Pension System Reforms: A Tale of Two Asian Countries

Ramgopal Agarwala
Distinguished Fellow, RIS
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The Singapore Model of Social Security

- Central Provident Fund set up in 1955 along the lines of similar funds in other British colonies.
- Evolved over time to become an instrument of forced savings, facilitating asset formation for households through lending for house purchase, education, and facilitating infrastructure investment by the government.
- Health components were added
- Supplementary pension provisions added with increasing life expectancy
- Instrument of macro-economic management through variation in contributions
- The system contributed to high growth rate of the country, macro-economic stability and old age security with housing as an important asset in old age.

Fractured Indian Pension System

- Employees Provident Fund Organization (EPFO) of India which was set up in 1952 similar to Singapore system.
- But instead of evolving in positive directions as in Singapore, it deteriorated under the weight of bureaucratic inefficiency and various ideological pulls.
- There are three different government managed systems covering government servants, organized sector employees and informal sector. In addition, there are many private life insurance and superannuation products with provision fro lump sum and/or annuity after a certain number of years.

Old DB system for Government

- For the government employees who joined service before Jan 1 2004, there is a defined benefit pension program which is quite generous in so far as pensions are linked not only to cost of living index but also to present wages of equivalent ranks. It also has a relatively low age of retirement, 62. This system has been in operation for a long time and has large unfunded liabilities. In some agencies of the Government, such as the Railways numbers of pensioners are now close to the number of workers and the burden of pensions is likely to increase significantly in the future. Modification in the age of retirement and delinking of pensions from current wages could be options to make fiscal burden manageable but the political feasibility of such reform may be remote.

New DC Pension System

- For those who joined Government service after January 1 2004, there is a different system. New Pension Scheme was announced in Budget of 2003-04. It has two Tiers. Tier I is mandatory for all Central Government employees (except Armed Forces) who join service on or after January 1, 2004. Employees will pay every month 10% of their salary and Dearness Allowance with a matching grant from the Central Government. The scheme has now been extended to most State Government employees as well. It is now also open to all other citizens of India with contributions to be decided by depositors subject to a certain minimum. There will be no matching grant from the Government for those who are not Government employees.
- The contributions and investment returns will deposited in a non-withdrawable pension account which will be portable. This will be managed by one of the pension fund managers (PFM) designated by an independent Pension Fund Regulatory and Development Authority (PFRDA) who will regulate and develop the pension market. The contributors would have a choice among three options: Option A would imply predominant investment in fixed income instrument and some investment in equity. Option B will imply greater investment in equity. Option C will imply almost equal investment in fixed income and equity. There will be a default option where investment profile will be determined based on age of contributor. Pension Fund Mangers will be free to invest in international markets subject to regulatory restrictions. Pension contributions and accumulation will be accorded tax exemption upto a certain limit but benefits would be taxed as normal income. Individual can normally exit at or after age 60 from Tier I. On exit 40% of the pension wealth will be used to buy annuity which in the case of Government employees would provide pension for lifetime of the employee and his dependent parents and spouse at the time of retirement.

- In addition there will be Tier II, which is voluntary where depositor can withdraw any time. The Tier II funds will be managed in the same way as Tier I funds and will be subject to tax as normal income on withdrawal.

- This was introduced under the influence of international community favoring the Chilean model and ha sall the uncertainties that have been found to be true for Chilean system.

Old Provident Fund system gets distorted

- The NPS co-exists with the older mandatory program under Employees Provident Fund (EPF) Act of 1952 managed by Employees Provident Fund Organization (EPFO). The Act is applicable to factories and establishments engaged in 177 industries employing 20 or more workers and functioning for more than three years from the date of establishment. The rate of contribution is 10% of wages by workers and employers' each. Employers can seek an exemption if they mange their own provident fund trust. Contributions are credited to individual accounts and benefits are equal to contributions of employees and employers plus returns thereon.
- However under the influence of ILO , there was as significant change in 1995 when Employees Pension Scheme was introduced. This is a defined benefit scheme where the monthly pension is calculated as follows:

  Pension = Pensionable salary x (pensionable years of service+2)/70

- Thus for member with 33 years of service, the pension is 50% of pensionable salary, which is defined as average of last 10 months' pay plus DA. This is to be funded by diverting 8.33 percent of the wage contributed by employers to the pension scheme with supplement of 1.66 percent of employees' wage contributed by the central government.
- This switch to defined benefit scheme is contrary to the worldwide trend of switching to defined contribution scheme (as in New Pension Scheme mentioned above) and may end up imposing a financial burden on EPFO which may have to be borne by the Central Government.

The Way Ahead

- In order to minimize the fiscal burden that pension systems may impose on the government and instead utilize the system for capital formation, there would be need for serious review of the whole pension system in India.
- First, the age of retirement may be treated as a flexible number reflecting life expectancy and work ability of the population. As life expectancy is increasing, so should the age of retirement.
- Secondly, instead of step jump into retirement, a system of gradual retirement may be introduced where workload and pay is gradually reduced.
- Thirdly, an effort should be made to utilize a significant part of the long-term savings under pension system for long-term investments that the Government needs to undertake to provide public goods in the economy.
- The Singapore pension system should be studied and lessons learnt in terms of the benefits the model might have brought to the overall development of the economy beyond private rate of return on the contributions to pension fund.
- Of course, the typical developed country PAYG system should be avoided like plague. The old age persons who are below poverty line should be helped along the same lines as other poor people are helped which includes a system of cash transfers.