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**An Analysis of Severance Pay Policies in India
and Sri Lanka**

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1. Introduction

As India and Sri Lanka address the opportunities and challenges arising from globalization and associated technological and other developments, the functioning of their labor markets has come under increasing scrutiny. Labor laws, regulations, and practices in both countries have traditionally reflected policies which relied on economic planning, public sector expansion, and overall economic growth to provide employment; while the growth strategy implicitly assumed relatively static and inward-looking economic structure. In view of their current strategies which increasingly reflect assumptions of more dynamic and outward-oriented economy, their labor market policies require realignment.

Another reason for the increasing focus on the functioning of the labor markets is that the two countries have achieved only limited success in generating employment, particularly in the so-called organized (or formal) sector which falls within the purview of the labor laws (World Bank, 2004; Sharma, 2005; Sundar, 2005). Importance of analyzing micro-economic aspects, particularly, impact of hiring and retrenchment costs, and of incentive structures for individuals and firms arising from current labor regulations and practices for balance between jobs creation and preservation of existing jobs is also being increasingly recognized (Vodopivec, 2004; Sundar, 2005; Nagraj, 2005; Sabharwal, 2005).

The formal social security systems in the two countries are characterized by dualism and relatively narrow coverage (Karunarathne and Goswami, 2002; Asher and Vasudevan, 2005). In both countries, civil servants, who constitute relatively small proportion (between 2 and 3 percent) of the labour force, receive non-contributory, Defined Benefit (DB), inflation indexed pensions, with generous provisions for commutation, and family benefits.

India has however fundamentally changed civil service pension system for the Central government employees (except armed forces) who entered after January 2004. The new system is based on Defined Contribution (DC) principle, with compulsory purchase of annuities at age 60 for part of the accumulations; and appointment of a pensions regulator (Shah, 2005). This system is designed to include voluntary members from both the organized and unorganized sectors; aims to minimize transaction costs; and ensure scalability.

Sri Lanka has adopted a limited contributory scheme for its civil servants, but it has not changed the DB basis of pensions (Karunaratne and Goswami, 2002). Private sector workers in both countries are covered under a DC scheme, though India has severely under-funded limited DB scheme as part of the national provident fund. These arrangements reflect dualism, and provide disincentives for mobility between public and private sectors.

The coverage of the formal schemes remains limited. In Sri Lanka, about a quarter of the labour force is covered, while in India the corresponding proportion is around 10 percent (Karunaratne and Goswami, 2002; Asher and Vasudevan, 2005). Social assistance schemes for the elderly in the two countries also have narrow coverage. Most of the workforce relies primarily on family support, and own savings for income support in old age.

It is in the above context that this chapter analyses severance pay practices in India and Sri Lanka, two countries with pluralistic institutions and democratic political system. The two countries have a functioning Free Trade agreement (FTA) since 1998 (the bilateral merchandise trade was US\$ 1.8 billion in 2004), and are negotiating a Comprehensive Economic Partnership Agreement (CEPA) which is expected to link the two economies, including their labor markets, much more closely.

Severance pay refers to payment made by the employers when there is permanent retrenchment of employees.¹ As neither country has implemented unemployment insurance which is the main form of severance payment in most middle and high-income countries², mandatory (or voluntary) lump-sum severance payments are of critical significance as they are the only short-term income maintenance or

¹ Temporary retrenchment due to weak demand or maintenance of capital equipment is called in India "lay-off", during which wages at varying rates continue to be paid.

² Origin of severance pay in the industrial countries was due to creation of labor codes in the beginning of the twentieth century, technological changes of the 1920s, and the great depression of the 1930s. Since then, expansion of welfare state and establishment of ILO (International Labor Organization) in post World War II have provided further impetus to short-term income maintenance measures. ILO conventions and EU (European Union) directives do not provide for severance payments in lump sum, but instead emphasize social risk-pooling unemployment insurance schemes. (Holzmann et al, 2003).

safety nets available to covered workers, while permitting restructuring of enterprises.

The analysis of the severance payments in the two countries also includes mandatory gratuity benefits. These are mandated when services of an employee are ended before or at the time of retirement. Thus, gratuity is essentially a part of deferred wage based on the length of service. It thus rewards loyalty to the employer. In both countries, Voluntary Retirement Schemes (VRS) have also been used for restructuring of enterprises. The term severance pay thus denotes all three types of payments in India and Sri Lanka.

As in other areas of public policy, design of severance pay and implementation aspects, with particular emphasis on administration and compliance costs, incentive structures, transparency, affordability, and scalability over time are of crucial relevance. (Vodopivec, 2004; Holzmann et al., 2003). As an example, widely used severance pay formula based on a multiple of years of service and salary, while relatively simple and enabling uniform treatment, may substitute for careful analysis of actual needs and affordability.

The paper is organized as follows. Section II provides an overview of the economic, demographic, and labor market characteristics for India and Sri Lanka. The discussion is designed to set the overall context within which severance pay practices in the two countries are examined in Section III. The final section provides the concluding observations.

2. Economic, Demographic, and Labor Market Characteristics

Table 1 summarizes selected economic and demographic indicators in the two countries, on the basis of which the following observations may be made.

Table 1: India and Sri Lanka: Selected Economics and Demographic Indicators, 2003

Category	Unit	India	Sri Lanka
Economic Indicators			
GDP (Current)	Billion USD	600.6	18.2
GDP Growth	Percent	8.6	5.9
GDP (PPP)	Billion USD	3078.0	72.7
GDP Per capita	USD	564	958
GDP Per Capita (PPP)	USD	2880	3740
Aid Per Capita	USD	0.9	34.9
Exports of goods and services (% of GDP)	Percent	14.5	35.8
Imports of goods and services (% of GDP)	Percent	16.0	42.4
Inflation rate (GDP Deflator)	Percent	3.2	5.0
External Debt (% of GDP)	Percent	16	46
Net Foreign Direct Investment (FDI)	USD Billion	4.3	0.2
Remittance receipts	USD Billion	10.0	1.1
Remittance receipts (% of GDP) ^a	Percent	2.1	7.0
Demographic Indicators			
Population	Million	1064.0	19.2
Population Growth	Percent	1.49	1.18
Total Fertility Rate	Births per Woman	2.86	1.98
Life Expectancy at Birth	Years	63.4	74.0
Urban Population	Percent	29	25

Source: Based on www.devdata.worldbank.org

^a remittance figures are for 2002

India's population (second largest in the world) and level of GDP (fourth largest in PPP terms), suggest that it is among the major economies in the

world. However, Sri Lanka's per capita income (USD 958 vs India's USD 568), and outward orientation (as measured by trade to GDP ratio) are both higher than India's. While India's 2003 GDP growth rate at 8.6 percent was higher than Sri Lanka's 5.9 percent, sustaining it represents a major challenge for India.

Sri Lanka received 35 times more in foreign aid per person than India in 2003. Indeed, India is a significant donor and credit provider to Sri Lanka. Sri Lanka's reliance on remittance receipts in relation to its GDP is more than three times that of India. Job market access for their workers (as well as jobs provided through outsourcing, not captured in remittance receipts) is of crucial importance for economic and social stability in both countries. Sri Lanka's external debt to GDP ratio is three times that of India. The FDI inflows for both countries are relatively low, an area where significant improvement is needed.

A comparison of demographic indicators (Table 1) suggests that Sri Lanka's Total Fertility Rate (TFR) at 1.98 is already below the replacement rate level of 2.15. India's TFR, while declining, is not expected to reach the replacement rate till around 2015. Life expectancy at birth is also much higher for Sri Lanka (74 years) than for India (63 years). Thus, Sri Lanka is expected to experience more rapid ageing than India. Urbanization at about 25 to 30 percent of the total population is at a moderate level in both countries.

Empirical evidence based analysis of labor force characteristics in both countries is hampered by good quality and timely data; and by insufficient dis-aggregation of employment categories, particularly for the informal (or unorganized) sector.³ Both countries need to urgently take steps to improve the quality and timeliness of the labour market data.

³ Three examples from India may be cited. Deshpande et. al. (2004) study uses labor force data for India till only 2000, and in some cases, till only late 1990s. They also report on the difficulties involved on collecting primary data relating to labour market. Sundar (2005) cites data for 1997-98 for distribution of number of workers by size of factories in India. Since then, considerable restructuring of Indian industry has taken place in India. It is indeed undesirable to draw policy implications for nearly decade old data in a period of rapid change experienced by India. Third, Sundaram (2004) shows considerable understatement in the widely used official figures of organized sector unemployment leading to poor quality of public debate on impact of reforms during the 1990s on overall employment. For Sri Lanka, Kelegama (1998), and World Bank (2004) have commented on the need to improve the labour market data.

Following observations may be made on the basis of available data on selected labor force indicators in the two countries presented in Table 2.

Table 2: Selected Labor Force Indicators of India and Sri Lanka

Category	Unit	Year	India	Sri Lanka
Working Age Population				
	Million	2000	619.7	11.4
	Million	2025	921.5	15.3
	Million	2050	1048.2	14.2
Labour Force				
Total	Million	2002	406.0	8.4
As % of total Population	Percent	2002	63.0	71.0
Employment Share by Industry				
Agriculture	Percent	2002	66.8	42.7
Manufacturing	Percent	2002	12.9	23.1
Services	Percent	2002	20.3	34.3
Employment by Sector				
Organized (Formal) Sector	Percent	2002	9.9	48 ^a
Unorganized (Informal) Sector	Percent	2002	91.1	52 ^a
Share of Public Sector Employment in Total Employment	Percent	2001	3.3	14.2
Membership of Trade Unions as % of Labour Force	Percent	2000	3.0	11.9
Educational Attainment of Labour Force				
Below Primary (Male/Female)	Percent	2000	44.0/58.0	4.1/11.0
Degree and above (male/female)	Percent	2000	8.3/4.1	1.9/3.6

^a our estimation. Source: Adapted from World Bank (2004)

First, India's working age population is expected to increase by more than two-thirds (from 620 million to 1048 million) between 2000 and 2050. Policymakers will need to provide opportunities for meaningful activities (including education and jobs) to the growing working age population. This is indeed among the most difficult challenges facing India, requiring reforms

in wide range of areas, including labor markets, educational systems, fiscal management, and technology policies.

India's labor force as percentage of working age population is much lower (63 percent) than Sri Lanka's (71 percent). If India's ratio approaches Sri Lanka's by 2025, India's labor force will increase from 406 million to 654 million, an increase of nearly 250 million, requiring generation of 10 million additional productive and sustainable jobs every year.

Worryingly, overall employment growth rate in India halved between 1993-2000 to 1 percent compared to the preceding six year period; while the growth elasticity of employment declined sharply from 0.52 to 0.15 (World Bank, 2004). The magnitude of the employment challenges facing India's policymakers and the Indian society is thus enormous, and should create a sense of urgency on the part of all stakeholders. Moreover, the emphasis should be on productive and sustainable jobs as many poor persons in India are economically active, but do not earn enough from these activities (Sharma, 2005; World Bank, 2004).

The working age population in Sri Lanka is expected to grow by one-third between 2000 and 2025, and then decline by about 8 percent to reach 14.2 million in 2050. This reflects Sri Lanka's demographic trends. Thus, its challenge in providing additional jobs will not be as severe as India's. It will need to rely to even greater extent than India on increased productivity to sustain rising incomes.

Employment share by sector exhibits differing patterns in the two countries. Sri Lanka's employment structure is relatively more balanced. India's share of employment in manufacturing at paltry 13 percent is about half that of Sri Lanka. However, as share of agriculture in employment declines from current 67 percent, three times its share in GDP, due to rising productivity, mechanization, and crop diversification, substantially more jobs will need to be created in manufacturing. This suggests that India's labor market reform will need to be consistent with facilitating growth of manufacturing employment (Nagraj, 2005; Sharma, 2005; Narayan, 2005). Contrary to widespread perceptions, the share of public sector in total employment at 3.3 percent is much lower in India than in Sri Lanka (14.2 percent)¹.

¹ The share of public sector employment in India appears understated. Mitra (2005) estimates this share to be 6.0 percent. This however does not invalidate the point made.

Low rate of unionization in India (only 3 percent of the labor force) as compared to Sri Lanka's 12 percent also reflects low priority given to manufacturing. It also raises an important question concerning the extent to which interests of current labor union membership should govern public policies concerning labor market and social protection in India.

In 2000, Sri Lanka had about 1600 labor unions, while the average size of the labor union was around 600 members. This is a relatively low figure, particularly considering low wage levels, to undertake complex and knowledge-intensive functions of labor unions, such as collective bargaining. In India, it is relatively easy to form labor unions, even when protection of statutory labor laws is absent (World Bank, 2004). Debate on reform of the governance and functioning of the labor unions to better align their management with the interests of the workers is long overdue in both countries.

Since manufacturing sector usually has greater potential for unionization, enlightened trade union leadership should give priority towards increasing manufacturing employment which is sustainable and productive, consistent with India's current market-oriented strategy. If the labor unions instead opt for prolonging state-led employment creation, (outside of productive infrastructure investment), and making it more difficult to restructure unviable enterprises, they and the political parties which sponsor them, will become less and less relevant for meeting needs of India's workers. The challenge is to make political system much more responsive to the needs of all workers, and not just those in the organized sector.

The term organized (or formal) sector in the two countries is used to denote employment covered by various labor laws, including severance pay, and gratuities.⁵ Only about 10 percent of the labor force is in this sector in India as compared with nearly 50 percent in Sri Lanka. In India, however, the proportion of those having regular incomes is about twice that of the formal sector. Even the broader definition leaves about four-fifths of the labor force in activities where labor protection is weak. Monthly wage differential

⁵ The size of firm to which different labour laws apply varies in India and Sri Lanka. In general, laws in Sri Lanka become applicable at much lower firm size than in India. As a result, size of formal sector estimated on the basis of applicability of labour laws may not be strictly comparable between the two countries.

between organized and unorganized labor at the same skill levels is estimated to be in the range of 3 to 5 to 1 in India (Mitra, 2005).

The unorganized sector in India is not only large but also quite heterogeneous. This characteristic and the lax enforcement of existing statutory provisions provide methods for bringing about labor market flexibility but without attendant social safety nets, and labor protection, while perpetuating dualism. They also increase uncertainty in business and provide rent-seeking opportunities to those charged with framing the rules and enforcing them, as well as to trade union management intermediating between workers and management.

Increasing the share of organized sector employment is essential even as restructuring of public and private sector organizations is facilitated. Higher employment needs to be pursued by eliminating artificial restrictions on the size of firms (e.g. removing ineffective protection to small-sector activities in India); by making labor laws consistent with current market-oriented economic growth strategy, and by enhancing capacity, accountability, and transparency of organizations entrusted with designing and implementing labor regulations.⁶ Formation of new companies and new areas of activities should become the primary avenue for generating additional employment.

Varma (2005) reports that in 2004, entrepreneurs in India were expected to go through 11 steps to launch a business, taking on average 89 days, at a cost equivalent to nearly half of per capita income. This compares unfavorably with 2 days for Australia, 24 days for Pakistan. In 2004, in Sri Lanka, the corresponding figure was 50 days, and only 10.7 percent of per capita income (The World Bank, 2004). Indian policy makers have realized the need to be more competitive in this area,⁷ and its structuring of the Special Economic Zones (11 are in operation, with several more awaiting implementation) incorporates the need to drastically reduce the time and cost associated with starting a business. These types of measures also

⁶ It is instructive that some states in India such as Uttar Pradesh have resorted to suspension of labor inspection of business premises as they are unable to ensure adequate accountability of those charged with such inspection. This is not an equitable and efficient way to bring about labor flexibility as it lowers costs for those employers who do not abide by statutory provisions, giving unfair competitive advantage to them.

⁷ The Indian Parliament passed the Special Economic Zone Bill in May 2005 but without providing discretion in implementation of the labour laws in these zones.

need to be extended to small domestic-oriented businesses as well as their employment generation potential is high. (Varma, 2005; Sabharwal, 2005).

Data concerning educational attainment of the labor force indicate that Sri Lanka has exceptionally good record in providing basic education to mass of workers; while India exhibits moderately better performance in educating its workers at the tertiary level. India is however concentrating on improving the basic literacy levels, and its performance is expected to improve significantly.

The above discussion suggests that sustaining high economic growth, managing globalization, and devising appropriate trade-offs between creating new jobs (and increasing economic efficiency of existing labor and capital resources) and modernization of labor market organizations should be major priorities for both countries. Therefore, reform of social safety nets, including of severance pay practices, should be consistent with the above priorities.

3. Severance Pay Arrangements

This section provides a brief overview of severance pay arrangements in two countries, and analyses their implications for functioning of the labor markets. As noted, the term severance pay is used broadly to also include gratuity benefits and VRS payments.

3.1 India

Under India's Constitution, labor issues are a concurrent subject, i.e. both the Centre and the States share responsibility. In practice, the Center's role has been predominant with States making relatively minor changes to the laws and regulations of the Centre. India's economic reforms since 1991 have however enhanced the responsibilities of the States in economic policy. Some states, such as Gujarat, and Andhra Pradesh have therefore suggested that the Constitution be amended to make labor issues solely a State subject. It is argued that this will permit those states which give high priority to reforming the current labor laws and regulations with the objective of making them more consistent with the requirements of more market-based and outward-looking economic policies to take a lead and better fulfill their enhanced economic responsibilities. It could also assist in better managing the politics of labor market reform.

India has an impressive list of laws and procedures for protection of workers,

primarily in the industrial sector (broadly defined) and in government employment (Samant, 2003). These are the two sectors accounting for the bulk of formal sector jobs in India.

3.1.1 The Industrial Disputes Act (IDA), 1947

The IDA, enacted in 1947, is applicable throughout the country and has been amended on several occasions. The last major amendment was in 1984, before India's economic reforms initiated in 1991. It is the main law governing exit, lay-offs, retrenchment, and closures of industrial enterprises. Over the years, the IDA has given rise to an impressive body of case law.

The IDA is applicable to any business, trade, undertaking, manufacture or calling of employer and includes any calling, service, employment, handicraft, or industrial occupation or avocation of workmen. This Act however excludes a person employed in Air Force, Army, Navy, Police service and a person employed in supervisory capacity drawing more than Rs. 1600 (US\$35) per month⁸. This Act is also applicable to the persons working in the Public Sector undertakings. In this case, the Government is considered as an employer.

The evolution of the Act's provisions may be briefly summarized as follows. Initially it had differing provisions for firms employing between 50 and 100 workers and for firms with 100 or more workers. Firms employing fewer than 50 workers fell outside the scope of the Act.

Initially, this act did not restrain employers from laying off (i.e., dismissing workers because of slackness in demand and with the intention of re-hiring them when business picks up) or from retrenching (permanent lay-off) workers, or from closing down unprofitable businesses provided they notified the workers or the unions well in advance. The 1957 amendment however required the employer to compensate the workers affected by closure in the same way as if they were retrenched.

⁸ Courts, including the Supreme Court have interpreted supervisory capacity so strictly that only employees like whole time Directors and Managers at the highest level are included in that category. This implies that most of the employees qualify as workman under IDA even if they earn a salary above Rs. 1600 per month. In recent years, courts have been taking a more balanced view between needs of the overall economy and society on the one hand and rights demanded by organized workers on the other. This is suggested by the recent decision of the Supreme Court to not permit strikes by government workers (Sharma, 2005).

Each of the three amendments of the IDA in 1972, 1976 and 1982 provided greater protection to workers than the preceding ones. It is not a coincidence that more stringent jobs preservation measures coincided with the two energy crisis in 1973 and 1979 respectively; and with general stagnation of the economy. Their legacy is still continuing, primarily in making psychological shift from jobs preservation to jobs creation more difficult to attain.

Chapter VB of the IDA requires employers employing 100 or more workers to give three months notice of a closure to workers (or their representatives) and to the government⁹. After an enquiry (itself a time consuming affair), Labor Department either grants the closure or refuses. In practice, permission for closure is rarely given, though there have been recent signs of flexibility. This provision of the need for government's permission is quite unusual and goes beyond the recommendations of even the International Labor Organization (ILO). This provision also injects unnecessary political element in business decision making potentially resulting in large opportunity costs to the economy, but permits rent seeking opportunities to those in charge of giving such approvals.

This provision is unsuitable for a market economy where an enterprise management should be able to decide the size of its workforce not just at the start of business but also during its conduct. This view has been endorsed by India's Second National Commission on Labour (SNCL) in a Report issued in 2002, which recommends that the government permission be required only if a firm employing more than 300 workers decides to close (Sundar, 2005).

Employers with 50 or less than 100 workers however need only to notify the government, while those with less than 50 workers have no obligation in terms of closure. In practice workers in such firms can appeal to other laws (for example Indian Contracts Act 1972) to restrict dismissals.

⁹ India's Labour Ministry has proposed raising the limit for industrial units seeking to retrench or close without government approval from 100 to 300 workers, while increasing the retrenchment benefits from 15 to 60 days wages for each year of service (the *Financial Express*, April 6, 2005). The proposal is therefore more restrictive than the SNCL's recommendation. Even this modest proposal has been opposed by organized labour. A major industrial state, Maharashtra, has already adopted this proposal in its industrial policy (Sundar, 2005).

Greater statutory protection for section of current organized sector workers need not imply that workers as a group benefit. Based on theoretical reasoning, this has been demonstrated by Basu et al (2000). Primary channels bringing about this result are reduced job opportunities due to impediments to formation of new companies; resources devoted to finding ways to get around to formal laws leading to inefficiencies and loss of competitiveness; and greater encouragement to adoption of capital intensive technologies.

Fallon and Lucas (1991) found that the 1976 amendments of the IDA, reduced the labor demand by 17.5% in India. An examination of the Indian annual survey of industries corroborates the result. During the 1980s and early 1990, there was a sharp drop in employment in firms employing more than 100 workers and mild decrease in firms employing between 50-99 workers. However, there was a sharp increase in employment for small firms (less than 50 workers). Similar findings have been reported by Deshpande et al (2004).

Retrenchment Payment: The provisions relating to payment of compensation for lay-off and retrenchment was introduced in 1953. An amendment in 1964 (IDA Chapter VA) currently requires an establishment employing 50 or more workers to provide the workers with one month's notice and half a month's pay for every year of continuous work by the worker at the firm when retrenchment is undertaken. If notice is not given, then one month's wages are required to be paid. This implies that for a worker with twenty years of service, retrenchment benefit is equivalent to 10 months salary. In comparison with other countries, especially Sri Lanka (see below), this is relatively low. Under the income tax laws, the maximum retrenchment benefit exempted from the income tax is Rs. 0.5 million (US\$10,900). Any benefit above this amount is subject to individual income tax.

The retrenchment law in India is silent on the treatment of several categories of workers such as those hired from sub-contractors, agency workers, consultants, and home workers (Deshpande et al, 2004). To attain labour market flexibility, firms in India appear to have resorted to greater reliance on types of workers where applicability of formal labor laws is subject to some ambiguity; or where formal labor legislation is regarded as being unduly restrictive in maintaining competitiveness in increasingly open Indian economy (Deshpande et al, 2004).

Currently, for firms employing more than 50 workers, the lay-off compensation is at the rate of 50 percent of the basic pay plus dearness allowance. This is in addition to the worker's wages during the layoff period. This applies for those who have been employed for one year or more. For firm employing less than 50 workers, only the wages need to be paid. No changes in this area are contemplated.

India thus combines fairly strong formal labour protection laws for the organized sector workers with relatively modest retrenchment benefit. There are however several gaps in the statutory provisions and the enforcement remain uneven and weak. It is these characteristic that perhaps led the SNCL to recommend trade-off involving less rigid formal protection laws and more generous retrenchment benefit varying by size of firms (22.5 to 30 days per year for firms with less than 100 employees, and 45-60 days for firms with more than 300 employees) (Sundar, 2005). In the event of closure, the SNCL recommended somewhat lower retrenchment benefits, though still varying with size of firms, and still higher than the current provisions. (Sundar, 2005).

Better enforcement and greater accountability for complying with labour laws are also needed. Both public and private sector firms are among significant number who have failed to pay full statutory benefits to their workers, including severance pay and provident fund contributions.

Policymakers recognize that employment potential of various types of non-permanent jobs is high requiring reexamination of the 1970 Contract Labour act. Permanent jobs alone will not be sufficient to meet India's daunting employment (and employability) challenge. This is indicated by the SNCL's 2002 Report. The challenge in this area is translating good economics into good politics.

3.1.2 The Payment of Gratuity Act (PGA), 1972:

This Act came into force in September, 1972¹⁰. The main objective of this Act is to provide for a minimum uniform scheme for payment of gratuity to

¹⁰ Though the Act came into force from 16th September, 1972 it is applicable to the employees employed prior to that date. Such retrospective application of the laws create uncertainty and increase risk premium for businesses and the country, particularly as jobs creation is among the most daunting challenges facing the country.

workers (including those retrenched) throughout the country. The Act does not prevent employer-employee contracts providing more generous gratuity benefits. The purpose of the act is to presumably instill loyalty among workers. This assumes that both employers and employees value long-term continuity of service.

The Act applies to firms employing more than 10 workers. Therefore, it has broader applicability than the retrenchment benefit provision which applies to firms employing 50 workers or more. Moreover, persons employed by government and other public sector organizations also receive gratuity benefits (in addition to pensions and provident fund benefits), but are not covered under the Act (Muthuswamy and Brinda, 2002).

An employee is entitled to gratuity benefits only after five years of continuous employment. But this is waived in case of death or disablement. The rate of gratuity is 15 days salary (basic wage plus dearness allowance) for every year of service, with a maximum ceiling of Rs. 0.35 million (US \$ 7,600). Since 1994, all employees irrespective of their wages have been eligible for gratuity. Since gratuity is paid to those retrenched, combined severance pay and gratuity payments already amounts to one month of benefit per year of service, subject to a ceiling.

Income Tax treats the gratuity received by the Government employees and others differently. Any gratuity received by a Government (whether state or central) employee is tax free. Gratuity received by employees of private or public sector firms is taxable if it exceeds Rs. 0.35 million over a life time.

The gratuity benefits are wholly borne by the employer. The employer however can obtain gratuity policy from the Life Insurance Corporation of India (LIC), a dominant state-owned provider with nearly 80 percent market share; or set up Income Tax approved Gratuity Trust to discharge the liability under the Act (Section 4A). This provision potentially permits development of the fund management industry, thereby adding depth to financial and capital markets and enhancing expertise. It is essential however that the Gratuity Trust be professionally managed and regulated. Income tax authorities are not the appropriate agency to undertake the regulatory

task, though they may still be involved in the granting of income tax exemption¹¹.

Funding levels for gratuity liability vary widely among the employers. Many public and private sector employers do not have adequate funding provisions, and this creates additional uncertainty for the workers. Adequate supervision and regulation as well as greater professionalism in managing gratuity liabilities are essential. One option would be to entrust this responsibility to the proposed PFRDA.

3.1.3 Voluntary Retirement Scheme (VRS):

The use of VRS in India has accelerated since the 1991 reforms in both the public and the private sectors (Sharma, 2005). Unlike laws governing retrenchment and closure, there are no statutory rules governing the VRS, provided employer and the unions agree among themselves. Consistent with international trends, ability of unions to disrupt operations has weakened due to changing public opinion and requirements of intense domestic and external competition. As a result the benefits provided under the VRS vary considerably from case to case, even for the same firm in their successive rounds of VRS.

There appears to have been insufficient recognition of the need to increase employability of those retrenched under VRS; and little help to the affected workers on financial planning have been forthcoming (Sharma, 2005). This is an area where enlightened employer-union cooperation should be considered.

The first Rs. 0.5 million (US \$10,900) of VRS payments are exempt from individual income tax. In general, the cost to the employers and the fiscal costs of income tax exemption are generally higher for the VRS than for layoffs, retrenchment benefits and gratuities.

To summarize, the most striking conclusion emerging from the above analysis is the current labour legislation and employment practices in India neither adequately protect over 400 million in the labour force nor are they conducive to rapid growth creation. The severance pay arrangements

¹¹ The proposed Pension Fund Regulatory and Development Authority (PFRDA) would be an appropriate regulatory authority for the Gratuity Trust. The insurance sector is regulated by the Insurance Regulatory Development Authority (IRDA).

however are modest by international practices.

Extensive restructuring has nevertheless taken place in both public and private sector firms and organizations, particularly since the early 1990s. This has been made possible by a combination of using gaps in current statutory provisions to increase the share of non-permanent workers; relying on lax enforcement and time consuming procedures; extensive use of the VRS; and adopting more capital-intensive methods of production and distribution. Ironically, the outcome of greater share of non-permanent workers in India is similar to those countries with much more flexible labour markets such as the U.S. and the U. K.

The key economic concern should be that the economic costs, including opportunity costs of delays in shifting existing physical assets and human resources from low-value to high-value added activities, and in realizing requisite scale and scope economies, have been high. As a consequence, in spite of India achieving annual real GDP growth of over 6 percent for nearly quarter of a century, the challenge of providing productive and sustainable jobs is not being met. Labour market reform will be necessary though not sufficient for meeting the employment challenge as other reforms, including higher and more effective public and private sector investment will also be needed. Both micro and macro economic factors need to be considered in the debate on labour market issues.

3.2 Sri Lanka

As in India, Sri Lanka has an impressive list of laws designed to protect workers. The Sri Lankan industrial law is quite complex. It comprises about 40 labour statutes, regulations gazette under the labour statutes, decisions made by the Labour Courts and the Appellate Courts, and collective agreements (Sarveswaran, 2000). Except for the gratuity provisions, major labour legislations pre-date Sri Lanka's economic reforms initiated in 1977.

3.2.1 Legislative Provisions

The main legislation governing the termination of employment in Sri Lanka is the Termination of Employment of Workmen (special provision) Act of 1971 (TEWA), and the Industrial Dispute Act of 1950, as amended (IDA). Both these laws are applied to the workers in the private sector. Sri Lanka established export processing zones in 1977. But to-date, Board of Investment does not have powers to negotiate flexibility in application of labour laws in

these zones when negotiating with the investors.

TEWA applies to an extensive range of industries, listed in the Schedule to the Act, including all shops, offices and factories. This reflects the implicit assumption of a relatively static economy. Both the IDA and TEWA define workman broadly as a person who works under a contract of employment in any capacity including apprentices.¹² TEWA however does not apply to the establishment with fewer than 15 workers or to workers with less than 6 months service.¹³

The legislative provisions governing termination of employment at the initiative of the employer in Sri Lanka do not set any standard for which dismissals can be effected, yet paradoxically provide stringent procedural controls on dismissal. TEWA specifically provides that the Labor Commissioner (from whom the employer must seek authorization to dismiss) may decide the application in his absolute discretion.¹⁴ The Commissioner may also order reinstatement of any worker. No distinction is made in the legislation between casual, probationary and fixed term employees. Under the Act, temporary lay-offs may also need the prior authorization of the Commissioner of Labor. The Labour Tribunals have large and growing backlog of unresolved cases.

Those employees not covered by the TEWA, who are not seasonal employees and work for an establishment of greater than 15 workers, and who have been employed for more than a year are entitled to one month's notice of any retrenchment¹⁵. In such cases the employer must also give notice to the Government and to any relevant union¹⁶. The dismissal can not be effected until two months after the notice has been given, unless an agreement to the contrary has been reached with the employee or his representative (IDA, Section 31G).

¹² Section 3(2), TEWA, and Section 48, IDA.

¹³ A worker employed in a firm with less than 15 employees is nevertheless permitted to apply to a Labour tribunal for gratuity benefits. This creates high transaction costs and uncertainty for firms, employees, and the economy as a whole.

¹⁴ TEWA, Section 2(b).

¹⁵ IDA Section 31E.

¹⁶ IDA, Section 31F(a).

Since there is no statutory minimum severance pay, the Commissioner of Labor determines the amount of the compensation to be paid to workers who are to be made redundant. In practice, the level of compensation approved by the Commissioner has been up to a maximum of 6 monthly wages per year of service, and on average were 1.6 and 3.1 monthly wages per year of service in 2000 and 2001, respectively.¹⁷ The total sums paid out to laid-off workers have been large, amounting to even 36-50 monthly wages, and the average payment in 2002 was Rs.57,700, equivalent to more than four-fifths of per capita GDP in 2000. This level of compensation is among the highest in the world.¹⁸

To reduce the non-transparency of the TEWA payments, employers have requested that the act is amended so that the compensation would be determined by a formula. In 2001, the Commissioner General of Labor did suggest a formula involving two to three months salary for each year of actual service or full salary for the remaining period of service up to retirement, whichever is less, subject to a maximum of 50 months salary. ILO prepared a proposal in 2003 for introducing unemployment insurance scheme in Sri Lanka. However neither the formula nor the insurance proposal has received the formal backing of the government.

The unusual and wide discretionary powers given to the Commissioner of Labor creates uncertainty in business planning, and gives rise to rent-seeking opportunities to stakeholders, particular to those entrusted with the discretionary powers, and needlessly politicizes economic decision making. This is indicated by the finding that in a significant number of cases unions affiliated to the ruling party have been favored over the rival unions in adjudicating cases (Kelegama, 1998). These types of powers are unsuitable for a market economy.

The TEWA does not apply to Government-Owned Business Undertakings (GOBUs) or SOEs.¹⁹ This is because under the Sri Lankan laws, a worker

¹⁷ These figures as well as those in the next sentence are based on communication by the authors with the ILO and World Bank officials based in Sri Lanka.

¹⁸ The corresponding figure for Asia as a whole for those with 20 years of service is only 0.8. all other regions including OECD are substantially less generous than Asia, let alone Sri Lanka (Holzmann et al. 2003)

¹⁹ All nationalized private firms under the Business Acquisition Act of 1971 were categorized as GOBU. They are actually SOEs with a different name.

in a GOBU is covered only by the government establishment code. Thus, the services of a worker of a SOE can be terminated without the specific permission of the Commission of Labor. A worker of a GOBU or SOE once retrenched is not permitted to seek redresses from the Labor Tribunal. Under the 1987 Act, after conversion of an SOE to a public company, the worker is treated as a private sector worker.

Retrenchment of workers in the SOES has been particularly contentious in Sri Lanka. The 1992 announcement by the President of the country made voluntary retrenchment the state policy as it guaranteed jobs to existing workers till the retirement age of 55. (Kalegama, 1998). The most common compensation applied in restructuring SOEs since 1992 has resulted in an average worker receiving total financial package of around Sri Lankan Rupees 0.25 – 0.3 million. Majority of the voluntarily retrenched workers were below 45 years of age.

3.2.2 The Gratuity Scheme

Gratuity benefits in Sri Lanka are governed by the Payment of Gratuity Act of 1983. The Act applies to employers with 15 or more employees in private and semi-government sectors. The act however does not cover public sector workers, though they also receive this benefit.

A minimum of 5 years of service is required to be eligible for the benefit. The gratuity amount is 15 days of salary for every completed year of service. The gratuity is paid regardless of the termination of employment. So for workers qualifying under TEWA, this is an additional benefit.

The gratuity funds are not regulated. No data on the extent of funding of gratuity liabilities are available. It would however be surprising if the funding levels were high. As in the case of India, there is a strong case to subject gratuity funds to regulatory oversight on governance, funding, and investments.

The above analysis of Sri Lanka's severance pay arrangements suggests the following. First, the labour legislation is strongly procedure rather than outcome oriented. Complexity of laws, including wide ranging right of appeal, make administration of labour laws unwieldy and time consuming. Nevertheless, considerable restructuring of public and private enterprises has taken place, with extensive use of VRS.

Second, while the statutory gratuity benefits are internationally comparable, retrenchment payments are left to be decided on a case-by-case basis by over-burdened labour officials. Resulting needless politicization of administration of labour laws has led to excessive emphasis on preserving existing jobs rather than creation of new jobs. Not permitting flexibility in application of labour laws in export processing zones after nearly 30 years of operation and when creation of jobs is a major task facing the policymakers, seems to reflect a certain rigidity in political economy and economic thinking.

4. Concluding Observations

As India and Sri Lanka continue to link their economies more closely with each other, and further integrate with the world economy, labour market issues, particularly proper balance between preserving existing jobs on the one hand and creating new jobs on the other, have acquired considerable urgency. The influence of their earlier economic, social, and political institutions and thinking however remains strong.

There is a strong resistance among their labour ministries and organized labour (constituting relatively small proportion of the labour force) to applying economic reasoning (eg. need to minimize transaction costs and opportunity costs) to labour legislation and its implementation. There is also reluctance to shift from excessive procedure-oriented to outcome-oriented approach to labour protection which could enable those not in the organized sector to benefit from jobs creation in many new diverse areas by established as well as newly formed companies. Unwillingness in Sri Lanka to adopt a formula for severance pay which will reduce transaction costs and minimize political influence on business decisions is among the most flagrant examples of the above tendencies. In both countries, there is a need to improve data and understanding of labour markets, with a view to generate policy options on labour issues based on analytical yet evidence-based research.

In both countries, extensive and relatively rigid formal labour laws have coincided with considerable restructuring, by both public and private sector organizations, and fairly low effective labour protection to the vast majority of the workforce. The methods used to bring about this result, such as lax enforcement, time consuming processes, and rent-seeking by privileged few are not conducive to meeting the daunting challenges of jobs creation.

Except for retrenchment benefits in Sri Lanka, severance payments in both countries are modest by international comparisons. So the opportunity for trading-off somewhat higher severance pay on the one hand and greater operational flexibility to public and private sector organizations, greater professionalism in design and implementation of schemes under the Labour Ministries, and emphasis on reducing transaction costs, particularly for formation of new companies exists.

The overarching challenge in both countries is for the political, business, and labour leadership to help translate sound economics into acceptable electoral politics. Rapid progress in meeting this challenge is not expected, but even small cumulative changes in the right direction have the potential for substantial welfare enhancement. This is a manageable task in both countries, but it should be pursued with a sense of urgency.

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