ECONOMIC FINDING • AUGUST 17, 2021

Contract Labor and Firm Growth in India

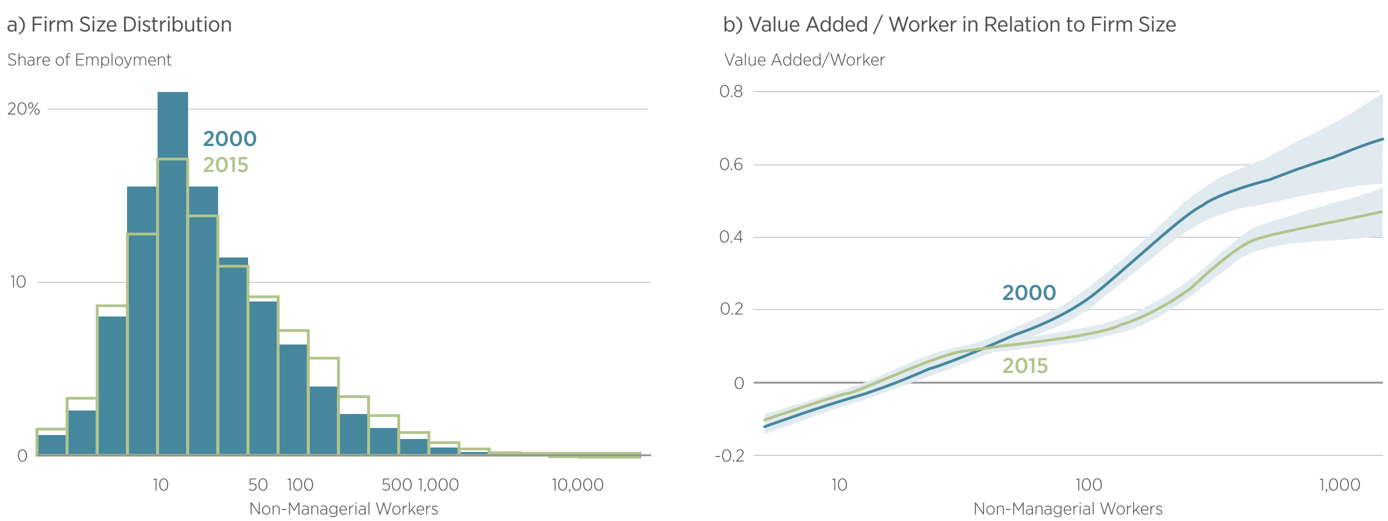
Based on BFI Working Paper 2021-96, "Contract Labor and Firm Growth in India," by Marianne Bertrand, Chris P. Dialynas Distinguished Service Professor of Economics, Chicago Booth; Chang-Tai Hsieh, Phyllis and Irwin Winkelried Professor of Economics and PCL Scholar, Chicago Booth; and Nick Tsivanidis, University of California, Berkeley

A 1947 worker-protection law that applies only to large firms has long stopped large Indian firms from growing. Since the early 2000s, large Indian firms have grown by relying on contract workers; such workers now account for almost 40% of the labor force of large Indian firms. The use of contract workers have also spurred increases in productivity and job creation among large Indian firms.

Many observers point to India's Industrial Disputes Act (IDA) of 1947 as an important constraint on growth. The IDA requires firms with more than 100 workers that shrink their employment to provide severance pay, mandatory notice, and obtain governmental retrenchment authorization. The IDA thus potentially constrains growth in two ways. First, the most productive Indian firms are likely sub-optimally small. Likewise, the Indian manufacturing sector is characterized by many informal firms, a small number of large firms, and a high marginal product of labor in large firms. Second, the higher costs faced by large firms in retrenching workers may dissuade them from undertaking risky investments to expand, one of the possible forces behind the low life-cycle growth of Indian firms.

The authors reveal that the constraints on large firms have diminished since the early 2000s, even though there has been no change in the IDA, and they offer visual evidence in the accompanying Figure. The left panel shows that the thickness of the right tail of formal Indian manufacturing increased between 2000 and 2015. The right panel shows

Figure 1 • Firm Size Distribution and Value-Added / Worker by Size (2000 vs. 2015)



Note: Left panel shows employment-weighted distribution of firm employment. Right panel shows coefficients and 95% confidence intervals from non-parametric regressions of log VA/Worker on log employment using Epanochnikov kernel with a bandwidth of 0.6. Employment is the number of non-managerial workers. Log VA/Worker is residualized by industry and year fixed effects.

Becker Friedman Institute
FOR ECONOMICS AT UCHICAGO

that average value-added/worker is increasing in firm employment in 2000 and 2015, but this relationship is more attenuated in 2015 compared to 2000, particularly for firms with more than 100 workers. If the marginal product is proportional to the average product of labor, and profit-maximizing firms equate the marginal product of labor to the cost of labor, then this suggests that the effective cost of labor has diminished for larger Indian firms compared to smaller firms.

What happened in the early 2000s to effect these changes? The authors argue that the decline in labor constraints faced by large Indian firms since the early 2000s is driven by firms' increasing reliance on contract workers hired via staffing companies. The IDA only applies to a firm's full-time employees; contract workers are not the firm's employees for the purposes of the IDA. The contract workers are employees of the staffing companies, and the staffing companies themselves must abide by the IDA. This loophole provides customer firms with the flexibility to return the contract workers to the staffing company without violating the IDA.

What was special about the early 2000s that caused an explosion of contract labor in India, when a legal framework for the deployment of contract labor was in place since the 1970s? The authors argue that a 2001 Indian Supreme Court decision paved the way for large firms to increasingly rely on contract labor. Prior to this decision, it was unclear whether firms who were caught improperly using contract workers would have to absorb them into regular employment, which plausibly made large firms reticent to rely on contract labor. The 2001 Supreme Court decision clarified that this was not the case, leading to a discrete change in the use of contract workers by large firms, in the employment share of large firms, and in the gap in labor productivity between large and small firms after 2001. In addition, these changes were more pronounced in pro-worker states and for firms with better access to staffing firms prior to the decision.

READ THE WORKING PAPER

NO. 2021-96 · AUGUST 2021

Contract Labor and Firm Growth in India

bfi.uchicago.edu/working-paper/202196

ABOUT OUR SCHOLARS

Marianne Bertrand
Chris P. Dialynas Distinguished Service Professor of Economics, Chicago Booth
chicagobooth.edu/faculty/directory/b/marianne-bertrand

Chang-Tai Hsieh
Phyllis and Irwin Winkelried Professor of Economics and PCL Scholar, Chicago Booth
chicagobooth.edu/faculty/directory/h/chang-tai-hsieh

CHICAGO BOOTH
The University of Chicago Booth School of Business