Indian labour market reform: What it means for economic growth and inflation

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LSE's Rajeev Sibal argues that labour market restrictions constitute the largest drag on Indian economic performance.

After strong economic performance until 2010-11, the Indian rate of growth slipped to 6.2 per cent and then five per cent. The political fallout of this slowdown is arguably more pronounced than the economic impact, but concerns are mounting that this may be the beginning of a downward trend in Indian growth. This blog discusses the big picture implications of the slowdown from a comparative perspective and identifies what can be achieved from changes in fiscal and monetary policy. I argue that the problem is not yet dire but could be if the fiscal dimensions of economic policy are not corrected. Specifically, I discuss the relationship between India's labour market structure and fiscal policy.

Catch-up development requires consistently high growth rates that are factors greater than those of advanced economies. India has largely achieved this challenging feat in the last decade. The rate of growth in India, even with the slowdown, is approximately triple that of the United States and well beyond the negative growth of the Eurozone; the recent slowdown is therefore a cause for concern but not alarm.

Similarly, in the short run, high inflation is not as problematic as it seems, despite its detrimental impact on real economic growth. Inflation can be good because it is an indication that Indians are eating better, substituting cereals with proteins, and have enough money left over for personal consumption. That said, inflation can also lead to long-term expectations of price increases, which will not always be accompanied by improvements in productivity—if not controlled, the economy could succumb to the pressures of "bad" inflation.

How then to address a slowdown in economic growth with persistent inflation? India's response is similar to that of any capitalist economy, a healthy mix of fiscal and monetary policy. Monetary policy adjustments are obviously easier to manage because they are much less political. India, fortunately, has a strong central bank that executes sensible policy; the comments of Dr Duvvuri Subbaro, the governor of the Reserve Bank of India (RBI), in his recent I.G. Patel memorial lecture at LSE are a testament to the strengths of the bank. He eloquently identified the key challenges facing the economy and discussed how the RBI could respond. The problem, however, is that the continued strength and aptitude of the RBI means that great gains are not likely to be derived from more efficient monetary policy.

The real answer to India's recent economic turbulence lies in the controversies of fiscal policy. Endemic politicking clouds reasoned fiscal policymaking. Change to fiscal policy usually follows crises because of entrenched interests and a fear of political risk. Amidst the recent slowdown and a ballooning current account deficit, action has been taken to further liberalise capital flows and reduce subsidies. The hope is that these changes can stimulate investment while alleviating the current account deficit. These solutions provide some cover in the short run but, in the long run, tougher problems need to be solved.

The domestic labour market constrains fiscal policy more than is acknowledged by politicians and economists. An estimated 90 per cent of India's labour market is informal. Why does this matter? Inefficient labour laws constrain firm development and economic growth; employers rely on the informal economy because the costs of formalisation are too high; meanwhile workers in the informal economy are excluded from basic protections. Stringent labour laws meant to protect workers, in the end, fail to protect 90 per cent of the workforce. I would argue that labour market restrictions constitute the largest drag on Indian economic performance. Still, in discussions of the state of India's economy and the budget review, labour is not directly discussed while capital, subsidies, agriculture, manufacturing, and industry are all highlighted.

What could labour market reform mean for fiscal policy? On the revenue side, formalisation of the labour force would significantly improve receipts since income and payroll tax revenues would expand exponentially. More efficient and less onerous labour laws would release the drag on small and medium enterprises that are poised for growth. On the expenditure side, a shift in corporatist institutions to regulatory institutions would lower costs. Labour market reform could help the state overcome the persistent current account deficit that currently underpins inflation while at the same time promoting growth.

The sooner that labour market reforms are addressed, the less cataclysmic change will be. The average Indian worker is better off today than he or she was 10 years ago, which could mean that workers will be more amenable to reforms if the political message is correctly portrayed. Additionally, programmes such as MGNREGA mean that agricultural workers will not be left behind if reform were to advance. Modernised employment programmes and benefits could provide a carrot for those interests opposed to change. The potential economic and fiscal solutions are many.

The Indian economy will correct itself; there is too much latent growth waiting to be unleashed. The steps taken by the federal government to reduce subsidies and liberalise capital flows will help the recovery. But the real drag on competitiveness is not capital market reform and liberalisation will not provide a magic stimulus. A range of indicators, including the Competitiveness Index produced by the World Economic Forum, highlight the considerable structural weaknesses of Indian labour markets relative to other dimensions of the economy. India currently has a unique opportunity to address labour market reform, and policymakers should take advantage because it cannot be ignored forever.

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