Are Retrenchment Laws Inefficient?

Errol D'Souza[♣]

Abstract: It is argued that anti-retrenchment laws end up hurting the workers they were designed to protect because firms decrease their demand for labour in anticipation of surplus labour during downturns. If free contracting between workers and firms is allowed we show in an efficiency wage set up that both firms and workers can behave opportunistically requiring third-party enforcement of employment protection legislation.

[♣] Professor, Indian Institute of Management, Ahmedabad 380015. Tel.: (079) 2630-8357/58. Email: errol@iimahd.ernet.in

Introduction:-

The issue of flexibility in the labour market has attracted a lot of attention in policy debates in India. The lack of flexibility in the labour market is often cited as the reason for poor performance of the labour market in terms of employment generation and productivity growth. A popular view is that increased integration of the economy and technological change require structural change in the organization of production in firms and the lack of flexibility in the labour market does not permit accommodation of this change. It is often pointed out that many labour market institutions such as wage settlements that are binding on whole sectors and dismissal regulations are relevant to only a small part of the workforce in what is called the formal sector which is not expanding at a sufficiently rapid pace. This has led to recommendations that these institutions be altered in order that the allocative function of the labour market be improved.

The important piece of legislation that has attracted all the attention is the Industrial Disputes Act (IDA) of 1947 which applies to establishments employing fifty or more workers in the organized sector. The IDA was amended under pressure from the trade unions in 1976 and 1982. The 1976 amendment of the IDA requires that if a firm employs 300 or more workers, then the workers cannot be laid off or retrenched without the permission of the government. The 1982 amendment of the IDA made this provision of government permission applicable to all firms employing 100 or more workers. This provision is known as Chapter V-B of the IDA which stipulated prior permission from government for layoff, retrenchment or closure. There is an exception for retrenchment resulting from power shortages or natural disaster but the penalty for retrenchment or closure without permission includes a fine and a prison sentence for the employer. Chapter V-A requires an establishment employing 50 or more workers to provide workers with 30 days notice and 15 days pay for every year of continuous work by the worker in case the firm retrenches workers for valid reasons. Circumvention of these laws by firms has taken

many forms – managements using lockouts as a means towards closure, subcontracting to pressurize workers to leave or accept voluntary retirement schemes, and transferring ownership as it is not incumbent on new owners to retain employees.

Basu (2002) has argued that legislation against retrenchment or dismissal of labour as in the IDA of 1947 can backfire because of failure to distinguish between what is good *ex ante* and what is good *ex post*. A law that makes retrenchment difficult is of course good for workers who are already employed. However, firms will be more wary of employing workers making labour a less valuable input and decreasing the demand for labour. As a result wages will fall and workers who benefit from more secure jobs lose out by having lower wages. Thus workers may be worse off as a result of legislation meant to make them better off. A formal statement of this argument is in Basu, Fields, and Debgupta (2001). Basu recommends on this basis that contracts between firms and employees should not be exogenously fixed by law (such as the restrictions on firing) but that there should be free contract between workers and firms which depending on preferences (including risk aversion) would see some contracts with low wages and long tenure for employees and some contracts with high wages and firing rights with employers. This argument that free contract leads to efficiency is an outcome of the traditional, perfectly competitive story in which workers and firms implicitly bargain for the efficient level of employment security. This as we argue below is a very unsatisfactory way of carrying out the analysis because in a competitive model when wages adjust the unemployment rate remains unchanged or zero.

A satisfactory model for the analysis of employment protection must be able to demonstrate not only that wages are endogenous but also that equilibrium unemployment is possible because labour markets like credit markets do not clear. Such an explanation is provided by efficiency wage models. In one variant of these models

workers are paid in excess of their marginal contribution and reservation wages in order to reduce shirking and increase labour productivity at the risk of involuntary unemployment (Shapiro and Stiglitz, 1984). In another version which is the deferred payment incentive version, the wage is initially less than the worker's marginal product and then increases as tenure in employment increases in order to induce effort over time. In both variants the threat of termination and loss of the efficiency wage deter employee shirking. However efficiency wage models also do not consider the possibility that when efficiency wages exceed worker's marginal contributions, firms have an incentive to terminate workers before the wages are paid. The response to this moral hazard as we argue is to introduce employment protection. Hence, labour protection laws may be necessary to deter employer opportunism. We first present the argument advanced by Basu in the next section and then employ a version of an efficiency wage model that considers the incentives of firms to terminate workers to illuminate the requirements for retrenchment laws.

Section II:

The Basu approach compares two alternative legal regimes – one in which employers are free to retrench workers at will (the free retrenchment or F regime) and another in which no retrenchment is allowed (the no retrenchment or N regime). In the simple version of the model there are n identical firms, each with a production function given by

$$q = \phi f(L) \qquad \text{---(1)}$$

where q is output, L the labour employed by the firm, and ϕ is a stochastic shock independent across firms and across time that takes the values of 1 and 0 with probability p and $(1-p)$ respectively. Each period a randomly selected pn firms have $\phi = 1$ and $(1-p)n$ firms have $\phi = 0$. We can think of $\phi = 1$ as a good production year for the firm and

$\phi = 0$ as a bad year. In a good year a firm maximizes profits given by $f(L) - wL$ and demands labour according to the condition $f'(L) = w$. The demand for labour is then given by

$$L = f'^{-1}(w) \qquad \text{---(2)}$$

In a bad year with $\phi = 0$ the firm will not demand any labour. The aggregate demand for labour in the F regime is then given by

$$L^F = \sum f'^{-1}(w) = npf'^{-1}(w) \qquad \text{---(3)}$$

If the production function is quadratic, i.e., $f(L) = (A/B)L - L^2/2B$ with $A, B > 0$ (and $L < A$), then, $w = f'(L) = (A/B) - (L/B)$ and $f'^{-1}(w) = L = A - Bw$. Hence,

$$L^F = np[A - Bw] \qquad \text{---(4)}$$

In the no-retrenchment N-regime a risk neutral firm that does not know the value of ϕ in advance will maximize expected profits $pf(L) - wL$ and demand labour according to the condition $pf'(L) = w$ or,

$$L = f'^{-1}\left(\frac{w}{p}\right)$$

As each firm is ex ante identical the aggregate demand for labour is given by

$$L^N = nf'^{-1}\left(\frac{w}{p}\right) \qquad \text{---(5)}$$

For the case of the quadratic production function,

$$L^N = n\left[A - B\frac{w}{p}\right] \qquad \text{---(6)}$$

The two labour demand curves L^F (equation 4) and L^N (equation 6) are graphed in Figure I. The supply curve of labour as drawn in Figure I is the standard upward sloping supply function $S = S(w)$, where, $S'(w) > 0$. Now, if the initial regime is one where retrenchment is freely allowed, then, equilibrium in the labour market is at point E^F. Suppose now that a new law is legislated that does not allow firms to retrench labour, then, the equilibrium shifts to E^N. Clearly both

wages and employment decline and workers are adversely affected by this legislation that was intended to benefit them[1]. Intervention meant to protect workers ends up hurting them. Basu argues on the basis of this that by severely limiting the scope of voluntary contracting between workers and employers India's labour laws have harmed workers and could have contributed to industrial strife.

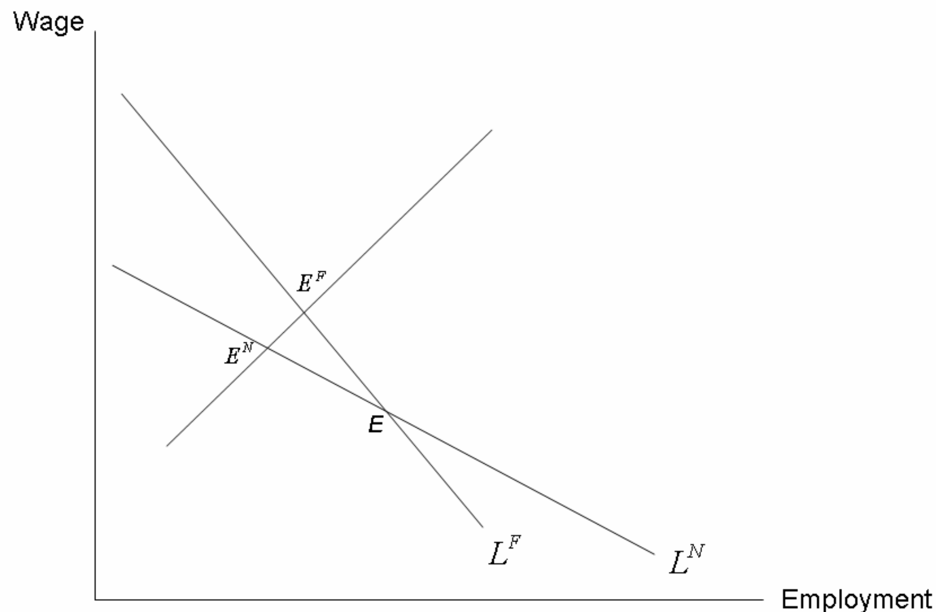

Figure I: Labour Market under the Two Regimes

Section III:

In an efficiency wage set up the problem of employment protection is best addressed in a simple two-period framework. At time t_0 the firm and the worker agree to a contract to be executed in period t_1. The contract states that the firm will pay the worker $(w > 0)$ if the worker expends effort $(e > 0)$ but the worker will be terminated from service without compensation $(w = 0)$ if the worker is caught shirking $(e = 0)$. The worker's disutility of effort is *e*. The effort provided by the worker is not easily observable by the employer or verifiable by a third party such as a court. The output generated due to the effort expended by the worker, however, is observable and verifiable.

At time t_1 the worker has the options of either working or shirking. If effort is expended the firm's gross benefit is y and if the worker shirks then expected output is py where $(1-p)$ is the probability of detecting a shirking worker. The firm also has two options before it[2] - to fulfill the contract or to behave opportunistically and terminate the worker. If the firm is opportunistic and the contract is terminated by it then it captures the full rents generated from the employee's efforts. If the firm honors the contract it pays the worker for effort or fires a shirking worker detected with probability $(1-p)$. Hence, the worker can be dismissed for two reasons- employer opportunism and verifiable shirking. The expected payoffs of the firm are in the lower left-hand corner of each cell in Table II and that of the worker in the upper right hand corner of each cell.

Table I: Efficiency wages when Firms and Workers are Opportunistic

		WORKER	
		Work	**Shirk**
FIRM	**Honour Contract**	$w-e$ $y - w$	pw $p(y-w)$
	Terminate	$-e$ y	0 py

The Table I depicts the opportunism faced by both firms and workers. The worker has an incentive to shirk if the wage is too low and monitoring is imperfect and the firm has an incentive to exploit the worker. When both firm and worker anticipate the other will behave opportunistically the worker will shirk and the firm will fire the worker and neither benefits from engaging in a contract. Employer reputation effects may result in the efficient contractual outcome where workers supply effort and firms honour the contract and compensate workers. But to expect all firms to have reputational capital is unwarranted and so employment protection legislation can play the role of restraining opportunistic behaviour by firms and

workers. Of course, it must be kept in mind that labour protection laws can reduce the effectiveness of efficiency wages and reduce worker productivity if it is a blunt instrument. An employment protection legislation whilst alleviating the worker's fear that he may be opportunistically terminated must at the same time allow the firm to terminate the worker if he is caught shirking. If there is third-party verifiable evidence of shirking then legislation should be such as to induce the expectation in the worker that termination of his services will occur.

There of course is the second variant of efficiency wages where workers are given deferred payments in order to elicit a performance bond in the form of effort over time (Lazear, 1981). Here even if the worker is fired with verifiable evidence he loses compensation due to him in the future. Also, the fact that compensation is deferred gives an incentive to employers to terminate services before the full term is served. To safeguard against this type of opportunism contractual safeguards in the form of a penalty on the firm in case of premature firing is called for. This function is typically performed by severance packages which specify a fraction of the worker's contractually established wage benefits to be paid to the worker if the firm chooses to terminate his services. In the product market when firms may behave opportunistically with respect to quality warranties are used to signal quality attributes. Similarly in labour markets when firms *and* workers may behave opportunistically *third-party* enforcement of employment protection legislation is called for. This legislation should not be written in stone but accommodate firing in case shirking by workers is established and severance payments in case firms wish to terminate workers regardless of shirking.

Conclusion:

Employment protection involves a whole range of measures apart from severance payments. These are designed so as to limit the

employer's ability to dismiss workers without delay or cost. The idea is to protect both workers and employers from opportunistic behaviour - tying their hands so as to make both better off by deterring them from short-termism. Some forms of employment protection need not entail immediate financial gains to either party. Administrative procedures such as writing to an employee concerned giving reasons for dismissal, specifying lengths of time that the employer has to wait for a response, and notices of termination where the length of notice varies by tenure and includes a cooling off period during which the notice may be issued but not become effective, etc., are employment protection measures that do not entail a direct transfer from the employer to the worker. These are often wise to include in employment protection legislation (as in the case of Chapter V-A) so as to delay dismissals and induce employers to negotiate over termination and not behave opportunistically.

One could argue that this increases job tenures and gives power to established workers with adverse effects on job creation. However, given opportunism, the only way that workers and firms will invest in a job is if there are speed breakers to opportunism. The unintended consequence that this may reduce turnover is an outcome that is an indirect cost of the gains to protection. Employment protection is usually thought of as creating redistribution towards labour, especially established workers, and is held responsible for creating rent seeking and efficiency losses. However, such policies also create immense insurance benefits by deterring opportunism. The challenge is to ensure that the efficiency losses are contained whilst the insurance gains are furthered. Employment protection should not be so rigid that it prevents change and preserves the status quo. It should not be so blunt that it is unable to distinguish between termination for shirking and opportunistic termination. Serious employment protection is counter productive when it is protectionist to vested interests and does not promote economic progress. Datta-Chaudhuri (2001) appropriately quotes Justice Mehta, a former Chief

Justice of a High Court, when he states that the view taken by many judgments "that to favour labour is the only goal of the statute (the IDA) is counter productive in as such as it ultimately harms the cause of labour itself."

Job security regulations are often seen as a source of rigidity and resulting in rents for organized labour. However, these regulations often emerged as a response to the threat of unemployment and income insecurity and are more a social insurance than rent seeking. Moreover, markets if left to themselves will not be able to device contracts that provide an efficient level of employment security. In a temporal world if workers tradeoff working with shirking, employers can similarly tradeoff honoring a contract with termination of employees. Opportunistic behaviour is often difficult to observe or to verify. In product markets opportunism can be nipped through signals such as the offer of warranties. In labour markets both firms and workers are susceptible to opportunism and verifying breach of contract is difficult. A meaningful way to get workers to invest in a job and employers to honour contracts is to legislate employment protection. The difficult task, of course, in reality is to ensure that employment protection does not become protectionist and an enemy of economic progress. It is premature to conclude that anti-retrenchment laws are inefficient and end up hurting workers.

Notes:

[1] Of course, the labour supply curve can be to the right of point E in which case legislation that does not permit retrenchment raises wages and employment, benefiting workers. The effect of the anti-retrenchment law is thus theoretically ambiguous but that is not important to our critique expounded below.

[2] For simplicity assume that at time t_1 the worker's effort decision is made simultaneously with the decision of the firm as to whether to honour the contract.

References:

Agrawal, P. (2000) – Labour Policies, Employment and Worker Earnings: Indian and International Experiences", in Satu Kähkönen and Anthony Lanyi (ed.) –

"Institutions, Incentives and Economic Reforms in India", Sage Publications, New Delhi, pp. 469-502.

Basu, K. (2002) – "Ideology, Economics and Labour Market Policy", in Rakesh Mohan (ed.) – "Facets of the Indian Economy – The NCAER Golden Jubilee Lectures", Oxford University Press, New Delhi, pp. 248-264.

Basu, K., G.S. Fields and S. Debgupta (2001) – "Retrenchment, Labor Laws and Government Policy: An Analysis with Special Reference to India", Paper written for the World Bank, Shrinking Smartly Research, Washington D.C.

Datta-Chaudhuri, M. (2000) – "Labour Markets as Social Institutions in India", in Satu Kähkönen and Anthony Lanyi (ed.) – "Institutions, Incentives and Economic Reforms in India", Sage Publications, New Delhi, pp. 449-468.

Davala, S. (ed.) (1992) – "Employment and unionization in Indian industry", Friedrich Ebert Stiftung, Delhi.

Deshpande, L.K., A.N. Sharma, A.K. Karan, and S. Sarkar (2004) – "Liberalisation

D'Souza, E. (1997) – "Labour Demand and High Development Theory", Economic & Political Weekly, Vol. XXXII No. 48.

D'Souza, E. (2001) – "The Relationship between Capital Markets and Human Resource Policies: Some Consequences of Flexibility", Twelfth IFCI Annual Lecture, University of Mumbai, mimeo.

Jenkins, R. (2004) – "Labor Policy and the Second Generation of Economic Reform in India", India Review, 3(4), 333-363.

Lazear, E. (1981) – "Agency, earnings profiles, productivity, and hours restrictions", American Economic Review, 71(September), 606-620.

Papola, T.S. (1994) – "Structural Adjustment, Labour Market Flexibility and Employment", Indian Journal of Labour Economics, Vol. 37.

Pissarides, C.A. (2001) – "Employment Protection", Labour Economics, 8, 131-159.

Schmitz, P.W. (2004) – "Job protection laws and agency problems under asymmetric information", European Economic Review, 48, 1027-1046.

Shapiro, C. and J.E. Stiglitz (1984) – "Equilibrium unemployment as a worker discipline device", American Economic Review, 74(3), 433-444.

Zagha, R. (1999) – "Labour and India's Economic Reforms", in T.J. Byres (ed.) – "The State, Development Planning and Liberalisation in India", Oxford University Press, New Delhi, pp. 160-185.

[1] Of course, the labour supply curve can be to the right of point E in which case legislation that does not permit retrenchment raises wages and employment, benefiting workers. The effect of the anti-retrenchment law is thus theoretically ambiguous but that is not important to our critique expounded below.

[2] For simplicity assume that at time t_1 the worker's effort decision is made simultaneously with the decision of the firm as to whether to honour the contract.