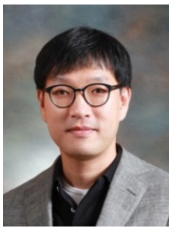
KIEP

Opinions

September 25, 2015

The Role of Labor Market Flexibility on Labor Markets in India



LEE Woong

Ph.D., Research Fellow, India-South Asia Team
Korea Institute for International Economic Policy

It is a common view that labor market flexibility is related to labor market outcomes, regardless of the country. For example, most widely used economic textbooks present that generous benefits for the unemployed in many European countries partly explain why the unemployment rate is higher in Europe than in the United States.

Today, labor market flexibility becomes a controversial topic because of its direct impact on business profits and workers' welfare, not only in the short run but also in the long run. On this issue, there is no distinction between developed and developing nations. For example, the peak wage system is a hotly debated issue in

Korea, while the amendment of the Industrial Dispute Act is one of the key factors in the Indian economy' reform symbolized by *Modinomics*.

Labor market flexibility in India is of particular interest, since employment protection legislation tends to be pro-worker rather than following global standards. In addition, the Indian economy has grown rapidly in recent years. India is set to surpass China with an expected growth rate of 7.5% in 2015, which is the fastest rate of growth among major economies. If India's rapid growth rate sustains, then it will become one of the key engines for global economic prosperity in coming years.

We examined the relationship between labor market flexibility and the number of new hires (a labor market outcome) through the job matching process in India. To do this, we estimated the matching functions that incorporate a proxy variable for measuring the degree of labor market flexibilities across states in India. We utilized the state-level panel data for more than 10 years, to address heterogeneities across states and to control for fluctuations over time. This study was designed to answer two main research questions. The first is whether flexible labor markets have better outcomes in the job matching process. The second question is whether the pattern of the matching function's coefficients is systemically related to the labor market flexibility across regions.

We found no direct relationship between labor market flexibility and new hires in the job matching process, when the labor market was analyzed as a whole. However, the findings pinpoint one clear pattern in the analysis when the labor market is partitioned into groups in terms of labor market flexibility: there is a substantial lack of labor demand in states where labor markets are not flexible.

This result is consistent with the prediction of economic theories. Firms are less likely to increase job openings in inflexible labor markets, which result in a shortage of labor demand. This finding provides important policy implications. For regions with inflexible labor markets, relevant policy measures should inevitably include policies that increase labor demand, i.e., creating new job openings, for instance through employment subsidies, rather than policies that impede labor market flexibility. KIEP