

Centre for Sustainable Employment  
Azim Premji University

CSE Working Paper  
2018-7

# Of "Missing Middle" and Size-based Regulation: A New Frontier in the Labour Market Flexibility Debate

R. Nagaraj  
April 2018

# Of “Missing Middle”, and Size-based Regulation

## A New Frontier in the Labour Market Flexibility Debate

**R Nagaraj**

### Abstract

Preponderance of small (that is, less than 10 workers) sized manufacturing establishments in India is said to reflect their inability to grow in size on account of prohibitive cost of regulatory compliance (and the associated corruption). Similarly, the “U” shaped (or bi-modal) distribution of manufacturing employment by size of establishment or enterprise – popularly termed the “missing middle” – is argued to be the outcome of the rigid labour laws, adversely affecting productivity growth. Do the foregoing propositions represent hard facts, or artefacts of mis-measurement and misinterpretation of the evidence? The paper contends that it is the latter: the observed employment distribution by size is more likely to reflect the widespread and growing evasion of official registration, and under-reporting or mis-representation in the administrative data. Further, the wide schism observed between the organised (formal) and unorganised (informal) labour markets represents persistence of surplus labour, and organisational dualism – *a la* Hella Myint – on account of technology and organisation of production in the modern sector; and perhaps not on account of policy induced rigidities in the labour market, as many contend.

Indira Gandhi Institute of Development Research  
A K Vaidya Marg, Goregaon East  
Mumbai 400 065.

Email: nag@igidr.ac.in

April 5, 2018

# Of “Missing Middle”, and Size-Based Regulation

A New Frontier in the Labour Market Flexibility Debate

R Nagaraj

## Introduction:

In 2011-12, there were 474.2 million workers out of 1247 million people in India (38 per cent) – as per the latest NSS (thick round) Employment and Unemployment Survey (EUS) estimates – following the broadest definition, namely the usual principal and subsidiary status (UPSS) of employment. Of the employed, about 40 million worked in the organised or formal sector, mostly in urban areas working full-time; 232 million (49 per cent) were employed (and under-employed) in agriculture and allied activities in villages. Between these two sectors, about 200 million workers were employed in non-farm informal activities, spread across rural and urban areas (with varying degrees of under-employment, or, disguised unemployment).

Indian labour market is dualistic: organised sector consists of workers employed in public sector, private corporate sector, factory manufacturing and registered educational and medical institutions receiving government financial aid. These workers are mostly educated, skilled and experienced often selected on standardised competitive national or state-level examinations, or on objective screening. As per the *Economic Survey*, private and industrial sectors within the organised economy employed 5.8 million workers in 2011-12, mostly producing traded goods. Just about 20 per cent of organised sector workers are members of trade unions (mostly aligned to registered political parties).

Numerous labour laws, and many ILO conventions (to which India is a signatory), protect (mostly) organised workers' rights. In non-farm unorganised (or informal) sector many organisational forms of production co-exist – ranging from subsistence household (or own-account) enterprises, to surplus generating wage labour employing enterprises, working as partnership and proprietary firms.

In seven decades of post-independence economic growth (with 4½ per cent annual per capita income growth in real terms), the labour market has undergone distinctive changes: it has moved from being a classical Lewisian two-sector dual economy, into a 3-sector economy described above, with the growing share of non-farm unorganised sector at the expense of the organised sector and agriculture. Theorising about the non-farm informal sector is a challenge, as it bears characteristics of both modern and traditional sectors. At the top end of the informal sector are highly productive, profit-oriented, manufacturing and services firms in urban areas; but most of the informal employment is concentrated in subsistence activities to eke out a living in household and non-household enterprises often using traditional means of production. Following Asia's experience in the 20<sup>th</sup> century, one expects the labour market dualism to disappear as the surplus labour gets absorbed in the modern sector with rapid growth, as Arthur Lewis theorised.

There could however be an alternative lens to view the labour market dualism, as being principally caused by “premature” or “ill-conceived” state intervention. In the neo-classical (or mainstream) economics vision, the persistence the dualism – characterised as the tiny high-wage island of protected and privileged workers in the organised sector – is viewed as the result of excessive protection or state intervention in favour of the organised working class (often pejoratively called the labour aristocracy), harming unorganised sector workers by erecting entry barriers. High wages and job security laws in the organised sector, it is often claimed, have turned wages into fixed cost leading to substitution of labour for capital, thus rising capital intensity of production and forgoing employment generation – potentially damaging expansion of labour intensive manufacturing and their export.

In other words, India’s modest economic performance compared to its Asian peers (despite the recent acceleration), poor employment and export growth of labour intensive manufactures are often attributed to excessive protection of the few in the organised sector, against the majority in the unorganised labour market.

The recent success of India’s IT outsourcing industry is often cited as a proof of what an un-regulated (or minimally regulated) labour market could accomplish (all else remaining the same) – as well illustrated in Gurucharn Das’s popular book *India Grows at Night* – that is, when government is asleep! Or, as joked in corporate circles, the success is due to the absence of a ministry of IT!

On the face of it, it is hard to ignore (or dismiss) the above perceptions. Looked closely, however, the arguments turn questionable both in theory and evidence. For instance, wage premium commanded in the organised sector could well be justified on efficiency wage considerations, including the need for workers to acquire firm and sector specific skills in an economy with very poor educational and skill levels. Similarly, the known chasm between *de jure* and *de facto* labour regulation denting the effectiveness of the seemingly stringent pro-labour labour laws perhaps takes the sting out of the argument of high cost of regulatory compliance (Hallward-Driemeier and Pritchett, 2015)

Alternatively, from classical or structuralist macro-economic perspective, constraints on labour absorption (to drain away the surplus labour) perhaps rests on modest agricultural growth, lack of physical infrastructure and social overheads, warranting large scale public investment. Moreover, historically speaking, one cannot ignore the fact that many labour regulations (premature or otherwise) were imposed during the colonial times to protect the interests of Manchester exporters, who were faced with rising textile exports from India. It illustrates path dependency in the national legal framework that is hard to ignore, or undo, in a deepening democracy.

The debates between the forgoing competing perspectives on the labour market have evolved through several iterations since the early 1980s, as well summarised in Kannan and Ravindran 2009, and Teitelbaum 2013. In the latest round, the debate has moved on to size-based regulation of enterprises, which

can be synoptically stated as follows: Universally, labour regulation increases with size of factories and firms. However, it is argued, given the high compliance cost, the labour regulations deters enterprises from growing organically in size to reap economies of scale in production. This causes a dichotomy in the size-distribution – metaphorically termed, the “missing middle” – deterring growth in formal (organised) sector jobs with better wages and working conditions.

This paper critically analyses the foregoing propositions (without going over the previous rounds of the debate). It is structured as follows: Section I outlines the propositions of the missing middle, and the size based regulations; Section 2 offers empirical evidence on these propositions; Section 3 discusses some broader issues concerning the labour market flexibility debate, and Section 4 concludes the study by summarising the main arguments and evidences.

## **Section I The Propositions**

### 1.1 The Missing Middle:

Anne Kruger (2013) used the term the “missing middle” as a metaphor for distortions caused by India’s business and labour regulations that are claimed to stymie expansion of labour intensive manufacturing. She argued that despite considerable de-regulations since the liberal (or free-market) reforms were initiated in 1991, India still suffers from excessive business regulations such as small scale industries promotion policies, and protection of organised sector workers. The fact that India does not have large-sized assembly factories as in China is often cited as an evidence (or an anecdote) to support the view. To quote Krueger,

One of the properties of unskilled-labour -intensive manufacturing seems to be that for many products, mass production is economic: Reports of Chinese factories with 10,000 workers are not uncommon, many of them undertaking similar repetitive tasks. ... India’s business and labour regulation serve as a major deterrent to mass production: Firms that have remained small have been rewarded, while it is not possible to produce the sort of large quantities needed for competing internationally without being in the organised sector of the economy (Krueger, 2013: 310).

*Prima facie*, Kruger’s proposition finds empirical support in Mazumdar, Sarkar and Mehta (2017) for 2011-12 (Figure 1). The figure shows a U-shaped curve of the size distribution of manufacturing employment, with least share in the size class of 50-99 workers, and the highest share in the smallest size class of 6-9 workers. However, Mazumdar, Sarkar and Mehta do not seem to refer to (much less endorse) Krueger’s arguments (more about it below).

### 1.2 Size-based regulation:

As in many countries, India too has many labour laws whose applicability often rises with size of factories or enterprises, as the cost of regulation, and the ability of larger firms to bear the higher costs rises on account of economies of scale in production. However, the critics of size-based regulation contend that since the

costs of regulation (including bribery) in India outweigh the advantages of scale economies, firms prefer to remain small, forgoing potential scale economies. This is evident in a visible fall number of establishments in the size class of 10 workers in the size distribution of manufacturing enterprises, as registration under the Factories Act, 1948 becomes mandatory for establishments employing 10 or more workers using power (Figure 2).<sup>1</sup>

The above view that size-based labour regulation is a job-killer is best expressed in the words of Arvind Panagariya: (Figure 3)

The labour situation is incredibly complicated: when you go from six workers to seven in a firm, the Trade Unions Act kicks in. When you go from nine to ten, the Factories Act kicks in. And when you go from 19 to 20, something else kicks in, as happens again when you go from 49 to 50 and 99 to 100. The biggest killer is the Industrial Disputes Act, which says that if you are a manufacturing firm with 100 workers or more, you cannot dismiss any of them under any circumstances unless you get prior approval from government. This is rarely given and it applies even if you go bankrupt, in which case you still have to pay your workers. This has important consequences, because investors are not going to enter into an industry if they can't exit. So India has a very pernicious set of labour laws and that really, to me, is the reason why Indian firms have remained so small on average (Panagariya, 2013).

The above view is often contrasted with the Chinese example, where employment in large sized factories are said to dominate. For instance, in 2004, factories employing 1000 or more workers constituted 35.1 per cent of factory employment; the corresponding figure for India is 25.7 per cent in 2007 (Bart Van Ark *et al*, 2010). In popular imagination, Foxconn's large factory employing over one lakh (100,000) workers assembling Apple Iphone, is often contrasted with tiny garment units in India employing less than 10 workers, as emblematic of why India has failed to become a global manufacturing hub.

## **Section II A Critique**

### **2.1 The Missing Middle – The origin of the concept:**

I M D Little (1987) originally coined the term the “missing middle” to refer a bi-modal distribution of factory (or organised manufacturing) employment in India, observing the smallest employment share in factories with 200 to 499 workers, compared to those in factories employing (i) less than 50 workers or, (ii) more than 1000 workers. In mid-1970s, over ½ of factory employment was concentrated in large factories employing over 1000 workers.

Little attributed the bi-modal distribution to the state-led heavy industrialisation strategy, resulting in large-sized (vertically integrated) factories on the one hand, and the dominance of consumer goods production in very small-sized cottage or traditional industries on the other. Such an industrialisation strategy, Little

---

<sup>1</sup>Though the registration is mandatory for factories employing 10 or more workers using power, it is mandatory for all factories (irrespective of size) for those in category 2m (i) and (ii), which is mostly beedi manufacturing.

contended, left a void in the middle of the size distribution of factory employment. Comparing it with the fast growing export-oriented Asian economies, Little maintained that middle sized factories or firms were most efficient, which were missing in India – hence the missing middle hypothesis. To quote Little:

“Small size certainly does not indicate high capital productivity. Indeed, the figures suggest that small firms rather often have both low capital and low labor productivity. Capital productivity and total factor productivity peak in the medium size range of 50-500 workers in most industries” (Little, 1987: 215)

“These surveys [conducted under Little’s leadership for a World Bank study] did not provide evidence that small firms employ resources more efficiently (either technically or from a social point of view) than large firms, nor even that they are reliably more labor-intensive. If our research can be held to suggest anything about size and economic or social desirability, it is that beauty is to be found mostly in the middle of the size distribution.” (Little, 1987: 215).

After nearly four decades, does Little’s empirical observation still hold? No, it does not (Figure 4). Employment share of factories employing 1000 or more workers per factory has declined from 43.3 per cent in 1974 to 26.4 per cent in 2007-08 (Nagaraj, 2015). In 2011-12, factory employment is more uniformly distributed across the size classes. In fact, the highest employment share now belongs to 200-499 workers, which is bang in the middle in the distribution – quite in contrast to what Little noted earlier.

Table 1 depicts the above-mentioned distribution for a longer period, since 1959. Evidently, employment share in the size class 100 to 499 workers rose from 21 per cent in 1959 to 32 per cent in 2007-08, whereas, in the size class 1000 to 4999 workers, the share has fallen from 36 per cent to 20 per cent during the same years. So, the middle which Little found missing in mid-1970s, is no longer so.

A closer reading would suggest that though Little discussed about the wide wage gap between large and small firms on account of labour regulation, he was careful enough to admit that much of it was on account of efficiency wage considerations. He certainly did not attribute the missing middle to size-based regulation, but his criticism was against India’s heavy industrialisation strategy, which had given rise to an inefficient size distribution of factories. For Little, missing middle was an empirical fact of his times; for Krueger (2013) it is a metaphor for all perceived ills of labour and business regulations throttling functioning of free markets.

Surprisingly, as evident from the quote earlier, Krueger bemoans India’s inability to set up large factories on account of labour rigidities, whereas Little was critical of the dominance of large factories – a contradiction that is hard to ignore!

Surprisingly, Mazumdar – Little’s collaborator in studying small industry in the 1970s – has taken an increasingly divergent position on the reasons for the missing middle. Though Mazumdar (jointly with Sarkar and Mehta) has shown the persistence of the missing middle (as mentioned earlier, in Figure 1), he has not

attributed it to labour market rigidity (as Krueger did). In fact Mazumdar and Sarkar contend that the missing middle is an inherent feature of economic dualism. To quote Mazumdar and Sarkar (2013):

The conclusions for policy makers tackling problems of limited mobility of small firms in Indian manufacturing sector – and its attendant problems of “missing middle” – are rather pessimistic. There is no single big recommendation, like tackling labour regulation, which is likely result in quick and significant solution to the system. Rather, progress has to be made a wide spectrum of policies, including reform of non-labour regulations. ... “[a]ttention of policy makers has to shift to increase land productivity in agriculture (Mazumdar and Sarkar, 2013: 136).

## 2.2 Size-based regulation:

As noted earlier, a sharp drop in the number of establishments at 10 workers in the size distribution of establishments is often taken as a proof of the sting of size-based regulation. Apparently, this is an uncritical use of the official data. Anyone familiar with industrial reality would admit (i) widespread avoidance or evasion of factory registration, and (ii) under-reporting of number workers employed in factory sector.

This can be demonstrated by the following. There are two data sources for the purpose: one, Economic Census enumerating all manufacturing establishments; two, Annual Survey of Industries, capturing all factories registered under the Factories Act. Obviously, (ii) above is a subset of (i). In 1981, as per economic census, 52 per cent of the factories employing 10 or more workers that legally came under the purview of the factories act did not registered under the act, or evaded the factory registration (Nagaraj, 1999). The ratio went up to 57 per cent in 1991; and to 66 per cent in 2013-14 (Figure 5). In other words, of all the manufacturing establishments that were, by law, required to be registered under the Factories Act, about 2/3<sup>rd</sup> of them did not register – thus violation of the law has been the norm rather than the exception – and the non-registration has been rising.

How does one interpret the fact? Surely it must be employers’ or entrepreneurs’ rational decision to maximise the profits. The finding also demonstrates how easy it is to evade even the most basic of the labour laws in India. If 2/3<sup>rd</sup> of the establishments can evade the minimum (or the first level of) regulation of factory registration, then the entire regulatory edifice is rendered practically ineffective. Moreover, the fact that the evasion of factory registration has increased with decline in the enforcement of the law after the liberal reforms since 1991 confirms that employers don’t care for the law.

Chatterjee and Kanbur (2015) show that most of the non-registration under Factories act is in smaller sized factories; that is, factories employing 500 or more workers do register (Figure 6). Hence the size distribution of factories reported by the official data is hardly reflects the ground reality. Therefore, any theorising about the onerous costs of complying with the labour laws based on the flimsy official data is simply hypothetical.



In 2011-12, as per economic census, manufacturing sector employed 60 million workers; of which 13.4 million, or 22 per cent, were in the factory sector. Chatterjee and Kanbur (2015), approach the problem of the size distribution from a different perspective. Comparing the size distribution of employment in Economic census and the Annual Survey of Industries, they find that 97 per cent of establishments lie outside factory sector. They classify the establishments employing 10 or more workers in the economic census as (i) compliers (ii) evaders (those employing 10 or more workers but evading factory registration), and (iii) avoiders. The study came to conclusion similar ours (drawn above):

With regard to India's Factories Act, this article shows that Outsiders [those which are outside the ambit of factories act] account for 97.3 per cent of firms and some 64.1 per cent of manufacturing employment (table 1). Evaders and Avoiders [of the factories act] combined account for 1.9 per cent of firms and 11.1 per cent of employment. The focus on (de)regulation as a route to employment and productivity growth therefore has to be balanced with a focus on improving the productivity of those firms that would not be affected greatly, or at all, by the legislation in question (Chatterjee and Kanbur, 2015, p. 409).

To sum up the foregoing analysis: Majority of manufacturing establishments and workers employed are outside the regulatory ambit, as they are too small. However, among the establishments employing 10 or more workers, which are mandated to get registered under the factories act, 2/3<sup>rd</sup> of them did not get registered in 2013-14. Most of those avoiding factory registrations belong to the size class of 10 to 100 workers.

The above finding of the evasion of registration by smaller factories is a confirmation of common knowledge drawn from numerous primary field surveys for a long time. Hein Streekerk (2001), a social anthropologist, who studied industrial workers in South Gujarat for over three decades, said the following about compliance with labour laws:

To save expenses on workers, construction and equipment owners are continuously occupied keeping their enterprises and workers outside the purview of this [Factories] act. They do so by officially employing less than 10 workers by splitting up firms and regularly closing sections and starting them again with other names. It is also done by laying off workers reinstating them after some time, by keeping two accounts, one meant for officials and the other for internal use and by 'keeping satisfied' those who are appointed supervise them, i.e. the factory inspector and his staff. Though figures are available now, it is still impossible to know the actual number of industrial establishments and workers in Valsad region through official statistics. One of the results of the combination of owners' continuous effort to evade legislation and biased officers is statistical obscurity and the official 'disappearance' of workers. The actual number of workers and factories is always much higher than the official figure (Streekerk, 2001: 2401).

Similar findings were reported by other field studies of manufacturing centres by Manjit Singh (1991) in Punjab to John Harris in Tamil Nadu in the 1980s (Hariss, 1982). Field work in the early 1980s in the industrial suburbs of Bangalore by this author for his doctoral dissertation was a confirmation of the same story (Nagaraj, 1989).

How does one understand such large scale and growing evasion of the Factories Act, the corner stone of labour regulation? It simply speaks volumes about the ineffectiveness of the rule of law, and the ease of getting away without complying. This demonstrates a complete disconnect between the legal rhetoric (accepted on the face value by many mainstream economists), and the ground reality. Therefore, simplistic arguments about the adverse effect of the laws on labour market performance can be as genuine (or misleading) as advertisements for financial products ignoring the fine print.

Proponents of labour market rigidity hypothesis have mostly relied on the textual reading of the regulatory *process*, and not its *outcome*. Instead if one asked the question: if the laws are so stringent why do they not get mirrored in the outcome of the laws – such as, in real wages, wage shares etc? The answer is simple: ineffectiveness of the laws.

This is best illustrated by the (widely discussed) Industrial Disputes Act enshrining job-security, as mentioned above in the quote from Panagariya. If the law was really so stringent, then how does one explain a steep fall in organised manufacturing employment between 1997 and 2003 when one in every 6 worker lost job (Nagaraj 2004); and again in 2008-09, in labour intensive exporting industries in the wake of the global financial crisis (Nagaraj, 2011)? In other words, the bark of the law is far louder than its bite.

How does then one understand the efficacy of the dysfunctional labour laws? Wouldn't getting rid of the regulation be desirable? Are we sure that Factories Act is one such redundant piece of legislation? Probably not, as demonstrated below.

After 1991, when the “inspector-raj” was practically given a go-by, there was a dramatic fall in the inspection rate of factories under the Factories Act (Figure 7). What was the outcome? A sharp rise in industrial accidents (Figure 8), suggesting a casual relationship between laxity in the law enforcement, and a rise in industrial accidents. It also seems to suggest that in spite of numerable shortcomings, the factories act did serve the purpose of protecting workers' safety, however imperfectly. Improved safety would surely have positive externality on the productivity of workers and factories. A lighter regulation of the laws calls for a closer scrutiny of the evidence and a careful re-negotiations (with all stake holders) to ensure workers' welfare is protected for greater good.

We now move from a specific law to a more general measure of outcome of labour regulation. Perhaps the best summary outcome indicator of labour market performance – economists would unanimously agree – is the long term trends in wages and labour productivity. Figure 9 plots real wages and output per worker (labour productivity) for four decades, from 1973-74 to 2013-14 for factory sector.<sup>2</sup> During the 42 year period, while real wages per worker grew annually at 1.2 per cent, labour productivity (real gross value added per worker) grew nearly 5 times faster at 5.8 per cent per year.

<sup>2</sup>Factory sector includes non-manufacturing activities like electricity, gas and water. But their share is insignificant to alter the reported trends.

The foregoing result holds (not reported here) even if (i) real wage per worker is replaced with product wage per worker, (ii) workers are replaced by employees, (iii) wages per worker is replaced by earnings per employee, (iv) non-wage benefits are included, and, (v) if net value added (NVA) is used instead of GVA, to net out the effect of growing capital intensity of production.<sup>3</sup>

This is perhaps the most robust evidence on how the output growth is shared between employers and workers in organised manufacturing. If the standard marginal productivity theory of wage determination is in force, then wages should have moved close to labour productivity, or the growth rates of wages and labour productivity should have been roughly identical. This evidently is not the case here. The fact that labour productivity outpaced wages growth by nearly five times over four decades, the reality seems closer to classical (Lewisan) model where constant wages leave all or most gains in productivity to capital, or employer.

During the same period, per capita income grew by 3.8 per cent annually, which is three times faster than the growth in real industrial wages per worker. It implies, organised industrial workers have lost out to average citizen in securing return for their effort. If this is the hard truth, can there be a justifiable claim that organised industrial workers – metaphorically the island of high wages – protected by labour laws have gained disproportionately vis-a-vis the rest of the economy?

### **Section III** **Some Analytical and Institutional Considerations**

3.1 As mentioned earlier, size-based regulation literature assumes that the regulations are the primary cause of the dichotomy between organised and unorganised sectors. By getting rid of them, it is implicitly argued, labour markets would turn homogeneous (hence formal), and would get rid of policy induced distortions. The argument however could have many analytical and empirical limitations:

Arthur Lewis argued that the distinction between the traditional and modern sectors (as per his model) was institutional, not legal. Traditional sector is a subsistence economy based on pre-modern social organisation, eking out subsistence using primitive, unchanging technology employing family labour to the fullest extent (as it's opportunity cost is zero). Going by the argument, informal sector cannot be counted as consisting of profit maximising enterprises. Therefore, considering the entire (formal plus informal) distribution of manufacturing enterprises or establishments for identifying the so-called missing middle seems analytically incorrect. More appropriately, one should only look at the segment of the distribution that can be counted as modern sector which follows profit maximising principle. Empirically this could include formal sector enterprises plus those enterprises in the unorganised sector which have

---

<sup>3</sup>These results could perhaps be useful for understanding which theory of wage determination – neo-classical or structuralist – better approximates Indian industry.

reinvested surplus in the enterprise (as a proxy for profit maximising enterprises).

3.2 Dualism in a developing country often exists on account of organisational and technological discontinuities in the modern economy, requiring educated, skilled and experience labour force to run complex organisations. Workers in the sector need to be compensated for education and skills, and who need to acquire firm and industry specific capabilities. This necessarily brings in segmentation in the labour markets that cannot be simply termed as policy induced rigidities. One needs to invoke Hella Myint's concept of organisational dualism to introduce productivity differentials between the organised and unorganised sector, hence the wage differentials. To quote Myint,

The qualitative differences in labour market in the modern and the traditional sectors contribute to the wage differentials between these two sectors in two different ways. First, there are information costs of selecting and recruiting the right type of person with appropriate physical and mental qualities for employment on a regular basis in the modern economy. Second, having found the right person, it would be necessary to retain him by paying an appropriate premium according to his ability and experience, In an underdeveloped economy with patchy information network and inadequate facilities for training and education, to transform the raw labour from traditional sector into suitable material for regular wage economy, a large element of labour market dualism would remain even if we could eliminate all artificial wage distortions. Thus, it is in the interest of business firms in the modern sector to pay higher wages for the "same" type of labour to retain a stable force of experience workers than it would be for business firms in the advanced countries which can draw upon a larger pool of experienced workers" (Myint, 1985: 33).

3.3 Further, if one accepts that organised sector labour got unionised, and acquiring the countervailing power associated with it, they were initially colonial legacies (as mentioned earlier). If the workers' unions got strengthened by following ILO conventions, it is part of post-war global development. It is hard to deny path dependencies (or simply history) in these matters, which are difficult to undo in a democracy (even if they are desirable). Moreover industrial relations are often outcomes of hard fought class struggle which cannot be easily reversed; market for labour is a social institution, hence different from Walrasian markets, as Robert Solow famously cautioned:

Labour market might just be different in important ways from the market for fish...

Solow went to elaborate:

My argument was that all our experience teaches us that the motives governing behaviour in the labour market are not exactly the same as those that govern the market when a fleet of fishing vessels return to port and auctions off its combined catch at dockside. Given that the motives are different and more complex, it is to be expected that labour market institutions will evolve in a way that does not simply mimic those we usually suppose to characterise a Walrasian economy" (Solow, 1990: 30 and 57).

3.4 Yet, technological and organisational dualism or the bargaining power of organised labour is not static. Labour supply improves with workers' education and skills acquisition, which tend to erode wage premium of incumbent workers in older industries. But the premium may show up in newer industries and activities as the economy diversifies. Thus the size and contour of labour market in the metaphorical island of modern sector (as conceived by mainstream economists) keeps varying with the changes wages and productivity. One can expect the distinction between the formal and informal sector to eventually disappear with rapid growth in labour demand in the modern sector, as Lewis theorised, and as witnessed in industrialising Asia during the last century. Until then, the theoretical lens of labour market dualism, with differing organising principles in the two sectors, is perhaps a better approximation of the reality, than viewing the dichotomy as an outcome of regulation.

### 3.5 Ambiguities in labour laws:

In the labour market rigidities literature, *prima facie*, numerous labour laws are argued to fortify the legal position of organised labour. Is it really so? One can consider numerous instances where the laws, instead of fortifying organised labour's bargaining strength, provides escape routes or creates legal ambiguities for litigation, in which case, workers cannot match employers' deep pockets for prolonged legal battles. (Jaivir Singh. 2015).

At the risk of over simplification, the problem is this: We have seemingly strict labour laws, often borrowed from the best practices from the developed economies. Many laws have overlapping jurisdiction, giving the impression of fortifying the bargaining strength of the organised labour. But the reality seems to be that given huge surplus labour willing to work at subsistence wage (floor of it is set by rural wages) - gives rise to enormous power to employers, whose interests lie in circumventing the seemingly strict labour laws. This gets reflected in numerous loopholes that get built into the laws, rendering them ineffective (or paper tigers). A way out of the dysfunctional regulatory regime is to simplify the laws, along with their strict enforcement. But there seems to be very little support for such pragmatic reforms. Why? My conjecture is that workers and employers favour the *status quo*, as a time-tested low-level equilibrium.

## **Section IV Summary and Conclusion**

The problem of the missing middle and the widely believed labour market distortions caused by size-based regulation can be legitimately seen as examples of dated facts, and mis-measurement and misinterpretation of evidence respectively. In 1987, IMD Little coined the term the missing middle to refer to the small proportion of workers employed in factories in the size class 200-499 workers in organised manufacturing, compared to over ½ of the workers concentrated in large factories with over 1000 workers per factory, the remaining being employed in small factories employing less than 50 workers per factory. Factually speaking, the problem has disappeared now. So the middle - as defined by Little - is no longer missing.

But, Anne Krueger (2013) has turned the “missing middle” into a metaphor for policy induced distortions that are said to throttle India’s labour intensive growth potential. More specifically, the missing middle is referred to the observed discontinuities in the distribution of factories (or establishments) and employment in total manufacturing sector (organised plus unorganised), supposedly caused by sized-based regulation. In this distribution, a distinct dip or a gap is discernable in number of enterprises and workers employed in factories with 10 workers. The aberration is attributed the mandatory registration under the factories act for those employing 10 or more workers using power. As the registration is said to be costly, it is argued, firms prefer to remain small, willingly forging potential scale economies in production. This, it is contended, is the principal cause of the persistence of large (and growing) unorganised manufacturing sector refusing to take advantage of potential productivity gains.

The foregoing argument suffers from measurement error: factories simply do not register under the factories act, and under-report employment. A comparison of economic census (for the entire manufacturing) and ASI data (for factory manufacturing) shows that in 1981, 52 per cent of factories employing 10 or more workers were not registered under the factories act. The proportion went up to 57 per cent a decade later, further to 66 per cent by 2013-14. In other words, evading factory registration has now a norm, than an exception. Large scale non-registration under the factories act is common knowledge for anyone familiar with the ground reality , which has been widely documented in many case-studies for a long time.

However, if one looks at the distribution of enterprises in total manufacturing, the proportion of enterprises avoiding or evading factory registration is just about one per cent. Thus over 90 per cent of enterprises are very small enterprises whose productivity is very low. If one is really concerned about poor productivity growth, then one’s concern should be on the unorganised sector enterprises, not simply those which are evading or avoiding factory registration.

However, this is not to deny dis-functionality of many labour regulations and the corruption involved in their implementation. Simpler, credible and transparent labour laws could surely reduce corruption and cost of compliance; better enforced laws would benefit workers as well. The reasons for the persistence of the dis-functionality, I contend, need to be sought in the political economy.

Contrary to the popular belief, segmentation of the labour market into organised and unorganised (or, between formal and informal) is not an artefact of labour regulation, but the defining feature of a labour surplus economy with a large traditional (subsistence) sector and a small (rapidly growing) modern sector with re-investing profits and drawing labour from the traditional sector. Further, technological and organisational dualism – as argued by Hella Hyint – reinforces the segmentation where organised sector workers have to be paid efficiency wages. Labour laws introduced during the colonial period, got reinforced as organised labour gained a political voice in a deepening democracy. Therefore, to view the dichotomy in the labour market simplistically as the outcome of

dysfunctional state intervention for the privileged few in the organised sector, against promoting labour intensive economic growth would be a caricature of the reality.

What then is the reality? A vast schism exists between the letter of the law, and the spirit of its implementation. While the liberal (or free market) critics point to the letter of the labour laws, they often ignore or overlook the outcomes of the laws. It is best illustrated with the example of job-security law, which states that in factories employing 100 or more workers, it is almost impossible to sack even a single worker. But evidence shows otherwise: Between 1997-2003 nearly 1 in 6 workers in the organised sector lost job, and again during 2008-09 (after the financial crisis), substantial job losses were recorded in official surveys.

If the labour laws were really so strict, it should get reflected in a steady rise in real wages and earnings in organised manufacturing, commensurate with labour productivity growth. But the long-term evidence for over four decades since early 1970s shows otherwise: While labour productivity in real terms grew annually at nearly 6 per cent, real wages grew just 1.2 per cent. This implies, almost all of the productivity gains has accrued to employers, which is perhaps the best economic indicator of the overwhelming bargaining strength of employers vis-a-vis their workers.

How does one understand the wide disconnect between rhetoric of the formal law, and the reality of the labour market outcomes reported above? We speculate on the possible reasons, which are the following: one, the formal laws are aspirational, unhinged from the ground reality of political economy. This is well evident in various loopholes that are built into the laws, providing enough escape routes for employers. To illustrate, the definition of worker varies across the laws. Similar is the case with the definition of child labour, which leaves out adolescent workers in the age group 14-18 without any legal protection. Likewise, in smaller factories in the organised sector, with informal contracts, it is often difficult for workers – if impossible – to prove their employment status. Therefore, plethora of labour laws, seemingly protective of the “privileged” organised sector, in reality, perhaps obfuscates legality to workers’ supposed disadvantages.

It would perhaps useful to conclude by suggesting that the labour market debate using secondary data seems to be yielding diminishing returns to research effort. The way forward seems to be to initiate careful field work based research preferably along with social anthropologists to break fresh ground.

## References

Amirapu, Amrit and Michael Gechter (2014): *Indian Labor Regulations and the Cost of Corruption: Evidence from the Firm Size Distribution*, November 2014.

Ark, Bart Van, Abdul Azeez Erumban, Vivian Chen and Utsav Kumar (2010): "The Cost Competitiveness of Manufacturing in China and India: An Industry and Regional Perspective", in Barry Eichengreen, Poonam Gupta and Rajiv Kumar edited, *Emerging Giants: China and India in the World Economy*, Oxford University Press, Oxford.

Chatterjee and Kanbur, 2015: "Non-compliance with India's Factories Act: Magnitude and patterns" *International Labour Review*, Vol. 154 (2015), No. 3.

Hallward-Driemeier, Mary and Lant Pritchett (2015): "How Business is done in the Developing World: Deals versus Rules." *Journal of Economic Perspectives*, Vol. 29, No.3.

Hariss, John (1982): "Character of an Urban Economy-Small-Scale Production and Labour Markets in Coimbatore", *Economic and Political Weekly*, Vol. 17. No. 24, June 12.

Kannan, K P and G Ravindran (2009): "Growth Sans Employment: a Quarter Century of Jobless Growth in India's Organised manufacturing", *Economic and Political Weekly*, Vol. 44, No. 10, pp. 80-91.

Krueger, Anne O (2013): "The Missing Middle." in *Economic Reform in India: Challenges, Prospects, and Lessons* edited by Nicholas C. Hope, Anjini Kochar, Roger Noll, and T. N. Srinivasan, Cambridge University Press.

Little, IMD (1987): "Small Manufacturing Enterprises in Developing Countries" *World Bank Economic Review* Vol. 1 No. 2:203-235

Mazumdar, Dipak, Sandip Sarkar and Balwant Singh Mehta (2017): "Inequality in India - I", *Economic and Political Weekly*, Vol. 52, No. 30, July 29.

Mazumdar, Dipak and Sandip Sarkar (2013): *Manufacturing Enterprises in Asia: Size, Structure and Economic Growth*, Routledge, Delhi.

Myint, H (1985): "Organisational Dualism and Economic Development", *Asian Development Review*, Vol. 3, No. 1.

Nagaraj R (2011): "Industrial Performance, 1991-2008: A Review", in *India Development Report, 2011*, edited by D M Nachane, Oxford University Press, Delhi, 2011.

\_\_\_\_\_ (2004): "Fall in Organised Manufacturing Employment: A Brief Note", *Economic and Political Weekly*, Vol. 39, No. 30, July 24.

\_\_\_\_\_ (1999): "How Good are India's Industrial Statistics: An Exploratory Note", *Economic and Political Weekly*, Vol. 34, No. 6, February 6-12.



\_\_\_\_\_ (1989): *Sub-contracting in Indian Manufacturing Industries: The Bangalore Experience*, Doctoral dissertation, the Centre for Development Studies, Trivandrum, the Jawaharlal Nehru University, New Delhi.

Panagariya, Arvind (2013): *Why growth matters: How India's growth acceleration has reduced poverty*, The Centre for Development and Enterprise, Johannesburg 2000, South Africa. [http://www.cde.org.za/wp-content/uploads/2013/09/Prof%20Arvind%20Panagariya\\_Why%20growth%20matters\\_%20How%20Indias%20growth%20acceleration%20has%20reduced%20poverty.pdf](http://www.cde.org.za/wp-content/uploads/2013/09/Prof%20Arvind%20Panagariya_Why%20growth%20matters_%20How%20Indias%20growth%20acceleration%20has%20reduced%20poverty.pdf)

Myint, H. (1985): 'Organisational Dualism and Economic Development', *Asian Economic Review*, Vol. 3, No. 1.

Shyam Sunder, K R (2014): "The Myth of Inspector Raj in India", *Economic and Political Weekly*, Vol. 49, No. 42, October 18 (web-exclusive).

Singh, Jaivir (2015): "Who is a Worker? Searching the Theory of the firm for Answers", in K V Ramaswamy edited *Labour, Employment and Economic Growth in India*, Cambridge University Press, Delhi.

Singh, Manjit (1991): *Labour Process in Unorganised Industry*, Mahohar, New Delhi.

Solow, Robert (1990): *The Labour Market as a Social Institution*, Basil Blackwell, Cambridge, Massachusetts.

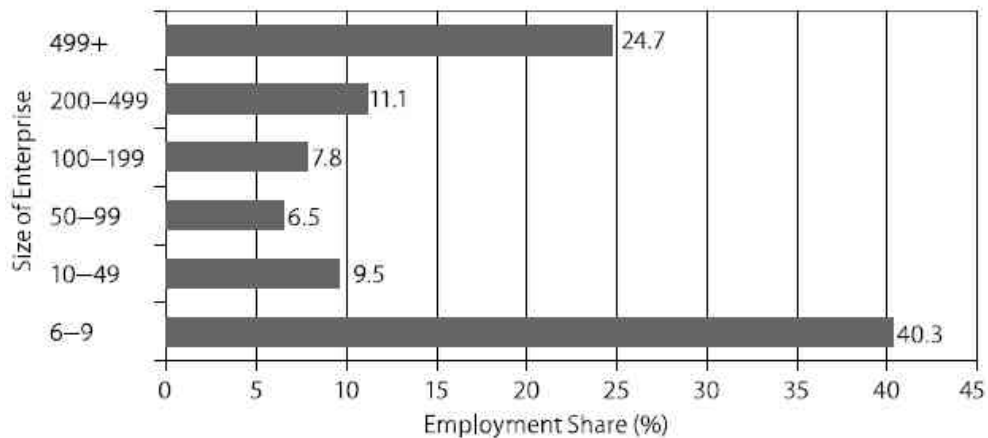
Streefkerk, Hein (2001): "Thirty Years of Industrial Labour in South Gujarat: Trends and Significance", *Economic and Political Weekly*, Vol. 36. No. 26, June 30, 2001

Teitelbaum, Emmanuel (2013): "Labour Regulation, Trade Unions and Unemployment", in Atul Kohli and Prerna Singh edited, *Routledge Handbook of Indian Politics*, Abingdon, Routledge.

Table 1: Employment distribution in Registered Manufacturing as per ASI data

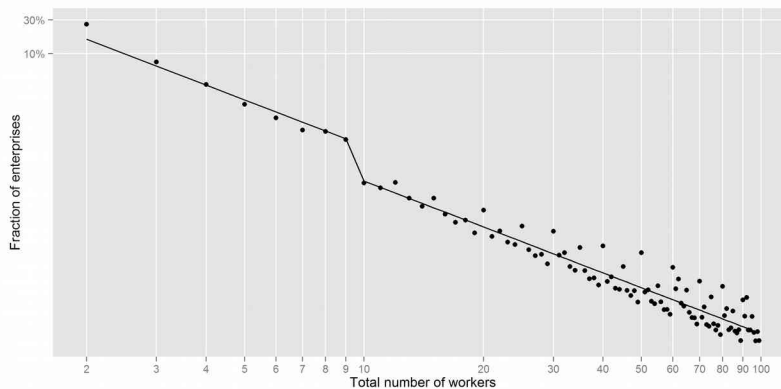
	1959	1973-74	2002-03	2007-08
0 to 49	15.5	14.4	20.5	18.0
50 to 99	8.4	8.2	11.7	11.0
100 to 499	19.5	22.5	30.0	31.4
500 to 999	10.4	11.6	12.2	13.3
1000 to 4999	35.9	29.5	16.7	20.1
5000 and above	10.2	13.8	9.0	6.2

Figure 1: Size Structure of Manufacturing Employment in India, 2010-11; Source: Mazumdar, Sarkar and Mehta (2017)



Source: Annual Survey of Industries (ASI), 2010-11 and Unorganised Manufacturing Sector Enterprises Survey, NSSO, 2010-11.

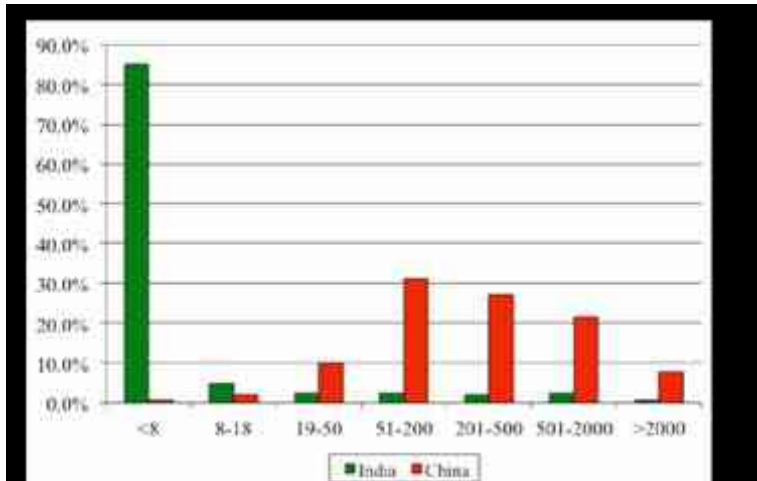
Figure 2: Downward shift at the 10-worker threshold in the distribution of establishment size, 2005, log scale (omitting establishments with more than 100 workers);



workers);

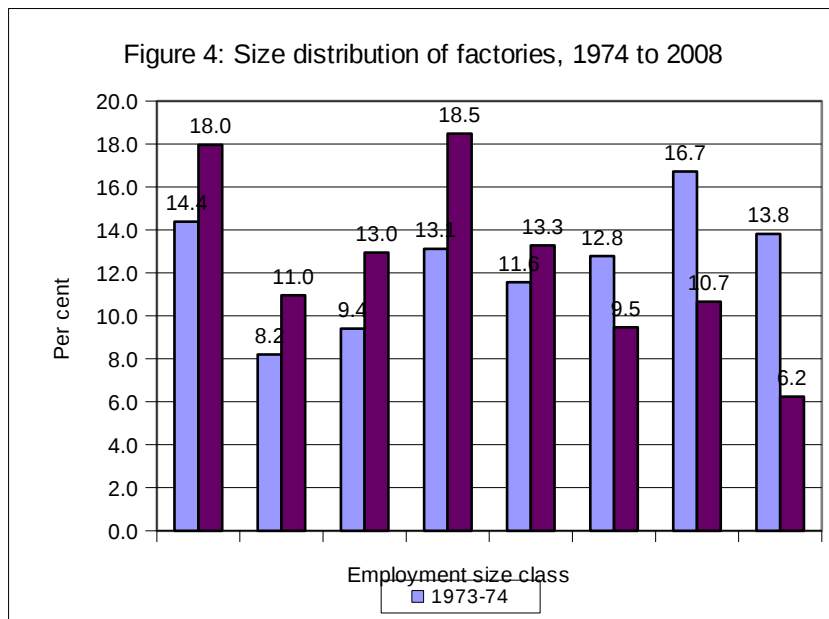
Source: Amirapu, Amrit and Michael Gechter (2014)

Figure 3: Size Distribution of Firms: Apparels



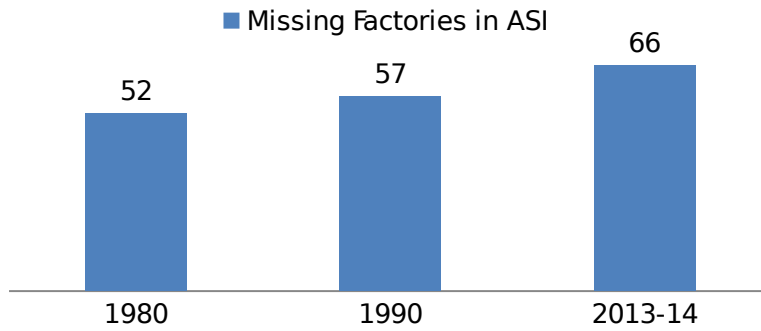
Source: Panagariya (2013)

Figure 4: Size distribution of Factories, 1974- 2008



Source: ASI, various issues

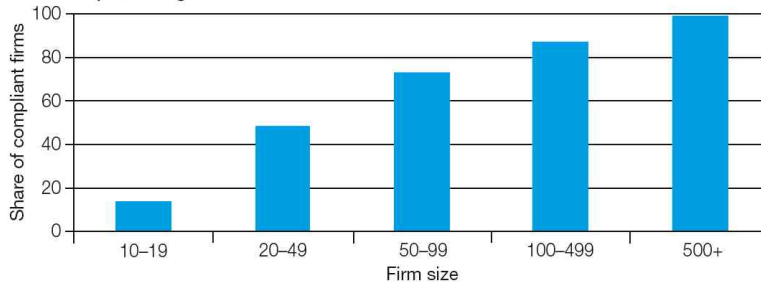
Figure 5: Missing Factories in ASI



Sources: Economic Census, and ASI, various issues; Note: The figure represents the ratio of (i) number of factories as per ASI, and (ii) number of establishments or enterprises employing 10 or more workers in manufacturing which, as per Factories should be registered under the act. So, the ratio shows the extent of non-registration or avoidance of registration under the act.

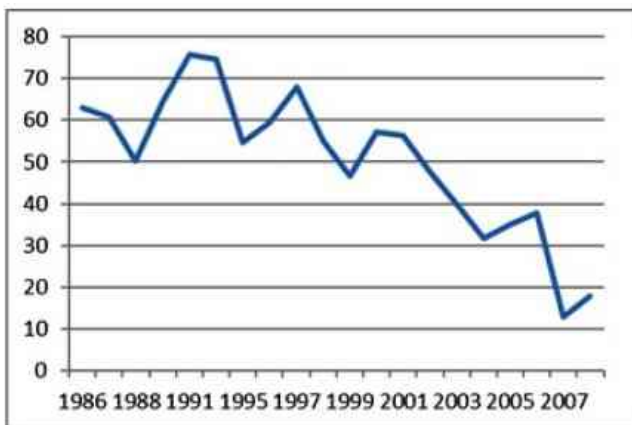
Figure 6: Share of compliant firms by firm size.

Figure 1. Share of compliant firms by firm size, ASI (2009–10) and NSSO (2010–11), percentages



Source: Chatterjee and Kanbur 2015

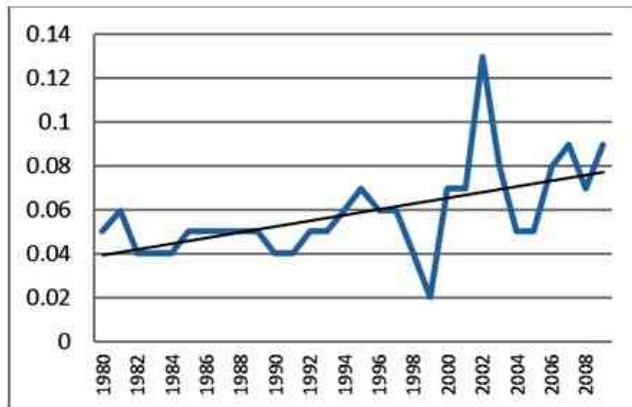
Figure 7: Percentage of registered factories inspected in India, 1986-2008.



Source: Indian Labour Statistics (various issues)

Source:Shyam Sunder (2014)

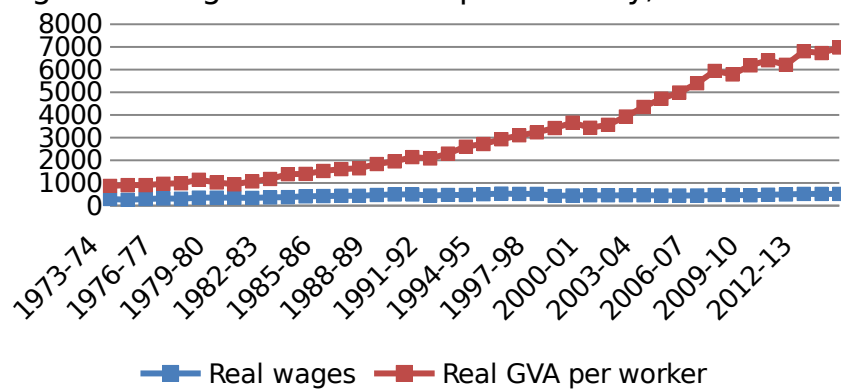
Figure 8: Number of Fatal Injuries per One Lakh Work Days Worked in the Manufacturing Sector in India, 1980-2009.



Source: Shyam Sunder, 2014

Figure 9: Trends in wages and productivity in Organised manufacturing sector, 1973-74 to 2013-14

Figure 9: Wages and Labour productivity, 1974-2015



Source: ASI, WPI and CPI - EPW Research Foundation series WPI