

A Consolidated Model of Pensions for India

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Executive Summary

“The whole is much more than just the sum of the parts” –Aristotle

An economy, apart from everything else, is a highly fluid transmission mechanism. Its beauty lies in how the smallest of changes have the most complex trickle-down effects. A paradigmatic example of how seemingly minor policy changes can jumpstart the economy can be illustrated by examining the effects of a reform in the pension system. The OASIS Report first brought out the possibility of pension reform in India.

A reform in the pension system tackles the primary problem of the financial sector in a dual manner. On the one hand introduction of private pension fund managers will ensure the large-scale mobilisation of savings. This would increase the rate of savings, which would lead to a higher rate of capital accumulation, crucial for a developing country like India. It has been proved statistically that private managers are in a position to earn greater returns from their sources. So in effect privatising the pension system would place a large pool of fund in the hands of efficient managers, specialising in this form of activity.

But that answers only half the question. At this point it may be prudent to ask, so where would these funds be diverted in the absence of adequate channels? This is where the overall commitment comes into the picture. Admittedly pension reform is only a small part of a larger programme of allowing private initiative in the economy. The channelisation may take place in a dual manner:

- a) The insurance sector also has a bearing on pension reform, as part of the pension assets may also be invested in private insurance companies. Hence a simultaneous reform in the insurance sector with greater freedom for private companies would be in order.
- b) It is important to note that even privatisation of state public sector units (PSUs) would have a bearing on providing investment channels, though in an indirect manner. This is where the financial aspect comes into the picture. When pension fund managers invest in public issues of companies who have acquired a stake in state PSUs the whole idea of “distribution of the assets of the public sector” is achieved in a fair manner. Thus it performs the operation of killing two birds with one stone—providing investment outlets as well as redistribution.
- c) Instruments such as index funds are another option for investment channels. It has been proved that by investing in an index fund and diversifying internationally one can earn a rate of return over and above the rate of inflation-- which is significantly higher than investing in government bonds. Pension fund

managers may even take this course of action if provided with the opportunity to do so.

Private investment in infrastructure has long been a ticklish issue in India. But with a move towards the private pension system this would no longer be so--the need of one is perfectly fulfilled by the opportunities offered by the other. Putting it differently, the pension fund managers would mainly deal in long-term funds, and infrastructure companies would normally provide a return only after a long period of time. The infrastructure companies could absorb these funds either directly or through an intermediary leading to a symbiotic relationship between the two.

It would also be worthwhile to mention that the biggest “positive externality” of pension reform will be felt in the area of fiscal deficit. As per the recent report of the government of India paying pensions is one of the largest components of government expenditures and this is likely to increase in the future with increasing longevity and life expectancy. In the long run this is an unsustainable situation. This has been one of the major reasons behind private pension systems in Chile and other Latin American countries. In India it is only a matter of time--and the clock is ticking away.

The tendency to issue government bonds for deficit financing, which finally manifests itself in inflation is a situation all too well known in India. It has been repeatedly emphasised that the government ought to keep this kind of activity under check. The nexus between the pension system and deficit financing is thus clear by the reality that a large part of pension assets administered by the government are invested in government bonds itself. It is impossible to eliminate this form of deficit financing through government bonds so long as there are agencies that are mandatorily bound to keep a part of their funds in this form. Hence the only method, to discipline this tendency is by privatising the pension system and prescribing just a minimal level of government bonds to be held in pension portfolios. The second-generation reforms in the pension system in Chile have also stressed on the fact that the prescribed minimum limits for government bonds in pension portfolios should be gradually reduced.

To save the best for the last, the consequences of pension reform that touches each person's life is its extremely human aspect. Private pension fund managers provide the individual what he never had before--the power of exercising his choice. An individual can choose between competing Pension fund managers, between the growth type or secure income type of schemes and may even plan to save more in the initial stages and retire early! He can decide for himself as to who would be the best agent to manage his money for him and act accordingly. Such options are not provided under a system administered by the government.

Thus the pension reform represents an ideology of freedom and trust, which if adopted has the potential to make a significant dent in many of the problems plaguing the Indian economy in the financial, fiscal and individual spheres.

“Old age is the most unexpected of all things that happen to man.”--Leon Trotsky

In India Old Age seems to be most unanticipated and consequently groundwork for it is quite inadequate. The hangover of the “welfare state” ideology has resulted in government sponsorship of a large part of pensions, which are a major part of government expenditure. As of now, payment of pensions constitutes a large part of the government’s expenditure. This is expected to increase more so in the future as the improvements in health have resulted in an increased life span of the elderly.

Need for reform in India

The deficiencies of the current pension system in India are as follows:

- low coverage
- under performance of Provident Fund schemes
- investment restrictions
- administrative difficulties
- underdeveloped private annuity market
- Increase in the informal workforce is further widening the skewness in the existing structure of pensions, which in turn introduces distortions into the labour market.
- The differences in pensions between public and private sector employees as compared to the public sector are wide.

There is an urgent need to:

- Reduce government burden: In India the number of elderly (persons aged 60 and above) is expected to increase by 107%, to 113.0 million by 2016.
- Involve unorganised sector: Barely 34 million (or less than 11%) of the estimated working population in India is eligible to participate in formal provisions meant to provide old age income security. Therefore, almost 90% of India’s workforce is not eligible to participate in any scheme that enables them to save for economic security during their old age.
- At present the pension Social Security system is based on employer and employee contributions, which largely excludes the unorganised sector.

Pension savings accounts represent real and visible property rights—they are the primary sources of security for retirement. A clear definition of property rights is a reaffirmation of the rights of people to their accretions.

The reform in the Pension system and the adoption of a system based on funded defined-contribution Individual Retirement Accounts will have a multi-pronged advantageous effect on the Indian Economy.

- The government’s burden of administering pensions will certainly decrease.
- With the entry of private Pension fund managers, pension assets will be invested wisely thus providing a larger amount to individuals at the time of retirement.
- Pensions, as an issue will be de-politicised and will become more of an economic issue.
- The development of the pension sector will create a symbiotic relationship with the Insurance sector.
- The element of forced saving inbuilt into the system of mandatory contributions will go a long way in increasing the rate of savings of the household sector which constitutes the largest part of savers in India. The effective mobilisation of these will go a long way to aid capital formation and economic growth.

This paper discusses the Pension system in India under the following heads:

- I. Current System in India.
- II. An illustrative model of a new Pension for India, learning from the international experiences in this field.

I. Current Systems in India

Employees' Provident Fund (EPF)

The EPF programme, established in 1952, is a contributory provident fund providing benefits upon retirement, resignation or death, based on the accumulated contributions plus interest, from employers and employees. Subscribers to the EPF have the option to make partial withdrawals for specified purposes such as house construction, higher education for children, marriage, and medical expenses associated with illness. Establishments covered by the EPF can either have the EPFO manage the provident fund, or can undertake processes to qualify as an exempt establishment, whereby they manage the provident fund themselves. In general, exempted establishments are large companies. (Private Provident Funds)

Statistics about EPF:

Workers covered	24 million
Contribution rate	12 % employers’ share and 12 % employees’ share
Total contribution	24 per cent
Diverted as under	<ul style="list-style-type: none"> ▪ Provident Fund - 15.67 per cent ▪ Pension Fund - 8.33 per cent
Government contribution in pension fund	1.16 per cent

Source: International Social Security Association; Twelfth Regional Conference for Asia and the Pacific; Bangkok, Thailand, 20-23 November 2000. “Challenges to Providing Social Security to the Informal Sector in India”, Ajai Singh, Central Provident Fund Commissioner, Employees’ Provident Fund Organisation, India; ISSA/ASIPAC/RC/THAILAND/2000/2-

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In India the EPF, has been used more as medium of tax evasion by the salaried classes as the entire amount deposited in EPF is deductible for income-tax estimation purposes. This negates the purpose for which it was originally set up for i.e. as a fund that would cover expenditure during the lifetime after retirement.

Employees' Pension Scheme (EPS)

The EPS, established in 1995, provides for the payment of a member's pension upon the member's superannuation/retirement, disability, and widow/widower pension, and children's pension upon the member's death. The EPS program has replaced the erstwhile Family Pension Scheme (FPS). Employers that are not mandated to be covered may voluntarily apply for coverage. The new scheme, known, as the Employees' Pension Scheme (EPS), is essentially a defined-benefit program providing earnings related pension on superannuation, disability or death. Thus, EPF members are now eligible for two benefit streams on superannuation – a lump sum EPF accumulation upon retirement and a monthly pension from the EPS.

The amount of the pension benefit is based on the employee's average salary during the final year of employment and the total number of years of employment. Under the EPS, members must have completed a minimum of ten years of service and must be at least 58 years old. However, if an employee has completed twenty years of service, he/she may obtain an early pension from age 50. Under this provision, the amount of pension benefit is reduced by 3 per cent for every year falling short of 58. Exemption from the EPS is allowed, but in this event, the employer will have to cover the government's contribution.

However, participation to the EPS program was voluntary for the existing workers as on 1995 but mandatory for the new workers whose monthly pensionable earnings did not exceed Rs. 5000. Aggrieved workers alleged that the pension from the EPS was substantially inferior compared to the public pension schemes and that the return from the scheme was even lower than the provident fund arrangement. The debate surrounding the EPS continues unabated till today, with many trade unions filing litigations against the scheme.

This new system along with the recommendations of the Fifth Pay Commission Report has only added to the liabilities of the government.

Employees' Deposit Linked Insurance Scheme (EDLI)

The EDLI programme was established in 1976. This programme provides lump sum benefits upon the death of the member equal to the average balance in the member's EPF account for the 12 months preceding death, up to Rs. 25,000 plus 25 per cent of the amount in excess of Rs. 25,000 up to a maximum of Rs. 60,000. Contributions received are kept in the Public Account and earn an interest of 8.5 per cent. Health care and

insurance are covered through Employees' State Insurance Corporation.

Insured persons	8.8 million
Beneficiaries	34.2 million
Contribution rate	4.75 per cent employers' share and 1.75 per cent employees' share
Total contribution	6.5 per cent

Source: International Social Security Association; Twelfth Regional Conference for Asia and the Pacific; Bangkok, Thailand, 20 - 23 November 2000.

"Challenges to providing social security to the informal sector in India", Ajai Singh, Central Provident Fund Commissioner, Employees' Provident Fund Organisation, India; ISSA/ASIPAC/RC/THAILAND/2000/2-INDIA

Other Schemes

The central government alone administers separate pension programs for civil employees, defence staff and workers in railways, post, and telecommunications departments. This is called the Civil Servants' Pension Scheme (CSPS). These benefit programs are typically run on a pay-as-you-go, defined-benefit basis. The schemes are non-contributory i.e. the workers do not contribute during their working lives. Instead, they forego the employer's contribution into their provident fund account. The entire pension expenditure is charged in the annual revenue expenditure account of the government.

Federal Government including military personnel	4 million
State Government civil services including personnel employed in state-owned public sector undertakings	6 million
Benefits available to those who are covered under the pay-as-you-go systems	50 per cent of average wage earned during the last 12 months.

Source: International Social Security Association; Twelfth Regional Conference for Asia and the Pacific; Bangkok, Thailand, 20 - 23 November 2000.

"Challenges to providing social security to the informal sector in India", Ajai Singh, Central Provident Fund Commissioner, Employees' Provident Fund Organisation, India; ISSA/ASIPAC/RC/THAILAND/2000/2-INDIA

In addition to the provident fund, workers in both public and private sectors receive a second tier of lump sum retirement benefit known as gratuity. It is paid to the workers who fulfil certain eligibility conditions like a minimum qualifying service period of five years. It is equivalent to 15 day's of final earnings for each years of service completed subject to a maximum of Rs. 350,000. The cost of gratuity is entirely borne by the employer.

The Public Provident Fund (PPF) scheme, introduced about three decades ago, is meant to provide unorganised sector workers with the facility to accumulate savings for old age income security. Under the scheme, amounts between Rs 100 to Rs 60,000 per annum can be deposited into the PPF account. These investments are eligible for tax rebate under Sec 88 of the Income Tax Act and interest at a guaranteed 11 per cent p.a. (till recently 12 per cent per annum) is fully tax exempt under Sec 10.

The scheme has poor coverage because of ineffective marketing and the service delivery is grossly inadequate. Being largely urban centric, the scheme is used more as a tax planning vehicle by high-income savers than an old age income security plan. The 11 per cent tax-free return that a PPF investor is guaranteed is equivalent to a 16.8 per cent pre-tax return for a marginal income tax payer.

In an effort to widen the reach of the social safety net for the aged poor, the central government, in 1995, introduced a more comprehensive old age poverty alleviation program called the National Old Age Pension (NOAP) under the aegis of the National Social Assistance Programme (NSAP). The scheme aims to provide monthly pension to thirty percent of the poorest elderly. This programme provides benefits for poor people above the age of 75 years. Under the programme a pension of Rs. 75/- per month is provided to eligible persons.

The formal old age income security system in India can thus be classified into three categories:

- The upper tier consists of statutory pension schemes and provident funds for the organised sector employees.
- The middle tier is comprised of voluntary retirement saving schemes for the self-employed and unorganised sector workers.
- The lower tier consists of targeted social assistance schemes and welfare funds for the poor.

Conceptual Explanations

Under a *defined-contribution plan*, workers build up either explicit or implicit retirement accounts that fund retirement. The benefit is determined by (1) the level and timing of contributions, (2) the rate of return on the retirement accounts and (3) the form in which benefits are realised, including annuitization, programmed withdrawals and lump-sum distribution. The relationship between contributions and benefits is transparent, which may improve compliance incentives.

In a *defined-benefit system*, benefits are usually determined by multiplying a replacement rate by a pension base.

The *replacement rate* is typically an accrual factor times the years of service, and the pension base is a function of a worker's earnings history. Since this type of system

often ignores the time path of contributions in calculating the replacement rate and the pension base, the tie between benefits and contributions can be quite loose.

In a *pay-as-you-go system*; pension payments are made using the taxes collected from the younger taxpaying generation. Their pension payments in turn are made from the taxes collected subsequently.

In a *Funded System*, pension payments are invested in a variety of financial assets. Funding provides an opportunity to capitalise from investment in financial markets, where the rate of return is likely to be higher than the implicit rate of return to contributions in a pay-as-you-go pension system. The benefits of funding can be enhanced by investment diversification. Funded systems can reduce-though arguably not eliminate-the vulnerability of a pension system to adverse demographic trends and political pressures.

In the Indian context, the financing issues arise primarily in four programs: the EPS, the CSPS, the GPF because of its integration into the government accounts, and the NOAPS. Each presents a potentially open-ended financial responsibility. A goal of reform should be to place explicit limits on these liabilities.

II Changes recommended

1. Structure of the new pension system

Research commissioned by Project OASIS shows that regular savings at the rate of between Rs.3 to Rs.5 per day through the entire working life easily suffice in escaping the poverty line in old age provided the pension assets are invested wisely.

The OASIS Report envisages a hierarchical structure for the pension system in India based on individual retirement accounts (IRA). Individual accounts imply full portability: i.e. the individual would hold on to a single account across job changes across geographical locations. The pension system would constitute:

- a) Points of preference (POPs): which would be post offices and local banks to deal directly with customers. A two-tier system with POPs with good information technology and telecommunications facilities is proposed, which would offer better services.
- b) Depository corporation: which would maintain the database of individual choices of schemes (viz. safe income, balanced income and growing income styles) and convey them to PFMs
- c) Pension fund Managers (PFMs): which would perform the task of fund management.
- d) Annuity Providers: The pension system design proposed here critically relies on annuity providers who convert the lump sum of assets (attained at retirement) into a regular monthly pension (or a variable annuity) until death. Annuities are a part of the life insurance industry. With the recent liberalisation of entry into life insurance, it is likely that we will see improvements to the extent where annuities are efficiently priced.

- The basic architecture of the system is hence one where individuals deal with POPs, which carry these instructions to the depository. The depository would maintain the database of all individual accounts as well as the instructions given by each individual. The depository would consolidate individual instructions into blocks of funds, which would be handed over to PFMs. In this system, PFMs would be able to focus purely on fund Management.

- It is emphasised that this 3-tier system yields the lowest transaction costs. But a method could also be devised to facilitate direct interaction between the individuals and PFMs. Hence in due course attempts should also be made to phase out the Depository Corporation so as to facilitate direct interaction between individuals and the PFMs on the lines of the Chilean model.

- As far as the retirement age goes, the Chilean system presents an interesting alternative. The meaning of "retirement" in the PSA system is much different from the traditional one.
 First, workers can continue working after retirement. If they do, they would receive the pension their accumulated capital makes possible and they would not be required to contribute any longer to a pension plan.
 Second, workers with sufficient savings in their accounts to fund a "reasonable pension" (50 percent of the average salary of the previous 10 years, as long as it is higher than the "minimum pension") may choose to take early retirement whenever they wish to.
 The retirement age that is established by law is 65 years for men and 60 years for women. The PSA system, on the other hand, allows for individual preferences to be translated into individual decisions that would produce the desired outcome. One way to facilitate choice making is through user-friendly computer terminals that permit the worker to calculate the expected value of his future pension, based on the money in his account, and the year in which he wishes to retire.

2. Private management of accretions through Pension Fund Managers

The model of private pensions should be implemented using private Pension Fund Managers (PFMs). The OASIS report recommends the establishment of 6 Pension Fund Managers (PFMs) so as to simplify choice for individuals. But this objection is misplaced, as, even if individuals themselves do not possess the knowledge of financial instruments, the market forces would enable them to decide to employ a PFM who would make these choices on their behalf. Hence, this number should be determined by the free interplay of market forces. The most efficient fund managers would survive while the rest would be weeded out and hence there should be no cap on their number. In Chile there is complete free entry for Pension fund providers, even if they are foreign companies, provided certain capital requirements are met. At this point, 19 private companies have received licenses to be pension plan providers for Polish workers. Most of them are alliances of Western and Polish

financial institutions such as Aetna, Citibank, Bank Paribas, Credit Lyonnais, Allianz etc. There is also a pension plan being provided by the Korean conglomerate Daewoo, and by the largest Polish cable TV station, Polsat.

3. Investment Options and Prudential regulations for PFM

Each PFM should offer at least 3 different type of investment alternatives:

a) safe income b) balanced income and c) growing income styles.

Regulations need to be laid down to harness the rate of return of the asset class and prevent malpractice and defrauding. In addition assurances also need to be made for ensuring the safety of returns.

Investment Guidelines	Safe Income	Balanced Income	Growth
Government Paper	>50%	>30%	>25%
Corporate Bonds	>30%	>30%	>25%
Domestic Equity	<10%	<30%	<50%
Of which, International Equity		<10%	<10%

Source: OASIS Report

An increase in the rate of interest by 1 percentage point over a lifetime of accumulations increases the terminal wealth of a pension program by 20%. In India, the funds deposited into pension accounts are invested mostly in government securities and securities under the special deposit scheme. The returns on these are highly limited. Ajay Shah in his paper argues that more profitable outlets for investing pension funds can be found by portfolio diversification and minimisation of risk. It can be proved for the Indian case that the terminal accretions obtained by investing in equities could be greater than those obtained by investing in govt. bonds. *Shortfall probability* is the possibility of underperformance of an all--equity option as opposed to the all--bond option. This probability is fairly small for India.

Equity investment is risky but also yields greater return. Hence the strategy to reduce risk and earn maximum return would be to:

- 1) Phase out equity exposure after age 50,
- 2) International diversification would greatly reduce risk and volatility. Expected rate of return taken as an average varies only slightly across different countries.

Investment strategy of 100% investment in government bonds:

	Rate of return GOI bonds	
Terminal Wealth	2%	4%
	Rs. 152,000	Rs. 215,00

Source: OASIS Report

Investment strategy of 100% investment in a NSE-50 Index Fund:

	Real rate of return in GOI bonds	
Equity Premium	2%	4%
10%	507,254	737,654
20%	775,761	1,165,611

Source: OASIS Report

The gain in the case of investment in 100% equity is 2 to 7 times more than in the case of government bonds.

The OASIS report recommends the following strategy to be adopted for three asset classes:

(a) For the first five years, all domestic equity investments should be implemented using index funds on the NSE-50 or the BSE-100 indices only. There should be no "active fund management" (where fund managers have discretionary control of which shares to buy). Pension funds should not engage in off-exchange transactions on domestic equities: this helps ensure a high degree of transparency in all transactions and a lower incidence of murky market practice. These rules would make it possible for pension assets to harness the "equity premium" (the higher return of equities) while suffering from none of the risks that flow from giving fund managers complete freedom in forming share portfolios.

(b) Investments in corporate bonds should be limited to investment grade corporate bonds in India, which are liquid. Liquidity helps ensure that the secondary market prices of bonds (which are used in valuation of pension assets) are reliable. The definition of a liquid bond should be as follows: the average impact cost (on the most liquid exchange in India) at transaction sizes of Rs.100, 000 should be below 0.3%. Pension funds should not engage in off-exchange transactions on corporate bonds: this helps ensure a high degree of transparency in all transactions and a lower incidence of murky market practice.

(c) International equity investment should only be implemented using index funds. One of the most outstanding features of the OASIS report has been its belief in investing part of pension funds in international equity. It has been proved that even if

passive fund management is adopted, returns can be maximised by investing in international index funds, which are more or less stable and hence involve a lower risk thus guaranteeing safer returns.

The OASIS Report has suggested certain stringent criteria for PFMs such as:

- (a) In the safe income style PFMs would have to guarantee that they would not underperform the weighted average returns of all managers in that style by worse than 2% points in a year.
- (b) Furthermore, the PFM also has to assure that it collects Rs. 10 billion worth of assets within 2 years or its fees would be dropped by 20% in the next year. These rules are unduly restrictive and arbitrary and signify a total lack of faith in private initiative. When the pension reform was first introduced in Chile similar guarantees were also required from AFPs, but now there are proposals to slowly phase out these guarantees. In Chile it is believed that such clauses led to a misallocation of funds: because of the guarantee system and the strict monitoring of their fees, the AFPs invested only in similar kinds of funds, consequently earning similar returns.

Even if this policy is initially adopted in India to prevent the negative political implications of having a brand new pension system with wide disparities in the results that it provides; slowly as the pension system matures, these clauses should be phased out. The long-term implications of such a policy are not advantageous as it would force PFMs to compete on the basis of non-price differentials such as quality of service etc. and would in general hamper the growth of a competitive market for pensions.

An alternate way to ensure safety and transparency without debarring free entry and exit or creating a prohibitive atmosphere is through clearer disclosure and prudential norms.

Different investment alternatives

Active Fund Management (AFM) adds value when fund managers are able to exploit market inefficiencies adequately and pay for the costs of transaction costs and management fees. Active management subtracts value in the absence of such abilities. In addition AFM also introduces risk in terms of performance of the manager subject to manpower turnover. Active management also introduces greater complexities since regulators have to deal with a variety of trading strategies used by managers. In contrast *passive fund management* harnesses the equity premium reliably by investing in Index funds. These are not vulnerable to volatility and are easier to regulate. An *index fund* passively replicates the returns of the index. The most useful kind of index is where the weight attached to the capital stock is proportional to its market capitalisation. The simplest method of implementing an index fund is through "full replication" where the portfolio held by the index fund is same as the index. The most basic foundation of indexation is the stock market index.

A passively managed fund investing both in domestic and international indices shows greater gains than the actively managed domestic fund.

While international diversification sharply reduces risk, it also reduces rates of return accessible to unleveraged investments since equity premium internationally is lower than that of India. The lower volatility of the world stock market index as compared to the much less diversified NSE-50 index will ensure higher rates of return.

The OASIS report recommends passive fund management using index funds in its recommendations. This however seems to be just a half-hearted attempt to the whole privatisation approach. Undeniably, index funds have the following advantages:

- 1) If markets are fairly efficient then it is difficult for active fund managers to obtain excess returns after considering extra fees and costs. Active fund management is a method of trying to earn excess returns. In this process, active fund managers expend resources on fund management and incur trading costs. Index funds lower expenditure by avoiding information collection and processing. Broadly index funds also engage in smaller trading volumes, which help, enhance returns through lower costs of transacting.
- 2) There is great difficulty in monitoring the activities of an agent. If a layer of intermediaries in the form of a pension committee is introduced then incentive schemes need to be devised to make both the committee and the PFM to act in the best interests of workers, which is a highly difficult task in itself.
- 3) In the case of quasi-nationalisation of pension accounts, when the bulk of the investment is done in equities there may be a large political risk where the government can use this control for meeting its political ends. However, this can be avoided if workers have their own IRAs and are given the choice of choosing a fund manager.
- 4) A naive comparison of returns across alternative funds is an inefficient way to measure, fund manager ability especially when there are significant differences in the levels of risk adopted by different funds. A casual comparison should give way to a more scientific process of evaluation. Hence for a deciding on a pension fund manager, more objective sets of guidelines are required. Active fund managers may be able to fulfil requirements of size, pedigree etc. at the time of selection but may fall short on grounds of performance, thus blaming the authority for a wrong selection of pension fund manager. Hence, in the case of pensions, poor asset return should be traced back to poor returns on the index--which would in turn infuse greater accountability.

However, the advantages of index funds do not necessarily mean that active fund management is in any way disadvantageous. Index funds themselves impose certain negative externalities:

- 1) Distorted cost of capital for index stocks
- 2) Inferior corporate governance
- 3) Diminished market efficiency
- 4) Enhanced concentration in the fund industry

In India, market inefficiencies may still arise on account of:

- 1) Poor information access: inferior disclosure laws
- 2) Inferior human capital
- 3) Higher transaction costs

But this does not mean that the individuals should not be given a choice to try their hand at active fund management. Even though the argument of increased transaction costs may hold, active fund management in itself has a high educative value and one should not discount the existence of certain enterprising individuals who would be able to use these inefficiencies and earn a higher rate of return on their deposits.

Moreover, individuals themselves should be given a choice of whether they would like to adopt passive or active fund management for their accretions along with the freedom to choose their fund managers. However there could be an argument that the “moral hazard” problem enters into the picture. That is, in case individuals are backed by too many government-guarantees then they would be prompted to take more risks than they would ordinarily have taken and hence would opt for the riskier strategy of Active fund Management. But this problem can easily be avoided. The individuals who are ready to take the chance with active fund management should be allowed to do so – at their own risk. Hence in the three-fold scheme recommended by the OASIS report an additional active fund management scheme should also be introduced and PFMs should be provided the option of carrying this style too.

To sum up, each of the investment strategies, be it active fund management, passive fund management or investment in indexed equities abroad, each has its pros and cons in terms of risks and return. Ultimately it is the individual who should be given the opportunities to translate his preferences to reality. On the other hand, as far as PFMs are concerned, efforts should be made to give up the closed approach and allow them freedom to function within a broad regulatory framework.

4. Role of the insurance sector

The reform in the pension sector is also closely connected with the insurance sector. The common ground between the two arises from the following considerations:

1. On retirement, pension assets may be invested with annuity providers, who form an important component of the insurance sector.

2. Moreover, both pension fund management and insurance deal with similar kinds of investments, i.e. long term. Hence a reform carried out in one of them will necessarily have a positive external effect on the other and as such both share a symbiotic relationship.

Private pension business is a part of insurance business in India. After nationalisation of the insurance sector in 1956, the Life Insurance Corporation (LIC) of India became the only player. The monopoly of the LIC seriously hampered the development and growth of the private annuity market. The Malhotra Committee (1994), the expert group that studied the insurance sector, suggested opening up of the insurance industry. Following the committee's recommendations, the government liberalised the insurance sector in the year 2000. As a result, private corporations including foreign entities are now being permitted to enter the private pension market.

The Chinese method of combining insurance sector liberalisation is a case in point. Pension reform and Insurance de-regulation both share a common aim. The insurance sector provides the necessary outlets for investment in annuities and the pension reform provides the momentum for insurance reform. Voluntary funds are usually managed by Life Insurance Cos. The Standard Life Assurance Co. of Britain will be participating in the reforms of the Chinese pension system. Officials at the Ministry of Labour and Social Security of China have signed an agreement with the British government, welcoming Standard Life Assurance Co. and other British insurance firms to take part in the reforms, said an official of the company's Shanghai branch. The Standard Life Assurance Co. will be sending its best experts to provide technical training and consulting services to China, said Robert Knight, who is in charge of the Asia-Pacific affairs of the company, during a visit to China recently. Pension reform has thus to go hand in hand with insurance sector reform. The first foreign license was granted to American international Assurance. 12 other companies have been given license and approximately 100 more are waiting.

The IRDA has recently released investment norms for insurance firms intending to enter the private pension market. The Insurance Regulatory and Development Authority (Investment) Regulations, 2000 (IRDA 2000) suggest that for pension and general annuity business, every insurer shall invest and at all times keep invested assets of Pension Business, General Annuity Business and Group Business in the following manner:

	Type of Investment	Percentage
i)	Government securities, being not less than	20%
ii)	Government Securities or other approved securities inclusive of (i) above, being not less than	40%
iii)	Balance to be invested in Approved Investments as specified in Schedule I and to be governed by Exposure/ Prudential Norms	Not exceeding

specified in Regulation 5	60%
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Note: For the purposes of this sub-regulation:

- a) No unapproved investments shall be made.
- b) All investments shall be made in graded securities and the grading shall not be less than of 'very strong' rating by a reputed and independent rating agency (e.g. AA of Standard and Poor).
- c) Every insurer shall invest assets in securities which are actively traded in any Stock Exchange in India and which are attributable to segregated funds, in respect of linked business.

The IRDA regulations fall short on many counts:

- The OASIS report recommends a minimum investment in foreign equity, but the IRDA regulations are silent with reference to investment in foreign equity. In 1990, further liberalisation took place in Chile when AFPs were allowed to invest in foreign equities and common stock of corporations. Similar steps also need to be taken in India to enable PFMs to harness the highest rate of returns. As and when the PFMs gain experience investment ceilings ought to be raised.
- The investment in Govt. and other approved securities is laid down to be a minimum of 40% in the IRDA regulations. This falls somewhere in between the safe and balanced income styles of the IRDA approach. The regulations of the IRDA approach therefore discount the possibility of implementing a growth based pension fund investment scheme.
- The sub-regulations make it amply clear that passive fund management is being favoured over active fund management.

PFMs should be granted adequate flexibility to make their portfolio choices. For example, in Chile, government regulation sets only maximum percentage limits both for specific types of instruments and for the overall mix of the portfolio; and the spirit of the reform is that those regulations should be reduced constantly with the passage of time and as the AFP companies gain experience. There is no obligation whatsoever to invest in government or any other type of bonds. Currently, AFPs are not being allowed to hold more than 45 per cent of assets in governmental instruments and 30 per cent in domestic equities. In 1995, the permitted share of foreign instruments was raised to 10 per cent. Rates of returns of AFPs have been very high, reaching an average of 13.6 per cent in the period of 1981-93.

In India too, the objective behind pension reform should be a strong ideological commitment to increase savings, reduce government burden and strengthen capital markets. Pension reform should not be visualised as merely another avenue for deficit financing through the sale of government bonds and treasury bills. The success of the new system can be guaranteed only if Pension Fund Managers are allowed to operate and compete in a free atmosphere. The structure of rules needs to be broad and accommodative and should be conducive to fostering healthy competition.

5. Role of government guarantees

To reassure the people to switch to the new system government guarantees play a vital role. These guarantees may take the following 3 forms depending upon the level of 'welfare' functions that the government takes upon itself to perform:

- In Chile the government provides welfare type pension funded from general revenues for workers with fewer than 20 years of contributions.
 - When workers with at least 20 years of continuous service, do not have enough capital accumulated in their accounts to fund a pension that meets the legally defined minimum pension, the government may add the money necessary to provide that pension.
 - Similarly if the funds in the retirement account of a worker are depleted before a worker dies then the government may give the worker the minimum pension.
- The government guarantees constitute the main element of the transition cost into a new pension system.

6. Administrative authority

The Indian Pensions Authority (IPA) would oversee the entire working of the system and handle the administration. CII, in a recent press release suggested that the insurance regulator could also supervise the pensions sector.

7. Removal of subsidies

The present contribution of 1.16% of wages by the Government to the Employees' Pension Scheme should discontinue. Instead, this contribution should be channelled into the National Senior Citizen's Fund as initial corpus for the first 3 years of incorporation of this Fund. Thereafter, this contribution should be discontinued. In addition, 25% of the premature and lump sum withdrawal tax on provident funds under the new IRA system should be transferred to this Fund annually.

8. Involving the unorganised sector

The absence of a unique social security number in India along with the high costs associated with implementation make it impossible to have a mandatory pension scheme for all. Specifically with regards to the unorganised sector, the PPF Scheme has clearly failed in attaining its objective of inducing savings. Even the Life Insurance Corporation (LIC) has neglected annuities and pension schemes, which have considerable potential among the self-employed and only 100 million people are covered by provident fund or pensions. LIC has no low premium policies like term or whole life insurance. Instead, it concentrates on expensive endowment policies. One of the biggest problems of most of the countries that have the experience of a private social security system is the inherent failure of involving the unorganised sector. In the case of workers in the organised sector, the employer contributes part of the contribution. However, this is only implicit and it is the worker who actually bears the entire burden of the contribution. In the light of this matter, it ought not to make a difference to the self-employed. There may be many reasons behind the lack of participation from the self-employed such as:

- a. By participating in the private pension system, a self-employed worker would be revealing information that he may want to keep private for income-tax reasons.
- b. Wealthy self-employed workers would have other means of providing for their own retirement including self-insurance and access to financial instruments that would provide a better combination of risk and return.
- c. It could be more profitable for them to rely on government guarantees. This is another area where the 'moral hazard' problem could come into play and hence, schemes need to be devised to make it more profitable for the self-employed to enter the formal pension system.

9. Misplaced priority on tax incentives

In India only a minuscule proportion of the population pays income taxes and other form of direct taxes. Hence the inbuilt tax deduction incentives benefit only these sections while the poorer majority are denied these immunities.

A better idea would be to replace the tax exemption with a tax credit system effect that produces a uniform tax incentive effect for all workers – for example by providing a direct state contribution to workers' retirement and savings accounts. A similar scheme has been introduced in Czechoslovakia. However one problem with the scheme has been that it has failed to link tax credit to a minimum contribution or saving rate so it has encouraged small amounts of savings. This general approach – called the CET approach is more superior from a social view. It would eliminate the preferential treatment of the tax paying workers, and could contain the tax cost of these exemptions or could achieve greater redistribution in favour of low-income workers for a given tax cost and would also encourage them to save.

10. Early withdrawals

One of the main problems of the Pension Schemes in India is the problem of premature withdrawals, which more than often results in poverty during old age. As of now there is no incentive to compel people to keep their savings till the maturity period and the tax incentives provided are the same even if withdrawals are made. The OASIS report suggests the abolition of tax on earnings of over 12 per cent in Provident Fund and levy of tax, at least of a 10 per cent, on early withdrawal from Provident Funds.

In this aspect an important lesson may be learnt from Singapore. In Singapore the funds for different purposes are segregated as far as possible, and therefore, a cap on premature withdrawal is ensured. Employees have a property right to the funds accumulating in their accounts and are able to withdraw funds for the purchase of a home, to buy life insurance or home mortgage insurance, and may borrow money from their account to pay for the college education of a family member. The designation of separate funds has achieved phenomenal results for Singapore, e.g., the highest rate of home ownership in the world (85%).

11. Inflation indexing

The National Old Age Social Security programme provides a monthly pension of Rs. 75 to the poorest 30% of the elderly. However, this contribution is highly meagre in the light of the present times. The argument for price indexation is that the old people are less able to adapt to falling incomes than young people are. Canada, UK and US have pensions indexed to prices. If pensions were indexed to wages, then changes in pensions would be linked to changes in productivity. In India, it would be a better alternative to enable the old to maintain their current consumption bundle by indexing pensions to prices. Using price rather than wage indexation would also help dampen the contribution rate increase and the wage increases may be put to use for other purposes.

12. Financing the transition cost

The transition cost for a new pension system may be three-fold:

- a. Cost of paying the workers who chose to remain within the old system.
- b. Cost of reimbursing those who chose the new system.
- c. Cost of the 'safety net' provided by the government.

This cost can be best borne in India by privatising the State Owned Enterprises. In such a case, Pension Fund Managers may also participate actively in buying shares of the companies being privatised. This would give workers the possibility of benefiting handsomely from the enormous increase in productivity of the privatised companies by allowing them, through higher stock prices that increases the yield of their PSAs, to capture a large share of the wealth created by the privatisation process.

To conclude: Foster experimentation and learning

A reform in the pension system is a long drawn out process, which requires ideological commitment in the first place. Ironically, it is the largest communist country of today that stands as a shining illustration to such commitment. In China, after Document 26 laid down the general features of a 3-pillar system of pensions, local experiments have been allowed to proceed. China is not following a top down blue print approach. The Chinese way of issuing broad central directives, letting local experiments proceed, then changing the central directives in the light of experience and then experimenting anew and so on is a unique process without close parallel elsewhere.

E.g., Liaoning, is a province of 40 million people and centre of a rusty industrial belt. Nearly one fifth of the province's overall financial expenditures were used to cover insurance payments, which the governor described as "really a heavy burden". This province has been chosen to implement a pilot project based on the 3-pillar scheme. Similarly, in India also, the key word for pension reform is flexibility. This implies that maximum room needs to be provided for local experiments. Rules need to be laid down clearly, but their number and level of stringency should not be overwhelming. In the long run, there needs to be a commitment to phase out most of the detailed

rules, leaving only a broad framework to act upon.

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