

Labour pains

China's new labour contract law is raising costs and accelerating the exodus of manufacturers to lower-cost countries, writes *Liana Cafolla*

The Chinese New Year began with a jolt for some mainland migrant workers. News reports said hundreds returned from their holiday to discover their overseas bosses had absconded, leaving behind abandoned factories and unpaid wages.

More workers are expected to face a similar plight in the coming months because manufacturers are complaining that a controversial labour contract law that took effect in January is pushing up production costs and adversely affecting their businesses.

Several South Korean and Taiwanese businesses are already relocating factories from China to countries with lower labour costs like Vietnam, according to published news reports.

One such firm is Compal Electronics, the world's second biggest maker of contract laptops. The company plans to open a new production base in Vietnam in 2009, a year ahead of schedule. The move led to speculation that the company is deserting China because of rising costs resulting from

the new labour law and a decrease in tax incentives for foreign investors on the mainland, according to a report carried in Taiwan's *Commercial Times*. The company, however, says it will maintain its factory near Shanghai.

Hard-hit manufacturing

The tougher law, passed in June last year, brought sweeping changes to work contracts, making it more expensive to dismiss long-term workers, limiting the flexibility of fixed-term contracts and empowering unions. The moves aim to enhance labour rights protection and minimize disputes.

Although the law applies to all mainland companies, the manufacturing sector is expected to be hardest-hit, says Jack Chow, partner of IPO and capital markets at KPMG China and Hong Kong.

"Historically, because of the short-term nature of employment with manufacturers in China, many previously under-reported their number of labourers with various authorities,

and it makes the new employment law an issue with them," he says.

Employers blame the new law for damaging China's status as the world's workshop and affecting Hong Kong investors in Chinese enterprises and listed companies. "In the past, there was not enough protection of workers. But now, the law is too radical," says Kaiser Tang, vice general manager of Best Cheer Stone Group, China's biggest stone manufacturer, which employs about 1,000 people.

Tang says he expects the labour rule changes will increase costs by around 20 percent and the effects will begin to show in March or April. What is also worrying Tang is that company management now faces tougher penalties, including jail terms, in case of accidents.

"As a middle manager, I am worried about the extra responsibility," he says.

A toy manufacturing company in Dongguan, which employs 800 staff



REUTERS/OTHK

and has an annual turnover of US\$13.5 million, agrees that the new law will raise costs by around 20 percent.

The owner, who asked not to be identified, says he had to convert all of his employees previously on fixed-term contracts into permanent staff after the Chinese New Year, in addition to giving them non-employment, retirement, medical, and accident insurance. “We have to increase everyone’s salary and buy four insurances for them,” he says. He plans to pass on the extra costs to his customers.

Implications of the new rules

The fact that the new law makes it more difficult to sack workers will add to costs, says Jungle Wong, practice leader of the human capital advisory services in Deloitte for China and Hong Kong.

“It will be more difficult to ask an employee to go without paying severance. In addition, the implementation of the labour law will be stricter than before, and some of the grey areas will be eliminated,” Wong says.

Analysts say the increased costs of the controversial law and the impact of a new corporate tax law that eliminates tax incentives for foreign enterprises may discourage foreign direct investment into China. FDI stood at a record US\$74.7 billion last year, Ministry of Commerce figures show.

The law comes in addition to growing competition from other developing countries. Labour costs in China had already been rising before the new law was introduced due to staff shortages and rising salaries.

However, labour-cost increases will be less significant in a wider picture of rising costs, says Jack Chow of KPMG.

“I think manufacturers were suggesting a 20 percent increase in their labour costs. But when it’s factored into the total manufacturing costs, I would say it would boil down to one or two percent because labour costs would not be a significant component in manufacturing costs,” he says. “So when comparing against the increase in raw materials or the fuel costs, I don’t think

the increases in labour costs will be a real concern to the manufacturers.”

Not all of the law’s requirements are new, but many have been strengthened or clarified. For example, it was unclear whether employers had to contribute to the social benefits of workers on fixed contracts. Now, it is clear that they do. The new law also emphasizes the need for employers to put written contracts in place.

“That’s not new but the penalties have increased so there is a much greater need for full compliance,” says Fiona Loughrey, partner and head of China employment group at law firm Simmons & Simmons. “So that is an administrative burden.”

“There is at least one provision in the new labour law which is actively of benefit to employers and that’s the cap on severance pay,” she added.

Severance pay is now payable if a fixed-term contract expires and is not renewed, unless the employee rejects a proposed renewal on the same or better terms. The amount payable depends



REUTERS/OTHK

on the length of employment and the average salary paid during the 12 months prior to the termination or expiry of the contract. However, it is capped at 12 months salary.

For employees with high salaries, the result will be a reduction on the amount of severance pay due, which may counterbalance the extra costs employers face for severance payments now required for fixed-term contracts that are not renewed, Loughrey explains.

The size of the burden for employers will depend on how diligently they adhered to previous legislation. A lack of compliance in the past, however,

naturally leads to speculation about adherence to the new legislation.

Foreign observers say past experience shows that even effective legislation is often meaningless because of the lack of proper systems to ensure compliance. Chow of KPMG, however, thinks authorities will likely crack down on irregularities under the new law.

“For those companies that previously underreported the number of labourers employed, they will be under the spotlight and they may expose themselves to investigation under the new employment law and be subject to penalties,” he says.

The impact on investors

Successive fixed-term contracts will become a thing of the past because the new law states that they are limited to two consecutive terms, although some provisions of the law in this regard are somewhat unclear, according to Simmons & Simmons.

Employees who have been working for a company for 10 consecutive years and those who complete their second fixed-term contract are entitled to open-ended contracts.

“The ultimate consequence of the new labour law will be the effective abolition of fixed-term contracts,” says China business consulting firm,



Dezan Shira & Associates. “Every fixed-term contract that expires creates a severance obligation. Without paying compensation, a problem employee cannot be dismissed. Business costs will rise due to the higher expenses for hiring and terminating staff.”

The effective elimination of fixed-term contracts means foreign invested companies that widely make use of them will have less flexibility in employment, according to Dezan Shira.

“They should check in time whether their budgeting has to take the payment of severance into account and to what extent. As termination against the law triggers a right of the employee to

be re-employed [or to be paid] twice the stipulated severance amount, the employer has to be very careful,” the consulting firm says.

But Loughrey of Simmons & Simmons points to a different possible outcome. She says some employers may renew a fixed-term contract twice with a particular employee and then replace him or her because of the restrictions placed by the new law.

“Instead of keeping persons on as long as they wanted to remain with that employer on a renew, renew basis, they would renew, renew and then let go. So they would pay the severance pay as a sort of an extra tax in doing business,” she says. “Now this would be unfortunate for the employee, particularly if there’s a slowdown in the economy.”

Dezan Shira says another cost implication for investors is the issue of underpayment of wages or social welfare, which is rampant in the mainland.

“This can be especially dangerous when acquiring companies or parts of companies as one may acquire all the liabilities as well,” it says.

Chow of KPMG says such practices will have to stop and it is up to auditors to ensure that companies are complying.

“Historically, as accountants, when we audited mainland manufacturers, we adapted the practices of the local authorities [on] short term employment, or there were local notices issued by the local authorities who accepted bases of contributions below the national standards,” he explains. “But all these practices will have to be eliminated going forward.”

He urges accountants involved in auditing mainland companies to watch out for non-compliance problems.

“When they audit or review a set of financial statements, they should question whether there is any misinterpretation of the new

employment law and whether there is any under provision of either social security contributions or payments of overtime to workers,” he says.

A step forward for labour rights

Despite the cost issues, labour rights activists welcome the new law as a step in the right direction. Han Dongfang, founder and director of activist group China Labour Bulletin, says the legislation will likely improve China’s collective bargaining system because until now, workers can only turn to the state-controlled All China Federation of Trade Unions when disputes arise.

“The ACFTU sees itself as a ‘bridge’ between labour and management, not merely as an advocate for labour,” Han recently wrote in *China Brief*, a newsletter published by the Jamestown Foundation in the United States.

“As such, it does not actively defend workers’ interests in negotiations with management, but seeks to facilitate a compromise between the two sides,” he says.

The new law requires employers to sign a collective labour contract with staff representatives and consult with them on issues affecting staff welfare. While the extent of consultation has yet to be clarified, Han says the move may help resolve increasingly bitter and costly disputes about underpayment and overtime.

Stella Hou, general manager of human resources firm Hewitt Associates, noticed that in recent years, mainland workers have become more vociferous in demanding redress due to a tighter labour market and greater access to information.

“You do see blue-collar workers stand up and file a case, whether they win or not,” she says. “I clearly see very, very high awareness, and increasingly so, among the employees of how to protect themselves, around what they deserve.” **A+**