The End of Service Gratuity: is it the beginning of the end?

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End of service gratuity ("ESG") is a topic that is currently stirring much debate. In particular, it was recently reported that after conducting a study into the ESG system, the World Bank recommended the establishment of a pension fund for expatriate employees to replace or supplement ESGs.

Whatever your opinion of the ESG, it is important to be aware of the ongoing discussions surrounding the gratuity payment scheme as any decision to reform the ESG model will impact on the majority of employees and employers in the UAE.

The ESG explained

ESG is a sum of money that an employer is lawfully required to pay an employee upon the termination of the employment relationship, subject to the employee satisfying certain conditions that are set out in the UAE Labour Law. The ESG scheme was introduced 40 years ago to ensure that when employment relationships were terminated, employees without pension benefits received a lump sum payment to assist them during the period following termination or for them to put towards their savings.

The payment is based on the employee's basic salary and length of service, although it may be reduced depending on the circumstances of the termination of employment and where the employee was working (see "reduced amount" section below). The calculation does not take into account payments that are additional to basic salary, such as housing and car allowance. However, where an employee receives a guaranteed or regular commission payment, this may be included within the calculation of basic salary for the purposes of the ESG calculation.

The amount

Employees with at least 12 months service are entitled to 21 calendar days' salary for each year of service in the first five years of employment and 30 calendar days' salary for each year of service worked beyond five years. The ESG payment is calculated on a pro-rata basis and therefore employees receive credit for the entire period of service. Importantly, the calculation is applied to the employee's salary at the time of termination, which can result in the ESG being substantial for long serving employees. The maximum ESG entitlement cannot however exceed two years salary.

Reduced amount

Where individuals are employed in onshore organisations within the UAE (and some of its free zones), reductions may be applied to their ESG entitlement should they resign from their roles. In particular, where an employee on a limited term contract with less than five years service resigns prior to the expiry of the fixed term, the employee is not entitled to an ESG payment whatsoever. In the case of an employee on an unlimited term contract, having been employed for more than one year but less than three years, he will receive one third of the full ESG entitlement. Where the period of continuous service is more than three years but less than five years the departing employee will be entitled to two thirds of the full ESG. Once an employee has accrued five years service, either on a limited or unlimited term contract, there will be no reduction pursuant to a resignation.

There are exceptions to the above rule for employees who are working within particular free zones, such as the Jebel Ali Free Zone, the Dubai Airport Free Zone and the Dubai International Financial Centre, where no reductions are applied to the ESG calculation where employees resign.

No ESG

In addition to the alternative options to the ESG system which are available to employers (see current alternatives section below), employees will not be entitled to an ESG where their employment terminates in the following circumstances:

1. The employment relationship terminates before the employee accrues 12 months service.
2. The employee was dismissed for a breach of Article 88 of the UAE Labour Law or for one of the ten reasons stated in Article 120 of the Labour Law.
3. An employee on a limited term contract with less than five years continuous service resigns before the end of the defined period.
4. The employee was employed pursuant to an unlimited term contract and resigned without notice (in circumstances other than those set out in Article 121 of the Labour Law).

The Region

The ESG system is not unique to the UAE. All of the other five countries in the Gulf Cooperative Council (“GCC”), namely Saudi Arabia, Bahrain, Kuwait, Qatar and Oman operate similar ESG models in respect of the non-national workforce although the calculation and specific conditions of the termination payment vary from country to country. It is estimated that the combined ESG liability of all employers operating in the GCC is more than US$15 billion (AED54.75 billion). Notwithstanding this, the appetite to review the ESG model is not as prevalent in the other GCC countries as it is in the UAE.

Current alternatives to the ESG

The current alternatives to paying ESG sums to employees are for employers to:

1. Provide a pension scheme to their non-national employees, which is more beneficial than what the employees would otherwise receive under the ESG model. Such a pension scheme must be published and known to all employees. Critically it must specify that it will be a substitute to the ESG and the employees must expressly agree and acknowledge that it will be paid to them in place of the ESG (if not the employee will be entitled to the pension and the ESG). However, as employers are not legally obliged to provide this alternative for non-national employees, the majority of private employers have opted to not put in place such pension schemes.
2. Register their UAE national employees into the state pension scheme and accordingly pay pension contributions to the General Pensions and Social Security Authority. National employees are subsequently entitled to draw a pension when they reach retirement age. National employees working in the private and public sector are usually registered onto the state pension scheme but where they are not, they will also be entitled to an ESG payment on termination.

A prudent employer may consider setting aside a sum equivalent to approximately 8% of its payroll each year (or a 13th month payroll sum) to ensure that its ESG liability is met on an ongoing and sustainable basis. If this annual payment was strategically invested then it is likely that the actual cost of ESG to the employer would be less than the ESG payment which is due.

Ongoing discussions

It has been reported that the UAE Government is tentatively considering alternatives to the current system. As referred to above, the Dubai Department of Economic Development recently instructed the World Bank to undertake a study into the current ESG system in the UAE, following which the World Bank recommended the establishment of a pension fund for expatriate employees in Dubai. Following receipt of the World Bank's report, Ali Ibrahim, Deputy Director-General for the Planning Affairs and Development department stated that creating the pension fund for expatriate employees is one of the most important projects which the department is focussing on. He stated that the Department of Economic Development "has started taking steps to implement the [World Bank] recommendations in coordination with other relevant local bodies".

An example of the how the proposed change may work is the introduction of a Government-led pension fund that requires employers to pay approximately 8% of basic salary into the fund and employees would receive pension payments following the termination of employment. Whether the pension benefit would mature at the date of termination or the date of retirement is unclear although the latter would seem a more straightforward option for all concerned.

Inevitably, the proposal for change has created debate about whether a change to the current system is necessary and whether it would be a positive measure for non-nationals working and living in the UAE.

Arguments for change

- Where an employer is in financial difficulties and/or becomes insolvent, the employee will have limited prospects of recovering their full entitlement to an ESG. This could have serious financial implications on departing non-national employees, particularly those with long periods of service who are relying on the ESG payment to supplement their retirement fund. This was a particular area of concern during the economic crisis in 2008/9, when many businesses were experiencing financial difficulties and business owners would disappear without honouring such termination payments.
- If an employee believes he has not received his full entitlement to an ESG payment, he is required to refer the matter to the Ministry of Labour. However, those employees who do not have the understanding or technical know-how to pursue a claim are at a significant disadvantage and are often unable to pursue a former employer for their ESG entitlement.
- As explained above, the ESG sum is calculated on basic salary alone. It is therefore common practice for UAE employers to particularise an employee's overall income into an artificially modest basic salary and increase additional benefits such as travel and housing allowance.
- Where an employee is dismissed for a specific cause and without notice in accordance with Article 88 or 120 of the Labour Law, the employee will not be entitled to an ESG. Some critics argue that this rule encourages employers to create artificial reasons for dismissing an employee pursuant to Article 88 or 120.

Arguments against change

- Non-nationals who intend to work in the UAE for a limited period only before returning to their home country prefer to receive a one-off payment rather than having to wait for a foreign based pension scheme, which contributions were made into for a limited period during their career, to mature when they retire in the distant future.
- If ESG funds are converted into a pension fund and invested in stock markets, there is a risk of those investments depreciating in value before the individual's entitlement to the pension matures.
- The current system has worked effectively for 40 years and the region continues to attract the most talented professionals from all corners of the world. Therefore, a significant overhaul of the ESG system and the introduction of a multi-billion Dirham pension fund would be a time consuming, expensive and risky process which is not necessary at the present time.

As you can see from the above, there are well founded and persuasive arguments for and against reforming the ESG system and the expat community's opinion is divided. In a recent Arabian Business Poll, it was determined that 31% of those polled believed the introduction of a pension plan could assist foreign workers in creating a nest egg for their retirement although 19% believed that the roll-out of a pension plan would deter foreign workers from moving to the UAE.

It is unlikely that a final decision will be made in the near future but it is certainly a debate that the employment team at Al Tamimi will follow with interest in the coming months. With an estimated total value of UAE companies' ESG liability amounting to more than AED 14.6 billion, it is a matter which will have a significant impact on non-national workers and the UAE economy in general.