

HOW SHOULD INDIA REFORM  
IT LABOUR LAWS?

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## **Abstract**

We examine the current policy debate around the reform of labour laws in India, which has been stimulated in part by the success of the Gujarat model of economic development. Gujarat's deregulatory reforms have included changes to the legal regime governing employment terminations, which could form a basis for a change in national-level labour laws. Evidence linking labour law deregulation to growth, however, is weak, whether the focus is on India or the experience of other countries. Building labour market institutions is a long-term process which requires investment in state capacity for the management of risks associated with the transition to a formal economy.

**Keywords:** labour law, institutions, India, law reform, Gujarat model

JEL Codes: J53, J58, K31

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## 1. Introduction

Labour law reform is currently on the political agenda in India, particularly in the wake of the election of the new Modi-led government at the centre. India's labour laws are decades old and are said to suffer from rigidities which are holding back economic development. Worker-protective labour laws, it is argued, are deterring investment and stalling the growth of formal employment. India's labour laws are set at an inappropriately high level for a developing economy, which would otherwise be in a position to use low-cost labour as a source of comparative advantage. The strict regulation of employment terminations ('retrenchments') in Part V-B of the Industrial Disputes Act 1947 (as amended) has been a particular focus of criticism. Critics of this law argue that as it targets larger plants and enterprises for regulation, it discourages the growth of firms, and contributes to labour informality.

Viewed in a comparative perspective, India's recent focus on labour law reform is not unique: other middle income countries have been having similar debates about the form and content of labour regulation. While these debates sometimes lead to deregulation, there is no worldwide trend towards the weakening of worker-protective labour laws (Adams and Deakin, 2015). Although the discourse of the World Bank and other international financial institutions remains focused on the need for flexibility in labour markets, there is an emerging view at country level that labour flexibility is not a sufficient condition for economic development, and perhaps not even a necessary one. Instead the focus is increasingly on how to build institutions for managing labour market risks in the transition to a formal economy (Marshall and Fenwick, 2015).

In this paper we seek to locate the debate over the future of labour law in India in the context of global trends, as seen through the lens of recent theoretical and empirical contributions to the study of labour regulation, and in relation to India's own experiments in regulatory reform, in particular the Gujarat model. Section 2 below outlines the movement of labour market theory away from equilibrium-based models, with their emphasis on labour law as a distortion of competition, towards an evolutionary understanding of labour market institutions, which takes a more nuanced view of their efficiency effects. Section 3 reviews recent empirical evidence on the operation of labour law systems, including India's. Section 4 looks at the Gujarat model and its combination of labour law deregulation, financial

incentives for business and infrastructural investment. Section 5 concludes.

## **2. Developments in the theory of labour regulation**

Beginning in the 1980s and gathering strength during the years of the Washington consensus, the economic critique of labour law was part of a wider case against regulation, which saw state interference as the source of distortions and inefficiencies in the operation of markets. This argument depended critically on the validity of its main premise, which is that markets, if unregulated, will move naturally or spontaneously to an equilibrium state. Neoclassical economics, which is the foundation of this view, has been highly effective in describing, and mathematically modelling, a state of the world in which, through perfect competition, supply and demand are equalised, and the aggregate wealth (or, in some versions, well being) of market actors is thereby maximised. In such a world, any outside interference with free exchange will, by definition, have negative effects on economic welfare. This follows axiomatically from the assumptions of individual rationality (consistent preferences coupled with maximisation) and market equilibrium which underlie neoclassical models (Becker, 1976).

It is one thing to model pure competition as a possible state of the world, and another to assume that it is the norm. Since the mathematical formalisation of the competitive market economy reached its apogee in the middle decades of the twentieth century (Arrow and Hahn, 1971), economic theory has directed its attention towards understanding how market exchange comes to be established in the first place, a very different question. This research agenda has gradually coalesced around the idea that perfect competition is a highly unusual state of affairs that it is not often, if indeed ever, replicated in real-life market economies (Coase, 1988). Meanwhile, the processes by which markets are instituted and sustained are still poorly understood, with historical research pointing to a range of causally relevant institutions (North, 2005).

The reorientation of the social sciences away from the study of markets in equilibrium towards analysis of the dynamics of institutions and institutional change has significant implications for labour markets in general and for the experience of developing countries in particular. A long tradition in economics, dating at least from Adam Smith (1776), recognises that power is unevenly distributed within the employment relationship. Modern institutional economics generally avoids using the term ‘power’ but

recognises that labour markets are far from perfect. Labour market outcomes are skewed by transaction costs arising from uncertainty and incompleteness of contracting (Williamson, Wachter and Harris, 1975) and by externalities arising from asymmetric information (Shapiro and Stiglitz, 1984). Characteristic features of labour market regulations in industrial market economies can be understood as evolved responses to the coordination problems associated with the distinctive form of the employment contract (Deakin and Sarkar, 2008): these include social insurance (Esping-Andersen, 1996), employment protection (Acharya, Baghai-Wadji and Subramanian, 2014) and worker representation (Rogers and Streeck, 1995). The right to strike, in addition to being framed as a human right deriving from the principle of freedom of association, can also be analysed as a counterweight to the managerial prerogative which law and custom together vest in the employer, with results that may in principle be conducive to the efficient operation of the market (Moore, 2014).

This point of view does not imply that labour market regulation is always and everywhere efficient. In the context of industrial economies with established institutions, there is a debate to be had over the appropriate form of regulation and over the degree of worker protection which is compatible with the use of the market as a mechanism of resource allocation. There may be trade-offs between equity and efficiency under certain circumstances, and complementarities between a fairer distribution and sustainable economic growth in others (Deakin and Wilkinson, 2005). In the final analysis these are empirical questions which cannot be addressed through theoretical reasoning alone, but a theory grounded in the experience of real-life economies is to be preferred to one based on axiomatic reasoning.

In developing economies, the debate takes a distinct form. Where the institutions which might underpin a formal labour market are still in the process of emerging, the issue for policy makers is, or should be, whether labour laws are likely to advance that process, or to hinder it (Marshall, 2015). On the one hand, there is a case against transplanting into a developing country context laws which were designed for mature industrial systems. In particular, laws which presuppose the existence of a formal economy in which wage dependence is the norm may have little relevance for economies in which the majority of the population relies on access to the land or the family for subsistence.

On the other hand, the transition to a wage-based economy with formal labour market relations does not occur in an institutional vacuum. Loss of access to traditional means of subsistence is compensated for by new forms of mutualisation and protection for the working population. In the global north, the transition to an industrial economy occurred coterminously with the evolution of institutions for managing and diffusing labour market risks, including laws on wage regulation, poor relief and apprenticeship, which anticipated later features of modern welfare states in Europe and North America (Deakin and Wilkinson, 2005). Thus the claim that developing countries have no need of laws to underpin emerging labour market institutions, whatever other arguments might be made in its favour, is not supported by the historical record of the countries which were first to industrialise. On the contrary, it was largely through the legal framework that labour capacity, which is not a 'natural commodity' (Marx, 1847; Polanyi 1944), acquired the form needed to sustain the complex economic relations and deep division of labour of a market economy (Deakin and Supiot, 2009).

Middle income countries today are very far from being pure subsistence economies. The characteristic pattern is for a formal economy consisting of a minority (of varying size) of the working population to coexist with a larger informal sector. In the informal sector, workers and households tend to rely for subsistence on a combination of waged work and access to the land and family incomes. Employment in the informal sector is irregular and discontinuous, as well as being insecure in the wider sense of providing limited access, at best, to collective mechanisms for sharing and diffusing labour market risks. In economies with this type of mix, it is far from clear that labour laws are irrelevant to the operation of the economy. Even when reliance on wage labour is partial or incomplete, laws which regularise the hiring process, protect the right to wages and permit workers to self-organise for the purpose of collective bargaining can address needs of workers in the informal sector for greater income security. Similarly, bringing informal enterprises into the coverage of social insurance systems can help mitigate the economic risks to which informal sector workers are exposed.

Much has been made of the argument that poverty in developing countries is the result of the failure of the legal system to recognise the interests of the poor in land and other tangible assets which could, with appropriate legal title, be used as collateral (De Soto, 2000). The limited success of land titling programmes to date suggests that the simple equation of legal rights

with developmental capacity is misplaced (Haldar and Stiglitz, 2013).

While there may be many reasons in practice for the failure of land titling to realise hoped-for economic benefits, the insight that the legal system plays a significant role in supporting economic exchange in middle income countries is not necessarily mistaken (Chen and Deakin, 2015). But it is striking that the proponents of legal formality in credit and capital markets should have had little to say about the role the legal system could play in promoting access to labour markets in middle income countries. There is an inconsistency in regarding credit as an institutional commodity when labour power is seen as a natural one, requiring nothing more than the free play of market forces. This omission is the more surprising since extending wage protection and social insurance systems has the potential to benefit a far higher proportion of the working age population in these countries than can be reached through land titling schemes.

### **3. Empirical evidence on the economic effects of labour laws**

Just as theory has moved on since the high point of the Washington consensus, the same trend can be observed in the empirical literature on labour regulation. In the late 1990s and early 2000s a small but influential literature appeared to have settled the debate in favour of the supporters of deregulation and labour market flexibility. Fallon and Lucas (1999), using a cross-national panel data analysis, found evidence of a negative relationship between worker-protective labour law and labour demand in a number of countries, including India. This finding was repeated in the larger panel dataset of labour laws across the world constructed by Botero et al. (2004). Of most significance for India was the study carried out by Besley and Burgess (2004), which found evidence of a negative impact on employment and investment of the adoption of worker-protective laws at sub-national (state) level. This study has been used to support claims that labour laws are one of the factors contributing to the relatively small size of the formal economy in India, which in 2014 accounts for less than 10 per cent of the total labour force.

Much has been written on the Besley-Burgess study. On one view, the methodology used to measure differences in state-level labour laws is insufficiently robust to justify clear conclusions being drawn from their analysis (Bhattacharjea, 2006, 2009; Jha and Golder, 2008). On another, once the Besley-Burgess index is corrected for coding errors, the same



negative impact of labour laws is found (Ahsan and Pagés, 2009). Even so, the results of the original study do not survive once account is taken of limited effectiveness, including court delays and difficulties of accessing the judicial system, in the enforcement of labour laws in India (Fagernäs, 2010). The econometric method used to test for correlations between the scores in the index and outcome variables measuring employment and investment has also been called into question (D'Souza, 2010). There is evidence that, in so far as there is a correlation between worker-protective labour laws and economic indicators, changes in the law are endogenous to those in the wider economy. Thus for the most part, Indian labour law has largely been responsive to wider factors in the economy, rather than a determining cause of them (Dutta Roy, 2004; Deakin and Sarkar, 2011).

An obstacle to achieving a better understanding of the role of labour law in economic development has been the lack of a data that can track changes in the legal framework over time in both developed and developing countries. The most widely used index for employment protection law is the OECD's Employment Protection Index ('EPI') (OECD, various years). However, it does not cover many developing countries, and while its ambit has recently been extended to include some systems outside the OECD, it does not provide a continuous time series for these countries. India and China, for example, are coded from 2008 only, and Brazil from 2010. The World Bank's Employing Workers ('EWI') Index provides longitudinal data on dismissal regulation (among other things) going back to the 2000s (World Bank, various years), but has been subject to criticism for its methodology (Manuel Report, 2013), in particular its focus on the regulations governing a standard employment relationship of full-time, permanent work which is not typical, in practice, for emerging markets. In both the EPI and EWI, data are based on mixture of survey evidence and analysis of legal materials, making it hard to discern the source of the codings.

The Centre for Business Research Labour Regulation Index (CBR-LRI) is a dataset constructed by researchers at Cambridge University (including one of the present authors) which provides a continuous time series on country-level changes in labour law going back to the early 1970s (or late 1980s/early 1990s in the case of former socialist systems) (for explanations of the methodology used in the construction of the dataset, see Deakin, Lele and Siems, 2007; Adams and Deakin, 2015). The data in the CBR-LRI are based on content analysis of legal texts and other primary sources of labour law rules, using a coding algorithm designed to capture gradations of labour

protection (so that on a 0-1 scale, a higher score indicates a greater degree of protection for the worker). As such, the dataset can only capture cross-national variations in the formal (de jure) law, but it can be combined with other indices, including the World Bank's Rule of Law Index (World Bank, 2015), to give a more complete picture of the operation of the law (see Deakin and Sarkar, 2008; Deakin, Malmberg and Sarkar, 2014; Deakin, Sarkar and Fenwick, 2014).

Table 1 sets out the scores in the CBR-LRI sub-index on dismissal protection for India (variables 25-31 out of a larger index consisting of 40 individual indicators). The explanations for the codings are provided at the point when the law changes (or from 1970, if it was in force at that point). The indicators cover the normal content of rules governing employment protection, including those regulating the minimum period of notice that the employer must give; entitlement to redundancy or severance pay; qualifying or arbitration periods; procedural and substantive standards relating to terminations; notification of dismissal; redundancy selection; and priority in re-hiring. The provisions of the Industrial Disputes Act 1947 as amended in 1976 are reflected in the high scores attributed to India for this part of the sub-index.

Some sense of India's position in comparison to other developed and developing countries can be obtained from Figures 1 and 2. India's dismissal laws are at the more protective end of the scale when compared to developing countries such as Germany and the UK, although they are not stricter than those of France. In relation to middle income countries (Figure 2), India has again scored more highly for worker protection, but the reforms made in China by the Labour Contract Act 2007 have removed the gap between these two countries, at least as far as the formal law is concerned. Changes made in the Labour Contract Act include a significant strengthening of procedural and substantive standards affecting dismissals and the introduction of rules on redundancy selection and priority in reemployment. The 2007 law also makes provision for trade unions to be consulted over dismissals and for the union to seek rectification of a dismissal carried out in breach of procedure.

**Table 1. Dismissal Protection in India, 1970-2013**

Variable	Template	Score	Explanation
Legally mandated notice period (all dismissals)	Measures the length of notice, in weeks, that has to be given to a worker with 3 years' employment. Normalise the score so that 0 weeks = 0 and 12 weeks = 1.	1970-1975: 0.33 1976-2013: 1	From 1970 the rule was one month or 4.3 weeks: Industrial Disputes Act (IDA) s. 25F. From 1976 it was three months for an employee with one year's service in an establishment employing 300 workers, reduced to 100 from 1984: IDA s. 25N, eventually declared constitutional in 1992 ( <i>Meenaskhi Mills</i> (1992)), although before then it was effectively in force in a number of states.
Legally mandated redundancy compensation	Measures the amount of redundancy compensation or severance pay payable to a worker made redundant after 3 years of employment, measured in weeks of pay. Normalise the score so that 0 weeks = 0 and 12 weeks = 1.	1970-2013: 0.5	IDA s. 25F provides that for a retrenchment to be lawful, compensation must be paid at the rate of 15 days' average pay for every year of service.
Minimum qualifying period of service for normal case of unjust dismissal	Measures the period of service required before a worker qualifies for general protection against unjust dismissal. Normalise the score so that 3 years or more = 0, 0 months = 1	1970-2013: 0.67	One year qualifying period for procedural protection and right to compensation for retrenchment (s. 25N IDA).
Law imposes procedural constraints on dismissal	Equals 1 if a dismissal is necessarily unjust if the employer fails to follow procedural requirements prior to dismissal. Equals 0.67 if failure to follow procedural requirements will normally lead to a finding of unjust dismissal. Equals 0.33 if failure to follow procedural requirement is just one factor taken into account in unjust dismissal cases. Equals 0 if there are no procedural requirements for dismissal. Scope for gradations between 0 and 1 to reflect changes in the strength of the law.	1970-2013: 1	Under the IDA, disciplinary proceedings must precede dismissal for misconduct. The workman must be informed of the alleged misconduct in writing and be given an opportunity to respond. Various formalities must be followed. See Industrial Employment (Standing Orders) Central Rules 1946, and extensive case law ( <i>Barot v. State Transport Corporation</i> (1966), <i>Brooke Bond India v. Choudhary</i> (1969), <i>Chandulai v. Pan Am</i> (1985)).

Law imposes substantive constraints on dismissal	Equals 1 if dismissal is only permissible for serious misconduct or fault of the employee. Equals 0.67 if dismissal is lawful according to a wider range of legitimate reasons (misconduct, lack of capability, redundancy, etc.). Equals 0.33 if dismissal is permissible if it is 'just' or 'fair' as defined by case law. Equals 0 if employment is at will (i.e., no cause dismissal is normally permissible). Scope for gradations between 0 and 1 to reflect changes in the strength of the law.	1970-2013: 0.33	The court will intervene where there is lack of good faith, a breach of natural justice, an error of fact, or in the case of a perverse finding: Industrial Employment (Standing Orders) Central Rules 1946; extensive case law beginning with <i>Indian Iron and Steel Co.</i> (1958)); IDA s. 11A, inserted in 1976.
Reinstatement normal remedy for unfair dismissal	Equals 1 if reinstatement is the normal remedy for unjust dismissal and is regularly enforced. Equals 0.67 if reinstatement and compensation are, de iure and de facto, alternative remedies. Equals 0.33 if compensation is the normal remedy. Equals 0 if no remedy is available as of right. Scope for further gradations between 0 and 1 to reflect changes in the strength of the law.	1970-2013:0.33 1976-2013: 0.67	IDA 1947, s. 11A, inserted in 1976, formally gave labour courts the power to grant reinstatement as the ordinary remedy for dismissal, although the courts have been reluctant to grant it e.g. where to do so would be contrary to industrial peace ( <i>Tulsidas Paul</i> (1964)).
Notification of dismissal	Equals 1 if by law or binding collective agreement the employer has to obtain the permission of a state body or third party prior to an individual dismissal. Equals 0.67 if a state body or third party has to be notified prior to the dismissal. Equals 0.33 if the employer has to give the worker written reasons for the dismissal. Equals 0 if an oral statement of dismissal to the worker suffices. Scope for further gradations between 0 and 1 to reflect changes in the strength of the law.	1970-1975: 0.67 1976-2013: 1	Between 1970 and 1975, under s. 25F IDA, the employer had to notify the state authorities, give one month's notice in writing, and pay compensation to the employee. Under s. 25N IDA, inserted in 1976, government permission and 3 months' notice were required for retrenchments in establishments of 300 or more employees, reduced to 100 from 1984.
Redundancy selection	Equals 1 if by law or binding collective agreement the employer must follow priority rules based on seniority, marital status, number of dependants, etc., prior to dismissing for redundancy. Equals 0 otherwise. Scope for further gradations between 0 and 1 to reflect changes in the strength of the law.	1970-2013: 1	The employer should follow the rule of seniority implied by the 'last in, first out' rule: s. 25G IDA.

Priority in re-employment	Equals 1 if by law or binding collective agreement the employer must follow priority rules relating to the re-employment of former workers. Equals 0 otherwise. Scope for further gradations between 0 and 1 to reflect changes in the strength of the law.	1970-2013: 1	There is a right to priority in re-employment on the part of retrenched workers: s. 25H IDA.
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Source: CBR Labour Regulation Index (see Deakin, Lele and Siems, 2007; Adams and Deakin, 2015).

**Table 2. Rules on notification of dismissals in selected countries, 1970-2013**

Country	Score	Explanation
Brazil	1970-1989: 0	Under Art. 477 of the Code on Labour Law, amended in 1990, a termination will only be valid if certain formalities are observed, including submission of a termination form to the Ministry of Labour.
	1990-2013: 0.33	
China	1986-1994: 0.5	Under the Provisional Regulations on Labour Relations (1986), the employer had to consult the trade union and make a report of the dismissal to the administrative authorities and to the labour office. Labour Law 1994 Art. 30 gave the trade union the right to make representations to the employer in a case where it considered termination to be inappropriate. The Labour Contract Law 2007 refers to notification to both the union and the public authorities in the case of both collective and individual dismissals. If the employer violates the law the trade union has the right to require rectification and the employer must consider the trade union's view and notify it of how it handled the matter.
	1995-2007: 0.75	
	2008-2013: 1	
France	1970-1972: 0	Under Law 75-5, the authorisation of a state body was required for economic dismissals, including individuals ones (Labour Code Art. L. 321-7). From 1986, this was replaced by a duty to notify the relevant state body. See now LC Art. L. 1233-115. Act No.75-5, codified as LC Art. L.122-14-1, provided that written reasons had to be given to the employee. See now LC Art. L. 1232-6.
	1973-1974: 0.33	
	1975-1985: 1	
	1986-2013: 0.67	
Germany	1970-1971: 0.5	Until 1972: §§ 65, 66(1) BetrVG (Works Constitution Act) stipulated that notification to the works council was necessary, but it was controversial whether violation of this norm affected the validity of dismissal (see Söllner, <i>Arbeitsrecht</i> , 3 <sup>rd</sup> edn., 1972, p. 164). § 102(1) BetrVG of 15 January 1972 (BGBl. I 1972, 13): violation does affect validity.
	1972: 0.67	
India	1970-75: 0.67	Between 1970 and 1975, under s. 25F Industrial Disputes Act, the employer had to notify the state authorities, give one month's notice in writing, and pay compensation to the employee. Under s. 25N IDA, inserted in 1976, government permission and 3 months' notice were required for retrenchments in establishments of 300 or more employees, reduced to 100 from 1984.
	1976-2013: 1	
Japan	1970-2013: 0	There is no legal requirement for notification of dismissals.
Russia	1992-2013: 0.33	Notification in writing to the employee (see now Art. 180, Labour Code).
South Africa	1970-2013: 0.33	Notification to the worker has been the norm in respect of individual dismissals under successive versions of the Labour Relations Act.
UK	1970-1971: 0	The normal rule since the inception of the unfair dismissal jurisdiction in 1971 (see now Employment Rights Act 1996) is that the employee must be given written reasons in writing.
	1972-2013: 0.33	
USA	1970-1988: 0	Written notice must be given to the exclusive representative or bargaining agent of affected employees or to unrepresented individual workers under the provisions of the Workplace Adjustment, Retraining and Notification Act 1988.
	1989-2013: 0.67	

Source: CBR Labour Regulation Index (see note to Table 1).

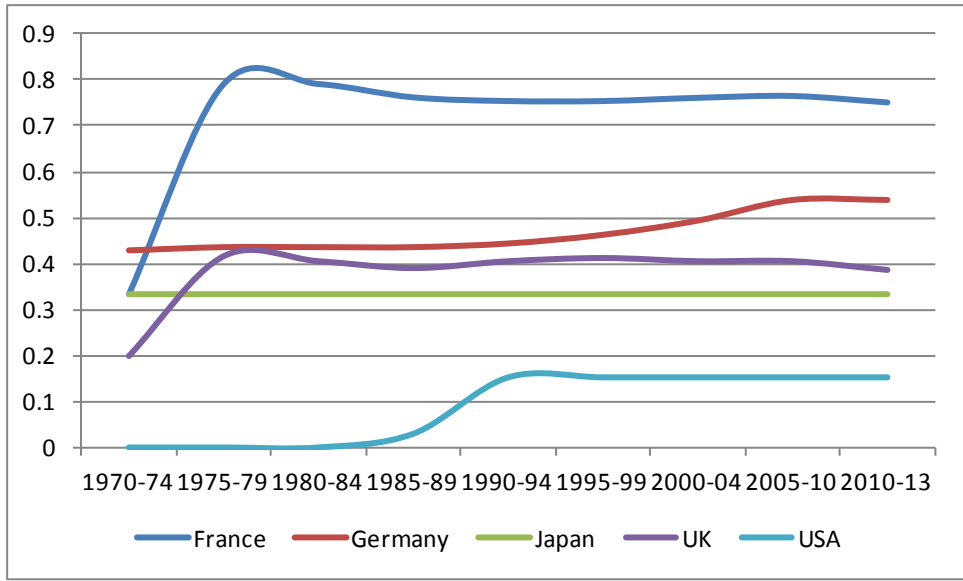


Figure 1. Dismissal laws in selected developed countries. Source: CBR Labour Regulation Index (see note to Table 1).

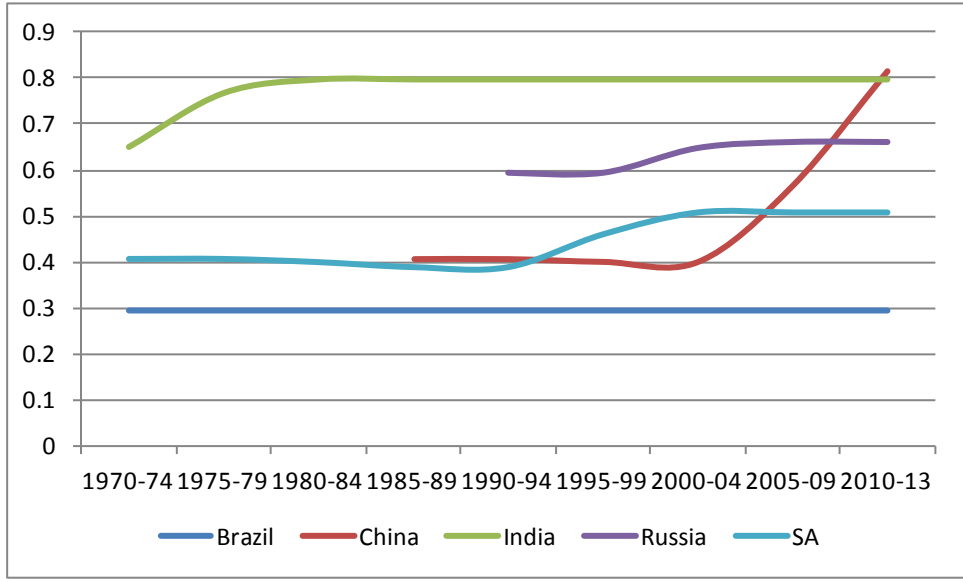


Figure 2. Dismissal laws in selected developing countries. Source: CBR Labour Regulation Index (see note to Table 1).

Averaging the scores in the CBR-LRI across countries for a range of variables over a period of years can give a broad-brush impression of trends, but may also gloss over relevant differences. The aspect of Indian labour laws which has given rise to most discussion and criticism is the requirement of government permission for large-scale retrenchments, contained in section 25N of the Industrial Disputes Act. On the coding algorithm used in the CBR-LRI, this change, made in 1976, makes Indian labour law among the most worker-protective in the world, but it by no means the only country with a high level of legal protection for workers in matters of dismissal.

Table 2 sets out in summary form the content of similar laws in other developed and developing countries. Nearly all have a notification law of some kind. France required administrative permission for dismissals between 1975 and 1986. This requirement was repealed in 1986 and replaced by an obligation to notify a state body, while also leaving intact the right of a dismissed worker to seek compensation or (less usually) reinstatement before a labour court. In Germany, notification of dismissal to the works council is required, and failure to comply with the process laid down for notification can lead to the nullification of the dismissal under certain circumstances.

When administrative permission was needed in France, prior to 1986, it was normal for it to be granted if the employer could demonstrate a *prima facie* case for the dismissal and if procedural requirements were followed. The move away from administrative oversight was accompanied by a strengthening of protection for the worker in the context of individual claims and by a growing role for collective worker voice on issues of dismissal. Thus it is not clear that the change of approach gave employers more leeway over dismissals than they had had before. In some ways they may have had less once the certainty of administrative approvals was no longer available. In Germany, although the works council can in principle exercise a veto power over a dismissal, this very rarely happens in practice. Works council approval is sometimes used by employers to provide legitimacy for dismissals which might otherwise have been questioned.

Thus in the European approach, laws on notification of dismissal generally do not constitute an absolute bar on employment terminations. Rather, they serve to proceduralise the dismissal decision, in the sense of subjecting it to standards of fairness whose application is worked out on a case by case basis. It is an open question whether such laws hinder or assist employers.



One view is that by legitimising dismissals, their overall effect is to strengthen managerial prerogative (Collins, 1995).

In the Indian context, the requirement of state permission contained in section 25N of the IDA may have been operated somewhat more strictly than its equivalents in western Europe. Empirical research (Ahsan and Pagés, 2009) suggests that the law has in the past provided a disincentive to employers to increase numbers in employment over the threshold at which the requirement is triggered (300 workers from 1976; 100 from 1984). A case may therefore be made for modifying the IDA's notification requirements.

However, as we have seen it is unusual for labour law systems to make no provision of any kind for notification. When formal administrative permission for terminations was removed in France in the mid-1980s, this was against the backdrop of a dismissal law which in other respects continued to provide significant procedural and substantive safeguards against dismissal, enforceable through recourse to the labour court (the *conseil de prud'hommes*). In Germany, the involvement of collective employee representatives in the dismissal process provides a check on the employer's termination power. In the Indian context, given the delays affecting court claims and the absence of a codetermination law or its equivalent, there can be no guarantee that the repeal of section 25N would allow a similar shift from one mode of regulation to another.

Reform of Part V-B of the IDA should also take account of the growing empirical literature on the operation of employment protection laws in Europe and north America. Although this is a developing field, the literature by no means points to a deregulatory agenda (for an overview, see Adams and Deakin, 2015). In studies making use of the CBR-LRI dataset, dismissal protection is seen to encourage innovation based on workers' firm-specific skills and knowledge (Acharya et al., 2014). Worker-protective dismissal regulation is generally correlated with improvements in productivity. In some countries (notably the USA), this results in reduced employment growth, as tighter controls over dismissal raise hiring costs, but in others (notably Germany), where dismissal laws operate alongside laws mandating vocational and educational training, these disemployment effects have been avoided (Deakin and Sarkar, 2008). The provisional conclusion to be drawn from this literature is that dismissal laws may be conducive to employment growth where they operate alongside institutions to promote investment in

human capital. Dismissal protection, along with laws mandating employee voice at work and collective bargaining over wages and terms and conditions, has also been shown to favour more egalitarian outcomes, in terms of the relative shares of wages and profits in national income (the 'labour share'), and by reference to the Gini coefficient, which is a general measure of economic inequality (Deakin, Malmberg and Sarkar, 2014; Deakin, Fenwick and Sarkar, 2014).

#### **4. The Gujarat model**

The 'Gujarat model' of development has become a byword in development and economic policy circles since Narendra Modi's election as Prime Minister on 16 May 2014. The focal point of Modi's electoral campaign was the promise that he would do for India as a whole what he did for his home state, Gujarat. Over his decade-long period at the helm since 2001, the state acquired the reputation of being unparalleled in its 'pro-business' approach, by offering a package of improved infrastructure (especially roads, but also ports) and good governance (reduced corruption and a streamlined bureaucracy, often achieved by means of innovative use of technology as in the case of the Jan Vikas Kendra simplifying certification processes, or the E-Jamin scheme for digitizing land records). Land and labour were offered on favourable terms to businesses, including through the creation of Special Economic Zones (SEZs) which were set up via forced land acquisition on a large scale. Under the Gujarat Industrial Disputes (Amendment) Act 2004 and the Gujarat Special Economic Zone Act of the same year, the bulk of national labour law was disapplied in the SEZs. In particular, Part V-B of the IDA was replaced by a more liberal regime for employment terminations, under which the requirement of administrative authorization for dismissals was replaced by a limited right to compensation for workers with a year or more of continuous employment. Further incentivisation was provided through 'assistance packages' for investments over a certain amount. The Gujarati government currently advertises 'path-breaking labour laws' alongside 'facilities and fiscal benefits' (mostly exemptions from taxes and planning rules) for firms relocating to its SEZs (Government of Gujarat, 2014).

There is however considerable dispute with respect to the nature of the Gujarat model. During the recent general election campaign, industry and investment, infrastructure and power were presented by its supporters as the key features of the model. Industrial growth appears to have jumped to 12.65

per cent per annum in the period between 2005-9, from 3.95 per cent in the period between 2001-4. Agricultural reform, channeled mainly through improvements in infrastructure (power, water, roads), also appears to have worked, with annual average growth rates in agricultural production of 10.97 per cent, the highest of any Indian state between 2001 and 2010. Improvements in healthcare and women's empowerment are also emphasized by the model's supporters, although gains on these fronts are more contentious.

Managing to out-compete several other Indian states in bids for international and domestic investment, Gujarat has established itself as a major industrial hub and manufacturing centre, becoming home to major industrial houses like Reliance and Essar, and developing a special competence in automobiles with investments from Maruti Suzuki and Ford. The obvious contrast to the Gujarat model in policy terms is West Bengal, ruled for the majority of the history of post-independence India by the communist party that was elected to power on the back of a widespread land redistribution policy, and associated with extremely stringent labour laws and support for trade unions. The weak economic performance of this state, despite its illustrious history, rich endowment of natural resources and advantages of geographical location, has become a cautionary tale of the ills associated with an over-protective government apparatus. The contrasting approaches of the two states were underscored dramatically by the defection of the Tata Nano car factory from West Bengal to Gujarat in 2008, in the wake of violent protests about forced land acquisition in the Singur region (Alfaro, Iyer and Arora, 2009).

The Gujarat model can also be contrasted with the Kerala model that has long been prominent in development discourses. Unlike the Kerala model, that became famous for its high attainment in Human Development-type welfare indicators (notably one hundred per cent literacy), the Gujarat model is more focused on traditional models of economic success, particularly high growth rates. Indeed, it was the contrast between these two trajectories of development that was the focal point of the Sen-Bhagwati debate (Dreze and Sen, 2013; Bhagwati and Panagariya, 2012) in the run up to the recent general election.

Thus the Gujarat model seems to exemplify the wisdom of the 'rule of law' orthodoxy, providing empirical evidence of the idea that a process of rationalizing institutions and a regime of deregulation, focused on a minimal

institutional structure providing clarity and certainty in the realms of property and contract, will bear fruit in terms of economic growth and prosperity. Indeed, it is this perspective that has informed the national government's initial labour law reforms of October 2014, which include streamlining databases of companies, modifying procedures for reporting on compliance with labour regulations, and reducing the discretion of inspectors. So far, the government has not proposed a more fundamental change to Part V-B of the IDA, but this remains an option for the future in what appears to be a cautious approach to the sequencing of reforms.

Before Gujarat is accepted as an undisputed 'gold standard' for Indian economic policy, however, there are a few points that should be considered. To begin with, an extensive literature indicates that the dynamics of institutional replication are more complex than they may initially appear (Berkowitz *et al.*, 2003a, 2003b). The apparent success of a certain set of economic policies in the context of Gujarat may be due to local factors such as a long-established entrepreneurial tradition in that state and advantages of geographical location that do not apply in other contexts.

The more fundamental question, however, is whether the transposition of the model onto the national platform would be desirable even if it were achievable. On this front, the first thing that is worth noting is that the key point on which the model has built itself is reform in land, labour and credit markets. As Polanyian scholarship emphasises, land, labour and money are not 'pure commodities'. Attempts to construct a market economy require the creation of institutional capacity and not simply the removal of government controls (Polanyi, 1944). In this context it is unclear what is distinctive about the Gujarat model, and what it offers beyond a policy of liberalisation and deregulation combined with subsidies for plant relocations which can by their nature be only temporary.

Nor is it clear that Gujarat's deregulatory approach should be credited with the growth it has achieved. Other Indian states, including Maharashtra, have grown as quickly as Gujarat or even surpassed it. Thus the idea of the Gujarat model is a unique path to unparalleled growth may be questioned.

Finally, while adopting the model in Gujarat may have led to positive outcomes in terms of growth, the model entails some questionable trade offs: there may have been gains in the aggregate, but this says little about how those gains are divided up (for instance what proportion of them accrues to

labour). Serious questions and concerns remain about the inclusivity of the model, and about social indicators (on health, education, infant mortality, and women's literacy) lagging behind the economic ones. Gujarat's scores on the Human Development Index place it below the national average, so that it is still classified as a 'less developed state'. The Union Ministry of Health and Family Welfare estimates that the shortage of doctors in Gujarat is 34 per cent, compared with the national average of 10 per cent, while one child in three in Gujarat is reported to be malnourished on 2013 estimates.

## **5. Conclusion**

The Gujarat model emphasizes the streamlining of governance structures as the pathway to development, with the deregulation of labour laws a key element of this process. The state appears to have reaped significant benefits from this approach in terms of attracting investment and augmenting growth. It is consequently a noteworthy model, and its successes are worth studying. However, implicit in the model are a range of normative and policy choices that need to be examined carefully before adopting it as a template for the entire country.

In particular, it is not clear that a policy of deregulation and subsidization of business through fiscal exemptions is sustainable over the longer term. This strategy may produce some quick wins for state governments keen to attract inward investment, but it will not lead to sustainable growth unless it is coupled with investment in institutional capacity. For the labour market, this means supporting the institutions through which human capital is created and sustained, in particular education and training systems and social insurance. Without such changes, it is unlikely that access to the formal employment will become a reality for more than a small minority of Indian workers, as it is at present. There may be a case for modulating the strict controls over employment terminations set out in Part V-B of the Industrial Disputes Act. However, removing all regulation of the termination decision and leaving workers with a limited financial claim following dismissal is unlikely to encourage investment in firm-specific skills. Such an extensive deregulation of dismissal protection would do little to help firms remain competitive over the long run. For India to embed the Gujarat approach to labour law at national level at a time when other middle income countries, including China, are strengthening employment protection rights, would

raise many questions over the direction of policy.

The Gujarat model also poses some difficult questions over potential trade offs between equity and efficiency. Weakening workers' rights is generally regressive in distributional terms, and economic growth without social cohesion comes at a wider cost. For India's policy makers, labour law reform poses the question of whether growth is to be seen as an end in itself or a means to other ends.

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