Ver 1.0

Pension Reform in India

By

Mukul G. Asher

Professor of Public Policy

National University of Singapore

Email: sppasher@nus.edu.sg

Word Count: 10401 (excluding abstract)

Exchange Rate: USD 1 = Rs. 40.42 as on July 03, 2007.

Paper to be presented at the conference on "The Indian Economy at 60: Performance and Prospects", A Conference to Mark 60 Years of Indian Independence organized by Australia South Asia Research Centre, The Australian National University, 20-21 August, 2007. Research Assistance by Amarendu Nandy, Sangeetha Thimaiah and Deepa Vasudevan is deeply appreciated.

ABSTRACT

Pension reforms are an essential part of managing India's calibrated globalization, based on open-society, open-economy paradigm. This paper argues that there is a strong case for reforming existing provident and pension fund organizations; and for better design and delivery systems for old age assistance. Three major areas which the reforms should address are enhancing professionalism in performing core functions; a systemic perspective facilitating establishment of a multi-tier social security system; and better governance and regulation. The paper also stresses the need to promote financial and pension literacy. Progress in the above areas would be facilitated if the Parliament passes the Pension Fund Regulatory and Development Authority (PFRDA) Bill expeditiously. India should also encourage pension research and education with a view to developing innovative approaches in addressing old-age income security.

Key Words: *India, pension reforms, provident fund, pension regulator, informal sector, social security reform.*

1. Introduction

India initiated 'open-society, open-economy' paradigm in 1991. Since then, its macroeconomic performance has been fairly satisfactory. Positive developments have occurred in real GDP growth, saving and investment to GDP ratios, international trade, and foreign exchange reserves (Table 1).

Table 1: India: Selected Indicators of Macroeconomic performance

Indicator	1991-92	1995-96	2001-02	2005-06
Real GDP (Rs. Billion)	7018	8991	12675	35672
Growth in Real GDP (%)	1.3	7.3	5.8	9.0
Inflation				
Wholesale Price Index – All commodities (Inflation in %)	13.7	8.1	3.6	4.1
Consumer Price Index- Industrial Worker (Inflation in %)	13.5	10.2	4.3	5.0
Domestic Investment				
Gross Domestic Capital Formation (% to GDP)	22.6	26.9	22.6	33.8
Gross Domestic Savings (% to GDP)	22.0	25.1	23.4	32.4
Foreign Investment				
Foreign Exchange Reserves (USD million)	5631	17044	51049	151000
Foreign Direct Investment (USD million)	129	2144	6131	4730
Total Foreign Investment Inflows (USD million)	133	4892	8152	9926
Trade				
Merchandise Exports (USD million)	17865	31797	43827	103091
Merchandise Imports (USD million)	19411	36678	51413	149166
Net Invisibles (USD million)	1620	5449	13485	42655
Current Account Balance (USD million)	-1178	-5910	782	-9186
Merchandise Exports/GDP (%)	6.9	9.1	9.3	n.a
Merchandise Imports/GDP (%)	7.9	12.3	12.0	n.a
Trade Balance/GDP (%)	-1.0	-3.2	-2.6	n.a
Current Account Balance/GDP (%)	-0.3	-1.7	0.2	n.a

Sources: Calculated from Government of India, Ministry of Finance, Economic Survey, 2003-04 and 2004-2005, 2006-07, Table 0.1 and RBI, Handbook of Statistics on the Indian Economy, 2003-04, Tables 1,2,10,140,153,215,216,224,225

Relative stagnation in agriculture which accounts for a fifth of GDP but for more than half of employment has however contributed to the concern that the growth has not been sufficiently inclusive[1]. Stagnation in organized sector employment, which usually falls under the purviews of various labor and social security laws, has also been a source of concern (Table 2). Generating varied opportunities for livelihoods and facilitating mobility of labor from agriculture to other sectors of the economy, without neglecting modernization of agriculture, is essential. This is because the most important macroeconomic variable in economic security, for both young and the old, is trend rate of economic growth.

The benefits of growth however should be distributed widely. It is in this context that successful reform of pensions and old-age financing or what may be broadly termed as 'social security system' has become an essential element of managing globalization. This is recognized in India's 11th five year plan which aims at "*faster and more inclusive growth*" (GOI, 2007a).

Table 2: India: Labor Force and Demographic Indicators

Indicator	Time Period	
Life Expectancy at Birth (Years)		
Male *Female*	2005-2010	63.2 66.7
Life Expectancy at age 60 (Years)		
Male *Female*	2005-2010	16 18
Total Fertility Rate *(No. of Children)	2005-2010	2.76
Population (million) *Females (million)* *Males (million)*	2005	1103.0 537.5 565.7
Sex Ratio *(males per 100 females)*	2005	105.2
Population above age 60 (million)	2005 2010 2050	87.5 100.8 329.6
Old Age Dependency Ratio *(%)* **	2005	15.6
Working Age Population (million)	2000 2025 2050	619.7 921.5 1048.2
Employment by Sector		
Organized (Formal) Sector (%) *Unorganized (Informal) Sector (%)* *Share of Public Sector Employment in Total Employment (%)* *Membership of Trade Unions as % of Labour Force (%)*	2003 2003 2001 2000	9.9 91.1 3.3 3 .0

Notes: * Total Fertility Rate is defined as the average number of live childbirths over a woman's lifetime
** Old Age Dependency Ratio is defined as $\frac{(population\ above\ 60\ years)}{(population\ 15-59\ years)} \times 100$

Sources:
1. State of World Population, UNFPA, 2004
2. Adapted from Liebig and Rajan (2004), P.20, Table 4
3. CIA World Fact book, Obtained from http://www.indexmundi.com/g/g.aspx?c=in&v=31
4. Census of India 2001
5. Adapted from Liebig and Rajan (ed.2003)
6. Census of India 2001.
7. Asher and Mukhopadhaya (2006).

Globalization has made social safety nets more rather than less necessary, as they cushion the blow for those most severely affected, help maintain the legitimacy of reform, and help avoid a backlash against the social and distributional consequences of globalization. This argument has considerable validity in the case of India.

India however cannot simply adopt the philosophy, program design, and structures of the current welfare states, for provision of adequate and sustainable social security for its population. Its size, heterogeneity, and institutional and economic capacities require innovative approaches. India will grow old before it becomes a high income country. This is not to suggest that greater competency and professionalism should not be pursued in reforming existing provident and pension fund organizations.

The main objective of this paper is to assess the current social security arrangements in India and to suggest reform directions. It is organized as follows. The next section (Section 2) briefly enumerates demographic and fiscal consolidation rationale for pension reform. This is followed by an overview of the current social security system in India (Section 3). Section 4 focuses on future reform directions. The final section provides the concluding remarks.

2. The Rationale for Reform

In addition to globalization, demographic trends and need for fiscal consolidation are two major reasons for social security reform in India.

India is experiencing a demographic transition, leading to lower total fertility rate (the rate was 2.85 children per woman in 2004[2]); increased life expectancy (In 2005, life expectancy at age 60 was 17 years for males and 18 years for females)[3] and greater proportion of the aged in population.

The share of elderly, or persons aged 65 years and above in India's population is expected to rise from 4.6 percent in 2000 to 9 percent in 2030. In absolute terms, the number of elderly (aged above 60) will rise from 87.5 million in 2005 to 100.8 million in 2010 (Table 2). If current retirement age of 60 is taken as the cut-off point, in 2030, elderly will approach 200 million, and further to 330 million in 2050.

There are considerable variations among regions and states in fertility rates, life expectancy, and patterns of internal migration. In general, the southern states will experience much more rapid population ageing than the states in the north (Dyson, 2002). The major public policy implication is that pension reform policies and programmes should not be based on the averages for the country as a whole, but on the basis of empirical data of each state. This is particularly relevant in designing defined benefit schemes, whether based on social insurance or provided by employers; and for social assistance programs. Predicting longevity trends and morbidity patterns is an inexact science. The actuarial assumptions should therefore reflect this, and permit flexibility in design parameters, if the schemes are to be sustainable over a long period.

An important implication of longer life expectancy concerns healthcare. Health resources consumed by a typical individual increases disproportionately with age. As an example, pension above 75 years of age consume much higher health resources per person than those between 65 and 74 years. Thus, pension and health care financing needs to be considered together for old age policy planning and programs. This is not an easy task. More research is urgently needed on such co-ordination.

Both the level and the pace of ageing are likely to provide significant challenges as even by 2030, India's per capita income will be relatively low. If the current normal retirement age of 60 is not increased, then the challenge of financing the elderly will be even greater. As women are increasingly living longer than men; greater feminization of the population is taking place (Liebig and Rajan, 2003). Providing secure and sustainable retirement income therefore ranks high in the social priorities.

The current demographic transition has the potential to provide India with a significant competitive advantage in the form of a "demographic dividend"[4]. In absolute numbers, India's working age population is projected to increase from 619.7 million in 2000 to 921.5 million in 2025, and to 1048.2 million in 2050 (Table 2). This is a double-edged advantage as it implies that net jobs creation must get priority over preserving existing jobs if this dividend is to be translated into higher growth and competitive advantage. However, higher working age population provides India with the potential to increase aggregate saving and investment rates, and thereby increase trend rate of growth (Sanyal, 2005). As the most important macroeconomic variable in providing economic security for both the young and the old is the trend rate of economic growth, India's demographic advantage phase could potentially permit it to make progress in developing more adequate and equitable social safety nets, while maintaining social cohesion.

To take advantage of the "demographic dividend", modernization of labor market structures and regulations will be required. The balance will need to be shifted to generation of additional jobs which are productive and sustainable rather than on preserving existing jobs. India's labor force in 2001 was 425 million, of which slightly less than a quarter was urban, while the rest was rural (Table 2). Design, structure and capacities concerning social safety nets differ considerably between urban and rural areas (Dev and Mooij, 2005). Thus, social assistance type programs, which require fiscal resources and effective public delivery systems, are likely to play a greater role in rural than in urban areas.

The greater prevalence of self-employment in rural areas requires differently designed pension schemes. In the urban sector, the nature of employment is also changing, with life-long employment becoming somewhat less prevalent, while labor mobility has become greater. Current trends suggest that by 2030, majority of India's population will be urban (Bloom and Canning, 2006).

The above trends have meant that much greater importance will need to be given to pension benefit mobility across sectors and occupations than has been the case so far, and to more flexible compensation packages incorporating some degree of individual choice among various benefits (Chatterjee, 2004). The human resource management function is therefore likely to become quite complex. The 200 million elderly expected in 2030, and the new young entrants to the labor force, will need to increasingly rely on their own mandatory or voluntary savings to finance retirement.

Reform of social safety nets is also needed to assist in the process of fiscal consolidation (essentially reducing budget deficits) and fiscal flexibility (reallocation of budget towards growth enhancing expenditures). India's combined public sector deficit has been close to 9 per cent for many years, and could act as a major constraint on achieving higher growth (IMF, 2001). An important legislative measure, the Fiscal Responsibility and Budget Management Act (FRBMA), passed in 2003 does provide a degree of fiscal discipline on the central government. Recent high growth and resulting tax-revenue buoyancy has helped in reducing the fiscal deficit of the central government. However, only a handful of the 28 states have such mandated constraints on their fiscal behavior. The expenditure reform, including pension expenditure, will be crucial in sustaining recent gains made in fiscal consolidation.

There are also limitations of the existing social security system arising from inappropriate design features, limited professionalism with which they are implemented and inefficient delivery of social assistance benefits (Government of India, 2000).

3. An Assessment of the Existing Social Security System

Since independence in 1947, India has constructed fairly complex set of social security laws, implementing regulations, and organizations. The policymakers have however essentially approached social security issues from purely welfare perspective and have under-emphasized the need for professionalism, long-term sustainability, robustness, and system-wide perspective

India's social security system has seven components - the Employee Provident Fund Organization (EPFO) schemes, the Civil Service schemes, the schemes of public enterprises, superannuation plans of the corporate sector, voluntary tax advantaged schemes, social assistance schemes, and micro-pension schemes (Figure 1).

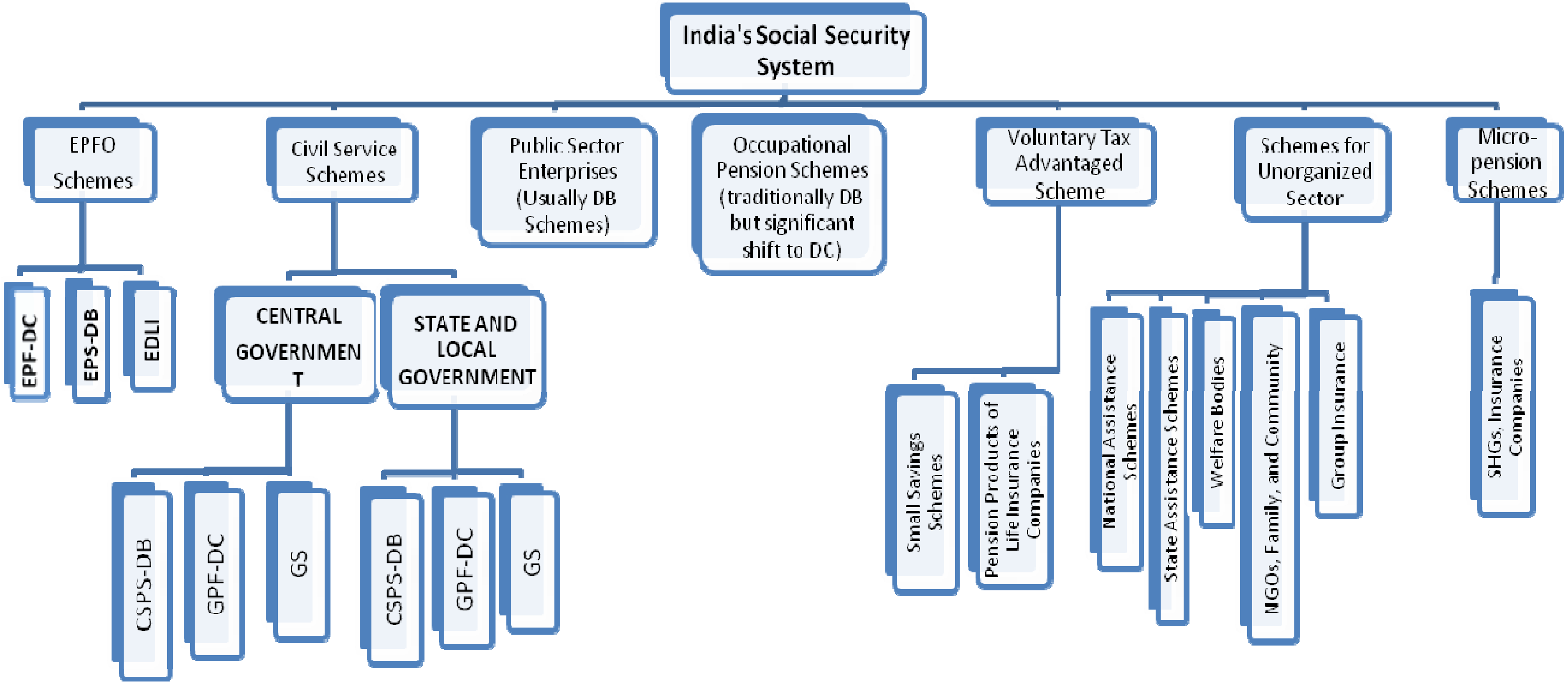
Civil Service schemes: The structure of retirement schemes for the 17 million civil servants at the Central, State and Local Government levels are broadly similar; consisting of three types of retirement benefits. Civil servants receive non-contributory, unfunded, Defined Benefit (DB) pension[5], which is indexed for prices and has fairly generous commutation provisions and survivors' benefits[6]. In addition, each employee is mandated to contribute a percentage of his salary to a Government Provident Fund (GPF) scheme. Finally, civil servants also receive lump sum gratuity benefit based on period of service and the salary level, with a maximum ceiling of Rs 0.35 million.

In principle, each State has the freedom to design pension plans for its civil servants. In practice, States usually adopt the pension schemes followed by the Centre with relatively minor modifications. As a result States with different fiscal capacities end up having similar pension schemes; a practice that severely affects the ability of the poorer states to meet their wage and pension liabilities, and still leave aside resources for meeting social and infrastructural needs.

Over the years, many implementing rules and regulations concerning commutation (i.e. the proportion of the total pension value which can be taken as lump sum) family pension benefits etc, have been introduced in an ad-hoc basis. Substantial efficiency, equity and cost savings are possible through parametric reforms in the existing civil service pension schemes. Such reforms involve altering the parameters of the existing pension scheme, such as the commutation formula, indexation method, eligibility criteria for family pension, etc. These reforms can help as over the years many ad-hoc provisions have been added, whose rationale may need re-examination. Thus, as provident fund, gratuity, and leave encashment allowance are all provided in lump sum at retirement, rationale for commutation as a method to provide for lump sum cash has become extremely weak.

The key reason for reforming these schemes is illustrated by the fact that while civil servants at all levels of government constitute only about 3 percent of the total labor force, their retirement benefits are already equivalent to nearly 2 percent of GDP. There is also high level of longevity and inflation risk protection as the benefits are indexed to prices and to wages. There are also generous survivors' and disability benefits.

Figure 1: India's Social Security System: An Overview



*From January 1, 2004, all newly recruited civil servants at the Centre (except for armed forces) are on a DC scheme. 19 states have also issued notification for a shift to a DC scheme, but their starting dates vary.

Abbreviations Used

DC	Defined Contribution
EPF	Employees' Provident Fund
GPF	Government Provident Fund
CSPS	Civil Service Pension Scheme
DB	Defined Benefit
EDLI	Employees' Deposit Linked Insurance Scheme
EPS	Employees' Pension Scheme
GS	Gratuity Scheme
NGO	Non-Government Organizations

Source: Authors

The civil servants are the beneficiaries of the schemes but they also are the key actors in formulating and in implementing the civil service pensions. There is no independent regulator which oversees these schemes. This is contrary to good governance practices.

The economic and fiscal unsustainability of the schemes, and need for labor mobility led the central government to introduce a New Pension Scheme (NPS) for the civil servants entering the government service since January 1, 2004. The NPS is designed to be a scalable and sustainable pension scheme (Shah, 2005).

Addressing the longevity risk (accumulated balances may prove to be inadequate during lifetime of the retiree), and inflation risk (maintaining real value of the annuity throughout the retirement period) will however be a challenge. Sustainable risk-pooling arrangements will be needed, but there is inadequate policy and research focus on developing such arrangements.

The NPS currently does not have a provision for disability and survivors' benefits. A common international practice is to provide for these benefits through a compulsory group insurance, with premium contributed by the members. The contribution rate of the NPS at 20 percent is relatively high by international standards. If 2 to 3 percentage points are diverted for such insurance, that could be sufficient to provide the coverage. Its flexibility should therefore be explored.

While the NPS is mandatory for the Central government employees, it has potentially a much wider reach. As of March 2007, 19 states which have decided to introduce similar schemes, mandating newly recruited civil servants to mandatorily join the NPS-type scheme. Some states are likely to implement the NPS in full without waiting for the political deadlock at the Centre (resulting in the PFRDA Bill not being passed by the Parliament) being resolved[7].

Various public enterprises and statutory boards and aided institutions can also join NPS. The individuals, particularly those that do not enjoy formal employer-employee relationship may also find NPS a useful vehicle for retirement savings provided some of the current schemes such as Public Provident Fund (PPF) are either phased out or made more market consistent.

The estimates for potential membership of the NPS vary widely. A 2004 survey commissioned for the Ministry of Finance suggest that roughly 54 million persons in the unorganized sector have both the interest and the financial capacity to participate in the NPS. A study by Cashmore *et al.* (2005) puts the estimate at 80 million. Over next three decades, about 20 million civil servants and public sector workers will mandatorily join the NPS. The total potential membership therefore is between 75 to 100 million.

With rising trend of wages in India, pension assets will also grow rapidly. Cashmore *et al.* (2005) estimates that by 2015, pension assets under the NPS will be US$ 175 billion. These will need to be intermediated through the financial and capital markets. The supply of investment grade debt and equity assets, including divestment through control of state enterprises will also be needed. Measures to broaden and deepen financial and capital markets, improvements in corporate governance and enhanced capacity and willingness for international diversification of provident and pension fund assets will be required to invest these assets in productive and growth enhancing way.

The NPS will be supervised by a regulatory body, called the Provident Fund Regulatory and Development Authority (PFRDA). The PFRDA can help in achieving greater professionalism and system-wide perspective by bringing the civil service pension schemes at both Centre and States, Provident and Pension funds of State Enterprises, and Occupational Pension Plans under its purview. Among the major components, only the EPFO is currently not mandated to be regulated by the PFRDA but this could change overtime. [1]

The PFRDA has appointed a central Recordkeeping Agency (CRA) and three fund managers to manage accumulated balances in the NPS while the states can appoint their own CRA and fund managers. Precedence by the Centre will have significant influence on the entities selected.

Current various components of India's social security system (Figure 1) are supervised and regulated by different agencies, with little coordination or focus. The EPFO acts both as service provider and regulator (as well as approving authority) for funds which seek exemption from the EPFO. This dual role represents fundamental conflict of interests and should be ended. Permission for superannuation funds and for the excluded funds is under the jurisdiction of the Central Board of Direct Taxes (CBDT). It also, in principle, regulates these funds, though it has no capacity to undertake effective supervision. Since there is no centralized database for firms who have received permission from the CBDT for pension plans, the overall assessment of the effectiveness of current policies is also hampered.

The annuities will continue to be provided by the life insurance companies which are regulated by the Insurance Regulatory and Development Authority (IRDA)[2]. An independent body is preparing revised mortality tables to enable better pricing of insurance policies and annuities in India. Since the NPS will involve exposure to financial and capital markets, regulated by Securities and Exchange Board of India (SEBI), close coordination among the three regulators, the Ministry of Finance, and the Reserve Bank of India (RBI) will be needed.

The Indian government is to implement the EET system of taxation for pension savings under which contributions and the investment income in the accumulation phase will be exempt from income tax, but the withdrawals in the payout phase will be taxed. The tax system therefore is being aligned with the international practices. The transition phase

[1] In a strongly worded editorial dated July 25, 2007, The Economic Times, India's leading financial daily, has argued that the EPFO has shown singular reluctance to modernize, and unless it urgently and visibly impoves its functioning, its members should be permitted to shift their funds to the managers appointed for the NPS. (http://economictimes.indiatimes.com/Opinion/Editorials/EPFO_needs_to_set_its_house_in_order/articleshow/2231384.cms)

[2] The Reserve Bank of India has permitted banks to manage pension funds through subsidiaries with which it must maintain arms length relationship. Indeed, State Bank of India is one of the entities approved by rge PFRDA to manage Pension funds.

however will have to be carefully negotiated. The 2007-08 budget did not contain any measures for implementing the EET treatment.

EPFO Schemes: EPFO was established in 1952. It thus predates the 1991 reforms which were designed to shift the state-market mix in favor of the latter, and integrates India's economy with the world economy in a market-consistent manner. It also predates globalization phenomenon.

It is an unusual national provident fund in combining a Defined Benefit (DB) (Employees Pension Scheme, EPS introduced in 1995) and a Defined Contribution (DC) (Employee Provident Fund, EPF) scheme for its members. For over half a century, membership is confined to 181 designated industries, in firms employing more than 20 workers. This reflects the static organizational structure and culture.

The EPFO is governed by an unwieldy Board of 45 members, with Minister of Labor as the Chairperson. The Board has shown no inclination to access the requisite expertise as indicated by the absence of any independent experts on the Board or by setting up of advisory committees.

Table 3 summarizes the contribution rates for each scheme. The EPF Scheme was established in 1952; EDLI Scheme in 1976; and the EPS in 1995. The EPS scheme is therefore relatively recent. The main challenge of paying promised pension benefits under the EPS, including family pensions to survivors, lies in the future[8].

Table 3: Contribution Rates for the Schemes of the EPFO

Contribution [% of wages]	*EPF (1952)*	*EPS (1995)*	*EDLI (1976)*	*Total Contribution Rate*
Employer	3.67	8.33	0.50	12.50
Employee	12.00	nil	nil	12.00
Government	nil	1.16	nil	1.16
Total Contribution Rate	15.67	9.49	0.5	25.66
Administrative charges paid by employer [un-exempted sector only]	1.10	Paid out of EPS Fund	0.01	1.11
Inspection Charges paid by employer [exempted sector only]	0.18	n.a	0.005	0.185
Benefits	Accumulation plus interest on retirement, resignation, death. Partial withdrawals permitted for specific purposes	Monthly pension on superannuation, retirement, disability, survivor, widow/widower), children	Lump sum benefit on death while in service	

Notes: 1. As of March 2007, the wage ceiling to which the contribution rates apply was Rs.6500 per month.
2. The figures in brackets refer to the year in which the scheme was introduced.

Source: Employees Provident Fund and Miscellaneous Provisions Act, 1952

The total contributions to three mandatory schemes are 25.66 per cent, subject to a ceiling of Rs.6500 of wages per month. The wage ceiling has been raised at regular intervals. In addition, EPFO levies administrative charges of 1.11 per cent (equivalent to 4.4% of the contributions); and inspection charges on EPFO exempt but regulated funds at 0.185 per cent.

The above contribution rates and charges represent benefit provision and administrative costs respectively. However, from an economy's point of view, cost of complying with EPFO regulations by establishments and members should also be added[9].

On March 31, 2003, cumulative investments under the EPF scheme stood at Rs.1027.5 billion[10]; and the stock of investments under the EPS 1995 scheme and EDLI scheme were Rs.450.5 billion and Rs.34.9 billion respectively. Thus, collectively, the EPFO held investments worth Rs.1481.5 billion under its three schemes, equivalent to nearly 6% of India's Gross Domestic Product (GDP) in 2003. The EPFO funds are almost wholly invested in government and public sector fixed investments. The EPFO Board has not permitted any funds to be invested in equities.

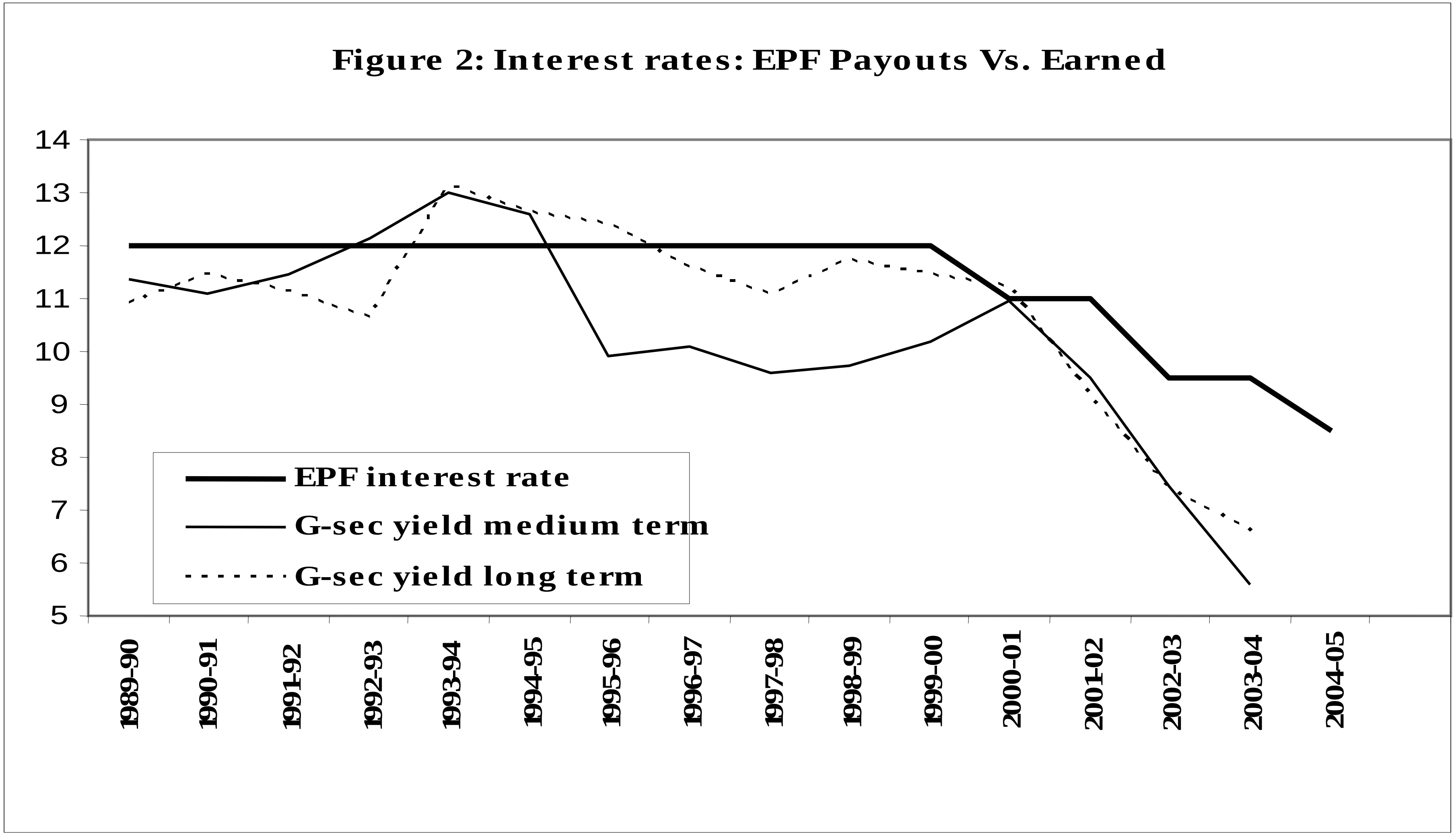
Figure 2 provides data concerning EPF payouts in comparison with the yield from government securities for 1989-90 to 2004-05 period. The data suggests that the EPF payouts have exceeded yields from medium and long-term government securities. The difference has widened considerably since 2000-2001. Since all of EPF investments are in government securities, the implication is that the EPF has been paying interests in excess of the yields from investments. This is clearly unsustainable. It is imperative that the EPFO learns to earn through modern portfolio investment techniques, and pays what it earns.

The impact of outmoded design features such as high pre-retirement withdrawals permitted by the EPF and the low real returns is evident in data on members' balances in Table 4. The data indicate that 85 per cent of the members have balances of less than Rs 20,000, accounting for 17 per cent of total balances, with an average balance of only Rs 3133. Any interest or other subsidies therefore will disproportionately accrue to those with large balances. There were only 86 members with balances above Rs 50 lakhs but there average balance was 54.5 lakhs. Thus, any interest subsidy will disproportionately benefit this group.

Table 4: Members' Balances (EPF)

Balance (in Rs.)	*No. of members*	*% of total members*	*% of total accumulation*	*Average Balance (in Rs.)*
Up to 20,000	293.4 lakh	84.58	16.98	3133
20,000 - 49,999	28.77 lakh	8.30	21.52	40,468
50,000 - 99,000	12.77 lakh	3.68	16.67	70,663
1 lakh – 1.99 lakh	7.91 lakh	2.28	20.25	1,38,414
2 lakh – 2.99 lakh	2.33 lakh	0.67	10.37	2,40,616
3 lakh – 3.99 lakh	82,629	0.24	5.23	3,41,959
4 lakh – 4.99 lakh	34,593	0.10	2.83	4,42,575
5 lakh – 9.99 lakh	36,297	0.10	4.29	6,40,229
10 lakh – 24.99 lakh	5973	0.02	1.45	13,16,782
25 lakh – 49.99 lakh	5973	0.0001	0.31	25,06,620
Above 50 lakh	86	0.00001	0.90	54,48,660

Source: EPFO, computed from Sridhar (2004



Source: Calculated by the author

The key challenge of the EPFO is to ensure that its high contribution rates translate into high benefits to its members and that its relatively large and costly administrative apparatus is commensurate with the quality and quantity of its services.

Public Sector Enterprises: Public sector enterprises including public sector insurance companies and banks, the Central Bank called the Reserve Bank of India, electricity boards, State oil companies etc have their own pension schemes, which are managed by the concerned enterprise with little regulatory oversight or supervision. The schemes are usually contributory in nature, but details about scheme design and their actuarial sustainability are not publicly available. Therefore the professionalism with which these schemes are designed and administered is also not known.

Occupational Pension Schemes or Superannuation Schemes: These refer to employer sponsored schemes that are not statutory, but provide additional post–retirement income to employees on a regular basis (Chatterjee, 2004). These are governed under the Income Tax Act by the tax authorities. The schemes can be DB or DC in nature; and the liabilities are met by setting up Trust Funds, either self-managed or managed by the Life Insurance Corporation of India (LIC). It is estimated that pension assets in the private sector are at Rs2000 billion (US$ 48 billion), most of which are being managed by the insurance companies.[3]

Since 1956, LIC has been managing a plan that invests all the monies received from various Employee Retirement Benefit Funds into a pooled fund, of which 95% are invested in government securities and bonds and 5% in equities. Self managed trust funds are governed by the restrictive investment guidelines, which limit the earning potential of these funds.

The investments of insurance company administered superannuation schemes are regulated by the Insurance Regulatory and Development Authority (IRDA), though the overall granting and supervisory authority are the Income Tax authorities. IRDA has permitted the pension fund component of insurance companies to hold a diversified investment portfolio, including equities. The funds however can only be invested domestically. Unlike EPFO, the IRDA's guidelines for investment of pension funds managed by the life insurance companies are consistent with modern portfolio management principles and practices.

India's 2005-06 Budget introduced a Fringe Benefits Tax (FBT)[11]. It involves what are administratively determined expenditures which may benefit employees, and therefore are taxed under the FBT. The statutory liability for the FBT is on the companies, though economic incidence which involves tax burden sharing among different economic agents once participants adjust their behaviour in response to the tax is unlikely to be solely on the employers (i.e. shareholders). The definition of fringe benefits used is quite broad, and very unusually, includes superannuation benefits[12]. Partially as a result of strong representations by the insurance industry, and trenchant criticism of the FBT, the 2006-07 Budget included the provision that contribution by an employer for superannuation up to Rs. 1 lakh per year per employee will not attract FBT. This has softened the impact of FBT on superannuation[13].

[3] 'Separate bill on pension funds for private sector on the anvil' Posted at www.livemint.com on Jun 24, 2007

Voluntary tax advantaged savings schemes: These comprise small savings schemes (In 2003-04, outstanding small savings formed 21.1% of the combined domestic liabilities of Centre and States, and gross mobilization was at 5.3% of GDP (Government of India, 2004)); and individual and group annuity schemes of life insurance companies. Interest rates on small savings instruments have traditionally been set at above market rates, which distort allocation of savings. In particular, savings intermediated through mutual funds and market-based instruments in financial and capital markets are adversely impacted. Though there has been some rationalization in rates since 2002, more progress is needed (Government of India, 2004).

Schemes for the Unorganized Sector: The life time poor are provided assistance through Social Assistance Schemes (SAS), both at the Central and in the State levels. These schemes are usually means-tested and targeted at the destitute and poor and the infirm population over the age of 60 years. The pensions under these welfare schemes are expected to provide between Rs.55-Rs.300 per month, but their coverage is limited to between 10 and 15 per cent of the elderly population (Vaidyanathan, 2005). In addition, these schemes are usually under funded, poorly targeted, and suffer from significant leakages (Rajan *et al*, 1999). At present, majority of the workers in the unorganized sector (who form more than four-fifths of the country's workforce) are protected only through the efforts of welfare bodies, the community, or NGOs.

There is however a recognition that the terms "unorganized" or "informal" and the term "rural" are too heterogeneous to be subjected to broad generalizations, particularly in terms of occupational income and consumption patterns (endnote 21).

In the Indian context., two broad options for expanding the pension coverage to include the unorganized sector are represented by the proposal based on social insurance of the National Commission for Enterprises in the Unorganised Sector (NCEUS) (Social Security Report available at www.nceus.gov.in), and the New Pension Scheme (NPS)-social assistance centred multi-pronged approach.

In a 2006 report, the NCEUS has advocated a comprehensive social insurance-based, government-run programme covering health benefits (hospitalisation, sickness allowance, and maternity benefit), life insurance, and provident fund (with provision for non-contributory pension for poor elderly workers). The report recommends coverage of 300 million workers over 5 years, i.e. 60 million persons per year. It does not project the future trends in unorganised sector employment.

However, this option has severe limitations.

First, it does not take sufficient cognizance of administrative constraints, particularly those relating to record-keeping, collection of contributions, management information systems, and paying the benefits in a correct way without any side payments. The experience with extremely poor record-keeping by the Employees Provident Fund Organisation, the civil service pension schemes, and the recently-launched National Rural Employment Guarantee Scheme does not inspire confidence. All these schemes have much smaller number of participants than envisaged just for the first year by the NCEUS, and they focus on only one type of benefit.

The transactions costs of administering and complying with the scheme are likely to be disproportionately high, given the low nominal amounts of contribution and benefits, and due to a plethora of national and state level administrative structures.

Second, combining different schemes with a diametrically opposed economics, and the need for sophisticated actuarial estimates on a disaggregated basis, into one overall social security programme is bound to lead to non-transparency, and mis-specification of actuarially appropriate contributions. Longer life expectancy for example should lead to lower cost of life insurance, but substantially higher cost of pensions and healthcare.

Third, the report does not give sufficient weight to managing the political risk which in the Indian context has a high probability of undermining the sustainability and integrity of even well-designed social insurance schemes.

Fourth, the report does not project finances over a long period (in the US, finances of such schemes are routinely projected for 75 years and are made available publicly); and treats financing issues in a cavalier manner, demonstrating little understanding of economics of social insurance. It is astonishing that the media report suggests that the chairman of the NCEUS indicated that financial costs of the scheme are not their problem but that of the government.

The report also implicitly relies on high administered interest rates subsidised by the government for managing accumulated provident fund balances. This defeats the purpose of mandatory savings because only when such savings are invested in growth-enhancing projects, can national savings increase?

Fifth, the nation-wide social insurance approach forecloses experimentation, flexibility and gradualism, which have been the hallmarks of India's successful calibrated globalisation.

Sixth, the NCEUS programme will immediately and substantially increase demand, particularly for health services, but there is no analysis of how the corresponding increase in the supply of healthcare services will be achieved. These can not be increased rapidly as there is a long lead time. Even for the current demand, supply of healthcare facilities, particularly for lower income groups, is grossly inadequate and inefficient. This is largely the failure of government-provided or guided facilities. The NCEUS option will give these governmental organisations vastly expanded responsibilities.

Mehrotra and Biggeri (2007) have argued against a universal, citizenship-based scheme for all workers in the short-run. A universal scheme will require the use of general government revenues to finance such a scheme, as beneficiary contributions are not expected to be sufficient; and the pre-requisites for such schemes such as registration and record-keeping systems are lacking.

They argue for a product/group or trades based risk-pooling mechanism that is not primarily financed from beneficiary contributions, but on special taxes on the concerned products. Since the social security schemes are for long term lasting 60 years or more, the existing product-based arrangements could in some cases be too static as economic structure may significantly over time. This is likely to be specially the case in India.

It is important to recognize that social risk-pooling can be undertaken in a variety of ways, and not necessarily through insurance alone. The point at which social risk pooling occurs, can also be varied through policy design. As an example, providing a bank deposit or a bond instrument in the pay-out phase of a DC scheme paying higher than the market interest rate financed through the general budget is a form of social risk-pooling. Similarly, targeted social assistance programmes, financed from general budgetary revenue is also a form of risk-pooling and risk-sharing. Insurance mechanism is exceedingly complex, particularly when a country is undergoing demographic transition, and changing morbidity and mortality patterns.

The innovations therefore should encourage variety of arrangements for social risk-pooling and risk-sharing, and not be overly fixed on one method such as social insurance.

Extremely limited fiscal capacity, poor targeting of beneficiaries and inefficient delivery systems with significant leakages are major constraints on the effectiveness of social assistance programmes to reach the large number of lifetime poor. But this method is equitable and potentially more effective, provided existing constraints are addressed. Therefore those in favor of expanded social assistance programmes should vigorously support fiscal reforms designed to bring about fiscal consolidation and fiscal flexibility, and civil service and governance reform.

Micro-pension schemes: A typical micro-pension scheme is based on voluntary savings, accumulated over a long period and intermediated through financial and capital markets by a professional fund manager. The total amount accumulated depends on contributions (less permitted pre-retirement withdrawals), and investment returns net of administrative, investment management and other expenses. At an agreed-upon withdrawal age (usually 58 or 60 years), the accumulated balances can be withdrawn in a lump-sum, a phased withdrawal, annuity or some combination of these methods. These also appear to show promise, though the pay-out phase needs to be given greater weight (Asher and Nandy, 2006b).

Recent examples of such a scheme both include UTI AMC as fund manager are in operation. The first by Self Employed Women Association (SEWA) was launched in April 2006; while the second by Bihar Milk Cooperative (COMFED) was launched in September 2006[4]. Their combined membership is only 1 lakh. In contrast, it is estimated that about 35 million individuals have benefited from micro-finance schemes, primarily through self-help groups (SHGs). While the short-term nature of SHG activities, and relatively short life span of most SHGs are not directly comparable to the long-term nature of the micro-pension schemes based on individuals, the members of the SHGs are potential customers for micro-pension schemes. The pension scheme involves contributions ranging from Rs. 50 to Rs.100 per month per member.

The contributions must be made until age 55 and the pension payments begin after age 58. The savings are pooled by the Bank and transferred to UTI Mutual Fund for investment management. Each member has a pension account with the SEWA Bank which regularly provides information about the pension accounts. It appears that the accumulated amounts

[4] Trade unions can be encouraged to participate in micro-pension schemes. If even a few trade unions initiate such schemes, it will advance pensions and financial literacy, with positive consequences for EPFO reform.

will be insufficient for substantial annuity. Therefore other options such as phased withdrawals may need to be considered. It is possible to introduce some social risk pooling through specially designed bank accounts and bonds (Asher and Nandy, 2006b).

Reverse mortgage arrangements to turn housing equity into retirement consumption stream represent another option. The 2007-08 budget has proposed that the National Housing Bank (NHB) consider such an instrument.

Micro-pensions have the potential to play a limited role as one of the methods for financing old-age (Asher and Shankar, 2007). The extent of their potential will depend on the following factors.

First, in the accumulation phase, minimizing the transaction costs associated with record-keeping, payment of benefits, communication to members, and investment policies and management should be given due emphasis. Second, in savings-based micro-pension schemes, investment, macroeconomic and other risks are borne by the individual. Risk-sharing arrangements have therefore been often advocated, although longevity and inflation risks will have to be addressed. Third, arrangements during the pay-out phase need to be carefully considered while 40% lump-sum withdrawal of the accumulated funds appears realistic. Fourth, micro-pensions represent a long-term financial contract, with potential for significant agency problems, and systemic risk to the financial system.

To make micro-pensions more attractive, considerable innovation which enables provision of goods and services to the poor at a fraction of the cost to the middle and high income groups should be applied to micro-pensions. This will require that organizations involved in micro-pension industry are able to benefit from economies of scale and scope[14].

Need for Reforms: Each of the seven components of the social security system is in need of urgent reforms. These should address two major limitations of the existing pension system.

First, there is a need to significantly enhance the professionalism with which the core functions are being performed by provident and pension funds. The core functions of any provident or pension fund include the reliable collection of contribution/taxes, and other receipts; payment of benefits for each of the schemes in a correct way; efficient financial management and productive investment of provident and pension assets; maintenance of an effective communication network, including development of accurate data and record keeping mechanisms to support collection, payment and financial activities; and production of financial statements and reports that are tied to providing effective and reliable governance, fiduciary responsibility, transparency, and accountability (Ross, 2000). The foundation of a sustainable pension system should be built on a judicial system with modern laws and regulations which are consistent with the economic paradigm of the country; enabling regulatory environment; sound scheme design; widespread use of information technology and adoption of good governance principles (Asher and Nandy, 2006a). The importance of tyranny of small numbers[5] should be clearly recognized in design and governance structures of provident and pension funds.

[5] As an example, even seemingly small alteration in parameters of a DB scheme, such as commutation rules, pension formula or age of receiving full pension could fundamentally alter the financial viability of the scheme.

Second, there is no overall systemic perspective of social security, despite over a decade of steady reform in other sectors of the economy. There are four regulatory bodies – IRDA, the EPFO, the Income Tax Authority and the newly set up PFRDA, each with some degree of jurisdiction in specific areas of operation. The presence of multiple regulators reduces the overall accountability of the operators, and does not produce a harmonized legal environment. The tax treatment of various provident and pension fund schemes also varies considerably. This is complicated by high administered interest rates on some of the savings instruments, whose receipts are channeled into government consumption expenditure.

As a result, the current system has many instances where sufficient attention is not being paid to improving professionalism and achieving international standards in management and efficient provision of retirement support. The EPFO, with balances equivalent to about 6% of GDP, may be considered to be among India's largest Non-Banking Financial Institutions. Yet its current governance structure is antithetical to modern norms of corporate governance. It is managed by the Central Board of Trustees, numbering 45 (an unwieldy number), entirely appointed by the Central Government, with no provision for independent experts from outside the government. There are many design provisions (such as permitting members to withdraw balances from the DB pensions scheme and yet retain pension benefits when later contributions are made) which need to be made consistent with modern provident and pension fund practices.

EPFO itself is both a service provider and the regulator for the sector, which includes over 3000 exempt funds. EPFO is responsible for granting exemptions and supervising exempt funds. Average balance in the exempt funds is larger than for the EPFO. EPFO does not have a professional investment or treasury department for managing funds of this dimension, even though it employs close to 20,000 staff. This is possible because it operates under an outmoded investment regime, which does not permit effective asset diversification among asset classes and sectors. Thus EPFO contributors are effectively debarred from earning market-related returns. Excessive political interference allows pension fund providers such as EPFO and post office savings schemes to maintain nominal interest rates which are higher than obtained from investments[15]. This is clearly unsustainable.

As the main social security institution in India, the EPFO must prepare itself to handle concerns over cross-border social security agreements. There are a large number of Indian citizens working abroad such as in the US, and Canada who contribute to social security systems of the host countries of workers and of India. Most however do not work long enough in these countries to receive benefits. The key constraint of the EPFO is its inability to effectively implement such agreements. This lack of professionalism on the part of the EPFO is therefore costing Indian workers and the country dear.

India is also a recipient country for foreign workers; about 0.1 million US citizens are employed in India. A cross-border agreement between the EPFO and foreign social security institutions is in the interests of both the foreign and host countries. Civil Service Pensions form only one component of the social security system, covering 3% of the labour force, but outflows on this account make up more than 2% of GDP. The Implicit Pension Debt (IPD), defined as the Net Present Value (NPV) of future payments to existing workers, existing pension pensioners and family pensioners, is estimated to be about 55 percent of GDP in

2004 prices (Bhardwaj and Dave, 2005)[16]. In any society, at any given time, only the consumption component of GDP is available for purchasing goods and services by both the young and the old. Since society has many priorities, resources for old age financing compete against other needs. If a small proportion of the elderly (such as civil servants in India) are allotted a disproportionate share of resources that society can set aside for the elderly; there will be severe challenges in addressing the retirement needs of the vast majority, creating marked dualism in social safety net provision. This in turn may negatively impact on political and social cohesion.

The states are also finding that meeting pension liabilities is adversely impacting fiscal consolidation efforts, and expenditure re-allocation towards growth and social cohesion enhancing expenditures. State-wise pension payments as a percentage of states' own revenue receipts have increased from an average of 5.2% during 1980-90 to 17.2% in 2001-02 (RBI, 2003). The situation is likely to worsen if no corrective actions are taken.

Little information is available about the actuarial soundness of retirement schemes of public sector enterprises, or on occupational pension schemes. There is obviously a need to regulate them to ensure greater professionalism, transparency and fiduciary responsibility. The proposed changes in India's accounting standards, particularly AS (Accounting Standard) 15 which will align it to FAS 87 of the international accounting standards will significantly increase disclosure and reporting requirements for pension, health, and other liabilities which the companies have left unfunded. This may create adverse impact on profit and loss accounts of the Organization. As an example, public sector banks have made pension, gratuity, and other promises. But it is not known to what extent they have provided for their funding. To the extent they have not, and the changes in the accounting standards will require them to do so, their reported profits will decline, with implication of their risk rating by financial and capital markets. It is essential that all these plans be regulated by a regulator.

The unorganized sector is quite heterogeneous. In fact, some workers in this sector (for instance, small but prosperous shopkeepers) maybe better equipped financially for retirement as compared to low-wage workers in the formal sector. Thus any social security scheme for the unorganized sector has to be nuanced, with scope for self-selection of participants, and in some cases specifically targeted. This suggests that any government contribution for the so-called unorganized sector will be unwarranted as many in the unorganized sector have the capacity, and perhaps, motivation to save for retirement. However, for a significant proportion that is life-time poor, more effective and generous social assistance programs will be needed. This is an important reason for fiscal consolidation and reform at both the Centre and in the States.

4. Reform Directions

It is clear that each element of India's social security system needs to be tackled differently, and improvements made should be consistent with the overall functions of any social security system (namely, smoothing consumption over lifetime, addressing against longevity and inflation risks, income redistribution, and poverty relief achieved in a sustainable manner). While there has been intensive debate on social security reform around the world over the last two decades, predictably no single model suitable for all countries has emerged. The World Bank's most recent position paper on pension reform is structured around a five-tier framework[17], and it recognizes that local context and capacities are crucial in determining the importance and sequencing of each tier, as well as how each tier is organized. The multi-tier framework is useful as it provides a strong rationale for drawing retirement income from a variety of sources, thus mitigating the risk of over-reliance on one scheme or method. This strongly suggests that each retirement scheme need not provide the requisite retirement resources and risks.

Broad Directions

In the case of India, broad directions of reform include expansion of social security coverage; increase in organizational efficiency and professionalism, provision of a systemic perspective and development of the sector in its entirety, including industry professionals such as actuaries and researchers[18]. Reform of social safety nets will require reform in complementary areas including financial and capital markets, fiscal management, labour market and administrative and civil service reform. Such complementary reforms are a huge challenge in any country, and India is no exception in this regard.

Pension Regulator

Establishment of the interim PFRDA (ordinance No.8/2004) in 2004 and the introduction of the PFRDA Bill (Bill No.36 of 2005) in the 2005 budget session of the Parliament constituted a major milestones. The Standing Committee on Finance of the Parliament has cleared the Bill, but the left Parties which have disproportionate influence on current coalition government, have stymied its passage. The government is considering a separate bill for voluntary defined contribution scheme for private sector workers. *('Separate bill on pension funds for private sector on the anvil' Posted at www.livemint.com on Jun 24, 2007)*

As discussed in the previous sections, the case for establishing a pension's regulator in India is overwhelming. Greater professionalism in the pensions industry; lowering of transactions costs in performing tasks noted earlier; greater efficiency in intermediating long term pensions savings to enhance economic growth which is a pre-requisite for economic security for both the young and the old; potential for pensions industry (and complementary reforms) to increase India's competitive edge and diversify export basket for services, all strongly suggest a need for a pensions regulator. It is noteworthy that high-income industrial countries do not leave pensions sector to be solely regulated to the forces of self-regulation or the markets, but have strong state regulators (regulation in this case is a public good which market will significantly under provide), supplemented by transparent rules requiring disclosure and transparency for even the state-run social insurance schemes[19].

It is essential that while the Parliament is considering the Bill, the interim PFRDA continues its dialogue with the States to ensure smooth integration of State and Central government pension schemes. While some of the parameters (such as the contribution rates) may differ among various states, and between states and the Centre, the PFRDA must remain the sole regulatory body for the civil service pensions.

The interim PFRDA can also help in ensuring that procedures of collections of pension contributions, record-keeping, member information dissemination etc are efficient with low transactions costs. It could also undertake studies of modalities for introducing the Central Record keeping Agency (CRA); Points of Presence (POP) mechanisms; and criteria for selecting pension fund managers[20].

Coverage

India faces a huge challenge in improving pension coverage (only about a fifth of the labour force is covered), particularly among workers who are not employed in the formal private or government sector. Of the total earning workforce of 450 million, 85%, or about 380 million work in sectors other than the formal private sector and the Government – and are usually classified as belonging to the unorganized sector.

However, the primary occupations of workers in this category are wide-ranging- including self-employed farmers and wage labour (accounting for over 60% of the unorganized sector), self-employed business owners (13.8%), salaried and/or contractual employees in the informal sector (5.4%), self-employed professionals (under 1%) and others (8.9%)[21]. There is great diversity in terms of size and regularity of income, savings potential and overall awareness of the need for and ability to save for retirement[22]. This poses serious challenges in achieving pension penetration: schemes have to be structured to enable workers in varying occupations with different income security levels to save for their retirement. The NPS permits any individual to voluntarily join scheme. The PFRDA would therefore need to devise appropriate regulations and schemes to encourage voluntary participation from both the organized and the unorganized sectors. The potential for voluntary NPS participation is large[23] But this will require social marketing, and considerable education and development effort. Confidence in the professionalism and competence of the PFRDA will be the key.

A modest increase in coverage may be obtained if the EPFO demonstrates the capacity to efficiently administer, and introduces modern investment management and governance structures. Currently, only establishments employing 20 or more employees are covered by the EPFO. But if it reforms, this can be progressively reduced to 10 employees. This may increase the membership base by perhaps 4 to 5 million. This is modest in relation to India's labor force, but is significant in terms of absolute numbers. The trade unions therefore have a direct stake in EPFO reforms. Reforms aimed at modernizing EPFO's organizational and governance structures would also end the practice of members withdrawing accumulated balances when changing jobs, and reduce the workload generated by such provision. EFPO's aim should be to make its operations consistent with long- term retirement financing institution rather than continue to operate essentially as a savings bank as is the case currently.

Two options for expanding coverage to include the unorganized sector were discussed earlier. It is worth emphasizing that social insurance however is a complex concept. The economics of life insurance and pensions are impacted in a diametrically different manner when life expectancy increases. The cost of the former goes down, while the cost of pensions and health care increases substantially. Moreover, the actuarial calculations relevant for pensions and for health insurance are very different, requiring robust and constantly updated databases and expertise in analyzing. The social insurance schemes need to be sustainable for over 70 years. Some of the benefits such as unemployment insurance and health insurance are not available to most in the organized sector. The report will vastly increase the demand for health care services and for pensions, but does not give due consideration to the supply side factors, particularly in the health sector.

Longevity and Inflation Risks
Adequate retirement provision requires addressing these risks. Traditionally, in the industrial countries, mandatory social insurance schemes covering most of the labor force have addressed these risks fairly satisfactorily, and have also provided disability and survivors' benefits. In a DC scheme such as the NPS, these risks are not addressed in the current design. Thus, high priority must be given to risk sharing arrangements between individual members, insurance companies, and the governments for addressing these risks in an affordable and sustainable manner. This is especially important in view of the mandatory annuity provision of the NPS. This issue is also of major importance in the DC schemes of the developing countries (Impavido, *et.al.* 2003).

EPFO's pension scheme (EPS) does not have inflation risk sharing mechanism, but its benefits do address longevity risks. However, even the current benefits are unsustainable as EPS is severely under-funded. (See endnote 16). So before addressing inflation risks, the EPS scheme will need a thorough reform, including substantial reduction in the replacement rate (the promised 50 percent rate is not sustainable), and modern investment management and administration.

In addition to longevity and inflation risks, the NPS will need to incorporate disability and survivors' benefits. This can be done through a group insurance scheme, with the premiums paid from the contributions to the NPS. Following the international practice, the cost should be borne by the members.

Tax Arrangements
The 2005-06 budget of the Central government has restructured the Income Tax Act (1961) to reflect modern concepts of savings and tax incentives. Tax rebates on life insurance provident fund and pension fund products, that were available under Section 88 of the act, have been abolished. Concurrently, Section 80L of the same act, which provides for deduction up to Rs 15,000 for interest earned from government securities, NSC (National Savings Certificates) and interest on PSU (Public Sector Undertakings) bonds has been omitted. It is expected that these and other sections pertaining to tax rebates or deductions on savings will be combined together, in order to bring in uniformity in tax treatment for all savings instruments. A simplified income tax slab structure, including much higher initial exempt levels of Rs 1.25 lakh for women, Rs. 1.5 lakh for senior citizens and Rs 1 lakh for others has been proposed. However, such differential levels of exemption complicate tax administration and need to be minimized.

It is expected that the investment in pension products purely for tax shelter purposes will be reduced with these measures. Specifically, the attractiveness of EPFO as a tax shelter will be considerably diminished[24]. Consequently EPFO will be increasingly compared with other PFRDA-regulated schemes in terms of service quality and professionalism, and be pushed to achieve better standards of performance. This implies that greater urgency is needed in modernizing EPFO governance and organizational structures.

This move is also intended to take the tax structure for pensions towards the international best practices of 'EET' model – exempt (E) from personal income tax during contribution, exempt (E) for accumulation and taxed (T) during withdrawal. The budget has proposed the setting up of an Expert committee on operationalization of the EET system for provident and pension funds sector and presumably for other savings as well. PFRDA schemes are already on the EET system, and such treatment needs to be extended to others such as the EPFO schemes, to ensure level and equitable treatment as well as for widening the tax base. Indirectly, tax reforms will encourage the growth of the new civil service and unorganized sector pension scheme set up in January 2004.

5. Concluding Remarks

India's open-economy, open-society paradigm requires inclusive growth to manage globalization in a sustainable manner. A well functioning social security system, with increasing coverage of the population and types of risks addressed is an important element of inclusive growth. Demographic trends, with large number of young coming into the labor force, need for fiscal consolidation and flexibility and need for greater labor market mobility are also adding urgency to social security reforms in India. The analysis in this paper suggests that the social security system which has evolved since independence is fairly complex, but suffers from severe limitations.

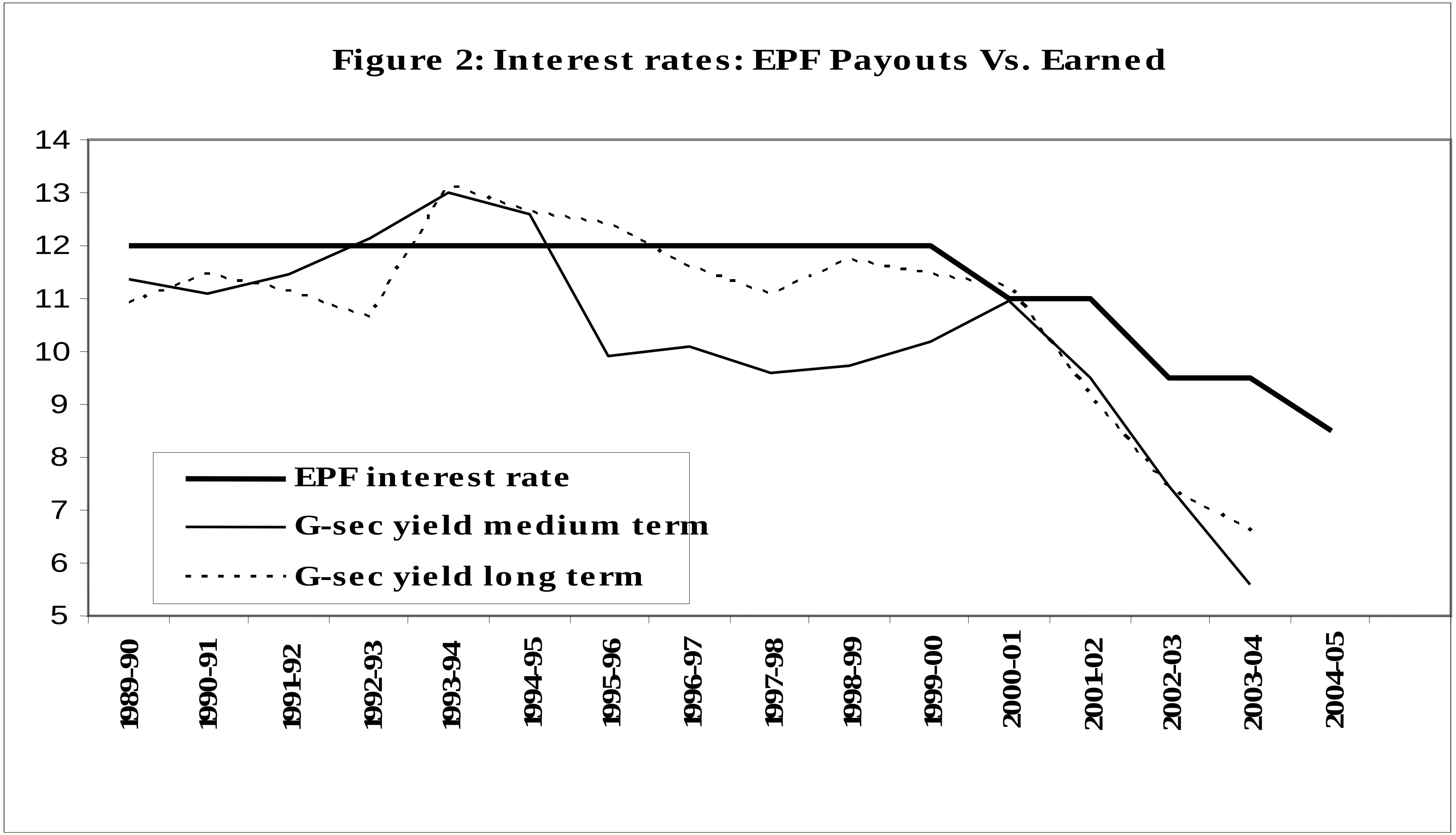
First, the core-functions are not being performed by the existing provident and pension fund organizations in both private and public sectors with requisite degree of professionalism. This will also require revamping of social security laws, and regulations as well as organizational structures.

Second, there is a lack of systematic perspective reflected in lack of coherence and capabilities of those regulating different components of the social security system. The New Pension Scheme (NPS) initiated in January 2204, representing a decentralized and scalable approach, is still to be made fully functional. In particular, the current coalition government has been unable to persuade some of its own partners to pass the PFRDA Bill introduced in the Parliament in 2005. This delay is acting as a constraint on the development of a pension system in which general public can have high degree of confidence, and thereby affecting their interest. The government is planning a separate Bill for those who want to voluntarily join the NPS, and to enable PFRDA to regulate occupational pension funds.

Third, the level of financial economics in general and pension economics in particular, remains low, even among trustees of provident and pension funds. The developmental role of PFRDA, is terms of financial education, needs to be undertaken with much greater urgency.

Fourth, the social assistance programs for the elderly suffer from lack of funds resulting in low level of assistance and coverage provided. Thus fiscal reforms at all levels of government and improvement in government delivery systems are essential to provide minimum old age support.

Finally, robust database, pension research capabilities and empirical-evidence based policies required to enhance effectiveness of current policies and to reform them, are in short-supply. Analytically rigorous and policy relevant research is essential for building a modern social security system in India.



Source: Calculated by the author

References

Andrews, E.M. and D.K. Wang, 2006, Pension Reform and Development of Pension Systems: An Evaluation of World Bank Assistance", Washington, D.C.: The World Bank.

Asher, M. G (2007), "India must breed more policy wonks", *Far Eastern Economic Review*, March.

Asher, M. and A. Nandy, 2006a, "Reforming Provident and Pension Fund Regulation in India", *Journal of Financial Regulation and Compliance*, Forthcoming.

Asher, M. and A. Nandy, 2006b, "Issues and Options in the Pay-out Phase in Defined Contribution Pension Schemes", *Processed*.

Asher, M. and P. Mukhopadhaya, 2006, "An Analysis of Severance Pay Policies in India and Sri Lanka" in Caroline Brassard and Sarthi Acharya (eds.), Labour Market: Regulation and Deregulation in Asia, New Delhi: Academic Foundation, 2006, pp. 141-165 (with Pundarik Mukhopadhaya).

Asher, M. and R. Sen, 2005, "India-East Asia Integration: A Win-Win for Asia", *RIS Discussion Paper RIS-DP #91/2005*, March.

Asher, M. and S. Shankar, 2007, "Time to Mainstream Micro-Pensions in India", *Pravartak: The Journal of Insurance and Management*, National Insurance Academy, School of Management. Vol II: Issue 3

Asian Development Bank (2005), Labor Markets in Asia: Promoting Full, Productive, and Decent Employment, Manila: Asian Development Bank.

Bhalla, S., 2003, "Not as Poor, Nor as Unequal as You Think: Poverty, Inequality and Growth in India: 1950-2001", Final Report of Research Project Undertaken for Planning Commission of India entitled 'The Myth and Reality of Poverty in India', Downloaded from http://www.oxusresearch.com/downloads/ei041203.pdf

Bhardwaj, G. and S.A. Dave, 2005, "Towards Estimating India's Implicit Pension Debt on Account of Civil Service Employees", Processed, July.

Bloom, D.E and Canning, D (2006), "Booms, Busts and Echoes", *Finance and Development*, 43, 3.

Cameron, D.R., 1978, "The Expansion of the Public Economy: A Comparative Analysis", *American Political Science Review*, 72, 4, pp. 1243-1261.

Cashmore, N., Leckie, S.H. and Pai, Y (2005), "Asia: Flow of Funds", Hong Kong: CLSA.

Chakraborti, R.D., 2004, "The Greying of India: Population Ageing in the Context of Asia," New Delhi: Sage Publications

Chatterjee, T.B., 2004, "Retiral Benefits in Existing Regulatory Scenario in India", Paper presented at ICICI Prulife Seminar, December 10-11, 2004

Clark, G.L., 2003, "Twenty-first century Pension (In)Security", in G.L. Clark and N. Whiteside (eds.), Pension Security in the 21st century: Redrawing the Public-Private Debate, New York: Oxford University Press, Chapter 9, pp. 225-251.

Dave, S., 2006, "India's pension reform: A case study in complex institutional change", January 11. Also available at www.iief.com

Dev, M. and Mooij, J., 2005, "Patterns in Social Sector Expenditure: Pre and Post-reform periods", in K.S.Parikh and R.Radhakrishna (eds), India Development Report 2004-05, New Delhi: Oxford University Press and Indira Gandhi Institute of Development Research

Dyson, T. (2002), "On the Future of Human Fertility in India", Country Paper UN/POP/CFT/2002/CP/6, United Nations: Department of Economic and Social Affairs, Population Division.

Government of India (GOI), 2000, "The Project OASIS Report", New Delhi: Ministry of Social Justice and Empowerment, January.

Government of India, 2005, "Economic Survey 2005-06," New Delhi: Ministry of Finance, July.

Government of India, 2007a, "Towards Faster and More Inclusive Growth: An Approach to the 11th Five Year Plan", New Delhi: Planning Commission.

Government of India, 2007b, "Economic Survey 2006-07," New Delhi: Ministry of Finance, February 28.

Government of India, 2004, "Report of the Advisory Committee to Advise on the Administered Interest Rates and Rationalization of Savings Instruments", Mumbai, January.

Holzmann, R. and R.Hinz, 2005, "Old-Age Income Support in the 21st Century: An International Perspective on Pension Systems and Reform", Washington D.C.: World Bank

International Monetary Fund (IMF), 2001, "India: Recent Economic Developments and Selected Issues", *IMF Country Report No. 01/181*, Washington: International Monetary Fund, October.

IMF, 2004, "World Economic Outlook: The Global Demographic Transition", Washington: International Monetary Fund, September.

Impavido, G., C.Thorbun and M.Wadsworth, 2003, "A Conceptual Framework for Retirement Products, Risk-sharing arrangements between providers and retirees", London: Watson Wyatt, RM-global-01.

Irudaya Rajan, S., U.S.Mishra and P.Sankara Sarma, 1999, "India's Elderly: Burden or Challenge," New Delhi: Sage Publications.

Jalan, B., 2005, "The Future of India: Politics, Economics, and Governance", New Delhi: Penguin Viking.

Katzenstein, P.J., 1983, "The Small European States in the International Economy: Economic Dependence and Corporatist Policies", John Gerard Ruggie (ed.), The Antinomies of Interdependence, New York: Columbia University Press, pp.

Liebig, P.S. and S. Irudaya Rajan (ed.), 2003, "An Aging India: Perspectives, Prospects and Policies," USA: Haworth Press.

Madhavan M.R. and Manghnani, R. (2005), "Legislative Brief: The Pension Fund Regulatory and Development Authority Bill, 2005", *Parliamentary Research Service* (www.prsindia.org).

Mehrotra, S and Biggeri, M, 2007, "Extending social insurance to informal wage workers" in Mehrotra, S and Biggeri, M (eds.), Asian Informal Workers: Global risks, local protection, New York: Routledge, Chapter 12, pp. 400-453.

Mitchell, O.S., and S.P. Utkus, 2004, "Lessons from Behavioral Finance for Retirement Plan Design" in O.S. Mitchell and S.P. Utkas (eds.), Pension Design and Structure: New Lessons from Behavioral Finance, New York: Oxford University Press, Chapter 1, pp.3-41.

Mukhopadhyay, P, 2007, "Right road but a broken cart", *Live mint*, March 6.

National Commission for Enterprises in the Unorganized Sector (NCEUS), 2005, Report on Social Security for Unorganized Workers, NCEUS: Ministry of Small Scale Industries, Government of India.

Planning Commission, 2002, "Tenth Five Year Plan 2002-2007-Volumes I and II," New Delhi, December 2001, available at http://planningcommission.nic.in/plans/planrel/fiveyr/10th/

Reserve Bank of India (RBI), 2003, "Report of the Group to Study the Pension Liabilities of the State Governments", Mumbai, October 2003

Reserve Bank of India (RBI), various years, Handbook of Statistics, Mumbai

Rodrik, D., 1998, "Globalization, Social Conflict, and Economic Growth" (Prebisch Lecture), The World Economy 21(2), pp 143-158

Ross, S.G., 2000, "Rebuilding Pension Institutions: Administrative Issues", Third APEC Regional Forum on Pension Fund Reform, March 30-31, Bangkok, Thailand

Sanyal, S., 2005, "Demographics, Savings and Hyper-growth", Deutsche Bank Global Markets Research, July 5.

Shah, A. (2005), "A sustainable and scalable approach in Indian pension reform", Available electronically at http://www.mayin.org/ajayshah/pensions.html, Last Accessed: 10 April 2006.

Sridhar, V., 2004, "An unkind cut?", *Frontline*, Volume 21, Issue 18, Aug.28-Sept 10.

The Pension Fund Regulatory and Development Authority Ordinance, 2004, Ord.No.8 of 2004

The Pension Fund Regulatory and Development Authority Bill, 2005, Bill No. 36 of 2005.

US Census Bureau, 2001, " An Aging World", Economics and Statistics Administration, United States Department of Commerce,US Government Printing Office, Washington D.C

Vaidyanathan, R., 2005, "Country Report: India", in Noriyuki Takayama (ed.), Pension in Asia: Incentives, Compliance and their Role in Retirement, Tokyo: Maruzen Co., PP 93-120

'*Mortality tables: Revised data on the cards*', Posted at www.livemint.com on Jun 29, 2007

ENDNOTES

[1] There has however been declining trend in poverty, though the rate of decline varies according to the survey method. The 61st round of large sample survey on household consumer expenditure puts the poverty ratio at national level at 22 percent, as compared to 26 percent in 1999-2000 (GOI, 2007, pp.207-208). The method used is the mixed recall period under which data for five non-food items are collected for a 365 days recall period, and for food on the basis of 30 day recall period. If Uniform Recall Period (URP) is used data for all items are collected on the basis of 30 day recall period. The poverty rate of 22 percent implies 240 million poor. Given India's low per capita income, poverty is much more visible and insidious, though India's Gini coefficient at around0.35 has not risen significantly, and is much lower than other comparable countries. Poverty and inequality should be kept separate. The former is much more amenable to reduction through public policies directed at high inclusive growth. Public policies can lead to rapidly rising inequalities, but are much less effective in significantly reducing inequalities.

[2] There is considerable regional variation in fertility rates. The southern region of the country is experiencing fertility rates at or below replacement rates, while some of the highly populated northern states have high fertility rates, with the western region somewhere in between (Chakraborti, 2004).

[3] According to LIC (1996-98) Occupational Pensioners Mortality, the life expectancy at age 60 was 22.5 years for all occupational pensioners, suggesting much longer period for which retirement support is needed.

[4] A major indicator of this advantage is the rising share of working age population in total population; it is expected that the proportion of the active-workforce in the population (i.e. persons aged 15-59) will rise from 58.2 % in 2001 to 64% in 2016 (Planning Commission, 2002). This share will not begin to decline till around 2045, but even then it will remain at a higher level than industrial countries, and China (IMF, 2004).

[5] In a Defined Benefit (DB) scheme, the benefits to be provided are explicitly stated, while contributions are left undefined. In a DB scheme, it is the plan sponsor which bears the investment, mortality, and other risks.

[6] In India, Pay Commissions are periodically constituted to recommend civil servant's pay and other terms of employment. The upward revision in nominal pay has also been applied to civil service pensioners. Thus, there is also wage indexation which is in addition to price indexation.

[7] In early 2007, the Central government has decided to give authority to the interim PFRDA to appoint record-keeping agency and fund managers for the NPS. But the political constraints have meant that only public sector organizations will be permitted to bid for these contracts. In the Finance Bill of 2007, proposal has been made to amend the Section 80CCD to enable not just the central government employees, but 'any other employer' to participate in the NPS.

[8] Estimates suggest that as of 2004 the EPS was under funded by at least Rs.220 billion (Bharadwaj and Dave, 2005).

[9] To my knowledge, no studies estimating such compliance costs have been undertaken, but anecdotal evidence suggests that the quality of service rendered by the EPFO is poor, and irregular side payments are not uncommon. In addition, the EPFO rules and regulations as well as budgeting and other administered procedures are outdated. Thus, the EPFO currently has no capability of transferring balances from one jurisdiction to the other when an employer changes jobs. More than four-fifths of EPFO's work load is unrelated to the retirement schemes. All these contribute to very high compliance costs. This is an area where more research is needed.

[10] This includes Rs.40 billion under EPFO regulated but exempted Trusts.

[11] The details of the FBT may be found in Finance Bill 2005 and Finance Bill 2006.

[12] Countries levying such a tax, such as Australia, specifically fully exempt superannuation contributions by both the employers and the employees at the time of contribution.

[13] Other arguments against the FBT however remain. First, it is an ad-hoc revenue measure which is inconsistent with the government's vision of moving towards low nominal income (and sales) tax rates- a broad base essential for a modern tax system. Second, it will inevitably provide greater discretionary powers to tax administrators and opportunities by industries to engage in lobbying for special exemptions. Both are undesirable. Third, voluntary superannuation funds have the potential to provide long-term funds to the financial and capital markets, and to contribute to financial innovation. These are essential if the government's objective of developing Mumbai into a financial centre is to be realized. Given such strong arguments against it, re-thinking on FBT is likely but the changes are unlikely until the 2006-07 Budget.

[14] This argument represents an application of the thesis advanced by Prahalad (2005) that those at the bottom of the pyramid should not be considered as beyond the reach of profit-making businesses. A necessary corollary of Prahalad's thesis emphasizing the consumption aspects is that capabilities of those at the bottom must be improved and appropriate infrastructure and policy environment should be provided for them to participate more meaningfully in the production activities.

[15] It has led to the curious practice of the EPFO Board considering interest rate to be credited to members' accounts at the beginning rather than at the end of the financial year.

[16] While there is a strong case for reforming the civil service pensions, the IPD estimate however should be kept in perspective, and their policy implications should be carefully considered. The IPD is a stock concept while the GDP is Flow concept. Thee IPD concept chosen by Bhardwaj and Dave, (2005) does not taker into account growth in GDP, focusing only on pension liabilities. Countries have traditionally under taken parametric reforms to manage pension liabilities, and there is considerable scope for such reforms in India. Never the less their study is welcome as it give impetus towards empirical evidence based policies.

[17] The tiers are as follows: a basic universal or means-tested social pension financed from budgetary sources forms the tier zero; a mandated socially risk-pooled public pension, DC or notional DC in nature and financed through contributions forms the first tier and mandated occupation or personal pension plans managed publicly or privately form the second tier. Voluntary occupation or personal pension plans form the third tier; and the last includes personal savings, home ownership, family and community support, gold, land and other assets (Holzmann and Hinz, 2005). This version has two new tiers, tier zero and tier four, and it recognizes that individual mandatory savings accounts and solely private management of their investments may not be appropriate when enabling conditions, such as good record-keeping, sufficiently developed financial and capital markets, including requisite human resources.

[18] Introduction of graduate level degree programs in pension science, and encouraging rigorous empirical evidence-based policy relevant research on pensions issues in India merit serious consideration. The aim should be to move away from descriptive, general and ideologically driven work on social security. India should therefore seriously consider developing a world class pension research centre.

[19] Requirements by the Social Security Administration in the US to mandatorily commission actuarial studies spanning 75 years projections, and making them publicly available through the internet are instructive in this regard. Moreover the OECD (Organization for Economic Co-operation and Development) undertakes regular comparative analysis of the impact of social security schemes in the member countries. The contrast with the lack of information about projections of public sector pension schemes in India; and not-easily accessible and often patchy EPFO annual reports is rather striking.

[20] For elaboration on CRA, POP and selection of pension fund managers, see Shah (2005).

[21] Source: AC Nielsen and ORG MARG National Data Survey Snapshots on Pension Reform for the Informal Sector in India, 2005, available at http://www.finmin.nic.in/stats_data/pension_data .

[22] In fact, the time may have come to drop the classification of "unorganized" sector for the purpose of pension scheme design and realize that individual sub-categories within this class are too heterogeneous to be combined in this manner. This is also indicated by the A.C. Neilson –ORG MARG survey mentioned in endnote 21.

[23] A Hong Kong based financial institution has estimated that by 2015, there are likely to be 8.6 million mandatory members of the NPS, with accumulated balances of US$26 billion (Cashmore *et al.*, 2005).

[24] Currently, employees earning up to Rs. 6500 per month contribute between 10-12 % of their basic pay plus dearness allowance, with a matching contribution by the employer. Those with higher starting salaries need not mandatorily join the EPFO. However, contributions higher than the mandated percentage, and contributions of those beyond the wage ceiling are also entitled to Section 88 tax benefits. As a result all EPF deposits offer a tax-free assured 8.5% nominal rate of return. This does not benefit the poor worker as much as the salaried and savings-surplus strata, which uses the EPFO as a lucrative investment avenue. Data on distribution of EPF supports this premise: As on March 31, 2004, 85% of the contributors had an average balance of Rs.3133 only, and a mere 3.6% of contributors had total EPF balances exceeding Rs.100, 000.