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Deregulation of Labour Laws and the Jobs Promise

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India has a labour problem: youth unemployment rates of about 10 percent, farm jobs still employing at least 40 percent of the workforce, and a need to create at least 8-10 million non-farm jobs annually to absorb the growing young population (Economic Survey, 2023). At the same time, the proportion of India's workforce in manufacturing has stagnated at about 13 percent for the last three decades. What explains this stagnation?

After liberalisation, the relative price of capital goods fell sharply following trade liberalisation and import tariff cuts, while real wages rose more moderately. This resulted in a rising wage-to-rental price of capital (w/r) ratio and capital deepening. Indian firms now tend to use less labour per unit of capital than firms in other countries at similar income levels, especially in labour-intensive industries like apparel.

Commensurately, labour's share of value added in India's organised manufacturing declined from 28.5 per cent in 1980–81 to 11 per cent in 2012–13. While this mirrors the global pattern of falling relative prices of capital goods and capital deepening, India stands out in having unusually low labour intensity for a low-wage economy. Firm size in India remains small, with almost 80 percent of the non-farm workforce employed in firms with fewer than 10 workers. Even among registered manufacturing firms, the median firm size is around 20 workers.

WHAT DO INDIA'S NEW LABOUR CODES CHANGE?

India has long had a labyrinthine labour law regime---over 40 central and 100 state laws dealing with different aspects of wages, industrial disputes, safety and social security. In 2002, the Second National Commission on Labour had recommended consolidation of labour laws to reduce complexity and inconsistent definitions.

Finally, India's four new labour codes, notified between 2019 and 2020 and brought into force from 21 November 2025, replace 29 central labour laws with a consolidated framework covering wages, industrial relations, social security and occupational safety. Importantly, the new codes attempt to balance the need for worker protection with ease of doing business.

Some crucial changes which aim to enhance worker welfare: a single definition of “wages” across laws, a national floor wage set by the Centre, minimum wage coverage extended from scheduled employments to all workers, common norms on working hours, safety, welfare facilities and registration for establishments, fixed-term employees (FTE’s) to now receive parity of wages and benefits with permanent workers, and appointment letters are now made mandatory for workers making it possible to track employment histories and nudging formalization. Finally, the codes provide for the creation of a Social Security Fund for unorganised, gig and platform workers. Aggregators (ride-hailing, food delivery, e-commerce, etc.) are required to contribute 1-2 percent of their annual turnover, capped at 5 percent of the amount they pay or owe to gig and platform workers.

Major changes which have reduced compliance costs for employers include: the applicability of standing orders and the requirement for government permission for employee layoffs increasing from 100 to 300 employees, a clearer framework for negotiating with unions, with minimum worker representation, and the removal of restrictions on women working at night or in certain occupations. There has been a substantial reduction in registrations, licences and returns. For example, the Occupational Safety, Health and Working Conditions Code has reduced registrations from 6 to 1, licences from 4 to 1, and returns from 21 to 1; the Code on Wages has reduced forms from 20 to 6 and registers from 24 to 2; and the Industrial Relations Code has reduced forms from 37 to 18 and registers from 3 to 0. Though they still fall short of one registration and one return benchmark for all labour related matters.

Most importantly, there has been decriminalisation of minor offences, with fines and improvement notices replacing prosecution. Size-based regulatory thresholds (10, 20, 50, 100 workers) often triggered additional regulations and inspections and were strongly associated with bribe seeking by inspectors. The new web-based random inspections can further reduce compliance costs for firms. However, serious, repeated or critical breaches are still imprisonable offences.

WHY THESE MATTER?

Evidence over the last two decades has repeatedly underscored that India's manufacturing growth has been stymied by its extensive labour regulations. Evidence shows that states with more flexible labour regulations have higher output, employment, investment and productivity growth in manufacturing, especially in labour intensive industries. In fact, product-market liberalisation increased productivity in states with more flexible labour laws but had little effect in rigid states, implying that labour regulation constrained firms' ability to respond to new opportunities. Estimates show that regulations under the Factories Act increase firms' unit labour costs by almost 35%.

More recently, our research shows that amendments that raised Industrial Disputes Act and Factories Act thresholds from 100 to 300 workers, and 10 to 20 and 20 to 40 workers, along with decriminalization of offences in some states over the last decade (also some major changes implemented in the new codes), increased plant employment and output by 5 percent in states which amended these laws relative to the others. Overall, there is sufficient evidence to show that rigid employment protection legislation and complex labour regulations have depressed firm growth and job creation in India's organised manufacturing.

WHAT ARE THE POTENTIAL IMPACTS OF THE DEREGULATION?

First, the change that has provoked the strongest backlash from labour unions is the increase in the threshold from 100 to 300 workers for requiring government permission to lay off workers. This is due to fears of employment losses. However, notably, about 15 states, including some large ones like Rajasthan, Madhya Pradesh, Uttar Pradesh, Maharashtra, Andhra Pradesh and Gujarat, had already amended their Industrial Disputes Acts over the last decade (some spurred after the pandemic) and increased the threshold beforehand.

Thus, the effect of this change on manufacturing employment will be marginal in most states. In fact, by spurring firm growth and entry, there will be a net creation of jobs rather than job losses. When separation is costly or unpredictable, firms choose capital-intensive technologies to avoid adjustment risk, even in labour-abundant economies. By making separations more predictable and less binding at lower levels of employment, the codes can reduce the option value of staying small and capital-intensive.

Second, complex regulation and high firing costs act like a tax on labour, raising its effective price relative to capital. Relaxing these, by simplifying compliance and through decriminalization, digital registration, and unified returns, reduces the effective wage component. This makes labour relatively more attractive at the margin than capital. It also reduces harassment, transaction and compliance costs for most firms. Reduction of legal uncertainty can also increase private investment. However, the culture of corruption by officials and harassment of firms needs to change on ground for effective realization of gains.

Third, requiring FTEs to receive equal pay and benefits as permanent workers, may reduce the incentive to rely excessively on third-party contractors. However, hiring contractual workers may solve a deeper problem e.g. specialization in core business tasks, training, recruitment etc than simply avoiding regulations and to that extent may have a limited effect.

ARE THESE ENOUGH?

While the above changes make important leaps, some of the provisions carried forward may still make manufacturing in India less attractive than our Asian competitors. For instance, overtime is fixed at twice the nominal wage. The standard overtime rate is typically 1.5 times the regular wage rate across most countries. The ceiling on the number of hours at 48 hours per week for a worker also makes labour more expensive, especially for industries which may experience seasonal demand. China legally sets 44 hours but often sees long hours. Similarly, Vietnam has a 48-hour limit but allows significant overtime (up to 300 hours per year) at a lower wage premium.

To bring some cheer, overtime capped at 75 hours a quarter has now been left to the discretion of states. Since 2020, some states like Haryana, Himachal Pradesh, Karnataka, Maharashtra, Odisha, Punjab, and Uttar Pradesh have increased the ceiling of overtime hours up to 144 hours per quarter. This potentially increases earnings for employees but high over time rates may still deter firms from employing labour beyond the usual 8-hours.

Second, a common national minimum wage floor in India----generally considered a good idea for ensuring basic income security and reducing inequality----can increase cost of labour in some states (especially the ones which already have a small non-farm sector). In India, the cost of living varies significantly between urban and rural areas, and across different states. A single, uniform national rate, even as a floor (unless taken as the minimum across the states currently) may be problematic given the large economic disparities.

Lastly, even if the new codes work as intended, manufacturing investment decisions depend on a broader package: logistics, power and infrastructure costs relative to peers, trade policy, export ecosystem, skilled labour, contract enforcement and importantly, land availability with little delays.

Comparative analyses of India's manufacturing under-performance emphasise that while labour regulation is important, it is only one among several constraints. While the new labour codes improve India's attractiveness for manufacturing investors at the margin, they are unlikely to be a silver bullet. Their impact will be realised only if accompanied by complementary reforms and credible implementation at the state level.



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