



# Happy Anniversary Payment of Gratuity Act 1972

This year India celebrated its 75<sup>th</sup> Independence Day, but how many people know it is the 50th Anniversary of the Payment of Gratuity Act 1972. The Act came into effect on 16 September 1972. Who knew! Gratuity is a familiar employee benefit in the formal workforce in India. An end of service lump sum benefit payment, where the amount of benefit is calculated according to its stipulated formula:

*“For most employees, it is the rate of fifteen days wages based on the rate of wages last drawn by the employee where, in the case of a monthly rated employee, the fifteen days wages shall be calculated by dividing the monthly rate of wages last drawn by him by twenty-six and multiplying the quotient by fifteen”*

**15/26 x last drawn wages**

Gratuity was introduced with the purpose of providing a suitable payment as a “thank you” / “gratuity” for the long service an employee would have given the company. In fact, the eligibility to receive a payment of about 5 years reflects that. It is also based on the last drawn wages and so there is some wage inflation protection built into the formula. Most workers would have really appreciated the lump sum payment on leaving service, whether by resignation, retirement, disability or death.

When introduced the average service tenure was probably envisaged to be long and so such a benefit, in the absence of formal pension plans in the private sector would have been very welcome.

Much of the Act has not changed since inception like, the definition of establishments where Gratuity is mandatory, threshold of number of employees where Gratuity becomes mandatory, service criteria for eligibility and the benefit formula itself.

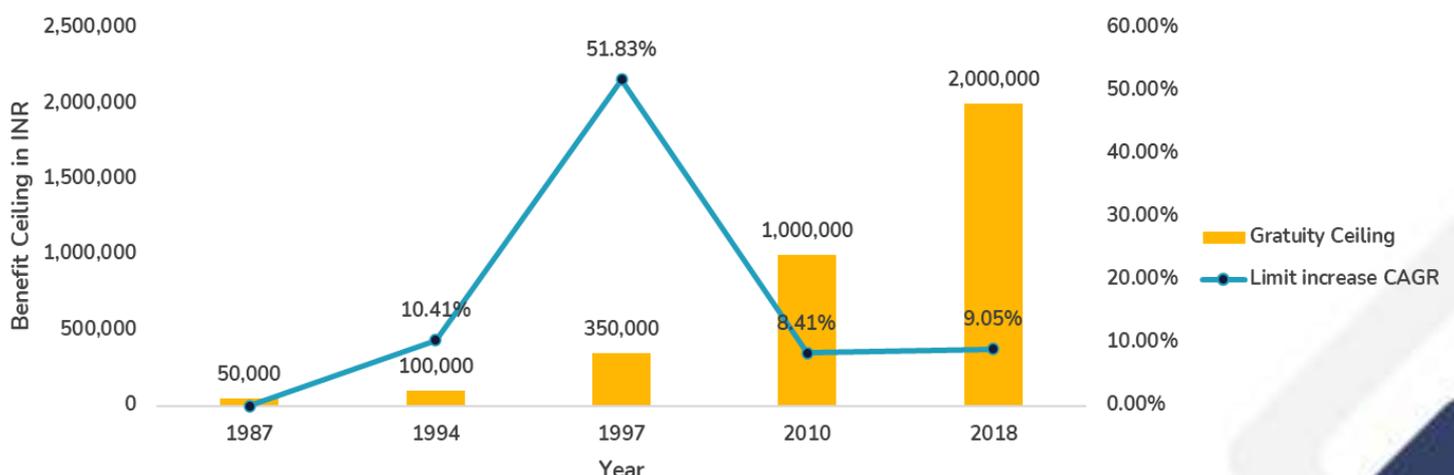
That is interesting given the changes that have happened in the workforce in the last 50 years.

However, the maximum benefit has been updated. The original Act had a limit on the eligible wages for the calculation. Starting at Rs 1,000 it increased in stages to Rs 3,500 by 1987. In subsequent years, a wage limit was removed.

In 1987, a maximum benefit of twenty months’ wages was replaced with a monetary cap of Rs 50,000.

The chart below shows how the maximum benefit cap has been increased since 1987.

Evolution of the Maximum Limit of Gratuity Benefit



Since a monetary cap was introduced, average annual inflation over that 35-year period has been approximately 7% p.a.<sup>1</sup> GDP per capita between 1987 and 2021 was about 6.4%<sup>2</sup>.

This compares to the cap increase of 400% or nearing a 13% CAGR over the 35 years. One can then definitely argue that the cap has kept pace with real wage inflation. A good value for employees.

**“Based on an internal study of KAP clients, just over 25% of companies have a scheme more generous than the Gratuity Act (i.e., a different formula or no cap)”**

Going forwards, it is interesting to note that an automatic indexation of the cap has been introduced in 2017 for Executives and Non-Unionised Employees of Central Public Sector Enterprises. The cap will increase by 25% once the dearness allowance rises to 50% (June 2022 is at 33.6%). Maybe, this type of a thing may follow for the private sector eventually?

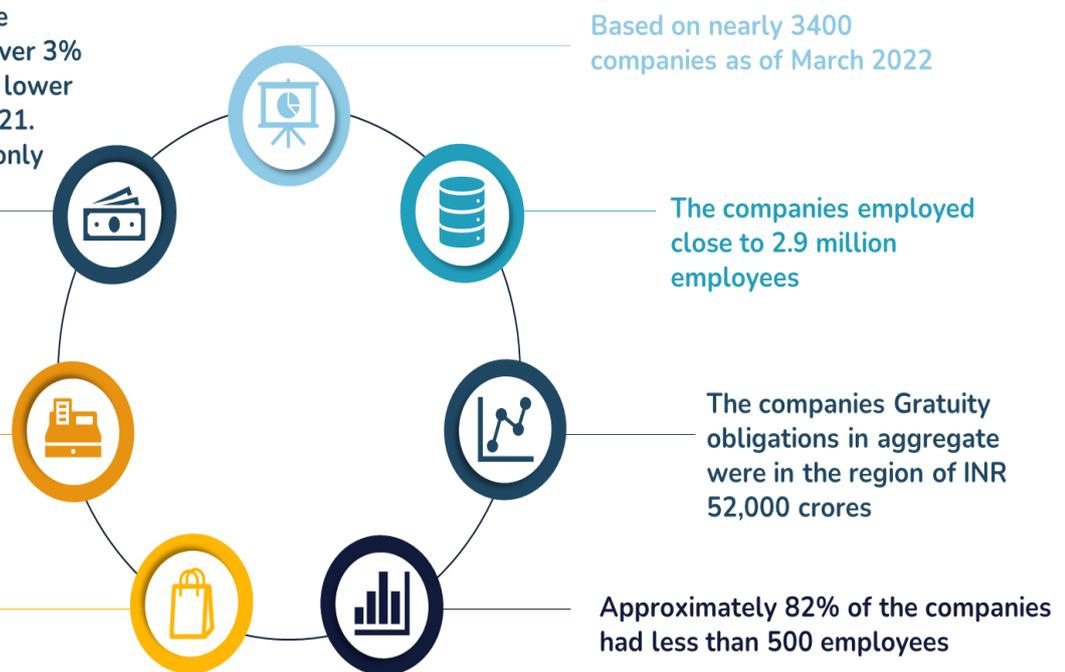
### Where are we currently, a bird's eye-view:

Based on KAP internal databases, we have briefly summarised a few statistics as an indicator of the landscape with respect to Gratuity benefits:

The average actuarial estimated cost of one years' gratuity formulae amongst these companies (i.e. service cost) was just over 3% of the annual gratuity salary. This was lower in 2022 compared to about 3.4% in 2021. Quite a difference to the 4.81% commonly used as a rule of thumb formulae

Out of those that have funded their scheme separately, assets are on average estimated to cover 90% of the projected obligations. Due to assumption changes and market value of assets, this improved by almost 4% between 2021 and 2022

Close to 42% of Gratuity schemes have been funded through a separate Trust. Although this is closer to 25% for companies with less than 50 employees and closer to 70% for those over 500 employees



<sup>1</sup> <https://www.inflationtool.com/indian-rupee/1987-to-present-value?amount=1&year2=2022&period1=10&period2=6&frequency=yearly>

<sup>2</sup> <https://www.macrotrends.net/countries/IND/india/gdp-per-capita>>Source</a>



## So, What's Next?

In the near term, the Code on Social Security is around the corner and will replace the Payment of Gratuity Act.

Whilst most of the Payment of Gratuity Act has been transposed directly, one impact is the benefits of employees where their applicable salary for the Gratuity calculation increases due to the change in definition of "Wages" for all the Labour Codes. We explored this back in 2020 in our article [The Code On Social Security \(2020\) - Wages definition implications on Gratuity and other Employee Benefits](#)

The Code has been rumoured to be implemented for a long time, but we still await. Being prepared for any impacts will be important for companies.

**We approximated that gratuity defined obligation at 2020 increased by an average of over 35% after making an approximate adjustment for the wages definition**

In the long term, it will be interesting to see gratuity benefits retain the same perceived value for employees. For the bulk of full-time permanent employees, the service period of approximately 5 years before becoming eligible for benefits is very long in this day and age. One idea might be to increase the service criteria together with an increase the benefit formulae as well. This may help Gratuity to serve its original purpose better and act a better retention tool, whilst not costing companies more (as less employees will reach the longer service criteria).

Other alternatives could be considered like replacing the defined formulae with an individual account-based approach. This is more complex and its relevance in India, given we have the Employee Provident Funds, needs to be considered carefully. It is an approach that UAE has recently introduced in certain circumstances instead of its traditional formula-based end of service benefits.

## Happy Anniversary

So, happy anniversary Payment of Gratuity Act and thank you for providing millions of workers over the last 50 years a tangible reward for their service with an organisation. We know you may not see a 51st anniversary but you will be there in spirit through the Code on Social Security.

Let us see where the next 50 years takes you!



To gain more insights on Gratuity and its transition to the Code of Social Security or on any other Employee Benefits and related discussions, please feel free to reach out to us at [kap@ka-pandit.com](mailto:kap@ka-pandit.com)



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