than most OECD and developing countries. Employers have evidently been able to get around India's rigid labour laws using contract and fixed-term labour, substituting labour with capital and keeping plant sizes small. According to OECD and World Bank studies, poor infrastructure, longer lead times required to start a business, enforce contracts, and liquidate a business compared to various other developing countries, most notably China, could also be deterrents to growth of the organised sector.

Product and labour market reforms make for greater labour flexibility and create more employment opportunities in the organised sector that could enable India to leverage its labour cost advantage and hasten the structural shift of employment out of low-productivity agriculture and boost incomes. Broad cross-country evidence shows that job security regulations reduce job turnover and raise the cost of employment, with detrimental fallout on the creative-destruction process that is vital to economic and technological progress. The OECD index of state level reform and administration of labour laws show Andhra Pradesh, Uttar Pradesh, Gujarat, Haryana, Rajasthan and Punjab as the most reforming, with Bihar, Goa, West Bengal and Kerala as the least. The top reforming states also had the most flexible labour markets, with those at the bottom the most inflexible, measured in terms of gross job flows. While increased turnovers tended to limit the fall in the labour share of value added, since the highest score was only 28/50, no state was able to do more than to stabilise the size of the organised sector. The OECD Survey also found that more restrictive labour laws had a perverse effect on the poor as they tended to increase the urban poverty rate and accentuated labour market inequalities by making it more difficult for vulnerable workers such as women, minorities and youth to enter formal sector employment in particular.

On account of its sheer size, the performance of Indian labour market has important global ramifications. The integration of the large labour force in China and India into the global market has had the effect of lowering the costs of goods and services, consumer price inflation and interest rates, and enhancing growth across the world. India's integration so far has been primarily through services. In his recent memoirs, Alan Greenspan suggests that this virtuous cycle may be losing steam. But India has the same advantage as China in labour intensive manufacturing. There is also enormous potential for significant gains in total factor productivity through improved human capital and major strides in secondary and technical education. Should labour intensive Indian manufacturing start booming, the consequential welfare gains through productivity shifts and efficiency gains would also be globally transmitted.

* OECD Economic Surveys. India. 2007. (OECD and Academic Foundation, New Delhi)

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