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Assessment of the Employees' Provident Fund in Sri Lanka

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Acronyms

AAIB	Agricultural and Agrarian Insurance Board
APPF	Approved Private Provident Fund
EPF	Employees' Provident Fund
LFS	Labour Force Survey of Census and Statistics Department
SLIPS	Sri Lanka Inter-bank Payment System

Foreword

Extension of Social Security Coverage to the Excluded

Only one in five people in the world has adequate social security coverage: yet social security is a basic need and a basic human right. Its fulfilment would contribute to the promotion of decent work and to the reduction of poverty. As a result of discussion during the International Labour Conference in June 2001, an international tripartite consensus emerged which urged member states to give priority to this issue and the ILO was called upon to launch a global campaign on extension of coverage. The Director General of the ILO formally launched the Global Campaign on Social Security and Coverage for All at the International Labour Conference in Geneva in June 2003.

The overall objective of the campaign is to extend social security to the excluded through the mobilization of key actors at the national and international levels. The process relies heavily on social dialogue and on innovative approaches to meeting social protection needs. Technical cooperation projects in many developing countries will be an important instrument in this process and, in as many countries as possible, an action plan for extension will be formulated based on a diagnosis of social security needs and weaknesses. Financial support was secured from the Government of the Netherlands for a technical cooperation project to be executed from early 2002 in three developing countries - Sri Lanka, Honduras and Mali.

In Sri Lanka, a national diagnosis of social security provisions and needs in Sri Lanka has been completed and a report is being prepared which will assess the existing system as a basis for formulating a national action plan. This diagnosis is based on a series of special studies of existing schemes and information on background issues.

This report is concerned with assessing the effectiveness of the Employees' Provident Fund in Sri Lanka.

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Executive Summary

The Employees' Provident Fund (EPF) was established in 1958 to provide a means for formal sector workers to obtain some income security on retirement. It belongs to a group of schemes that were established at that time also in Singapore and Malaysia, as a second-best alternative to the national pension system already existing in the United Kingdom. Factors preventing the establishment of a universal pension system at that time included the small size of the formal sector, the large percentage of the overall population not in employment, and the lack of administrative capacity to implement more complex schemes.

The EPF is managed by the EPF division of the Department of Labour, whilst the Monetary Board of the Central Bank is responsible for fiduciary matters, including management of fund investments. The EPF is a mandatory, contributory Scheme that covers employees in the private sector. Workers and employers are required to make pay-roll contributions at the rate of 8 per cent and 12 per cent of earnings respectively, with the employer responsible for registration of the worker and remittance of contributions. Contributions are credited to a notional individual account held in the name of the worker, and interest is credited at the end of each year to the account balance. A new account is set up each time the worker changes employer, although provision is made for merging account balances on request. The worker may withdraw the accumulated balances as a lump-sum if he/she retires at the age of 55 years (50 for women), which is the statutory age of retirement. The workers would continue contributions to the fund if they continue to work after the official age of retirement. EPF does not offer any pension benefit, or any options for workers to convert their lump-sums into annuities or pensions, and these options in practice do not exist in the private market. There is also limited provision for withdrawal of funds under specified circumstances, or use of account balances as collateral for housing loans. Provision was originally made for firms to opt out of the EPF, if they established alternative Approved Private Provident Funds (APPFs) or Private Contributory Pension Schemes, meeting stipulated minimum criteria, and several of these APPFs were created.

The EPF currently has 9.3 million accounts, of which only 2.0 million are active. Given a private sector employee workforce of at most 2.8-2.9 million, the effective coverage is 65 per cent or more of the intended workers. Total fund balances reached Rs. 295 billion by end of 2002, representing an average account balance of Rs. 30,000/=, with members terminating their accounts in that year encashing an average of Rs. 120,000/= each.The EPF is the primary holder of government debt.

More than 95 per cent of EPF funds are invested in government securities and loans. Annual administrative costs, which are paid from the returns, are very low at less than 0.1 per cent of fund assets. Although it is permitted to diversify into private equities and other investments, its ability to do so is constrained by the overall size of the fund (it is half as big as the total capitalization of the Colombo Stock Exchange), which reduces the availability of alternative investment options. Another constraint, which is the lack of trained fund managers, has recently been addressed by training several of its officers in fund management. The EPF has been subject to considerable criticism of its investment record, and alleged below-market rates of return. However, most of this criticism is unjustified, and part represents advocacy by those who stand to directly benefit in management fees if management was outsourced. The overall historical real rate of return since its inception is certainly low and not much above zero. However, this average includes the first two decades of the EPF, when there was not much concern to ensure market rates of return, and then the performance during the 1980s, when large macroeconomic imbalances and high inflation rates resulted in negative rates of return. Since the early 1990s, the EPF has improved its overall real rate of return after administrative expenses, averaging 2-4 per cent since 1990. This is close to the maximum sustainable long-run rate given that economic growth itself has averaged 3-5 per cent and the size of the EPF in relation to the overall economy.

The EPF is a fully-funded Scheme, and hence it does not on paper have a funding gap. However, as the Scheme matures, the fund will require an ever increasing flow of payments from the government on its debt, which ultimately must be paid for from taxation. The major deficiencies of the EPF Scheme concern the inadequacy of the income replacement that is possible under the Scheme, the lack of any pension benefit, the lack of any risk-pooling between individuals, and an inherent gender bias against women.

A typical male worker who pays EPF contributions his whole working life from the age of 18 to 55 years obtains a lump-sum, which, if converted at no cost to a pension, would provide a replacement income level at best of only 25 per cent of his average life-time wage. For a typical woman who retires at the age of 50 years, and who has spent 3-4 years out of the workforce for child-rearing, the replacement level is even less than 20 per cent. Given that life-expectancy is rising, the situation will actually be even worse than this for currently young workers. The second problem relates to the fact that this option of converting the lump-sum into an equivalent pension is anyway not available, since cost-free annuities don't exist anywhere in the world, and certainly not in Sri Lanka. A lump-sum is inferior to a pension in that it places the burden on investment and sensible management on the retiree, and hence it provides no insurance against longevity in retirement. Most EPF retirees are condemned to a retirement in poverty, unless they have substantial other sources of retirement income.

The EPF Scheme is a relic of the mid-twentieth century, and will not meet the demands and needs of workers and retirees in the coming decades. The low notional retirement age of 50-55 years is an unsupportable anachronism when life expectancy has risen to more than 73 years. Most female EPF members can expect to spend more years in retirement than they spent in work. Improvements to the Scheme are possible and feasible, whilst retaining its funded nature which appeals to policy-makers. Reforms should aim for the following objectives:

(i) Replacing the current lump-sum benefit with a true pension benefit, albeit funded.

(ii) Substantially improving the overall replacement level of the retirement benefit without making recourse to government subsidies, or placing unreasonable new burdens on workers.

(iii) Eliminating the gender bias.

(iv) Improving overall labour market efficiency by making it easier for individuals to switch between employment sectors without losing pension benefits.

A strategy to do this should involve the following reforms:

(i) Convert EPF from a fully-funded, mandatory, defined-contribution individual accounts-based scheme into a fully-funded, mandatory, contributory defined-benefit national pension scheme, which would form the central element in a national pension system. This would require replacing the current lump sum with an actuarially determined pension benefit.

(ii) Gradually raise the age at which members stop making regular contributions and become entitled to a full pension benefit. This would need to be done over many decades, and with sufficient notice given to middle-aged workers.

(iii) Eliminate the gender bias against women who on average live longer than men, by eliminating the disparity in notional retirement ages.

(iv) Increase the contribution rate from 20 per cent to 22-24 per cent. In combination with raising retirement ages to at least 65 years, this would enable raising the replacement level to 60 per cent of average life-time wages.

(v) Inflation-index the pension benefit to prevent retirees being impoverished during retirement.

(vi) Maintain the central management of fund assets as now, but with attention paid to ensuring that the recent rates of return are maintained or improved to close to the underlying economic growth rate.

(vii) Substantially invest in the necessary human technical and actuarial resources required to run such complex social security schemes.

Any alternative set of reforms which either solely increase contribution rates or raise retirement ages will not be viable, as the required increase in rates or retirement ages would be too great to be acceptable. In addition, any changes will have to be accompanied by improvements in the retirement benefit such as providing a true pension entitlement, if they are to be acceptable. As often in life, a middle path is best.

Introduction

The Employees' Provident Fund (EPF) is by far the largest such fund in Sri Lanka. It was established in 1958, around the same time that similar provident funds were established in Singapore and Malaysia, then still under British colonial rule. In retrospect, given the relatively advanced state of welfare policy in Sri Lanka at that time, the motivations and rationale for establishing the EPF in Sri Lanka were quite similar to those in the more urbanized and economically developed Singapore and Malaysia. Policy makers in all three countries wished under ideal circumstances to adopt the state pension system as existing in what was then the British model, but practical and economic realities prevented such a system being realized. In Singapore and Malaysia, the Central Provident Funds (their equivalent of the EPF) were designed by British civil servants sent from London as second-best options to substitute for the perceived unfeasible UK pension model. In the case of Sri Lanka, the EPF was largely chosen and adopted as a model by Sri Lankan civil servants and political leaders, albeit at a time when they were perhaps more closely integrated than now to policy debates in the English-speaking world. The major difficulties preventing the adoption of a universal pension system at that time would have included the large proportion of the work-force who were in subsistence agriculture and non-formal employment, and the large proportion of the population who were not of adult age or participating in the work-force. In addition, the practical and technical difficulties of designing and managing a national pension system, given the then existing capabilities of the Sri Lankan state would have influenced policy makers, in addition to the relatively low rates of economic growth that Sri Lankan policy-makers had experienced since the global recession of the early 1930s induced by US trade isolationism.

Since 1958, the EPF has operated relatively smoothly under Central Bank supervision. It now controls the largest stock of savings in the country, and plays a major role in public policy, not only as a potential source of retirement income for its beneficiaries, but also as the major financier of the government structural fiscal deficit.

In recent years, both the actual and perceived shortcomings of the EPF system have attracted much debate. However, many of the most frequently alleged shortcomings and deficiencies are misplaced, and some of the most substantial deficiencies have been overlooked. Nevertheless, the relative success of the EPF can and should be built on to further improve its benefits for its current beneficiaries and to extend those to a larger cross-section of the workforce.

1. Establishment and Organization of the Employees' Provident Fund in Sri Lanka

1.1 Establishment and Enabling Legislation

The Employees' Provident Fund was established through legislation in the year 1958 by the Employees' Provident Fund Act, No. 15 of 1958. The main objective of the EPF is aimed at providing superannuation benefits to the corporate and mercantile sector employees, other than those employed in the Government and Local Government Service, and those who are self employed. Accordingly, the employees who are primarily covered by this Scheme are those in the private sector and public sector corporations.

It currently covers almost one-third of the total labour force. As of end of 2001, the Employees' Provident Fund maintained 8.8 million accounts of which, only 1.9 million were active accounts, and it had Rs. 247 billion in assets in its investment portfolio. It also remains a major source of borrowing by the Government.

1.2 Administrative Structure of the Scheme

By virtue of the original legislation, the general administration of the EPF was vested in the Commissioner of Labour, whilst fiduciary responsibility was entrusted to the Monetary Board of the Central Bank of Sri Lanka. The administration and the enforcement of the Employees' Provident Fund Scheme is thus shared between two institutions, which are the EPF Division of the Department of Labour attached to the Ministry of Labour and the Central Bank of Sri Lanka.

Much of the administrative activities are carried out centrally by the Department of Labour, whose head office is located in Colombo. The Department of Labour is headed by the Commissioner General of Labour, and certain of his staff are assigned to the EPF Division to carry out EPF-related activities. The Department's responsibilities mainly include:

(i) Registration of employers and members for the EPF
(ii) Recovery of contributions
(iii) Determination of payment of benefits
(iv) Checking of defaulters and taking legal action against them
(v) Liaison with the Central Bank and the other institutions for successful implementation of the Scheme.

The Commissioner General of Labour or an officer authorized on his behalf has the legal power to access any place of work, at any time of the day, to examine records or registers relating to the earnings of any employee.

The Monetary Board consists of three persons:

(i) Governor of the Central Bank of Sri Lanka as Chairman (ex officio)
(ii) Secretary to the Ministry of Finance
(iii) Nominee of H.E., The President.[1]

The Monetary Board is assigned with the responsibilities of:

(i) Receipt of all sums of money paid as contributions
(ii) Maintenance of a general account in respect of the fund
(iii) Maintenance of accounts of registered employments and members
(iv) Depositing contributions
(v) Investment of money and determination of interest
(vi) Preparation of balance sheets
(vii) Payment of benefits in accordance with the certification of the Commissioner General of Labour
(viii) Issuing of certificate of balance to the housing loan recipients
(ix) Notifying employers and employees who are members of the fund the balances lying in the account of each member
(x) Receiving surcharges

Most administrative functions of the EPF are executed by the Department of Labour. The Department of Labour's EPF Division is assigned the function of collecting contributions. In addition, the EPF itself has a small staff of approximately 100-150 persons, who are all seconded from the Central Bank to the EPF.

[1] For many years, this has been Mr. C. Chanmugam, a retired Finance Ministry official, and Senior Fellow at the Institute of Policy Studies.

1.3 Eligibility

The Scheme intends to provide social security to the persons employed in the private sector organizations, statutory organizations and all the employees who fall into the category of workers under what is termed 'Covered employment'. The operation of the Fund commenced with the publication of orders prescribing certain employment as 'Covered employment'. A 'Covered employment', as described by the Act is, any employment including any employment in the service of an establishment or an institution in the Private Sector, State-sponsored Corporations, Statutory Boards and Peoplised organizations whose capital or a part of whose capital is provided by the Government. As such, the Scheme covers both employers and employees for all employment other than those engaged under the Government of Sri Lanka, Local Government, or any Local Authority. Accordingly, the following categories of employees, both male and female, who are employed in an above-mentioned covered employment are entitled to membership of the EPF:

(i) Employees who are permanent, non-permanent,temporary, apprentices, casual employees, those who work in shifts during the day, those who work for a period less than one full day
(ii) Employees who work on piece rate, on contract basis, on commission basis, on quantum of work basis
(iii) Employees on monthly, weekly or daily wages
(iv) All ranks of employees from labour grades to management grades.

As the Employees' Provident Fund (Special Provisions) Act specifies, no employee is liable to be either a member of or pay contributions to any other provident fund, pension or superannuation fund or scheme other than the EPF after he/she has been appointed as an employee in a covered employment. At the same time, no employer is empowered to do the same in respect of his/her employees, or establish a provident fund, pension fund or any other superannuation fund or scheme with the intention of providing such benefits to his/her employees.

1.4 Enrolment

Enrolment function is conducted by the staff of the Department of Labour EPF Division, who are assigned to the operation of the EPF. Unlike most other retirement schemes in the country, the EPF deals only with employers, and not with the covered employees. As a mandatory system, the Scheme works on a compulsory contribution basis whereby employers are required to remit a portion of their employees' wages together with their employers' share of the contributions. Registration is thus the responsibility of the employer.

As the EPF is a mandatory Provident Fund, an employee working under covered employment becomes automatically entitled to gain membership of the Scheme from the first day of the commencement of work in such an organization. In fact, it is the obligation of the employer to take immediate action to register the new member under the EPF. As such, the employer is required to complete certain forms – A, B and H, and deliver them to the Labour Office of the area within 14 days of the recruitment of the new employee. After examining the forms, the Labour Office would return the form B to the employer along with the certification of the Deputy Commissioner of Labour in charge of EPF. The form B is considered as the certificate of membership, and thus is a valuable piece of document, since it is used in all subsequent transactions with regard to the EPF.

Once a member is registered he/she is also given a membership number, which is the number assigned to the individual account maintained by the Central Bank in respect of a particular member. Each year, a Statement of Account is issued under the above number specifying the amount lying in the account to the establishment to which the member is attached.

In the event that a certain employee changes occupation to work in another covered employment, he/she is not required to fill out another form B. Instead, he/she could present his/her existing form B over to the new employer and fill out a new form – form G. After completing the form G, the new employer is required to return both B and G forms to the Labour Office where a new number is given to the form B and returned back to the employer.

In those instances, where the information in the form B is wrongly entered, the Labour Office in the area has to be notified with appropriate supportive documents. These include a letter from the employer to prove that the names in the form B and the name of the member are the same, birth certificate, marriage certificate, and a photocopy of the National Identity Card certified by the Grama Niladhari and countersigned by the Divisional Secretary. Once this is done, the Labour Office will correct the details, and return the form B back to the employer.

An employee has the opportunity to nominate an heir to the EPF account in existence in respect of him/her.

1.5 Contributions

Contribution rates

EPF contributions are required to be jointly made by employer and employee, on a monthly basis. At its establishment, the employee and employer contribution rates for the EPF were set at 4 per cent and 6 per cent, respectively, of total earnings. Subsequently, the contribution rates were revised upwards twice, first to 6 per cent and 9 per cent (1981), and finally to the current rates of 8 per cent and 12 per cent respectively.

The original Enactment of the EPF also makes provision for both employees and employers to contribute higher percentages if they so wish. If such a decision is taken, the Commissioner General of Labour has to be notified immediately before such contributions are made. Where an employee and his/her employer opt to pay a higher percentage, such election is irrevocable and they are liable to pay the percentage specified in the notice sent to the Commissioner General of Labour.

The employers are required to pay the contributions, which consist of the money deducted from the salary of the employee and the amount paid by the employer in respect of the employee to the Fund before the end of each month.

The contributions payable to the Fund are computed on the total earnings as follows:

(i) Salary, wages or fees
(ii) Cost of living allowance, special living allowance and other similar allowances
(iii) Payments made in respect of holidays
(iv) Cash value of food supplies, cooked or otherwise
(v) Food allowance
(vi) Any other kind of remuneration that may be specified.

Contribution procedures

The employer is obliged to remit due contributions to the EPF. In procedures that were established at inception in 1958, this is done by the employer filing with the EPF each month, a schedule containing the details of the members (name, number, amount of contribution, etc.), together with payment. The EPF on receipt of the payments, then updates the individual member accounts with the credits, a process that used to be done wholly manually, but is now computerized. Payment is usually done by cheque.

EPF is engaged in several measures in recent years to streamline and modernize this process. First, the collection of remittances has been centralized at the head office in Colombo, starting in 1998. Second, a scheme was started in 1999 to permit large employers, with a computerized pay roll to submit their information electronically via diskettes and email. In this scheme, employers also have the option to make payments electronically through the Sri Lanka Inter-bank Payment System (SLIPS), instead of sending cheques. In the first two years, this scheme was extended to 100 employers. In 2001, the account reconciliation system, which was previously done manually, was computerized, and now electronically obtains daily statements from the banks.

In the event that an employer fails to make the due contributions on the due date, he/she is liable to be charged with an additional surcharge, if the reasons for the delay in payments are unsatisfactory. At the commencement of the Fund, as specified in the Principal Enactment, where the contributions are in arrears for a period not exceeding one month, a surcharge compounded at 10 per cent of the amount of the contributions due was charged. If the back payments are for a period between 1-3 months then the employer was liable to be charged 15 per cent of the amount of the contributions due. If the said period is for 3-6 months the surcharge falls at 20 per cent and in the event that the period of arrears exceeds 6 months the surcharge was to be set at 25 per cent of the contributions due.

The above specification with regard to the surcharge on neglecting payment of premia was repealed by an amended Act in 1981 with new regulations. As such, under the amended Act, when the contributions are in arrears for a period not exceeding 10 days, a surcharge of 5 per cent of the contributions is due and if the said period is between 10 days and 1 month, the surcharge is at 15 per cent. If it is between 1 month and 3 months, the add-on amount is 20 per cent of the contributions and in the event that it is for a period of 3-6 months, the amount charged is 30 per cent. If the arrears are for a period exceeding 6 months but not exceeding 12 months, the charge is 50 per cent and if it is more than 12 months, the surcharge would be 50 per cent of the contributions due.

When the employer is unable to settle the default in the payments by paying outstanding premia along with the prescribed amount of surcharge, the Commissioner General has the authority to issue a certificate via a District Court, and seize and sell all movable and immovable property of the employer, in order to recover the due amount.

Further, the Act prohibits any employer to reduce earnings of his employees or bar them from access to other benefits provided by him by reason of his liability to pay contributions or surcharges in the event of arrears in respect of his employees. At the same time, he is not entitled to deduct any amount from the earnings of the employee to substitute for the share he is liable to pay in respect of the employee.

Despite these penalties, employers frequently fail to register their employees and to make the necessary payments. In the past, this was often without the knowledge of the employees, who believed that the contributions have been made. Often, this is discovered only when the employee retires, and attempts to collect their account balances from the EPF. This particular problem arises essentially because historically only the employer communicates with EPF. However, by communicating fund balances on a regular basis directly to the employee, the EPF would be in a position to identify those cases where the employee is not aware of the failure to make payments. However, such a policy would not address those instances where the employer fails to register the employees, and makes no attempt to deceive them, on many occasions with the connivance of the employees. The EPF has instituted measures in recent years to send members statements of their account balances on a half-yearly balance, but it was not possible to evaluate how effective this has proved in improving overall compliance.

1.6 Benefits

The core objective of the EPF is to provide an employee with a means of income security in the form of a lump sum benefit on retirement from employment. Therefore, the core benefit that the members of this Fund are entitled to is a superannuation benefit upon retirement on reaching the statutory age of retirement. This age is 55 years for male members, and 50 years for female members. This lump-sum benefit consists of the cumulated contributions to the individual member's account, together with the cumulative interest credited to it by the EPF.

In addition to the payment of a lump-sum at the nominal retirement age, the EPF has provided a number of additional benefits in recent years. In 1988, the EPF Act was amended to permit members to pledge up to 75 per cent of their account balances as collateral for housing loans from approved state banks. In 2000, this was further extended to permit obtaining a second loan, on settlement of the first loan. However, 90 per cent of members availing themselves of this benefit have defaulted on their housing loans, indicating that they regard it as a means of withdrawing their balances. Yet this is an extremely inefficient way of doing so, since the EPF charges not only the unpaid principal and interest to their account balances, but also a 30 per cent penalty. Nevertheless, the number of members making use of this facility has increased. In 2001, the EPF issued more than 16,000 approvals for such loan collaterals, representing Rs. 2,091 million in total loans.

In addition to the age limits, there are certain other instances where the members are granted the opportunity to obtain the benefits. Under the EPF Act, there is provision for members to make early withdrawals from the fund under restricted circumstances, such as, in the event of cessation of employment due to reasons of health, marriage, permanent migration etc. For instance, the Act provides the female members to claim the superannuation benefit in the event where she ceases to be employed, as a result of entering into marriage. Such a female member is entitled to claim her benefits if she is married within 3 months of leaving service or in the event that she has left service within 5 years of marriage.

The occurrence of a permanent and total disablement of a member, who is rendered incapacitated as a result of the disability and is unable to work, also entitles the member to withdraw the sum of money credited to his/her account. However, he/she could do so only upon provision of a certificate certified by a medical practitioner, registered under the Medical Ordinance, stating the employee's incapability of work as a result of his disabled condition. If the Commissioner General of Labour has reason to doubt the veracity of the medical certificate submitted by the member, he has the authority to refer the member for a re-examination by a Medical Board or a Government Medical Officer. If the previous certificate submitted by the member is found to be false by such re-examination, the Commissioner General could reject the certificate and refuse to accept future certificates issued by such registered medical practitioner.

A member also has the possibility of claiming the amount of money from the Fund lying in his account in the event of migration to another country outside Sri Lanka. At the same time, a member, who commences work in a pensionable employment after ceasing to be employed in a covered employment is also entitled to gain the benefit disregard of the age requirement. As such, according to specifications in the Amendment Act of the EPF (Amendment Act, No. 1 of 1985) the persons who take up employment in the following sectors are considered as employment in a pensionable employment; employment in the Public Service, in the local Government Service constituted by the Local Government Service Act, No. 16 of 1974, in the District Service established under Section 47 of the Development Councils Act, No. 36 of 1980, in the service of any local authority other than as a member of the Local Government Service.

At the same time, those who leave service due to the closing down of a corporation, due to its peoplization or conversion into a Company or due to retrenchment are also able to claim the benefits of the Fund before he/she reaches the statutory age of retirement. Similarly, when employees are retrenched from a state Corporation, when a Government business undertaking or Corporation is converted into a public company or is closed down, the members are entitled to receive the EPF benefit.

In the event that a certain member continues to work even after attaining the defined statutory age, he/she is entitled to benefits for the period exceeding the statutory age, and the Fund is liable to pay him/her a sum in this regard for such period. Further, the Act also allows no member to withdraw any money credited to his account more than once within a period of 5 years.

If a member dies before he is entitled to receive the sum in the account in his/her name, or before receiving after becoming entitled to it, the Act provides for the member to nominate an heir to the EPF and the money to be paid to the person nominated by him/her. A member has the possibility of nominating one or more heirs. If there is more than one nominee, the sum is to be divided among them all equally unless the deceased member has stated the share of the sum to be given to each nominated person. If there is no such person nominated by him/her, the legal heir of the deceased member is entitled to the amount by order of court under the Inheritance of Property Act.

1.7 Approved Private Provident Funds and Approved Contributory Pension Schemes

The original Employees' Provident Fund Act made provision for the setting up of Approved Private Provident Funds (APPFs) and Approved Contributory Pension Schemes, and therefore could be substituted by the latter schemes provided they meet the basic contribution requirements stipulated by the government. As the principal enactment specifies under Section 27, where such a scheme has been established before the appointed date for the benefit of any employees in a covered employment, the administrators of such a scheme should furnish the Commissioner with particulars relating to the scheme or fund within 3 months of declaration of that employment as a covered employment. If the Commissioner is of the opinion that the alternative scheme fulfils the stipulated requirements, he will declare such a fund or scheme as an approved provident fund or an approved pension scheme. After such declaration, the contributions from employees of such an employment are not payable to the Employees' Provident Fund but are payable to the new fund or scheme instead.

In the event that an employer of a covered employment wishes to establish such a fund or scheme, he could forward the prescribed particulars related to same to the Commissioner. If the Commissioner approves of it after examining the particulars, he could declare it as an approved provident fund or an approved pension scheme. Similar to the above case, the contributions to the EPF by the employees of such a fund or scheme cease if the Commissioner approves of the new fund or the scheme and the employees are required to pay the contributions to the new fund.

However, if an employee liable to pay contributions to the EPF has joined an employment functioning under an approved fund or a scheme, or is covered by the new scheme or fund as a result of an establishment of the new approved fund or the scheme, the balance lying in the EPF is retained in the EPF account in his/her name to be paid under the circumstances of paying benefits described earlier. When an approved provident fund is wound up, the administrator of the fund is required to transfer all the contributions and interest lying in the approved provident fund to the Employees' Provident Fund. Such transfer of money to the EPF is also required when a member of an approved provident fund begins work in a covered employment where there is no approved provident fund but where the contributions are paid to the EPF. In such a circumstance, after the member informs the Commissioner of his/her new employment and requests his/her account in the approved provident fund in the previous employment to be transferred to the EPF, the Commissioner would inform the responsible administrators in writing to direct the ex-employee's fund and interest to the new account opened in his/her name at the EPF.

According to the Act, the rules and regulations pertaining to the newly established approved fund or the scheme cannot be changed without consulting the Commissioner. If the administrator of an established approved provident fund fails to comply with the regulations and rules in respect of it or where the fund or the scheme is not approved by the Commissioner or where the Commissioner is not satisfied with the management of the fund or the scheme, the contributions and the interest thereon have to be transferred to the EPF. When the money is transferred to the EPF, the Monetary Board will open an individual account with regard to each of the employees and credit the money lying in the previous account to the new one.

Further, when an employer of an approved scheme or a fund fails to pay the due contributions on or before the due date of each month to the dissatisfaction of the Commissioner, the employer is liable to pay a surcharge as follows:

(i) When contributions are in arrears for a period not exceeding 10 days, a surcharge of 5 per cent of the contributions due
(ii) When contributions are in arrears for a period exceeding 10 days but not exceeding 1 month, a surcharge of 15 per cent of the contributions due
(iii) When contributions are in arrears for a period exceeding 1 month but not exceeding 3 months, a surcharge of 20 per cent of the contributions due
(iv) When contributions are in arrears for a period exceeding 3 months but not exceeding 6 months, a surcharge of 30 per cent of the contributions due
(v) When contributions are in arrears for a period exceeding 6 months but not exceeding 12 months, a surcharge of 40 per cent of the contributions due
(vi) When contributions are in arrears for a period exceeding 12 months, a surcharge of 50 per cent of the contributions due.

The money thus received as surcharge is deemed as income of that fund or scheme and is distributed among the members of the fund.

This study has not engaged in a separate review of the existing APPFs and their operation. However, the World Bank (2000) reports that 60 per cent of the APPFs under-performed the EPF during 1995-2000 in terms of investment returns.

1.8 Operational Activities

Administration

The EPF is economical in its use of resources for administration. The EPF employs relatively few persons to manage its operations, and it is in a position to enjoy economies of scale, and also has the advantage of enjoying considerable institutional stability for a long period of time. As explained above, the EPF relies primarily on 500 or so dedicated staff of the Department of Labour EPF Division, and 100-150 staff of the Central Bank for its administrative operations, including collection of contributions. All such expenses incurred by these two agencies in carrying out their EPF functions are in theory charged to the Fund. In recent years, such annual expenses as charged, have ranged between Rs.100 and 290 million (Table1.1). This has represented approximately 0.1 per cent of total fund assets, which is extremely low by international standards (World Bank, 2000). The issue that these reported expenditures do not include all relevant costs, such as staff costs has been raised. Nevertheless, whatever the discrepancy, the overall annual expenses of the EPF operations would still represent less than 0.15 per cent of total fund assets.

Enrolment and coverage

In its first year of operation, EPF enrolled 400,000 members. By end of 2001, there were 8.8 million member accounts at EPF. However, only 1.93 million of these accounts were active, the rest being inactive in most cases because the employee had shifted employment.

Table 1.1: Administrative expenses of EPF, 1980-2001 (Rs. Million)

Year	Labour Dept (Rs.Mn)	Central Bank (Rs. Mn)	Total Expenses (Rs.Mn)	Fund Assets (Rs. Mn)	Investment (Rs. Mn)	Expenses as % income
1980	2	10	12	5,013	392	0.2
1981	2	12	14	6,128	548	0.2
1982	3	14	17	7,524	749	0.2
1983	3	15	18	9,342	1,004	0.2
1984	3	18	21	11,691	1,289	0.2
1985	10	18	28	14,722	1,690	0.2
1986	11	17	28	18,452	2,098	0.1
1987	12	21	33	22,569	2,560	0.1
1988	16	26	42	27,977	3,085	0.1
1989	19	28	47	33,696	3,369	0.1
1990	21	34	55	40,471	4,090	0.1
1991	19	42	61	48,809	5,091	0.1
1992	22	57	79	58,086	6,227	0.1
1993	25	61	86	70,852	8,250	0.1
1994	30	64	94	85,387	10,097	0.1
1995	33	78	111	102,326	12,044	0.1
1996	40	87	127	122,329	14,120	0.1
1997	42	102	144	144,092	15,941	0.1
1998	53	123	176	167,470	18,742	0.1
1999	64	121	185	193,846	20,575	0.1
2000	103	156	259	222,928	23,697	0.1

Source: "Employees' Provident Fund Annual Accounts" Reports (various years).

Analysis of LFS 2000 data indicates that out of an estimated 6.7-6.9 million working population (excluding the Eastern and Northern Provinces), 2.8-2.9 million were employees employed in the private sector. Not all of these would necessarily be eligible to participate in the EPF, but this indicates that 65 per cent is a reasonable lower-end estimate of the effective coverage of the target population. Overall, approximately, 30-35 per cent of the active labour force are active contributors to the EPF at any one time.

Total member balances by end of 2001 had reached Rs. 256 billion, representing an average account balance of Rs. 30,000/=. However, the average accumulated balance totals for individual members would be higher than this, since many members have more than one account. In 2001, there were 93,000 refunds of members' balances, representing Rs. 11.2 billion in assets, which indicates that currently retiring members have terminal account balances averaging Rs. 120,000/=.

Investment of funds

The Monetary Board of the Central Bank is responsible for managing the investments of the EPF. It should be noted that the other statutory responsibility of the Monetary Board is to ensure that the government places its debt issuance in the most economical manner.

Historically, the EFP has invested predominantly in privately-placed Government of Sri Lanka loans, and other government securities such as treasury bills and bonds. In recent years, it has been permitted to invest in equities and other instruments, and secondary market activities. The Central Bank has trained fund managers since 1999 to manage such diversified investments, but the overall share allocated to such investments remains small (Table 1.2), and total equity investments were only 0.5 per cent by end of 2001. At the same time, it should be noted that the EPF faces a major constraint to rapidly shifting its investments out of government debt, which is that the most likely place for such investments – the Colombo Stock Exchange – is itself smaller than the EPF total assets and too illiquid to absorb such funds on a large scale.

Table 1.2: Allocation of investments by EPF, 1999-2000

	1999 (Rs. Million)	2000	1999 %	2000 %	2001 (Rs. Million)	2002	2001 %	2002 %
Government of Sri Lanka Loans	151,507	157,155	81.50	73.20	178,003	172,455	72.10	61.03
Treasury Bonds	26,912	47,303	14.50	22.00	60,998	100,310	24.71	35.50
Treasury Bills	2,845	4,798	1.50	2.20	2,627	2,623	1.06	0.93
Repurchase Agreements	915	1,622	0.50	0.80	1,122	3,464	0.45	1.23
Debentures	2,998	2,639	1.60	1.20	2,684	2,299	1.09	0.81
Commercial Papers	23	0	0.00	0.00	0	0	0.00	0.00
Trust Certificates	105	82	0.10	0.00	75	0	0.03	0.00
Unlisted Shares	72	72	0.00	0.00	103	103	0.04	0.04
Listed Shares	539	1,159	0.30	0.50	1,264	1,311	0.51	0.46
Total	185,916	214,830	100.00	100.00	246,875	282,563	100.00	100.00

Source: "Employees' Provident Fund Annual Accounts" Reports (various years).

2. Review of Investment Performance and Returns

The investment performance of the EPF is frequently criticized, and this has been a major rationale for recent calls for its reform. However, much of that criticism is either misplaced, based on selective use of facts, or simply the advocacy of vested interests.[2] It is not the purpose of this review to undertake a detailed assessment of the EPF investment performance, but a brief review of the facts is appropriate given the centrality of this issue.

2.1 Payment of Interest

Interest on members' account balances is paid yearly, after determination by the Monetary Board. In general, this rate is essentially the investment return for the year, net of the modest administrative expenses of the Fund, taxes to government, and other allowances set aside. The income tax liability is 10 per cent of the gross income received as interest and dividends. There is no tax paid on capital gains on treasury bills and bonds, and shares, as these are exempted from tax under the tax laws.

Overall, almost 99 per cent of total investment rturns are paid to members, as shown in (Table 2.1), which outlines how the total investment return after tax was distributed in 1999 and 2000.

It should be noted that the declared official rate of interest paid on members' accounts understates the effective rate of interest paid, as the official rate is paid on the accumulated balances at the end of the year, on 31 December. So for example, the official rate of interest declared for 2000 was 11.5 per cent, but this was equivalent to a rate of 11.69 per cent on actual balances during the year.

2.2 Return on Investments

The EPF has been in operation for more than 40 years, and obtaining market returns on the assets represented by members' balances has not been the major concern for that whole period. Certainly, it was not the case during the first two decades of operation, when the historical legacy in Sri Lanka was of a country with both low levels of inflation and low economic growth rates. In this low interest, low inflation, low growth environment, the EPF's initial policy of maintaining with

Table 2.1: Use of post-tax investmet income of EPF, 1999-2000 (Rupees)

Total income net of taxes	24,093,394,607	
LESS Interest paid on refunds (current year)	-696,801,615	
LESS Balance carried forward for next year	-122,036,004	
Available Income	23,274,556,988	
	Allocation of Income	
Administrative Expenses	258,790,867	1.1%
Allocation to Building Reserve Fund	0	0.0%
Allocation to Technology Reserve Fund	100,000,000	0.4%
Allocation to Profit Equalization Reserve Fund	100,000,000	0.4%
Interest at 11.5% on Members' Balance	23,019,539,705	98.9%

Source: "Employees' Provident Fund Annual Accounts" Reports (various years).

[2] It is evident that some of the most vocal calls for restructuring of the EPF Scheme and its investment operations come from individuals in the private fund management industry, who would be the most direct beneficiaries of any such changes.

infrequent annual changes, a constant administered interest rate on members' balances was largely effective in ensuring that the real annual return on members remained positive, and the annual real rate of return averaged 1.0-2.4 per cent up to 1967.[3] This was largely in line with underlying growth in real GDP per capita (Table 2.2).

However, the environment began to change in the late 1960s. First, the oil crisis of 1974 and emerging economic difficulties led to a rise in underlying inflation in the economy. Although the Monetary Board began to increase the administered interest rate every year after 1968, there was clearly a time lag in the response, resulting in deterioration in the real rate of return on members' balances. During 1968 to 1977, the real rate of return deteriorated, and averaged only -0.3 per cent to -4.5 per cent. Second, in the late 1970s, economic liberalization had two major structural impacts. Economic growth accelerated and has averaged 4-6 per cent per annum since 1978, and a closely-linked shift into structural budget deficits have led to a higher inflation and interest rate environment. This environment of faster per capita income growth placed a premium on the EPF obtaining real positive rates of return on members' balances in order to ensure that final balances kept pace with rising wages, but it would appear that this again took time to have an impact on the overall policy agenda. The high inflation rates also made it more difficult for the EPF to achieve real positive rates of return, and this would also have taken some time for adjustment. There is a clear deterioration in real rates of return during the period 1977-1990, and the average real rate of return during this time-period was -1.25 per cent to -1.50 per cent per annum. The combined impact of this sustained deterioration in investment returns was that the EPF proved a poor custodian of the members' balances during 1968-1990.

However, perhaps in response to such criticisms, the EPF has substantially improved its performance since 1990, and has evidently managed to incrementally improve its performance. During this period, it has progressively raised the real rate of return on members' balances from close to zero to almost 4 per cent (Table 2.1). The recent performance is close to the underlying rate of growth in real per capita income in the economy. Given the large size of EPF assets, this is close to the maximum possible rate of return for any such fund, since the long-run return on investments in an economy cannot rise much beyond underlying economic growth.

Most of the voiced allegations of EPF underperformance have been based on averaging the long-run rate of return since its inception. The geometric mean of the annual real rates of return between 1958 and 2000 lies between 0 per cent and 0.2 per cent. However, this ignores the quite substantial changes in the economic and policy environment that the EPF has faced during that time-period. A more relevant analysis is of recent rates of return, which are probably the best pointer to future rates of return by the EPF. These indicate that the EPF in fact has performed quite well, achieving close to what is the theoretical maximum that would be expected of such a fund, given underlying GDP growth. This conclusion is strengthened by the observation that the majority (60 per cent) of privately-managed APPFs have in fact achieved worse real rates of return than the EPF during the period 1995-2000.

The EPF enjoys considerable economies of scale in managing its assets, resulting in very low administrative charges – certainly much lower than what a privately managed fund would charge. Combined with its improving performance in the past decades, leads to a conclusion that the investment returns of the EPF are in fact good and unlikely to be improved upon by radical changes.

[3] The real rate of return on members' balances is the difference between the nominal rate of return and the underlying rate of inflation. The EPF publishes such estimates in its annual report, based on the inflation rate. However, the GDP deflator is probably a better index of underlying inflation than the official inflation indices, and so Table 3.2 also calculates the real rate of return based on using the Central Bank GDP deflator.

Table 2.2: Rates of return on EPF member's balances, 1960-2002

Year	Official Rate of return declared	Effective rate of return	Inflation	GDP deflator	Real rate of return 1	Real rate of return 2	Cumulative real of return since 1960	3 year average of real rate of return
1960	2.50		(1.62)					
1961	2.50		1.26	(1.70)	1.24	4.20	4.20	
1962	2.50		1.43	(1.42)	1.07	3.92	4.06	
1963	2.50		2.35	1.65	0.15	0.85	2.99	2.99
1964	2.50		3.13	0.51	(0.63)	1.99	2.74	2.26
1965	2.50		0.27	0.10	2.23	2.40	2.67	1.75
1966	2.50		(0.18)	(0.50)	2.68	3.00	2.73	2.47
1967	2.50		2.23	2.23	0.27	0.27	2.38	1.89
1968	3.00		5.84	10.22	(2.84)	(7.22)	1.18	(1.31)
1969	3.50		7.41	4.05	(3.91)	(0.55)	0.99	(2.50)
1970	4.00		5.90	3.63	(1.90)	0.37	0.92	(2.47)
1971	5.00		2.68	3.50	2.32	1.50	0.98	0.44
1972	5.00	6.50	6.27	4.35	0.23	2.15	1.07	1.34
1973	5.50	6.62	9.68	17.41	(3.06)	(10.79)	0.16	(2.38)
1974	6.00	6.85	12.33	26.03	(5.48)	(19.18)	(1.22)	(9.27)
1975	6.00	6.56	6.73	7.26	(0.17)	(0,70)	(1.18)	(10.22)
1976	6.00	6.34	1.21	6.01	5.13	0.33	(1.09)	(6.51)
1977	7.50	7.94	1.25	18.71	6.69	(10.77)	(1.66)	(3.71)
1978	7.50	8.13	12.11	7.83	(3.98)	0.30	(1.55)	(3.38)
1979	8.00	8.56	10.76	15.69	(2.20)	(7.13)	(1.84)	(5.87)
1980	8.50	9.05	26.12	18.17	(17.07)	(9.12)	(2.21)	(5.32)
1981	9.50	10.03	17.98	20.50	(7.95)	(10.47)	(2.60)	(.891)
1982	10.00	10.55	10.84	9.92	(0.29)	0.63	(2.46)	(6.32)
1983	12.00	12.62	13.96	14.60	(1.34)	(1.98)	(2.43)	(3.94)
1984	12.50	13.17	16.64	17.02	(3.47)	(3.85)	(2.49)	(1.73)
1985	12.50	13.21	1.46	0.97	11.75	12.24	(1.90)	2.14
1986	12.50	13.17	7.98	5.83	5.19	7.34	(1.55)	5.24
1987	12.50	13.02	7.72	6.98	5.30	6.04	(1.27)	8.54
1988	13.00	13.60	13.99	11.55	(0.39)	2.05	(1.15)	5.14
1989	11.00	11.45	11.57	9.59	(0.12)	1.86	(1.05)	3.32
1990	11.50	11.93	21.49	20.01	(9.56)	(8.08)	(1.28)	(1.39)
1991	11.50	11.97	12.19	10.98	(0.22)	0.99	(1.21)	(1.74)
1992	11.50	11.87	11.39	9.98	0.48	1.89	(1.11)	(1.73)
1993	13.50	13.99	11.74	9.47	2.25	4.52	(0.94)	2.47
1994	12.75	13.17	8.45	9.35	4.72	3.82	(0.80)	3.41
1995	12.75	13.15	7.67	8.43	5.48	4.72	(0.64)	4.35
1996	12.75	13.12	15.94	12.10	(2.82)	1.02	(0.60)	3.19
1997	12.75	13.03	9.60	8.93	3.43	4.39	(0.47)	3.28
1998	12.75	12.46	9.40	9.21	3.06	4.02	(0.37)	3.79
1999	11.50	11.72	4.70	4.16	7.02	7.27	(0.17)	4.97
2000	11.50	11.69	6.20	7.28	5.49	5.00	(0.05)	5.07
2001	11.50	11.69	14.20	13.66	(2.51)	(0.71)	(0.10)	3.33
2002	12.10	12.26	9.60	8.32	2.66	3.96	(0.0035)	2.12
	Average	8.35	10.95	10.68	11.30	0.21	(0.06)	

Note: Real rate of return 1 is calculated using the inflation rate used by EPF in its Annual Report, and Real rate of return 2 is based on the GDP deflator of the Central Bank.

Source: "Employees' Provident Fund Annual Accounts" Reports (various years), and authors' calculations.

3. Assessment of ability of Employees' Provident Fund to provide social security to its target population

The primary purpose of the EPF Scheme is to ensure that the eligible employed have increased income security during old age. By design, it aims to achieve this by providing members with a lump-sum of savings at the age of 55 years. The members are free to utilize these funds at that point in any manner they wish. The EPF does not provide a pension in the sense of a commitment to provide regular periodic payments to retired members, and does not provide any options for the members to reinvest their savings in an annuity. The Scheme is fully-contributory and does not require additional government subsidies.

The key questions with respect to the savings component are thus:

(i) Does the EPF Scheme, as presently constituted, provide a basis for an adequate level of replacement income for its members in old age?
(ii) Does the Scheme effectively reach its target population of the employed workers?
(iii) If the EPF Scheme does not provide its members with the basis for an adequate level or replacement income, are there feasible alternatives consistent with its current operations?

The cursory review that has been possible in this study indicates that the answer to the first question is no. The answer with respect to the second question is yes to a large extent. The answer to the third question is almost certainly yes, and is addressed in Section 4.

3.1 Adequacy of Retirement Income

The EPF scheme suffers from three major deficiencies in this respect:

(i) The Scheme does not offer its members a pension or any regular periodic income after they retire, nor any options for members to obtain this with their lump-sum. This implicitly places the full risk for above-average longevity on the individual member, and places the burden for effective investment of savings after withdrawal on the member
(ii) Assuming that members were able to obtain at no cost actuarially-fair annuities to invest their lump-sum in,[4] the likely level of replacement income for most workers will be only 20-45 per cent of average wage, and will decline as the individual ages in retirement[5]
(iii) In most countries, public policy has an interest in ensuring a minimum level of pension for the lowest-wage workers, and this usually requires some redistribution within a pension system, as these workers universally are unable to accumulate enough savings to obtain a retirement income that would keep them above the poverty line. This is not possible with the EPF scheme, as this is purely an individual account-based system, with no possibility for risk-pooling or redistribution.

Lack of a periodic retirement income payment

The first deficiency is explicit and follows from the original design of the Scheme. However, most individuals would prefer to have a long-term periodic retirement income rather than a lump-sum. As demonstrated by the Farmers', Fishermen's and Self-Employed social security schemes, it is possible to provide a regular pension payment in a contributory scheme. However, the EPF differs from these other schemes in that it does not involve any government subsidy. Since the final payments are based purely on the member's actual contributions, there is no provision or requirement for any government subsidy or guarantee. If the EPF was to provide a pension benefit instead of a lump-sum benefit, it would need to use detailed actuarial analysis to ensure that benefit payments are matched to the Fund's underlying assets. The Fund providing such a benefit has significant advantages over the only other alternative, which is for the members themselves to obtain annuities:

(i) In practice, annuities cannot be obtained without considerable charges in the private market. A centrally-administered pension scheme eliminates such management transaction costs

[4] This is purely hypothetical, as private markets are not able to offer such annuities. Even in the largest and most sophisticated annuity markets of the USA and UK, such annuities typically carry a minimum 30 per cent charge.

[5] It is possible to design an annuity which is inflation-protected, but these are in practice unusual and depend on the availability of government-guaranteed inflation-linked securities, which are increasingly in short-supply globally. No such annuities are available in South Asia.

(ii) A centrally-funded pension scheme has more options for providing inflation protection in its pension payments than what members would have in the private annuity market, where such products are generally not available.

Low level of replacement income

The second deficiency relates to the low-level of replacement income. Member withdrawals in 2001 averaged Rs. 80,000/=. Assuming that it was possible to convert this into a no-cost 25 year annuity at 12 per cent interest,[6] this would translate into a monthly payment of Rs. 850/= (equivalent to $0.30 per day), which was less than 14 per cent of the average GDP per capita level in that year, and well below the poverty line. A couple consisting of two such members would still have a combined income of less than the monthly payment in the government's main poverty programmes. If this was their sole source of income, they would find themselves in the bottom decile of the income range. EPF members thus cannot rely on their EPF accounts to be their predominant source of income, if they wish to remain above the poverty line, or even have sufficient food to eat.

To only a limited extent does the inadequacy of the annuity value of the lump-sum reflect under-performance of the EPF in managing its investments. The average EPF member retiring in 2001 most likely experienced an average rate of return on their account balances of approximately 0 per cent. Even if the real rate of return had been consistently 2-4 per cent per annum,[7] this would only have increased their lump-sum payment by 50-100 per cent. Even in that scenario, the equivalent annuity level (Rs.1,200/= Rs. 1,700/= per month) would still have kept them below the poverty line.

The major reason for the implicit low replacement level in the EPF scheme is the short period of contributions in contrast to the likely life expectancy faced by members. Even a member who enrols at the age of 18 years, can only hope to make 38 years of contributions in comparison with his life expectancy at age 55 years of over 23 years. The situation is even more stark in the case of a woman. Assuming she does not temporarily withdraw from the labour force for reasons of child-birth and child-rearing, as many do in Sri Lanka, she would only be able to make contributions for 32 years (till age 50), in comparison with an average life expectancy at age 50 years of almost 32 years. If contribution rates are in the range of only 20-25 per cent, it is simply not possible for any investment system consistent with the laws of economics to translate her lifetime savings into a retirement income which is more than 30 per cent of her average lifetime wage. This indicates that the major route to boosting the value of the retirement benefit in EPF is to increase the overall period of contributions. This can be done in two ways:

(i) Extending the standard period of contributions beyond 55 years for men, and increasing the age limit for women beyond 50 years, so as to at least reach parity with men.
(ii) Removing an upper age limit for making contributions, and permitting those who wish to continue working after the standred age limit to do so, and to continue to make contributions to the EPF in return for actuarially fair increases in their final entitlements.

Other factors that lead to inadequate member balances at retirement include mobility of workers between jobs which are covered by EPF and those which are not. The options for transferring accumulated retirement benefits between schemes are non-existent, except in the case of the APPFs and the EPF. Providing such mechanisms would enable individuals to build up their retirement income provisions, despite switching jobs, and would increase overall job mobility in the economy.[8]

3.2 Coverage of EPF

The EPF is targeted at the employee workforce in the public and private sectors, other than those who are already covered by other pension or superannuation arrangements. It is not possible to make a detailed analysis of its coverage in this study, but based on the reported numbers, it does appear to reach at least 65 per cent of its target population.

6 25 years is a conservative estimate of the life expectancy at the age of 55 years.

7 An investment return of higher than 2 per cent is unlikely since that would have been greater than underlying growth in real GDP per capita during the relevant time period.

8 To this extent, a national pension system with such provision would contribute to overall labour market flexibility and economic efficiency.

It is known that some employers do attempt to evade EPF registration. However, there are no reliable estimates of the extent to which this occurs, and how many persons are failing to be covered as a result, and their characteristics by type of employer and demographics. It is recommended that this be best investigated by adding a special module to either the regular Central Bank Consumer Finance Survey or the Census and Statistics Department's Labour Force Survey, to actually check the EPF registration status and contribution record of household respondents.

4. Possible Reform Strategy for the EPF Scheme

It is not in the scope of this study to develop detailed reform options for the EPF Scheme. However, the assessment undertaken points to a possible strategy for making the EPF Scheme a more effective and sustainable retirement income scheme, and one better suited to the needs and potential of its second half-century.

4.1 Objectives of a Reform Strategy

The elements of such a reform, if taken together, would have the following objectives:

(i) Providing members with an actual pension or periodic retirement income, instead of the current lump-sum payment, with better risk-pooling to protect against the effects of above average longevity

(ii) Substantially improving the overall replacement level of the retirement benefit without making recourse to government subsidies, or making unreasonably large changes to the Scheme's obligations or burdens on workers and employers

(iii) Eliminating the gender discrimination in the current Scheme that effectively guarantees that women have worse retirement provision than men

(iv) Reducing the need for tax-funded transfers to alleviate poverty in the poorest retirees by partially addressing this within a single pension scheme

(v) Improving overall labour market efficiency, by making it easier for individuals to switch between sectors without losing pension rights.

4.2 Elements of the Reform Strategy

i. Convert EPF into a contributory pension Scheme

The EPF would be converted from a mandatory, contributory, individual accounts-based scheme into a mandatory, contributory national pension system for all employees. Individuals and employers would continue to make fixed monthly contributions as now, but instead of crediting them to individual member accounts, they would be credited to a single national fund. In practice, this is no different to what actually happens currently, but there would no longer be a notional rupee balance in each member's account. Instead of accumulating a rupee balance as now, members would accumulate notional credits towards a final pension. As current members might be reluctant to lose their existing account balances, this might be introduced incrementally, either solely for new enrollees or on a mixed basis for all new contributions, which would involve preserving the existing accumulated balances of current members and enrolling new members on the new basis.

ii. Convert the lump-sum benefit into a pension benefit

Instead of simply refunding the accumulated savings to each member on retirement age, the pension fund would provide them with an entitlement to a periodic pension from the notional age of retirement till death. The value of this pension would be actuarially calculated and would be equivalent on average to what they currently obtain as a lump-sum benefit. This would not require a government subsidy, as the total value of all pension commitments would be matched by fund assets. Each individual's pension entitlement would be linked directly as now to their lifetime contribution history. Implementation of this element would require the EPF and the country to invest in training of actuaries and related human resources, and in developing institutional mechanisms to ensure that actuarial advice can be obtained by the Fund and by Parliament without undue political interference.

iii. Gradually raise the age at which members stop making regular contributions and become entitled to a pension in a pre-announced schedule

Ultimately the pension age should be linked to increases in life expectancy. However, to make up for the failure to adjust the retirement age since 1958, there would have to be an interim period when the retirement age is raised faster than the increase in life expectancy. Given current life expectancy in Sri Lanka, and trends in other countries with similar demographic profiles, such a schedule might consist of raising the retirement age by 6 months every year until the retirement age reaches 67 years. This would raise the male retirement age in the EPF from 55 years to 67 years over a quarter of a century. Since this would have major implications for those workers currently in their 40s who would have expected to retire at the age of 55 years, there might be special procedures to protect their interests, or a publicly announced five year delay in implementing the increases.

iv. Eliminate the gender bias in the EPF by eliminating the disparity in retirement ages

The gender discrimination inherent in the current Scheme arises from the fact that adult female life expectancy is 3-4 years greater than males, and that women are far more likely than men to outlive their spouses in old age and thus risk poverty in retirement. As a first step to addressing this, the female retirement age implicit in the EPF system would be raised faster than for men, until it reached parity with the male age.

v. Introduce an explicit redistributive element into the pension formula

Each individual member's pension entitlement would be based on an actuarially-based formula to ensure that overall pension commitments increase in line with underlying assets. However, it should be possible to introduce minor adjustments to such a formula to permit a modest amount of redistribution from the highest paid workers to the lowest paid. An example of such a formula is that used by the US Social Security System.

vi. Increase the contribution rate from 20 per cent to 22-24 per cent

Increasing the period of contributions and reducing the time spent in retirement should permit substantial increases in the effective replacement rate, but will not be sufficient to raise these to more than 60 per cent of average life-time wages. A modest increase in contribution rates would support raising the replacement rate further, but without imposing excessive additional burdens on employers and employees.

vii. Maintain the real return on fund investments at3-4 per cent per annum, or just under the underlying growth rate in real per capita GDP

A real rate of return close to GDP per capita growth would permit the pension fund to offer not only inflation-indexed pensions, but also some upward revision of pensions to partially compensate for real wage growth. This might best be done by continuing the management of fund assets under current arrangements. The performance of the EPF in the 1990s has been quite respectable and sufficient to ensure real rates of return, although further diversification as EPF is already experimenting with, might be pursued further. The underlying rate of return in the 1990s has been close to what one might expect in a market economy, where the long-run rate of interest should be closely related to underlying real GDP per capita growth. At the same time, the EPF has demonstrated that it is extremely efficient in its administration, keeping those costs at less than 0.15 per cent of total asset value, which is unlikely to be possible for any fund manager other than a centralized investment agency investing primarily in government securities.

viii. Make the EPF Pension Scheme the central element in national pension system

The EPF has proved a far more efficient and more successful fund manager in recent years than either the AAIB and the Social Security Board, or the majority of private APPF managers. Transferring responsibility for fund management for the other three national schemes (Farmers', Fishermen's', Self-Employed) to the EPF, would permit overall administrative costs to be reduced for these three other schemes, and permit these schemes to have access to higher quality technical and actuarial expertise. At the same time, these other schemes are partially subsidized, and so fully integrating them into the EPF would present a number of dilemmas. A more feasible alternative is to reorganize them on the same lines as the proposed EPF pension scheme, but with separate and lower levels of pension entitlement, and separate pension funds. If subsidies are necessary for these other schemes they would be made directly to their pension funds, and the principle that the EPF is fully-contributory would be retained.

4.3 Comparison of the impact of Reform Options

The reform strategy outlined above involves combining a number of parametric reforms of the EPF contribution system, together with conversion into a full pension scheme. Substantially raising the replacement rate implicit in the EPF is not likely to be feasible by focusing on one type of change only.

This is illustrated by some tentative calculations of the impact of changing different elements of the current contribution and investment arrangements.

The current EPF contribution scheme has the following elements:

(i) A fixed contribution of 20 per cent of the wage by all members from the age of 18 years to 55 years in the case of men and 50 years in the case of women

(ii) Investment of the fund balances primarily in government debt with a real rate of return of 2-4 per cent per annum(based on recent performance)

(iii) A lump sum payment at the age of 55 for men (50 years for women), which for the purpose of this analysis will be treated as convertible to a pension, equal in value to a no-cost actuarially fair annuity at an interest rate equal to the investment return of the EPF on its assets.

As a thought experiment, assume that average real wage growth in the economy is 2 per cent, that the average real rate of return on EPF investments is 2 per cent, and that the average EPF member experiences 2 per cent wage growth throughout his/her working life, and works non-stop from the age of 18 to the age of 55 years (50 for women). Life expectancy at the age of 55 years is assumed to be 25 years for both sexes, and at the age of 65 is assumed to be 15 years for both sexes.

On this basis, the current EPF system would be able to provide an inflation-indexed pension equivalent to 35 per cent of the final wage gross of employer's EPF payments for a man retiring at the age of 55 years and equivalent to 27 per cent of final wage net of EPF payments for a woman retiring at age 50 years. Let us also assume that policy regards a desirable replacement level as 70 per cent of the gross wage including EPF contributions by employer and employee.

The following are estimates of the impact on final replacement rates (as a percentage of final wage gross of the employer's EPF contribution) of changing the various possible parameters:

(i) Impact of raising rate of return on investments, with no change in rate of annual wage increases: If the EPF was able to raise its real rate of return to 3 per cent, the replacement rate would increase to 48 per cent, and if to 4 per cent to 65 per cent. However, as noted above it is not feasible in the long-run to maintain long-term investment returns in an economy above underlying wage growth, so such rates or return are not realistic or feasible. In order to achieve a 70 per cent replacement rate, the real rate of return would have to increase to 4.3 per cent, or more than 2 per cent above the trend rate in wages.

(ii) Impact of raising retirement age from 55 years: If the notional retirement age was raised to 65 years, the replacement rate would increase to 64 per cent. In order to achieve a 70 per cent replacement rate, the average retirement age would need to be raised to 67 years.

(iii) Impact of raising contribution rates:If contribution rates were raised to 25 per cent, the final replacement rate would increase to 44 per cent, and if contributions rose to 30 per cent the replacement rate would increase to 53 per cent. In order to achieve a 70 per cent replacement rate, the contribution rate would need to be increased to 40 per cent.

Simply relying on adjusting one feature of the system would entail very significant costs and burdens in order to deliver an adequate replacement rate of final wage, or would have to assume long-run rates of return on investments which are greater than the maximum indicated by economic theory. Each one of the above options taken by themselves is either not feasible (raising average rates of return substantially higher than GDP growth), or would meet substantial resistance from workers and employers(raising retirement age to 67 years or raising contribution rates to 40 per cent).

However, if combined as a bundle of adjustments it is possible to obtain the same outcome at relatively less cost. For example, raising the retirement age to 65 years, which is already the trend in Europe, Japan and USA, and increasing the contribution rate to 22 per cent would deliver a replacement rate of 70 per cent, without any increase required in the investment return. If investment returns were increased by 0.5 per cent (probably just feasible), then raising retirement to 64 years and keeping overall contribution rates at 20 per cent would suffice. What all these calculations point to is that it would be possible to provide relatively high levels of pension income for most workers simply by increasing retirement ages and a modest increase in contribution rates.

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