CONTRIBUTION-BASED SOCIAL SECURITY ACT

:::::: POLICY BRIEF ::::::

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Inroduction

The incumbent government unveiled the Contribution-based Social security Scheme which is the first of its kind in Nepal. This scheme provides a foundation of income security on which individuals can build a plan for contingencies of old age, disability, accidents, curative or preventive medical care. It is an extended form of social protection that reduces risks and ensures compensation should the need arise.

Although the scheme is a social policy instrument that protects and safeguards the interest of the marginalized and vulnerable labour class, significant concerns that undergird social insecurity and injustice have been raised regarding the same. This is the foremost reason as to why both employers and employees are seemingly reluctant to participate in this scheme. The following points outline the key pain points that need to be reviewed under the Contribution-based Social Security Act.

1. Inability of SMEs to cope with the rising costs

	Section	Sub-Section	Cla-use	
Act	7	1		The Ministry shall publish the information in the Nepal Gazette on the recommendation of the Committee regarding the rate of contribution to be made by the listed employer on its own behalf or from the contributory income of the contributor
Pro-cedure	25			Distribution of Contributions: The employer shall deduct 11 percent of the workers' basic remuneration and add 20 percent of the worker's basic remuneration to the total amount and deposit the fund to the total of 31 percent. (a) 1 percent for Medicare, Health and Maternity Protection Scheme (b) 1.4 percent for Accident and Disability Protection Scheme (c) 0.27 percent for the Dependent Family Security Scheme (d) 28.33 percent for the Old-age Security Scheme

While the implementation of the contribution-based social security scheme has ensured protection to the wage workers, the employers in the private sector - particularly small and medium enterprises (SMEs) – are marred with mounting challenges in terms of sourcing funds for an expanded social security fund coverage. In Nepal, SMEs comprise a substantial part of the economic activity as they provide employment to 1.7 million people and contribute around 22% of the total GDP.

Like any other form of enterprise, SMEs are subject to myriad of costs that range from administrative to operating expenses. Moreover, the government has instituted the minimum wage at NPR 13,450 to establish a living wage and protect workers against unduly low pay. To top it off, the contribution-based social security scheme stipulates that the employer has to contribute 20% of the employees' basic monthly salary to the fund. The introduction of this scheme puts a strain on SMEs that are already subject to tight liquidity. It not only increases the employers' cost of production but also makes it problematic for businesses to sustain labor-intensive businesses. Even though large businesses may find it easier to cope with the wage spike, this added cost may discourage existent SMEs to function and potential entrepreneurs to venture into the ecosystem. As employers find the cost of doing business too high, this may thrust them to slide into the informal sector for mere survival.

In order to offset this rising wage cost, SMEs may pay the nominal amount of minimum wage to the employees, start reducing their salary (in a manner which makes the net effect on part of the employer the same after paying 20 percent to the contributor), or skimp their increments. At the very least, they may move to use other methods to hire people which will allow them to shy away from their obligations under the Act, for instance terming employment as consultation services, which will eventually affect the employees' job security. Besides, it is highly likely of the employers to pass the impact of their contributions to the consumers. This can result in the higher prices of goods and services in the market resulting in an increased rate of inflation.

Recommendation

Firstly, an assessment of the ability of employers to pay the amount of contribution must be done. For instance, large scale businesses do not have any problem with complying with the Act because such businesses already provide facilities under the Act albeit in a different manner. Such compliance is possible for large scale businesses owing to the sheer amount of capital available and revenues earned. However, SMEs may not have the capacity to contribute 20 percent of the employee's salary. Therefore, different rates of contribution can be assigned depending on the size of the business, by doing so compliance with the Act can also be ensured. India's Employee provident Fund Scheme is for this matter an example that can be looked upon where rates are different based on the number of people employed by an organization.

2. Reduced consumption and Declining Rate of Return

	Section	Sub-Section	Clause	
Act	14	1		The Fund shall pay the contributor who has participated in the Social Security Scheme as specified in the relevant security scheme
Procedure	21			After the completion of the retirement age, the contribution amount that includes the contribution of both the employee and the employer along with the return accrued from the Social security fund will be divided by 180 months (15 years); the contributor will receive this amount as his lifetime retirement payment each month

According to the life-cycle hypothesis of consumption suggests that individuals plan their consumption and savings behavior over their lifetime, by accumulating when they earn and by dissaving when they retire. When individuals allocate their income towards saving, the income for consumption decreases. In order to offset the negative impact of a decline in consumption, individuals thus channel their savings into productive investments.

However, the social security fund accumulates monthly installments wherein an amount equivalent to 31% of an employee's salary is deposited. As low or lower middle-income groups account for majority of the population in the country, on a financial level, they may rationally value spending a certain portion of their income today regardless of how much that money may be worth decades in the future. For these aforesaid individuals, being forced to forego spending that money today represents a loss, irrespective of any future 'return'. Hence, contributing one-third of their monthly income (given that the employer reduces the salary of the employee as stated in the above point) translates into decreased amount of money for consumption and erosion of their purchasing capacity. With the already low level of per capita wage for majority of workers in the country, this reduced consumption capacity indicates hardships they have to face presently for the benefits in a distant future.

Similarly, the Act does not lay down the rate of return/interest that the contribution in the fund will accrue upon retirement; hence, we cannot guarantee if the fund will provide a dismal rate of return or no return at all during maturity. Moreover, the Act stipulates that rate of inflation will be prescribed by the Board, this further defies the concept of time value of money for the contributor. In both cases, the poor rate of return signifies that the retirement benefits will be far lower than if they had been available to invest privately.

Recommendation

Instead of providing a monthly pension an option should be provided to withdraw the amount as is necessary. Furthermore, the scheme can be run as a savings account wherein the contributor gets to withdraw amounts as is necessary or can opt for a pension scheme. Where the contributor chooses to opt to use the amount as is done in a savings account inflation rate need not be adjusted, the adjustment of inflation of a fixed percentage or of the prevailing rate of inflation should be done on a yearly basis where the contributor chooses a pension scheme.

3. Discrepancies between Civil Servants and Private sector Employees

	Section	Sub-Section	Clause	
Act	21			The provision regarding the civil servants or those who receive remuneration from the government shall be as prescribed by the Government of Nepal

Although the Prime Minister's Social Security Plan was initially launched with the intention of treating both civil servants and private employees alike whilst providing the same level of benefits to both parties; in reality there exists a large number of discrepancies. Section 21 of the Act states that detail procedures for contribution-based scheme of civil servants will be as prescribed by the Government of Nepal. In line with the same, a year after the contribution-based Social Security Act was enacted, the Pension Funds Act was enforced detailing out the provisions relating to the contribution-based scheme for civil servants. While examining closely, it becomes evident that although a contribution of 31 percent of the private employee's salary is deposited to the Social Security fund as opposed to 12 percent of the civil servants' salary, greater amount of benefits are available to civil servants.

The primary difference arises out of the manner in which the monthly installment to be received after retirement is calculated. While in case of private employees the total contribution plus the interest rate is divided by 180, in case of civil servants this amount is calculated by multiplying the amount of last drawn salary by total number of years in service and dividing such amount by 50. This effectively means that civil servants will receive a higher amount of monthly installment of the pension fund even when the contribution rate is only 12 percent. This begs the question as to how the Employer's Provident Fund is able to provide higher monthly installments at lower rates of contribution and why such facility cannot be provided by the Social Security Fund.

In addition to this, an increment of 10 percent is provided every three years in order to adjust for inflation, while in case of the social security fund, discretionary power to decide the need and rate of inflation is given to the board. Furthermore, civil servants are also allowed to take loans from the EPF at subsidized rates. However, this facility is absent in case of employees of private firms.

Recommendation

When the EPF is able to provide higher returns at lower rates, responsibility of managing pension fund of employees employed in the private sector must be given to the EPF rather than the Social Security Fund.

4. The issue of taxation

	Section	Sub-Section	Clause	
Procedure	25			Distribution of Contributions: The employer shall deduct 11 percent of the workers' basic remuneration and add 20 percent of the worker's basic remuneration to the total amount and deposit the fund to the total of 31 percent.

The issue of double taxation has been the predominant reason why employees and employers alike have been hesitant in recent days to enroll in the social security scheme. While it has recently been decided that the amount of contribution can be deducted from taxable income of any person, the limit of such deduction however has been set to a maximum of Rs 300,000. Although this may sound as a relief to many, those who earn higher incomes will be subject to higher taxes. This is owing to the fact that the 20 percent contribution of the employer is first added to the yearly income of the employee before being transferred. This subsequently pushes the individual to fall under the upper strata of the tax ceiling while also being subject to a 15 percent tax during withdrawal of the pension fund. It is also important to note that in all countries where social security scheme is prevalent, the amount of contribution is tax free.

In the event of such unclarified provisions, the issue of double taxation i.e. income tax from the taxable income of the employee and future tax when withdrawing pension has become the primary reason why most employers and employees have been unwilling to enroll.

Recommendation

The Act must clearly state that total contribution amount can be deducted from the taxable income of the employee or provision relating to the same must be provided in the Income Tax act wherein the provision should clearly state that the total contribution made to the social security fund.

5. Less than required medical benefits

	Section	Sub-Section	Clause	
Act	10	1	a	The Fund shall carry out the following social security schemes under this Act: (a) Medical Treatment and Health and Maternity Protection Schemes
Procedure	3			The Medical Treatment, Health and Maternity Protection Scheme comprises of (a) Medical Treatment and Health Safety Schemes and (b) Safe Motherhood Schemes for the Contributor or Contributors Wife

Procedure	4			Contributors who have contributed at least three months to the Social Security Fund will receive the benefits of the scheme as per Section 3. This feature will be applicable for a period of three months after any contributor ceases to contribute
Procedure	6	1		Limitation of Facility: Contributors will be provided with the following health conditions: The amount of the facility to be provided to the contributor who is admitted to the hospital for treatment shall not exceed Rs.1,00,000/-

Social Security Scheme Working Procedure states that one percent of the total percentage of contribution is allocated for medical coverage. As per the same facility is provided for:

- Using consultation services from the doctor
- Diagnosis and treatment expenditure
- Medicine bill
- Maternity benefits
- Cost pertaining to admission into the hospital
- Cost pertaining to treatment received while staying in home due to inability to visit the hospital

Although on paper it seems that the facility is a remarkable one which acts as a substitution to medical insurance, a deeper analysis of the provisions shows otherwise. Firstly, the amount provided is only limited to Rs 100,000 per year, secondly only eighty percent of the cost is covered. This begs the question as to whether Rs 100,000 is enough for covering critical illness treatment; medical insurance provides much better coverage than the prevailing social security scheme. As such would it reasonable to contribute to the scheme when very little services are provided.

Another point to consider is that the Government run medical insurance program provides coverage of Rs 100,000 per year for up to five members of the same family for a yearly premium of 3,500 while the social security scheme only provides such facility to the employee only that too at a higher premium rate.

Furthermore, this facility is only available after a contribution for three months has been made and can be availed for a period of three months after an employee has stopped making contribution. In other words, such facility is not provided after retirement, a period when most people are susceptible to contracting medical emergencies owing to their age. Another to factor to consider here is that, if a person becomes unemployed for a period more than three months and needs certain amount for treatment after the third month of unemployment he/she receives no facility under the scheme. Considering the fact that he/she has no source of income and no facility is available under the scheme (Loan cannot be taken, periodic withdrawals cannot be made from the fund), getting medical treatment becomes difficult. This in reality is against the intention of the scheme in itself which is to provide social security to the employees be it in the form of pension, accidental coverage, medical treatment cost or dependent family protection.

<u>Recommendations</u>

- Allowing employees to periodically withdraw amounts as is necessary for medical treatment and deducting the amount form their accounts
- Allowing such facility to be availed for a specified period even after retirement
- Increasing the coverage of medical cost in order to incorporate cost of treatment for dependent family

6. Payment of Pension Arrears

	Section	Sub-Section	Clause	
Act	14	2		If an individual dies or is believed to be dead before receiving the facilities as prescribed by the Sub-Section (1), then such facility shall be paid to the person who wishes to receive it, or to his dependent family

Procedure	24	c		If any contributor not having received monthly pension for 180 months dies, pension equivalent to 50 percent of what the contributor had been receiving will be provided to either the husband or wife of the contributor provided that such person is not receiving any other pension or has no alternative employment and the marital status has not been cancelled.

According to the aforementioned Section, in the case of death of the contributor, the dependent family is said to receive pension benefits. However, the Directive states that the pension is provided only to the husband or wife of the contributor and is entitled to lifetime pension benefit equivalent to 50% of the pension. The crux of the matter is that there is no provision wherein anyone other than the spouse is entitled to the pension arrears on account of death of the contributor. As the definition of beneficiary is only limited to the spouse, this clause overlooks and omits those who are financially dependent on the contributor.

While separate schemes in the form of dependent family protection exists, it must be noted that such schemes are only available in the event of the death of the contributor before retirement. This is owing to the definition of the contributor which states that any employee contributing in the scheme or any employee of the government of Nepal or the employee of the informal sector. Similarly, the definition of employee as per the prevailing laws i.e. Labor act 2074 states that an employee is a person who by taking remuneration offers services to the employer using his physical or mental capacity. Per these definitions, if a person dies while he/she is unemployed, the dependent family is deprived of this scheme.

Recommendation

In line with the same it must also be acknowledged that the total contribution is the self-earned property of the contributor and the power appropriate such contribution must be given to the contributor and not be mandated through legislations.

Inclusion of a provision where any contributor to whom any pension amount is payable by the Government may nominate any other person, referred to as a nominee, who must be allowed to receive benefits/arrears of pension after the death of the contributor.

7. Inability to withdraw the amount

	Section	Sub-Section	Clause	
Procedure	20		(a) (b)	The retirement protection plan will include the following types of workers: • workers who have maintained an employment relationship with any employer after 1st Shrawan, 2076 • as per the prevailing law, those enrolled in the employee provident scheme can by writing and application be a part of pension scheme

The contributor is unable to withdraw the amount owing to the above clauses, which is also the primary reason for the reluctance among the general public to enroll into the contribution based social security scheme. While it is a welcome initiative taken by the Government of Nepal to ensure old age benefits in the form of mandatory pension for all employees starting employment after Shrawan 1st 2076, the provision itself has become the undoing of the Social Security fund with many employees being hesitant to enroll in the absence of facility to withdraw the full amount of contribution instead of monthly fixed pension.

An individual experiences various other immediate and heavy financial pressures other than what has been covered by the scheme. These pressures may range from buying/repairing home to paying college tuition for the children. In such a circumstance where trouble strikes, the fact that one cannot withdraw his/her own contribution reflects the absence of emergency cushions for such individuals.

Moreover, the cultural dynamics of Nepal is such that post retirement, majority of the people depend upon their adult children for subsistence while the savings done by them is used for the purposes of relaxation in the form of lengthy vacations or fulfillment of other desires for which savings are made. In such event, the inability to withdraw the full amount of contribution hinders the desire of many retired employees. Simply providing an option with regards to the same might help instill the idea of having a choice and personal freedom rather than the notion that the savings are forced thereby warranting greater compliance.

Moreover, the Labor Act defines that the retirement age is 58 years while the Social Security Fund only provides the pension payments at and from 60 years. This not only indicates lack of harmonization between two major Acts, but also generates difficulty for contributors who retire at the age of 58 but are unable to incur benefits for two years i.e. until they reach the age threshold.

Recommendation

- Providing an option to withdraw the total amount of contribution
- Moreover, the scheme can also be run in the form of savings account, wherein if the contributor chooses not to receive monthly pension, he/she can withdraw the total amount as is done with any savings account maintained at a bank or financial institution.

8. Inability to channel the funds appropriately

	Section	Sub-Section	Clause	
Act	32	3		When investing in any sector pursuant to subsection 1, the total amount of investment shall not exceed 20 percent of the total amount in the Social security fund

The overall fund of an individual that is deposited into the Social Security Fund is not channeled into productive assets; only 20% of the total fund is invested while the remaining 80% is kept idle. This begs the question as to whether a 20 percent investment will give sizeable and attractive returns. It is also important to ask whether investment of only 20 percent is enough to provide attractive returns to all pensioners and contributors. Other things to consider here is the current investment climate and whether such investment in Nepal can yield proper returns, the assets that would be invested in, whether such assets are lucrative, whether the market for such assets is developed, the inherent risks associated with the assets to be invested in etc.

Recommendation

It is understandable that incentive for keeping funds static is cautionary i.e. so as to not run out of money to provide for pensioners. But this objective can be better achieved if the total amount required for providing pension for a minimum of three years is kept static rather than 80 percent.

SAMRIDDHI FOUNDATION

Samriddhi, The Prosperity Foundation is an independent policy institute based in Kathmandu, Nepal. It works with a vision of creating a free and prosperous Nepal.

Initiated in 2007, it formally started its operations in 2008. The specific areas on which the organization works are:

i. Entrepreneurship development
ii. Improving business environment
iii. Economic policy reform
iv. Promoting discourse on democratic values

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(more information at www.samriddhi.org)

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