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Preparing For Labour Codes

One of the significant reforms to look forward to as we head into the second half of the calendar year 2022 is the implementation of the labour codes in India. As part of the reforms, 29 current labour laws would get consolidated into 4 codes. Provision of social security and health coverage to 40+ crore unorganized workers, reduction in labor compliance burden of employers, women empowerment, the introduction of national floor wages, enhanced use of technology, and structured resolution to industrial disputes are some of the top objectives of the labour codes. As per information released by the labour ministry in March this year, 27, 23, 21 and 18 States/UTs have pre-published draft rules under the Wage Code, Social Security Code, Industrial Relations Code, and the Occupational Safety Code respectively. This indicates steady progress towards final notification expected within the current financial year and organizations should prepare in advance to implement the new rules smoothly. While these reforms are expected to promote ease of doing business in India, some of the provisions are expected to increase compensation costs for employers. India incis already witnessing one of the highest wage inflations in recent years. Aon's salary increase survey already projects a 9.9% salary increase for 2022 but the implementation of the labour codes could potentially lead to further increase of payroll costs. Let us look at some of the big-ticket compensation elements undergoing a change along with the industry impact of these.

Definition of Wages: The Labour Codes propose a new definition of "Wages" which would apply to all social security schemes going ahead. As per the proposed definition, the wages shall consist of all remuneration including Basic Pay, Dearness Allowance, and Retaining allowance and shall exclude components such as House Rent allowance, provident fund, conveyance, leave travel, overtime, and Commission with a rider that proposed Wages as a percentage of Gross Pay cannot fall below 50%. Historically, social security plans in India did not have a common definition of pay and most of them were largely calculated and paid on only Basic Pay. Aon research suggests that the majority of the organizations (73%) in India have a Basic Pay to Gross Pay ratio of 30-40% and balance components consist of tax-efficient allowances which are usually not counted for determining social security benefits and contributions. Therefore, implementation of the proposed definition of Wages would take the applicable Wages to be in the range of 50%-70% of Gross Pay, thereby increasing costs toward statutory schemes.

Gratuity Benefits: The Gratuity benefits will see the largest impact of the new Definition of Wages. Gratuity is paid at the exit to the employee only after 5 years and therefore the liabilities are provisioned in the Balance Sheets in advance. Aon research suggests that as of 31 March 2021, the top 50 companies of the Nifty 50 Index reported Gross liabilities against Gratuity to the tune of INR 80,000 crores. These are backed by assets that cover approximately 80% of the liabilities. Once the new definition of Wages is adopted, Gratuity liabilities are expected to increase significantly, particularly for organizations where the Basic Pay to Gross pay ratio has been quite low historically. This would increase the accrual expenses and would require additional cash contributions to maintain funding ratios. Aon's pulse surveys on the progress of Labour Codes also suggest that 29% exploring capping the Gratuity benefits at the statutory limit of Rs 20 lakhs which could adversely impact long-tenured and senior staff who have earned large Gratuity benefits.

Provident Fund: While the proposed Definition of wages also covers the statutory Provident Fund, the impact could be limited as PF contributions are voluntary above the statutory wage limit of INR 15,000 per month. Aon Benefits databases suggest 70% of organizations already pay contributions on full Basic Pay which largely is above the threshold limit for most of the organized sector. Similarly, the new definition of wages also impacts statutory benefits like Employees State Insurance and Payment of Bonus Act, however the eligibility for these schemes also is limited to those earning up to INR 21,000 per month, therefore the impact could be limited to those earning below these thresholds.

Leave Encashments: Another key element is the provision of encashmentsof unavailedleave by employees in excess of 30 days at the end of the year. Aon Benefits surveys suggest only 28% of organizations allow encashments at the end of the year and the remaining organizations lapse unavailed leaves if they exceed the maximum limits as per company policy. 42% of organizations also indicated that they are looking at ways to control leave encashment costs as employees have accumulated large leave balances by taking a lower number of leaves during the last two years of Covid. These encashments too would take place as per the new definition of wages in the future further increasing employer costs.

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Maternity: The existing provisions of 26 weeks of paid maternity leave along with the employer-established facility of creches where there are more than 50 employees have been maintained. As more employees head back physically to the office, the usage of creche facilities is expected to increase, therefore organizations should ensure they set up an in-house creche facility or enter into external vendor tie-ups to ensure compliance.

Overtime: Organisations may also have to budget for additional costs arising out of overtime work done by employees. As per proposed rules under the OSH Code, workers overtime work in excess of 48 hours a week would have to be compensated with overtime wages at twice the rate of their standard wages. Organizations would have to identify the categories of employees eligible for such overtime pay and set up systems and processes where they are able to track overtime work. This is particularly critical under a work from the home scenario which is an allowable provision under the draft standing orders for the services sector.

Compensation Structure: While there has been no mandate for companies to change their compensation structure or existing CTC models, 21% of organizations say compensation structure changes are being considered proactively to ensure compliance and manage costs. This would indicate companies aiming to have an acceptable mix of basic pay, included and "excluded" allowances within their compensation structure keeping in mind payroll costs, employee expectations, tax benefits, and labour code guidelines. Additionally, 36% of organizations are looking at increasing basic pay to align with the new definition of wages. This would have a direct impact on employees take-home pay as this leads to higher provident fund contributions. For example, if the basic pay to gross ratio is increased from 30% to 50%, employees would face an approximately 5% cut in take-home pay and a similar amount would instead be redirected into the provident fund boosting retirement savings.

Fixed Term Employees: Organisations hiring or planning to hire fixed-term contract employees would be required to offer similar compensation and benefits as given to permanent employees thereby bridging the pay gap between fixed-term and permanent employees. Even gratuity to fixed-term employees would have to be paid on exit after 1 year of service as opposed to 5 years currently applicable to permanent staff.

All the above issues are critical, impacting both employers and employees. Therefore, organizations should proactively assess the impact of the above labour code provisions on their payroll costs and ensure adequate budgeting to avoid surprises once labour codes are implemented.

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