

Working paper

Interaction of Labor Law and Economic Growth

Case Study of
Sheikhupura

Mir Anjum Altaf

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Interaction of Labor Law and Economic Growth

Case Study of Sheikhupura

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The International Growth Centre

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PROJECT OVERVIEW

The project is entitled “The Interaction of Labor Law and Economic Growth – Case Study of Sheikhupura.”

It is part of the portfolio of projects undertaken by LUMS for IGC on aspects of economic growth in the region centered on Lahore and including the surrounding small cities that are or can be part of the metropolitan labor market.

In the first project in this series (Altaf 2013), representatives of all seven participating cities identified the significant impact of labor laws on both the welfare and productivity of industrial workers. As a result, it was decided to explore the interaction between labor laws and economic growth more formally through a dedicated study. Sheikhupura, a half-million sized industrial city about 30 miles from Lahore, was selected for the case study based both on its proximity to Lahore and the range of its industrial base varying from small factories to MNCs.

The aim of the project is to produce findings and recommendations that would provide useful inputs in reviewing/formulating:

- Labor policy: In particular with reference to labor law and working conditions.
- Economic growth policy: In particular, how to enhance labor productivity using legal tools and frameworks.
- Legal policy: With particular reference to legal reforms that address redundancies and inefficiencies especially in labor law.
- Governance policy: By providing insights that would serve as a basis for reforms in other cities and at the provincial level.
- Accountability policy: By enhancing the understanding of citizens, members of the labor force, and business owners of issues related to their respective welfares.

EXECUTIVE SUMMARY

- Representatives of small cities have consistently drawn attention to violations of labor laws and their negative impact on worker welfare and productivity.
- This case study of Sheikhpura, a half-million sized industrial city about 30 miles from Lahore, identified five labor laws with a major impact on worker welfare and productivity – Factories Act, 1934; Minimum Wages Ordinance, 1961; Payment of Wages Act, 1936; Punjab Industrial Relations Act, 2010; and Workmen's Compensation Act, 1923.
- Our observations of small scale industry, employing the majority of the industrial labor force, revealed desperate, survival level, working conditions at less than the minimum wage, with little or no protection from various forms of exploitation and exposure to hazards, with virtually no mechanisms of redress, no collective bargaining, little or no investment in human capital improvement, and sustained poverty over generations.
- The balance of power among the three key players – workers, factory owners, and government regulators – was determined to be completely one-sided with the latter two holding all the cards.
- The strategy of choice for the factory owners and government bureaucrats was one of extensive collusion.
- This collusion allowed gross violations of all the laws with various subterfuges and mechanisms, the most egregious being the outsourcing of labor hiring to contractors less subject to the application of the laws thereby diluting the responsibility of factory owners.
- We characterized the situation in the small-scale industry in Sheikhpura as one of a low-level equilibrium trap sustained by a prisoner's dilemma in which no individual

firm could afford to change the terms of engagement with either the workers or the regulators.

- Our review suggests convincingly that market forces alone are not sufficient to break out of the low-level equilibrium trap escaping which would be in the long-run interest of both factory owners and workers.
- We rely on a detailed economic history of the American South to argue that only federal action can change the terms of engagement creating a new level playing field and forcing all factory owners to act in their own long-term interest.
- We are aware that the federal government in Pakistan has been unable to initiate such action and that the trend in South Asia is in the opposite direction owing to pressure generated by globalization to create business-friendly environments.
- To generate a new dynamic, in addition to strengthening existing penalties, we recommend a series of measures that would incentivize companies to voluntarily improve working conditions and standards. A calibrated carrot and stick regime supported by public disclosure and citizen labor boards are central to sustained progress towards greater social justice and workplace democracy.
- There are no fundamental reasons that prevent the government from adopting some or all of the recommended measures. Failure to do so would leave no recourse except that of political mobilization and social activism in support of the much-needed changes.
- Grassroots mobilization and consumer activism in developed countries have often succeeded in convincing governments and employers to curb harmful labor practices and have been lauded for their contribution. Recent public interest litigation on behalf of workers in the Punjab taking advantage of a period of judicial activism illustrates both the need and the possibilities in developing countries.

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1.1 PROJECT DESIGN

The study envisaged four distinct phases:

1. A desk study to determine the comprehensive list of laws bearing on issues related to labor.
2. A series of focus group discussions to identify the subset of these laws with the most impact on worker welfare and industrial output, both positive and negative.
3. A verification of this identification via an exhaustive investigation of case law in Sheikhpura.
4. A conceptual and empirical analysis to assess the impacts of the various labor laws on worker welfare and worker productivity.

1.2 PROJECT IMPLEMENTATION

In accordance with the study design, the set of labor laws that comprise the labor code in Pakistan were identified via a desk review. This was followed by intensive focus group discussions, chaired by the President of the Sheikhupura Bar Council, with lawyers, labor court prosecutors, and labor department representatives in Sheikhupura.

The focus groups concluded that the five laws most relevant to the project were the Factories Act, 1934; Minimum Wages Ordinance, 1961; Payment of Wages Act, 1936; Punjab Industrial Relations Act, 2010; and Workmen's Compensation Act, 1923.¹ The focus groups also provided insights into the loopholes in and violations of the aforementioned laws during implementation. In order to understand the diverse perspectives of stakeholders the focus groups were complemented by factory visits and interviews with industry experts, enterprise owners, the District Officers of the Labor Department in Sheikhupura, Lahore, and Rawalpindi, the Directors of the Social Security Department in Sheikhupura and Rawalpindi, the Director at the Labor Department Headquarters in Lahore, the President of the Bar Council Sheikhupura, and workers across industries in Sheikhupura. The insights from the focus groups were combined with information obtained from 14 in-depth interviews with workers (including 2 females), a labor controller (*munshi*), and a quality inspections manager.

The information obtained from the focus groups and interviews was then crosschecked against the actual case law filings available with the Labor Department. A summary of this quantitative analysis is included in subsequent sections of this report.

Following this stage, the study design called for an empirical assessment of the impact of these laws on worker welfare and productivity by selecting a sample of employers with variations in the implementation of labor laws. This proved impossible because factories were not open to sharing data or allowing interviews with either staff or workers. Since many workers lived in enclosed factory compounds with restricted access, primary data collection on either welfare or productivity was not possible. We did interview off-site workers to get a sense of welfare conditions but no substitute was possible for information on productivity or

¹ Following the passage of the 18th Amendment, labor became a provincial subject and provincial governments are responsible for implementing labor laws. Therefore, all the statutes identified above are provincial statutes. However, these provincial statutes are almost exact copies of the federal statutes that were in force prior to the promulgation of the 18th Amendment. Qazi (2011) identifies the problems emerging from this devolution.

output. Secondary data available from the Household Integrated Economic Survey and the Labor Force Survey were unhelpful as these were aggregated at the district and not the city level. We were also unable to locate any secondary data at the factory level on implementation of labor laws or productivity. Therefore we were unable to estimate differences in worker welfare and productivity arising from differential application of labor laws.

It became progressively clearer that there was a tremendous asymmetry in the power of the three key players involved in the interactions – factory owners and government functionaries exercised much more power than workers. It also became clear that the optimal strategy for the former two was collusion which yielded significant economic gains at the expense of workers. This explained why owners were not ready to share data regarding outputs and why departmental records were so unhelpful. A high degree of bribery and corruption militated against the disclosure of facts and information. At the same time it was very hard to reconcile narratives as the two key stakeholders employed a strategy of shifting blame on to the other although it was clear that the state of affairs could not be sustained without their agreement and coordination.

On the other hand, the general conditions of workers were so abject that not much further study was needed to appreciate it. A detailed study would not challenge the basic parameters of the prevailing situation.

For this reason, the study had to be adapted to examine the capital-labor relationship in a broader, more qualitative, framework. The insights that resulted from such an analysis form the basis of the recommendations offered in the report.

Fieldwork for this part of the study included interviews with 36 laborers employed in factories along the Lahore-Sheikhupura-Faisalabad Road, Warburton, and adjoining areas. The industries represented by these factories included food, textile, chemicals, utensils and waste management. Detailed, qualitative interviews with both structured and unstructured questions and responses were administered to the workers in the vicinity of the factories after the end of a shift or in labor colonies. Because labor colonies are populated mostly by non-local workers, the latter were more heavily represented in the sample which included both male and female workers. Labor officers were interviewed in Sheikhupura, Lahore and Rawalpindi. These interviews were free-flowing in the form of conversations about problems in implementing the law, generally observed loopholes in the existing legal mechanism,

standard practices followed by the department, and specific measures to improve the situation.

The outcome of the observations and field interviews was that after grasping the dynamics of the triangular relations between capital, labor, and regulator in Sheikhpura, the study evolved into identifying the behavior of each in the existing conditions and the strategies employed by them to advance or protect their interests. Based on this analysis a number of measures were proposed to improve social welfare in the short-term and economic welfare in the long-term. We believe that these recommendations have validity beyond Sheikhpura at the provincial and national levels in Pakistan.

2. PROJECT FINDINGS

2.1 CRITICAL LABOR LAWS

The five provincial labor laws with the most impact on the labor market in Sheikhpura were the following:

1. **The Factories Act, 1934:** This act outlines everything that needs to be provided to the laborers in a factory ranging from proper working conditions to health and safety. It also covers aspects such as payments during holidays, overtime rates, etc.
2. **Minimum Wage Ordinance, 1961:** This Ordinance determines the minimum wage that is to be offered to the workers. The Punjab Government has recently set this wage at Rs. 10,000 per month for an unskilled worker. In addition, the Government has classified 51 different types of skills each with its corresponding minimum wage.
3. **Payment of Wages Act, 1936:** This Act was introduced to ensure that workers received their payments on time and there were no discrepancies in the said payments. As per this law, in case of an error, the worker can go straight to the authorities (usually the National Industrial Relations Commission) for redress.
4. **Punjab Industrial Relations Act, 2010:** The main purpose of this Act is to regulate trade unions. Under this act, all trade unions that exist are to be registered with the labor office and their operations monitored and regulated. The Act also gives the Labor Office the authority to cancel the registration of a trade union in violation of rules. Each district has its own labor office. Although the Act primarily deals with collective bargaining, it provides an important avenue to an individual worker under S. 33 for redress of individual grievances².
5. **Workmen's Compensation Act, 1923:** If a worker is injured at work, there are certain entitlements as compensation for loss. There are two types of

² In the case where decision under this section given by the Labor Court is not complied with within seven days or within the period specified in the decision, offender can be punished with imprisonment for a term which may extend to three months or with fine which may extend to five hundred thousand rupees or with both [S. 33(8)].

injuries that can occur: temporary injury and permanent injury. In case of a temporary injury, a worker has to be granted Social Security³ leave on the recommendation of a physician in addition to half the salary for the duration of the leave. In case of a permanent injury, the worker can either be given a pension for the rest of life or can be assigned alternative duties.

³ In Pakistan, Social Security benefits cover a number of basic needs for a worker and his/her family, including educational benefits in which the worker's children are entitled to attend a school free of cost. Other than that there are medical benefits that a worker and the family can avail including free treatments from specified hospitals. Under the same scheme, the workers are also entitled to marriage and death grants. If the worker's daughters are getting married, he is entitled to a sum of Rs. 100,000 and there is no limit to the number of times the grant may be availed. The death grant (a sum of Rs. 500,000) is awarded to the heirs of the worker. These are grants given by the governments with no payback required. According to the lawyers present, the implementation of these grants is generally reasonable.

2.2 CONDITIONS IN SHEIKHUPURA

2.2.1 WORKER DEMOGRAPHICS

While most workers in Sheikhupura are locals or from nearby villages, there are also those from places much farther away like D.G. Khan and villages of South Punjab. Such workers lived in housing provided by factories. The majority of workers is unskilled and employed in manual labor like picking and moving heavy machines and goods.

2.2.2 RECRUITMENT OF WORKERS

Most employees at the managerial or supervisory levels are hired directly by industrial establishments. Those we interviewed had been with individual establishments for extended periods and their compensations complied, in general, with minimum wage laws.

Labor in other categories was, however, hired indirectly. The factory owner generally enters into a formal “contract for services” with an intermediary known as a subcontractor (*thekedaar*). The subcontractor, in turn, hires labor informally. The factory owner pays the subcontractor a fixed price per worker. This device is meant to shield the factory owner from legal liability under labor law since the laborers who effectively work for him are, technically, not his “employees” but rather the employees of his “contractor”. Contractors are generally people who are better placed to collude with the regulators and ensure continuing non-compliance with labor law. As can be expected, even if a firm pays the subcontractor the legal minimum wage per worker (which it generally does not) the workers themselves receive less. Additionally, workers do not have formal contracts or job security and are consequently not eligible for social security mandated for factory workers under the law. This mechanism absolves factory owners of responsibility for the contracted workers. Depending on local bargains with government inspectors some employees have proper contracts and social security records, as proof of compliance, while the majority of the subcontracted labor is not part of the official records.

The superior courts have, over the course of years, and most recently in *Fauji Fertilizer Company Ltd. v. National Industrial Relations Commission* (PLC 2014 SC 10), taken notice of this legal subterfuge. They have held that a laborer will be considered a factory owner’s employee provided there is evidence of “a master and servant relationship”, i.e., effective control, even if the laborer is technically the employee of a subcontractor. In essence, then,

the liability for labor rests with whoever effectively benefits from its production. Nonetheless, piercing through this legal subterfuge requires adequate knowledge of the law as well as legal representation, both of which are often beyond laborers' capacities to acquire or hire. Tacitly worded service provision contracts, lack of knowledge, and unaffordable representation also make it difficult for the proverbial "master and servant relationship" to be reasonably established in a court of law.

2.2.3 TRADE UNIONS

Trade unions are conspicuous by their absence from the labor market of Sheikhpura. The few unions that do exist are mostly headed by a person appointed by the employer and hence do not satisfy the condition for free association. Moreover, workers are rarely aware of their presence. Those with some awareness have little faith in these unions and hence do not approach them with their concerns.

The absence of unions means that workers have little or no collective bargaining power. With the labor hiring outsourced to subcontractors, high unemployment, availability of surplus labor, and weak collectivization, the situation for workers is desperate. Just finding employment is the major goal and losing a job the biggest fear. There is thus very little protest against the visible prevalence of exploitation.

2.2.4 WAGES

Interviews with laborers across industries indicate that monthly compensation for unskilled workers ranges from Rs. 7,500 to Rs. 10,000 for duty shifts of 8 to 10 hours a day (against the official minimum wage of Rs. 10,000). Female respondents reported lower wages for equivalent work. The salaries of the *munshi* and the manager in our sample were Rs. 15,000 and Rs. 20,000, respectively, for the same or fewer hours of work per day.

Almost all respondents agreed that the compensation is barely enough for subsistence, leaving little or no savings. It was their opinion that higher wages would make them more productive.

2.2.5 WORKING CONDITIONS

In general, working conditions were unsatisfactory and in specific industries, e.g., those involved with waste materials, were decidedly unhealthy. Little or no precaution was being advised or followed, if advised. Factory managers assumed no responsibility nor paid heed to

the harmful effects of certain clearly hazardous environments. The workers did, however, express the desire to be shielded against hazardous environments and to be provided with adequate safety equipment.

Working conditions for females were even worse. Sexual assault by owners (and their relatives) was mentioned as common practice but rarely reported because of fear of losing employment. The *munshis* were also often reported to exchange favors with female workers.

2.2.6 IMPLEMENTATION OF LABOR LAW

Focus group discussion indicated that most factory owners had found mechanisms to avoid the implementation of labor laws in ways that precluded liability. The following violations were mentioned most frequently:

- i. **Under-reporting of the number of employees:** A typical example of a common practice was of a factory employing 1300 workers but reporting only 200 on the books. Only the latter were insured and eligible for Social Security entitlements.
- ii. **Social security contribution:** The Director of the Social Security Department alleged that factory owners and businessmen did not cooperate with the social security department and did not contribute the requisite funds for their employees. Further, many factory owners hired laborers on a temporary basis thus limiting their access to insurance and Social Security benefits.
- iii. **Minimum Wages:** The minimum wage introduced by the government was rarely implemented and the inspection checks failed to uncover these violations. As a result, it was guesstimated that only about 30 percent of factories paid the minimum wage to their employees.
- iv. **Discrimination and Harassment:** On one visit a representative of the government's labor department offered some observations off the record. He mentioned gender-based wage and work discrimination, sexual harassment, and child labor as being common practices across the industries. Our in-depth qualitative interviews also revealed sexual harassment of females and lower wages for equivalent work.
- v. **Bonded/Child Labor:** The incidence of child labor is particularly high where bonded labor is involved. Brick kilns, workshops, and hotels have the highest number of bonded laborers. Although the courts have declared bondage a

crime, this practice is still prevalent across the country. Cases of child workers injured on the job but denied benefits and compensation on account of being below the age of entitlement were narrated in interviews.

- vi. **Weak Implementation:** While the policy of ‘surprise raids’ should act as an deterrent to concealing facts, collusion between employers and inspectors generally means that factory owners are aware of when ‘surprise visits’ will take place and hence are able to conceal facts. Lack of coordination amongst government institutions was also mentioned as a reason that enables factory owners to get away with malpractices. The lawyers whom we consulted at the courts pointed out that they could reasonably estimate the actual labor force working in an industry by looking at the machinery installed and multiplying by the number of workers needed per unit. However, when results of surveys and audits were sent back to the law enforcement agencies for correction, they were ignored.
- vii. **Bribery:** Our informant mentioned that the government officials assigned to factory audits and surveys generally asked for bribes to understate the number of employees and overstate wages paid. Thus a factory with more than a thousand employees could actually have a reported labor force of a few hundred in the audited records,
- viii. **Lack of Awareness:** An alleged lack of general awareness amongst the workers about their basic rights was cited as one reason for the weak implementation of labor laws. It is not clear however whether the desperation to hold on to jobs in a labor surplus environment is not a more serious reason for the lack of worker pressure for their rights. This is compounded by the lack of faith in the legal machinery. Court proceedings are a long, painful, and expensive process rendering them inefficient. Most workers cannot afford legal counsel and, being uncertain about the outcomes of the suits, they steer away from pursuing their claims.

2.2.7 JOB SATISFACTION

When asked if they were satisfied with their current jobs, almost all workers expressed relief that they have jobs at all in an environment of serious unemployment. Considerations of happiness or job satisfaction seemed a luxury, overshadowed by the dire need for some form of employment for survival. There was an excess supply of unskilled labor and those

interviewed were acutely aware that they could be fired at any time and replaced with more compliant workers. Workers from afar were reconciled to not being able to go home for months as long as they could earn something to send back.

2.2.8 LEGAL LOOPHOLES

In addition to the outright violations of law mentioned in earlier sections, several loopholes exist to allow employers to evade compliance, accountability and prosecution even when government functionaries or judicial processes attempt to intervene.

- i. **Unregulated Informal Economy:** By subcontracting certain production processes and transferring them from regular to contract labor, industrialists are able to evade responsibility and thus refuse to claim liability when issues arise of noncompliance with the law. The few provisions that exist to deal with such a situation in the current legal structure are rarely implemented and often require legal representation that is costly and unaffordable for most laborers. As a result, employers are able to ignore minimum wage regulations, social security requirements, overtime payments, and even rules relating to injury compensation by hiring external contractors to provide the labor force. This run-around relies on the unaccountability of third-party labor contractors – their incomes are not documented and they evade government investigations on compliance with labor laws. These factors combine to create a loophole where employers gain the flexibility to flout the laws and contractors have an incentive to earn a premium by supplying cheap labor.
- ii. **Ineffective Penalties:** Fines are imposed for legal violations and additional compensation mandated in case of underpayment to laborers. However, we confirmed that the threat of fines is insufficient disincentive for most employers. Since most employers can underreport employment because of the outsourcing loophole, fines and compensation add up to less than the increase in total costs that would result from full compliance with the law. Acceptance and payment of fines is thus the less expensive and more preferred alternative in the existing situation.
- iii. **Slow Judicial Processes:** The slow and cumbersome judicial procedures militate against compliance in the labor market. Years can be consumed in litigating a single case as revealed by our investigations and petitioning

laborers rarely possess the physical, mental, or financial strength to fight to the end. Thus many cases are never filed. Even when cases are heard, petitioners mention witnesses absconding or changing their statements under pressure. We suspect that the inefficiency of the judicial process is a deliberate loophole to preserve the status quo.

- iv. **Inadequate Opportunities to Form Associations:** Perhaps the most alarming revelation of our research was the absence of unions in almost all factories that we managed to visit. There was no forum for workers to collectively voice their demands, and many (especially female workers) were, in fact, unaware of what a union and its functions implied. In the rare cases where a union existed, it was in the hands of agents of owners. It was difficult to ascertain whether it was the workers' own disinterest or the management's active role that resulted in this situation; however, the fact that the law is silent on a complete absence of unions, in spite of the same being a fundamental labor right under ILO guidelines, is in itself a loophole that facilitates labor law violation and noncompliance.

2.2.9 CASE LAW

To get an idea of the nature and incidence of labor code violations, case law from 2008 onwards was reviewed (records from earlier years were unavailable). The review indicated that most claims were filed under section 15(2) of the Payment of Wages Act, 1936 and Section 10-B of the Minimum Wages Ordinance, 1961. The Workmen's Compensation Act, 1923 was also resorted to and several cases were filed under it.

Regarding settlements and judgments, the trend was towards out of court settlements. However, in some cases, a penalty was awarded to the respondents and they were given a time period (usually 30 days) in which to make the payment. The amount of the penalty ranged between about Rs. 16,000 to Rs 20,000, depending upon type of complaint.

Data for the past two years showed the average number of new cases reported per month under the Payment of Wages Act, 1936 as 19 as compared to 6 under the Workmen's Compensation Act, 1923. Thus cases under the Payment of Wages Act, 1936 were generally more reported.

Investigating decisions by month, it was found that on average 26 cases were decided under the Payment of Wages Act, 1936 and 7 under the Workmen's Compensation Act, 1923. The highest number of cases decided under the Payment of Wages Act was 146 in September 2013. However, for pending cases by month for the same two statutes, the averages were 305 and 45 respectively. This reveals a growing backlog, which inevitably results in excessive times to decision, a discouragement for plaintiffs – justice delayed is clearly justice denied. To some extent this slow pace may be a deliberate practice to bias outcomes against those with limited staying power.

One story, narrated by a middle-aged woman and her son during a field visit, can serve as an illustration. The woman's husband, a driver in a factory, died of a heart attack at work and was entitled to compensation under the Workmen's Compensation Act, 1923. The survivors had been visiting the department for a year but there was no resolution because the responding party did not show up and the hearing date was repeatedly deferred. The factory had promised to employ the son but had not given him a job. The woman stated her average monthly expenditure was Rs. 10,000 and the family was struggling to survive while repeated court visits were further straining the budget. She was critical of the Labor Department and complained that there were hundreds of people in the same situation seeking justice without hope.

3. CONTEXTUALIZING SHEIKHUPURA

3.1 CHARACTERIZING THE SITUATION IN SHEIKHUPURA

Based on investigations and interviews, the most apt characterization of the situation, at least of the informal industrial sector in Sheikhupura, is a stable low-level equilibrium. Wages of workers are at subsistence levels and are kept there by a surplus of unemployed labor. With little or no steady savings, there is negligible investment in human capital. Worker productivity remains low as a result.

Collusion between factory owners and government regulators is the dominant win-win strategy for both players. As a result, nominally progressive labor codes for the protection of workers are ignored. Working conditions fall below specified standards with no safety equipment available in hazardous work places and no preventive measures in vulnerable sites. Rescue services are minimal resulting in the loss of lives. Most incidents go unreported unless either the scale or the links with the export sector focuses media attention. Such was the case, for example, of the Baldia Town fire in a garment factory in Karachi that claimed 258 lives. Even then compensations and reform remained patchy and elusive (labourwatchpakistan.com 2013; Rehman 2012).

Such conditions, characterized by hopelessness, negatively impact the productivity of workers but keep them employed because of lack of alternatives for survival and the absence of a trade union movement that has been co-opted by factory owners.

At the same time a characteristic prisoner's dilemma is at play in which no single firm in the competitive market has the incentive to alter the conditions of work or the compensation offered. This is the case even though there is an understanding amongst some owners that better conditions do lead to improvements in productivity.

While conditions are somewhat better amongst the MNCs and the industrial establishments associated with exporting industries, the informal sector where the bulk of the labor is employed shows no dynamic that can lead to a self-propelled exit out of this low-level equilibrium. The social loss is significant because the existence of so many people at survival level keeps purchasing power low which negatively impacts the prospects for consumer-driven growth, the development of industries catering to the demand of the majority of the population, and investment in human capital improvements for the future.

The combination of the low-level equilibrium and the prisoner's dilemma is putting future prosperity at stake. Short term gains of factory owners and government functionaries are being obtained at huge cost to the welfare of workers and growth of the national economy.

3.2 GENERAL OBSERVATIONS ON LOW LEVEL EQUILIBRIUM TRAPS

Low-level equilibriums are marked by low output and productivity, less than full utilization of labor and capital, low incomes, low domestic demand, and weak investment in human capital by the poor. The net result is weak economic growth (Rangarajan and Dholakia 1979).

Developing economies with low per capita incomes are generally characterized by low savings and investments which together create conditions for low-level equilibrium traps which are stable and self-reinforcing. Despite much rhetoric to the contrary, there are few credible examples where economies have broken out of such traps on their own. In most cases, state intervention in one form or another is required. One such was characterized by Rosenstein-Rodan as the ‘big-push’ (Hoff 2000).

There are some examples of how countries have broken out of low-level equilibrium traps. Japan at the close of the 19th century (Nelson 1960), South Korea in the middle of the 20th century (Singh and Siregar 1997), and China at the end of the 20th century are much quoted examples. In each case, a strong state intervention was behind the leap to higher growth.

However, we are now living in times in which state intervention is out of favor and there is a preference for market-driven alternatives. Most of the current discussion on labor laws in the context of business considers them an impediment that frustrates growth (WDR 2012; Shah 2013).⁴

There is a conflation in this argument that is a source of confusion. The argument is based on the observation that big firms are more productive than small ones and that labor laws discriminate against big firms thereby pushing them to remain under the radar with multiple small units. This may well be true but the fact is that there are a very large number of industrial units that are genuinely small. Doing away with the protection afforded by labor laws to help a part of the sector become big would further hurt the welfare of thousands of workers in informal or small-scale industry. Our concern in this study is the latter

⁴ Indeed it is ironic that absolutely miserable working conditions and continued poverty are celebrated as triumphs of the capitalist market economy (Brook 2014).

constituency not the former. Other, less harmful, ways have to be found to promote some firms to grow in size.

The World Bank's approach of viewing laws as interference in free market mechanisms has also come under criticism in recent times. Several indicators have traditionally been used to denote investor friendliness and the overall wellbeing of the business environment; they have included the Ease of Doing Business and the Employing Workers Index (EWI). These indices attempt to rank countries by the relative ease with which investors can do business; measurements include the ease with which workers can be hired or fired and the stringency of the overall labor regulatory environment that might hamper business activity. Striking contradictions have come to the fore recently: for example, while the EWI and Ease of Doing Business indices presented Georgia as a "model" in terms of a deregulated labor market, ILO remained highly critical of the Georgian labor regime for its failure to afford labor protections and its restrictions on collective bargaining mechanisms. Other countries, often the subject of criticism by ILO, have also featured highly on indices such as EWI and Ease of Doing Business.

Consequently, it has been argued that such indices, while supportive of the global deregulation agenda, fail to account for labor welfare mechanisms and other vital economic activity that might result from protection. As a result, the World Bank indicated a shift in its approach in the World Development Report 2013, and the official usage of the EWI was also discarded.

Research has also found that many problems are the result of poorly designed and implemented laws, and access to land, credit, and quality human capital is of bigger concern for many firms in markets like India. This leads some to propose better facilitation of businesses along with more stringent, locally developed labor regimes that can lead to effectively implemented labor welfare as well as profitable business opportunities (Dasgupta 2014).

3.3 GENERAL DEBATES ON LABOR POLICY: TIGHT OR LOOSE?

There is an ongoing debate about optimal labor policies summarized in the 2013 World Development Report on Jobs.

It is argued that stringent labor policies (strictly enforced minimum wages, specified working conditions, social security for all employees, etc.) may lead to unemployment and reduced output in developing economies. Profit-driven infant industries may reduce the number of workers. Inefficiently administered policies would trigger inefficient outcomes by entrenching bribery and corruption. Social protection and unemployment benefits may generate disincentives to work for marginal labor.

At the other end of the spectrum, labor protections are considered essential to eliminate exploitation of workers and to facilitate job search and job matching.

Cross-country examples are marshaled in support of the various positions. Laissez-faire advocates cite the positive example of the US where minimal regulations have yielded employment and job security and of North African and South European states where stringent laws have failed to boost productivity. Interventionists point to Germany's success with labor policies that helped ride out the financial crisis (WDR 2013).

Such anecdotal examples are not of much help being bereft of contextual specificities. Empirical evidence of regulations on employment and output is mixed. A number of Latin American labor markets show negative impacts (Heckman and Pages 2000). In Colombia and Indonesia, minimum wage laws have helped young workers. The evidence on effectiveness of unions in terms of employment, productivity and wages is also mixed and inconclusive (WDR 2013).

On balance, social, political, and economic specificities argue against transferring broad experiences. The analysis and recommendations have to be built from the ground up and anchored in the local context. A thorough understanding of the local labor market and the society in which it is embedded is needed. Policies should be geared towards addressing critical issues and be sensitive to the context in which they would be implemented.

3.4 SHEIKHUPURA: POLICY FRAMEWORK

Given the labor market dynamics, it is essential for all proposals to be derived from a coherent understanding of the local context to ensure a coordinated and integrated package for reform.

As mentioned above our analysis suggests a low-level equilibrium trap reinforced by a prisoner's dilemma and sustained by a strategy of collusion between business and local government functionaries.

Each of these is well documented. Signs of the low-level equilibrium are legion – wages stuck at subsistence, no human capital accumulation, and low labor productivity. The prisoner's dilemma in a competitive market constrains the action of even the few industrial establishments that realize that better compensation and treatment of labor would yield productivity gains. And the strategy of collusion is left in no doubt by the refusal to share information and records.

Thus while all the laws required by virtue of being signatories to the International Labor Organization exist on paper their implementation is sporadic, arbitrary and grossly incomplete. Forgery, misreporting, and bribery are rampant; factories contract undocumented labor; and influencing or otherwise taking over of unions stifles collective action by laborers.

Adding to the difficulties is the ideological consensus that views labor laws as interference with the working of otherwise efficient free markets. The World Bank has viewed stringent regulations as hindrances to the business environment leading to lower country rankings on indices such as the Ease of Doing Business Index and the Employing Workers Index.

The generic solution that emerges from this perspective is one of scaling up firm size. Even in Sheikhpura, it was pointed out that most of the big companies like ICI and Nestle aim to maximize output and profits and therefore keep their workers happy by providing them with productivity-enhancing benefits. Small industries, in whose products the share of labor costs is higher, do not have a long-term view and aim to save money by squeezing workers.

The Social Security Director in Sheikhpura pointed to GSP+ as a source of improvement. GSP Plus status will allow almost 20 percent of Pakistani exports to enter the EU market at zero tariff and 70 percent at preferential rates. This would allegedly be beneficial for the

economy as well as for workers. Collaboration with the European states would increase trade and likely attract European investment. According to the Director, this would spur competition for local industries and given that foreign companies adhere to labor laws, push it to improve the implementation of laws as well.

This is the traditional economic argument and we base our lack of conviction in it for the following reasons. First, while it is true that economic scale helps, it is not possible to scale up all small industry within any reasonable time frame. Second, export industries are already present in Pakistan and they do have a positive spillover on other exporting competitors. But evidence, even from such export-oriented cities as Sialkot, is that there is virtually no spillover effect on non-exporting industries. Even within exporting industries, the improvements are not across the board. For example, in the Karachi factory fire in which 250 workers making garments for export died, the trial is yet to begin two years after the accident (Tanoli 2014).

3.5 A RELEVANT CASE STUDY: THE AMERICAN SOUTH

The best case study we have found to make the argument we wish to present is a detailed historical analysis of industry in the American South that establishes how the combination of low-level equilibrium and prisoner's dilemma in a private market-oriented economy was broken. The victims of this low-level equilibrium were African-Americans but the conceptual and theoretical parallels with the situation in Sheikhpura are very clear.

It is worth quoting at length from Ira Katznelson's review (2014) of Gavin Wright's path-breaking book *Sharing the Prize: The Economics of the Civil Rights Revolution in the American South* (Belknap Press/Harvard University Press, 2013).⁵

The problem under consideration was the abysmal working conditions in cities in the American South in the middle of the 20th century. The prevailing orthodoxy was that market forces would overcome the discrimination over time and economic growth would lead to prosperity for all.

Wright shows that segregation was the "business policy of profit-seeking firms" that "firmly believed that an end to segregation and moves towards racial equality would prove costly in economic terms." He documents that "Economic development and the growth of cities did not produce a more decent racial order." Rather it was the Civil Rights Act of 1964 and the Voting Rights Act of 1965 that brought about "vast material changes." "A dirt-poor region made huge strides in overcoming devastating poverty, distortions of land-holding, deep wage and wealth disparities, debased educational systems, pervasive illiteracy, and catastrophic public health."

"If the first contribution of *Sharing the Prize* is the demonstration that economic modernization did not produce civil rights, the second is a rich empirical demonstration of how this great leap actually worked." In brief, Wright describes how the operative conditions were changed by law forcing business to alter its calculus of profit and loss thus leading to a new equilibrium – "the profit-seeking strategies of private decision-makers changed because a new and more just economic order was imposed."

⁵ Gavin Wright is Professor of American Economic History in the Department of Economics at Stanford University.

And the new conditions triggered positive ripple effects – “These labor market shifts were closely associated with important gains in schooling. Only when the labor market began to open up did educational change come.”

“This forced change led to big jumps in sales and profits. After the fact, as Wright observes, it became clear that southern businessmen had been “locked into a low-level equilibrium, the stability of which was bolstered by the fact that they did not see it that way themselves.””

This empirical work raises many questions for abstract economic theory: “In showing how the fight for economic fairness was realized only when Washington imposed a new order on an unwilling South, Wright returns again and again to the limitations of his own discipline and the failure of economists to confront the paradox revealed by the failure of business groups in the urban South to end racial practices that actually hurt their economic prospects... and opposed state and national efforts at racial integration, a policy that subsequently emerged as ‘the best thing that ever happened to the white South.’... From the perspective of economics, this behavior represents an anomaly, a case in which a set of profit-seekers “had to be coerced by the federal government to act in its own economic self-interest!”

“From this experience Wright draws a lesson for economists. Awareness and calculations “of costs and benefits can change over time,” and “these changes can be impelled by the exercise of political and economic pressure, as well as persuasion.” To understand economic choice, the broad lesson Wright wishes to convey is the need to attend to specific historical trends and circumstances, attention often lacking in his discipline, where elegant models often are appreciated for the degree to which they are thought to be applicable across time and space.”

Wright shows convincingly “how black mobilization and federal action, not demographic change or economic modernization, transformed the South and the country. Paying heed to “Wright’s analytical history of “a strong interventionist central government policy that worked...in a mutually supportive partnership with grassroots political mobilization” takes on fresh urgency.”

Substitute social justice for racial justice and the working conditions described in this account are almost entirely applicable to what we saw in industry in Sheikhpura. We are firmly convinced that the way to escape the prisoner’s dilemma and break out of the low-level

equilibrium trap is the one that worked in the American South – grassroots political mobilization, social involvement, and federal action.

Based on the understanding of the Sheikhpura labor market developed during this study, a reading of theoretical literature, and the detailed historical case study presented above, we suggest a number of measures to consider for improving the situation in Sheikhpura.

4. POLICY RECOMMENDATIONS

4.1 RECOMMENDATIONS

The recommendations that follow aim to strengthen the implementation of existing penalty-based legislation. More importantly, however, they go beyond the punitive approach to include incentive-based instruments that reward progressive employers for voluntarily adopting better labor practices. The recommendations also include measures of public disclosure that could be used to further influence firm behavior in a positive manner.

There are no fundamental reasons that should prevent a government from implementing most of the policy recommendations included in this enhanced penalties and incentives regime.

4.1.1 REGULATE THE INFORMAL (INDUSTRIAL) LABOR MARKET

Improving compliance and enforcing the existing set of labor laws has to involve closing the loopholes offered by informal labor markets. While the country's superior courts have already ruled in favor of recognizing informally employed labor as that attached to an establishment given the existence of a "master and slave" relationship, the same is barely known even to government functionaries involved in monitoring the implementation of the law. It is also relevant that establishing such a relationship in a court of law would require resources and legal representation that is beyond most laborers; establishments and contractors, on the other hand, can get away with better resources and opportunities to collude.

One possibility could be the recognition of labor contracting as a separate category in the service industry. This would imply a formal oversight structure within the existing legal framework for contractors who supply informal labor to factories and other establishments. This would be followed by enforcement of regulations making it mandatory for companies to hire only from registered labor contractors.

These steps would ensure not only that companies will employ (directly or otherwise) from registered sources, but contractors will also have the incentive to register themselves to be able to operate in the labor market.

4.1.2 CARRY OUT SURPRISE VISITS TO AUDIT LABOR PRACTICES AT INDUSTRIAL ESTABLISHMENTS

Malpractices at the workplace continue undetected mainly because of collusion and rent-seeking behavior of the involved parties (violators and inspectors). Additionally, the hiatus in inspection for a period of 9 years (2003-2012) has acted as a deterrent to the already weak inspection apparatus of the state (Labor Watch Pakistan 2012).⁶ The increase in the number of labor inspectors has also not been concomitant with the increase in the number of establishments and this is a gap that needs to be rectified.

Controlling malpractices requires random and surprise checks at factory premises. Given that government departments have minimal incentives in this regard, this function could be outsourced to private audit firms whose contracts would be subject to renewal based on performance.

4.1.3 REFORM THE PENALTY STRUCTURE FOR VIOLATORS

As discussed earlier, fines are rarely enough to deter firms from violating laws⁷, and even when imposed, employers are able to escape the true costs that they owe their workers due to other loopholes in the system. Employers, in most cases of violation, are able to evade imprisonment sentences because they are well-placed within the existing system and hence better able to defend themselves in courts of law.

Fines need to be increased to serve as adequate deterrent and could be supplemented by imprisonment in cases of continued non-compliance. While some offences (e.g., payment of wages below the minimum level set by the government) do carry prison sentences by law, they are rarely enforced. If this sentence can be extended to all labor related offences, and be made more stringent, the social stigma of a prison sentence would serve as a cautionary signal in business decisions.

⁶ In Karachi, in the aftermath of Baldia fire factory, the Labor Minister told the press that the Chief Minister of Sindh instructed him to not carry out labor inspections (The Express Tribune 2012).

⁷ Maximum Terms of Imprisonment under Labor Laws:

- 1) Three months imprisonment for first time violations [S. 33(8) of PIRA];
- 2) Six months imprisonment (maximum) for repeated violations [S. 61 of the Factories Act];
- 3) The Minimum Wages Ordinance 1961 [S. 9(3)] and Punjab Minimum Wages for Unskilled Workers Ordinance, 1969 [S. 7] provide a term of six months in case of employer's failure to pay wages at the minimum wage rate;
- 4) The Labor Court can also imprison a person for failing to redress an individual grievance [S. 33(8) of PIRA].

4.1.4 PROMOTE UNIONIZATION

The right to organize, to form unions independent of government or employer influence, and to bargain collectively as opposed to individually are all recognized by the ILO in the 'Declaration of the Fundamental Principles and Rights at Work'. This needs to be taken up as a critical issue at the highest level. When the right to organize is recognized, resisting the provision of the same should also be recognized as a criminal offense and penalties introduced for such practices.

4.1.5 JUDICIAL REFORM

An important step towards enforcing labor legislation is a fair and efficient judicial system. Special labor courts or tribunals, while they do exist, are marred by slow judicial practices. Deliberate time-wasting tactics must be curtailed by an appropriate penalty structure to ensure closure of cases within a specified time duration. Separate labor appellate benches at the High Court could also be considered for speedy disposal of appeals.

4.1.6 ENCOURAGE TRAINING AND HUMAN CAPITAL DEVELOPMENT

In the given situation an external stimulus is needed to incentivize and trigger a positive cycle of human capital accumulation and awareness of labor rights. Cost sharing schemes and/or tax rebates can be offered to employers engaged in certified training and skill upgrades for their workers.

The federal and provincial governments have extensive training institutional networks that can assist in such an endeavor. These include the Technical and Vocational Training Authority (TEVTA), the Punjab Board of Technical Education (PBTE), the National Vocational and Technical Training Commission (NAVTTTC), the National Productivity Organization (NPO), and the Skill Development Council (SDC). The Punjab TEVTA has a technical education center and a vocational education center in Sheikhpura with additional service centers in Lahore and Gujranwala. Additionally, all districts of the Punjab are well covered by TEVTA's vocational and service centers.

4.1.7 SET UP VOLUNTARY LABOR STANDARDS PROGRAMS AND AGENCIES

There is need to design a regulatory and monitoring structure that better aligns the incentives of industrialists, government, and workers in order to break out of the low-level equilibrium.

We propose the introduction and public disclosure of a set of labor welfare standards. These would be part of an incentives and penalties regime that enables employers to both benefit from improved standards and get penalized for non-compliance. A pilot can be run in Sheikhpura before being extended across other districts.

A set of comprehensive labor welfare standards with minimum thresholds and a hierarchy of levels to be achieved over time can be prepared in consultation with international agencies and relevant departments and stakeholders. The standards would include measures for wages and compensation, safety, social security, discrimination, harassment, and appeal processes. All labor working in a factory, whether permanent, contracted, or subcontracted, would be covered by these standards. Independent audit firms would periodically assess factories and assign a rating based on the degree to which the standards have been achieved.

We suggest that such a regime would better align incentives by tying the ranking to tangible benefits. Employers achieving higher rankings could be rewarded with appropriate benefits including tax credits, less onerous monitoring, and priority in access to public services.

These incentives would be in addition to a baseline set of benefits for all employers that choose to voluntarily participate in the program. The baseline package could include facilitation in government procedures, cost-sharing for schemes related to education, health, and human capital accumulation, and facilitation of training and educational programs for workers through organizations like TEVTA, etc.

Participating employers that default could be penalized by temporary suspensions that would take away the baseline benefits. While the details of the regime are subject to further analysis the point stressed here is that positive incentives for compliance need to be introduced.

The program would, like other standardized ratings such as ISO, be voluntary in nature. Administrative costs like those of audits can be covered through a small cess on all industrial production at the district level. This would also encourage employers to participate in the program since they would already be paying part of its costs.

Once a pilot has been implemented, model industrial estates can be established for factories enrolled into the labor standards program. These estates can receive special privileges like

import quotas, tax credits, and other benefits, as previously discussed, in exchange for independent and rigorous auditing. By concentrating compliant factories in an area, local wages and acceptable labor practices could be expected to improve.

Rollout of Program: If the program is extended to other districts, district- and firm-based rankings could be developed. The top performing districts and factories would be recognized and rewarded with additional benefits to serve as encouragement for others. Recognition at the district level (the measure would include both extent of participation and performance) would generate peer pressure on non-participating and non-compliant employers since they would be holding back benefits the district could avail.

4.1.8 PUBLIC DISCLOSURE OF LABOR RATINGS

The above measures have to be complemented with a regime of public disclosure designed to energize consumer mobilization in favor of compliance with standards. The illustrative example is the very successful public disclosure experiment in Indonesia – PROPER (Environmental Compliance and Enforcement in Indonesia, Rapid Assessment, 2008). The program relied on a very simple, easy-to-understand rating scheme whose self-reporting was mandatory for all participating companies and subject to verification by independent third-party auditors. In the Indonesian case, gold-rated companies were those that achieved the highest rating, followed by green, blue, red, and black ratings. Green signified above average ratings, blue indicated legal compliance, red signified below average performance on some indicators, while black identified companies in serious violations.

The rating agency would then ensure public dissemination of the list of manufacturers along with their color codes. These could be printed and distributed and also displayed on a public TV channel dedicated to consumer issues. Companies could also be required to display their color ratings on their packaging. Consumers could be advised to patronize gold-rated companies and avoid those with black and red ratings even if their products were priced lower.

Such a program introduces a demand side intervention in the dynamic and attempts to emulate the pressure that is exerted by foreign consumers on export-oriented companies but is absent for companies producing for the local markets. We believe that given reliable information, a sufficient number of local consumers might also prefer to buy from companies

that treat their workers better, which in turn would spur companies to do better in their own self-interest.

The out-of-pocket costs for such a program could be generated by an appropriate cess on all small-scale industries so as to be non-distortionary in a competitive market. Increased productivity and lower expenses on health care etc. should significantly offset the costs of such a scheme. From a social welfare perspective, the transition to a new equilibrium is accompanied by huge gains to the economy as documented by Gavin Wright in the case of the American South.

4.1.9 CITIZENS' LABOR BOARD

As a final component of the proposed structure, a citizens' board might be introduced at the city or district level to be an active participant in both the design of the system and its implementation. Such a board would include individuals from the media, academia, youth organizations, and women's groups so as to involve the entire spectrum of citizenry in the endeavor to improve the living standards of the majority.

5. CONCLUSION

Extensive discussions with labor lawyers lead us to the robust conclusion that the problem in the labor market is not in the absence of laws but in their implementation. In fact, there is near consensus that the existing laws are comprehensive and progressive and the supporting institutions also all exist in one form or another. However, the institutional and bureaucratic rot is so deep that effective implementation is well-nigh impossible.

Given this situation, the recommendation of more laws to ensure implementation of existing laws is counter-intuitive. Exhortations for better and more honest implementation also suggest a denial of the existing reality.

Our approach has been to identify the laws that are critical to labor welfare and suggest how, in the given situation, some progress might nevertheless be possible. In addition to purely punitive measures, we recommend adding an incentive regime that would create an impetus for progressive employers to voluntarily introduce better measures thus triggering a virtuous cycle. We have also recommended the introduction of private third party monitors and public disclosure to create space for better employers to distinguish themselves thereby further strengthening incentives for voluntary improvements.

Our discussions with labor activists suggest that the progressive laws in existence at this time date to two major waves of the past – the 1920s and 1930s in British India and the late 1960s during the Ayub Khan government in Pakistan. Both these waves were the outcome of strong unionization and mobilization for collective bargaining. Subsequent periods saw the erosion of labor movements and the suppression of labor unions. We are once again in a period of very weak labor rights and a belief that pro-business measures⁸ are needed to spur economic growth. This leads to the conclusion that continued neglect of labor conditions might leave political mobilization and civic activism as the only vehicles for social change.

Social and consumer activism have a legitimate, and indeed a much lauded role, in such situations as witnessed over the course of time in the now industrially advanced countries.

⁸For example, the new BJP government in India is experimenting in Rajasthan to amend the Industrial Disputes Act, the Contract Labor Act, and the Factories Act to ease requirements on the corporate sector (Chandru 2014).

Mobilizations to curb child labor, sweatshops, and hazardous workplaces are well known.⁹ The lasting impact of Upton Sinclair's exposure of conditions in the meatpacking industry (1906), of the civic response to the Triangle Fire in New York City (1911), and of Cesar Chavez to the unionization of farm workers in California (1970s) are just some of the celebrated examples from the US. Very recent examples of similar consciousness in Pakistan ought to be seen in a similar framework.¹⁰

We consciously highlight this aspect of labor history because shifts of discourse are valuable in themselves – they make it possible to reimagine the margins of acceptable action.

⁹ These include reform of the soccer ball industry in Pakistan and the garment industry in China. For a comparison of the very different response to accidents in the textile industry, see Naim (2012).

¹⁰ An example of such social involvement is the recent public interest litigation filed by a law student at LUMS. This suit, favorably adjudicated by a bench of the Supreme Court of Pakistan, pertains to the death by silicosis of 18 workers employed in stone crushing factories in Gujranwala district adjacent to Sheikhpura (Express Tribune 2014).

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