

Chapter 2

Labor Markets in Developing and Transition Countries

2.1 Introduction

In the standard treatment of labor economics, we assume a homogeneous and aggregated work force. The labor market is characterized by demand and supply functions, each responding to the change in real wage. While the demand curve is derived from the aggregate short-run production function, the supply curve is derived out of the labor–leisure choice problem. The aggregate utility from consumption and leisure is maximized subject to a fixed time constraint; a portion of which goes on to the labor market and the rest to leisure. It should be immediate that a rise in real wage, *ceteris paribus*, lowers the time spent in the labor market and adds time to leisure. The demand side of the labor market is responsive to the real wage in just the opposite manner. A rise in real wage payable to the workers lowers the demand for labor in the aggregate. In fact, the well known result on “efficiency wage” and unemployment available in Shapiro and Stiglitz (1984) uses this simple intuition to show that a rise in real wage may significantly lower the incidence of shirking in the workplace owing to the unemployment pressure created by the higher wage. Let us briefly elaborate on this result before providing an analytical structure of the labor market equilibrium.

Shapiro and Stiglitz (1984) had shown that the offer of efficiency wage (meaning, wage paid above the market-clearing level of productivity/wage in a competitive system) to the workers lowers shirking on the job at the firm level. In a market characterized by a large number of identical firms, if one firm benefits by offering an efficiency wage, the other firms with full flow of information among them quickly replicate that and raise the wage too. In fact, if one firm offers efficiency wage, and others do not, then both wage and employment implications of this policy get fairly limited. Since no other firm, but one, implements the efficiency wage, the average wage still remains low, and the employment level high. Consequently, if the workers in the implementing firm lose jobs due to shirking, they are quickly rehired elsewhere (assuming that loss of jobs due to shirking does not carry a stigma), and pay only a small penalty due to shorter unemployment

spells. However, if every other firm follows the same policy of efficiency wage in the labor market, it raises wage, and lowers aggregate demand for labor. Thus, without incurring the internal monitoring costs and without direct punitive measures, the firms are directly able to extract greater productivity from workers by creating the pressure of unemployment in the labor market. The workers who are now fired for shirking on the job would hence find it rather difficult, under the circumstances, to regain employment because the rise in wage leads to lower demand for labor in the aggregate creating a larger unemployment pool. This would naturally imply that if unemployed in the regime of economy-wide efficiency wage, the waiting time for a job opportunity to present itself will be much longer compared to the nonefficiency wage regime, and therefore would influence the workers still employed not to shirk at the workplace. The opportunity cost of employment is, however, not zero in the said model, because the typical developed countries offer generous unemployment benefits to its workers.

It should be different in developing countries where unemployment benefit is either unavailable or dysfunctional. The workers would be pushed to the unorganized sector, which adjusts wage and employment instantaneously to accommodate labor inflow. We discuss the characteristics of the informal production segment later in this chapter. Absent informal sector, workers must remain involuntarily unemployed.

Analytically speaking, the equilibrium real wage is determined in the following manner. $(w/p)^*$ is derived as a solution of the following demand function equating the supply function:

$$N_d\left(\frac{w}{p}\right) = N_s\left(\frac{w}{p}\right). \quad (2.1)$$

Interpretation of the supply function is of critical importance. There are two basic options:

1. Each worker wishes to supply more working hours as (w/p) moves up until a critical level beyond which the relationship ceases to be monotonic.
2. Workers may be homogeneous in all aspects except that they have different preferences for leisure. As (w/p) moves up, more people wish to work, i.e., those who have stronger preference for leisure are allured into the job market.

In the first case, at $(w/p)^*$ demand for total working hours is matched by the supply. All along the supply curve, everyone remains employed but for $(w/p) \neq (w/p)^*$, there is a mismatch between number of working hours demanded and supplied. Therefore, one could suggest that for $(w/p) > (w/p)^*$ they will be *fully employed* in the physical sense, and there will be no *visibly unemployed* person. But the neo-classical adjustment mechanism will make sure that (w/p) declines and reaches a level such as $(w/p)^*$.

3. The second interpretation tells us that at $(w/p)^*$, L^* number of people work for h^* number of hours each. If there are L number of potential workers, then $(L - L^*)$ do not wish to work because they do not get a wage greater than $(w/p)^*$.

If $(w/p) > (w/p)^*$, then \tilde{L} number of people ($\tilde{L} > L^*$) may want to be a part of the labor force but demand for labor at that wage is $L^d < \tilde{L}$. Unemployment is a direct outcome of this labor market mismatch. The developing and transition countries generally face substantial mismatch in their respective labor markets, for which the institutional characteristics play a major role.

In fact, the extant literature suitably discusses the labor market institutions and policies in the transition countries of Eastern Europe and Central Asia among the larger set of developing and transition countries. The studies analyze links between these institutions and policies and the performance of labor markets (e.g., Boeri and Terrel 2002; Cazes 2002; Fialova and Schneider 2009). These and similar other studies are essentially motivated by the idea that the economic transition and reforms in the labor market offer conditions for natural experiments (e.g., Boeri and Lehmann 1999; Svejnar 1999, etc.). The countries of Eastern Europe regularly claim that the imposed standardization during the communist period created a lot of homogeneity in terms of initial conditions in their labor markets. The heavy thrust of industrialization during the Soviet planning era led to shortage of labor, no open unemployment, very high levels of unionization, and no unemployment protection—apparently a strange mix of features that would appear artificially maintained in the light of the union bargaining, and other common practices in any labor market discussed in later chapters of this book.

How does a transition economy (TE) described above react to market forces? Essentially, these countries are also exposed to a high degree of economic fluctuations with regard to income, investments, employment levels, etc., shaping the adjustments to the market forces—which has been the key structural change in the transition countries—moving from a centralized planned economy to a market economy. Lehmann and Muravyev (2010), for example, show that despite the difference in the magnitude and length of the transition shock, the unemployment rate in Poland (19.0%) has persistently remained much higher than that in Ukraine (8.6%) in the year 2004. Also, according to these data, the Czech Republic and Slovenia had low unemployment rates compared to Albania and Slovakia where unemployment has stayed above 10% for the most part of the reported period. Overall, the data show that a few years since the beginning of market reforms, the experiences of transition countries, including labor market outcomes, revealed great differences, often comparable with the differences between the USA and Western European labor markets (Rutkowski 1996). The authors point out that the divergent labor market outcomes in transition countries cannot be attributed to economic shocks only, and a large part of the explanation belongs to freshly evolving labor market institutions and policies (also see Svejnar 2004), including adoption of previously nonexistent unemployment benefits. Lehmann and Muravyev (2009) further suggest that the benefits were, however, fraught with significant amount of uncertainty, and were often discontinued during the 1990s, when transition was still at a nascent state, (also see, Riboud et al. 2003), and that the governments struggled to keep a low fiscal deficit. A usual outcome of the labor market transition is a lower level of unionization compared to earlier regimes and the transition countries were no stranger to this phenomenon (viz., Borisov and Clarke 2006; Kohl 2008, etc). Sometimes, as

we shall discuss in the last chapter, unions bargain rather strongly in favor of higher wages and not for maximizing employment. Within the smaller member group, the unions may in fact show larger domination in terms of policy issues. Many developing countries of the south and those in Central Europe bear direct testimony to such patterns (Rutkowski 1996).

The countries of the region introduced a number of tax reforms, e.g., the switch to the flat personal income tax rate had become a common feature of most countries, following the experience of Estonia in 1994. However, the tax burden on labor had remained rather high in Central Europe, though not in most of the other transition countries (World Bank 2007). While active labor market programs have been introduced throughout the region, their share in the gross domestic product (GDP) has been lower than in the old member states of the EU and substantially lower in Southeastern Europe and the former Soviet Union (World Bank 2005). Importantly, despite such general trends, the variations across countries within the same group have remained considerably high. For example, Estonia and Slovenia are often mentioned among the success stories among transition countries, but they have had perhaps the most dissimilar labor market institutions and policies among the Central and Eastern European (CEE) countries in the past 20 years.

Lehmann and Muravyev (2010) comment that despite the potential benefits from exploring these large variations in labor market outcomes, institutions, and policies in Eastern Europe and Central Asia, relatively little has been done so far. The main reason is the unavailability or the low quality of data, especially from the early stages of the transformation process. As a result, most of the existing studies in the context of transition adopt a partial approach by focusing on particular institutions and policies. For example, Nivorozhkin (2005) studies the effect of active labor market policies (ALMP) in Russia, Commander and Heitmueller (2007) discuss the role of unemployment insurance in unemployment dynamics of the countries in transition, and Behar (2009) focuses on both tax wedges and unemployment benefits in the new EU member states. These papers that attempt to evaluate the whole set of the core institutions together (following Nickell 1997) adopt either a purely descriptive approach or supplement data from a few transition countries with that available from the Organisation for Economic Co-operation and Development (OECD) economies or EU member states (Cazes and Nesporova 2003; Ederveen and Thissen 2007; Fialová and Schneider 2009). According to Lehmann and Muravyev (2009), “while there are potential benefits of combining data from established market economies with those from transition countries, it may require more careful econometric modeling and estimation than has been done thus far to account for different initial conditions, shocks, and differences in the general institutional environment.”

Overall, these intuitional characteristics, with partial evidence concerning the link between institutions, policies, and labor market outcomes in transition countries, are still fairly limited by the availability of appropriate data. Nevertheless, some studies suggest that employment protection may indeed affect labor market outcomes in the transition countries (e.g., Cazes and Nesporova 2003) along with country-specific labor market policies (Rovelli and Bruno 2010). In contrast, Commander and Heitmueller (2007) find no link between the generosity of the unemployment benefits and unemployment rates in transition countries and

suggest that the overall link between institutions and unemployment rates is weaker in transition countries than in Western Europe and other OECD countries. Note that, some OECD countries even have the trade adjustment assistance (TAA) as an unemployment benefit policy offered to its workers retrenched due to the penetration of import goods in the domestic market. Recent studies dealing with developed countries with low-skill intensive import competing goods highlight that there is inadequate attention to cases of compensation for retrenched, aged, medium-skilled workers (Davidson and Matusz 2006; Kletzer 2004; Kletzer and Litan 2001; etc.). Kletzer and Litan (2001) suggest that the policy of “wage insurance” (or, wage subsidy) to the workers from the import industry is the best way to redistribute the positive gains of free trade, without the usual unemployment benefit-related disincentives in the labor market. Davidson and Matusz (2006), while using a much bigger canvas with dynamic implications and training, show that trade liberalization may hurt both “movers” and “stayers” of the import industry, and that there may be at least two ways to compensate those who lose due to freer trade. Given an ability/skill-based continuous distribution of labor—the single input in their economy—a wage subsidy generates higher level of welfare for all. It needs to be mentioned that a “wage subsidy” under TAA is conceived as a partial payment (say up to 50%, Kletzer 2004) towards the “positive” difference between the wage a retrenched worker earns on a new job and that received in the previous job from which unemployment was caused by trade liberalization only. Given conditions for who should qualify, it has been argued that the compensation should come from a lump-sum transfer of tariff revenue (Davidson and Matusz 2006; Mayer 1984). There may be a case for adoption of the TAA in transition countries also (see, Beladi and Kar 2011).

The analysis in this chapter documents considerable heterogeneity in the evolution of labor markets in TEs over the last two decades, especially at the level of separate countries. The countries of the Commonwealth of Independent States (CIS) appear by far the most diverse in terms of economic development and labor market dynamics, with increasing divergence in the most recent years.

The set of labor market institutions that TEs had at the beginning of transition was rather atypical of mature market economies, but has changed substantially over the last two decades. There has been considerable liberalization of labor regulations in TEs, more pronounced than in the old EU member states. By now, most TEs have established sets of labor market institutions and policies, which are similar to those existing in mature market economies. In fact, available data from the TEs suggest that deregulation of labor markets improves their performance. There is also substantial evidence from TEs that reforming two institutions jointly or applying broad reform packages will generate larger benefits than a partial reform focusing on a single labor market institution.

Clearly, however, the brief review in this chapter does not accommodate many important issues that might have strong implications for the labor market dynamics in TEs. This is particularly true of inter-country (undocumented) migration and informal employment, which has apparently been more significant in transition than in OECD countries. We will subsequently discuss a bit of the observed adjustments

in the organized sectors, with special focus on the Indian experience with trade and labor market reforms.

2.2 Wages and Employment in the Organized Sector

One of the most interesting questions in the face of economic liberalization in India has been the flexibility of formal wages and its implications for the level of employment. It is simple to understand that if the fall in labor supply in response to wage cut outweighs the increase in the demand for labor due to falling wages, then the level of employment must fall. It is possible in agglomeration economies that some regions display a situation where the downsizing of the formal sector and loss of productivity actually translates into job losses or wage cuts or both. It may also be the case that, in some other pockets, there might be a strong inducement towards higher employment and higher wages, leading to prevalence of wide disparities both in the labor market and in the economy in general. It seems that the growth in total factor productivity (TFP) leads to simultaneous improvements in standard growth elements, real wages, and employment in some regions of the country. In fact, there are earlier estimates of the growth rates in wages and employment obtained by selecting two subperiods in the pre and post-reform decades in India: 1979–1980 to 1990–1991 and 1990–1991 to 1997–1998. In a related attempt, Nagaraj (1994) observed that the earnings per worker grew faster than the per capita income in the 1980s mainly due to an increase in the number of man-days per worker. Later, Tendulkar (2004) notes that the organized labor market in India has been under a state of churning, especially during the reform period, as the formal rules incorporated in the protective labor legislation continue to persist, despite its inability to protect employment in the face of growing domestic and foreign competition. It comes as no surprise that the crosscurrents of protective schemes and the constant search by the employers to switch to cost-saving techniques, including those resorting to flexible labor allocation modes and outsourcing to sectors where the labor laws are less stringent, create a state of redundancy (see Datta 2003, for more on social costs of unemployment, etc.; Fig. 2.1).

2.3 Labor Market Reforms in India

The concept of labor market reforms in India is in its nascent stage, and consequently, despite high recurrence of the debate in various forums, little or no progress has been witnessed in the recent times. In the economic survey (2006), the Ministry of Finance noted, “Various studies indicate that Indian labor laws are highly protective of labor, and labor markets are relatively inflexible. These laws apply only to the organized sector. Consequently, these laws have restricted the mobility of labor, have led to capital-intensive methods in the organized sector, and adversely

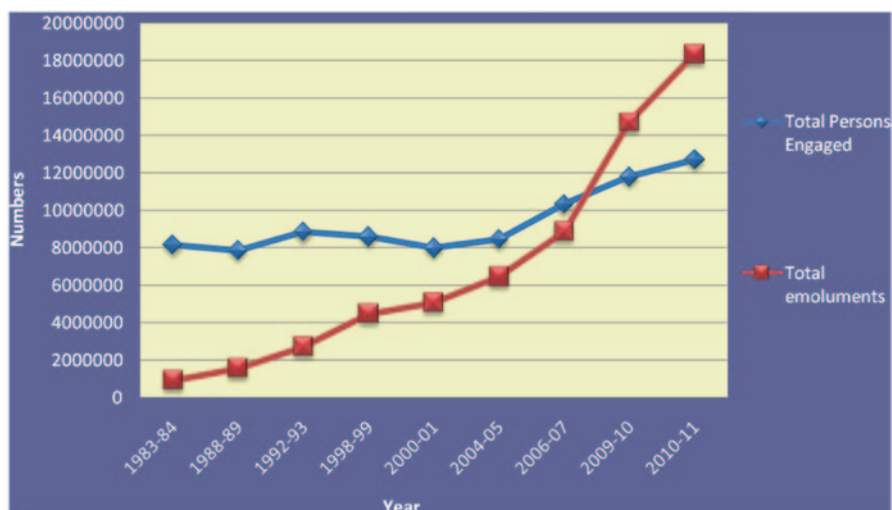


Fig. 2.1 Patterns of organized employments and emoluments (All-India). (Source: Annual Survey of Industries, CSO, Government of India, various years)

affected the sector's long-run demand for labor. Labor being a subject in the concurrent list, state-level labor regulations are also an important determinant of industrial performance. Evidence suggests that those states of India, which have enacted more pro-worker regulations have lost out on industrial production in general" (p. 209). It is probably well known by now that the views put forward in these lines are constituted from the findings of Besley and Burgess (2004), which essentially show that, states like Gujarat, Maharashtra, Orissa, and West Bengal, which enacted pro-worker legislations, were also the states with high incidence of informal activities compared to states that were classified as pro-employer. While the former experienced low industrial growth, declining formal productivity, etc., the pro-employer states reported positive growth in most of these aspects. Some of the contemporary studies also used the Besley-Burgess (2004) formulation to reclassify the states according to the initial labor laws constituted with subsequent amendments (Hasan et al. 2003), and establish that trade reforms increases the own price elasticity of demand more vigorously in the states where the labor market is more flexible. However, it turns out that the classification scheme selected for the states—whether pro-labor, pro-employer, or inflexible labor markets—plays a crucial role in guiding the outcomes. Not surprisingly, there is a contemporaneous body of literature on the subject, which subscribes to a different viewpoint especially with regard to the Industrial Disputes Act (IDA) of 1976 and 1982 (for a review of the empirical literature, see Bhattacharjea 2006). Clearly, therefore, there is a case for reevaluating the normative concerns of the labor market flexibility on sound theoretical and empirical grounds. What we attempt in this subsection, however, is to take another look at the state of the labor laws and regulations in India that can be of significant influence on the industrial situation in the country, especially at a time when the

waning labor union memberships and substantial informalization of the labor force dominate the labor market.

It should be mentioned that much of the Indian reform program has concentrated on industrial and trade policies. The most important changes so far have been the removal of licensing, de-reservation of small-scale industries, phased reduction of tariff rates, shortening of the negative list for exports, welcoming foreign investment, and, above all, curbing the monopoly of public sector in almost all industries. Capital and foreign exchange markets have also been significantly liberalized. However, very little has changed in the area of labor laws and labor regulations, and according to Nagaraj (2007), “Like in many developing economies, in India too, labor legislations tend to be aspirational with limited effectiveness, in the absence of a credible enforcement mechanism. Ambiguity in the legal system leaves considerable discretion to the administration and to the judiciary that could be detrimental to the smooth function of the labor market” (p. 5). Considering that labor laws have direct implications for the industrial sector, the sluggish pace in the reforms have attracted attention from many quarters, and the political and judicial concerns acting in favor or against the process cannot be completely neglected if one has to understand the normative implications of any reform in a populist democracy like India. Let us begin with the state of the labor laws in India.

2.4 Labor Laws in India

The Factories Act, 1948, essentially defined and categorized the industrial workers in India; the Shops and Establishments Act, a state legislation, did the same for the services sector. The Factories Act is intended to protect the safety and working conditions and mandates registration of all factories employing ten or more workers using power on a regular basis (20 or more workers without using power). The mandated benefits for workers—provident fund, gratuity, provision of food in the workplace, and so on as defined under the Factories Act—increase with the factory size. In fact, the industrial relations in India is regulated by three major central acts, namely: (i) the Industrial Employment (Standing Orders) Act, 1946 (IE), (ii) the Trade Union Act, 1926 (TU), and (iii) the IDA, 1947. Let us offer brief descriptions of each of these acts here.

The IE act requires that the status of an industrial employee, along with the conditions of recruitment, confirmation, misconduct, discharge, disciplinary action, leave, holidays, etc., be explained to the employee by the employer in the most precise terms. The act applies to the whole of India and to all industrial establishments where 50 or more workers are employed. The act also provides for severance pay.

The TU act, on the other hand, is one of the few labor laws that remained almost unchanged from the pre-independence period. The act recognizes workers’ freedom of association to express grievances, to engage in collective bargaining, and to pursue civil and political interests among themselves. A union requires at least seven members for registration, and it can be formed at the factory level as well as at the

industry level. Half of the office bearers of a union must be engaged in the industry to which the union belongs. One of the crucial provisions of the act is that the union members and office bearers are protected from criminal and civil suits in relation to bona fide trade union activities.¹

While this act has been held as the hallmark of trade unionism, very little has been done to revise it in light of the changed circumstances. The act is so general that it views participation in a political strike as legitimate as in an industrial strike. There are other difficulties, as the law is not particularly helpful in reducing the multiplicity of unions with conflicting agendas and viewpoints or to identify the legitimate negotiating authority.

In the planning era, trade unions also grew in strength largely to capture a share of the rent generated by import substitution policies. Large powerful unions with strong political affiliations were a common occurrence. In the post-liberalization era, collective bargaining has taken a more decentralized character. With fewer governmental controls and steady disappearance of trade barriers, the unions' need to maintain strong political links has certainly waned. Consequently, the relations between trade unions and political parties, with which they sought affiliation, was significantly weakened

Industrial Disputes Act: Any dispute on terms and conditions of work, or disagreements during negotiations over wage or any other matters, come under the purview of the IDA. Enacted in 1947, it replaced the Trade Disputes Act of 1929. The IDA became the main governing legislation with respect to industrial relations all over the country. As its importance grew over time, several amendments were passed in 1964, 1965, 1971, 1976, 1982, and 1984 to improve on its shortcomings and also to strengthen the interventionist role of the state.

The act aimed at creating a legal and regulatory framework within which industrial disputes can be peacefully resolved. Among the main provisions of the act are: (1) defining the legality of strikes and lockouts; (2) restrictive procedure for layoffs, retrenchment, and closure; (3) compensation for layoff and retrenchment; (4) conciliation procedure; and (5) a three-tier system of adjudication.

The legality of a strike or lockout primarily hinges on the question of fair use.² For example, a sudden strike or lockout³ is illegal in public utilities; prior notice

¹ See Table 2.3 for trends in TU membership between 1987 and 2001.

² The Act states, "No person employed in a public utility service shall go on strike in breach of contract, without giving to the employer notice of strike, as hereinafter provided, within six weeks before striking or within fourteen days of giving such notice." A strike or lock-out shall be illegal if; it is commenced or declared in contravention of section 22 or section 23; or it is continued in contravention of an order made under sub-section (3) of section 10 [or sub-section (4A) of section 10A]. The Act states, "No person shall knowingly expend or apply any money in direct furtherance or support of any illegal strike or lock-out" thus prohibiting financial aid to an illegal strike. Penalty for illegal strikes and lockouts ranges from 1-month prison term to monetary fines of 1000 rupees.

³ Lockout is a temporary closure of plant by managements when their negotiations with workers unions fail. It is a mirror image of strike by workers, technically speaking.

must be served. The employers or employees are expected to inform the labor commissioner before declaring a lockout or going on a strike. In all such disputes, the labor commissioner is, in principle, a party to the decisions. In all industries, when a dispute is under conciliation or adjudication, fresh strike or lockout is illegal; but continuance of old strike or lockout can be legal. On the other hand, a strike or lockout in retaliation of an illegal lockout or illegal strike is perfectly legal. It is also important that a striking employee must qualify as a “workman” as defined in the act, which means that (i) his wage must be below a certain level, (ii) he is not a contract worker, and (iii) he is not a manager or supervisor.

Rules regarding layoff, retrenchment, and closure of a unit are far more restrictive. The IE Act permits certain types of layoff (as contractual) or retrenchment (on disciplinary or medical ground). But if it is instigated by financial reasons, then IDA comes into force. The IDA, since 1976, made it *mandatory* for employers to seek prior permission from the government to layoff or retrench any worker, or close down the unit.⁴ Besides, in the organized sector, workers are entitled to severance pay at the rate of half month’s salary for every year worked.

While large firms generally faced more restraints with regard to their preferred wage–employment practices, relatively smaller firms can freely layoff or retrench in compliance with the IE Act (wherever it is applicable). In the event of retrenchment, the principle of “last come first go” applies. However, not all laid-off or retrenched workers are eligible for compensation; only the permanent workers are eligible for compensation and that too only when the firm employs more than 50 people.

Finally, it is noteworthy that the enforcement of the IDA and IE Act is primarily the state governments’ responsibility, which typically brings up the issue that we have discussed in the beginning of this subsection. The states are also empowered to pass enabling legislations within the framework of the central acts. Most states have indeed amended the IDA many times to address the local concerns. Researchers believe that these amendments have largely reflected the state government’s activism and ideology on the labor issues. Some states have made changes in favor of the employers (such as Andhra Pradesh), while quite a few states have favored the workers (such as West Bengal).⁵ The following table Table 2.1 provides the average man-days lost, average number of workers involved per dispute, etc., during 2001–2004. The trend seems that the average time loss per dispute is still steadily rising in India.

Industrial Relations Given the complex and divergent nature of labor legislations, it is not surprising that Indian industry has long been plagued by disputes. Though there is an elaborate procedure of dispute resolution, in practice the system has

⁴ Private firms have to seek permission from the state government, and the central PSUs from the central government.

⁵ For example, in 1987, Andhra Pradesh failed to comply with an order by the state government constraining disputes as a punishable offence. Though this applies to both workers and employers, in practice it has a greater impact on the workers. On the other hand, West Bengal passed many pro-worker acts. For example, in 1980, it made the prior payment of compensation to the worker a precondition for closure, although the central ID Act does not require so.

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