Sustainable pension reform in India: towards a market-based system

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Abstract:
Market-based pensions are developing slowly in India because of distorting tax rules and draconian investment regulations. Recent reform proposals point to the right direction but fail to address the fundamental issues. Instead of creating large-scale pension policy blueprints, India needs to develop better tax rules, reduce regulation and let markets develop products to meet the needs of the people.

Introduction

India is one of the largest countries in the world in terms of its population size and among the fastest growing world economies and the rapid economic development has increased interest in pension reform. One reason for this increased interest is that the pay-as-you-go pension scheme for India's public sector workers is approaching insolvency. Additionally there are worries that rising longevity and declining birth rates will make formal pension arrangements necessary, as the traditional family system is coming under strain.

This paper outlines the systems for old-age security in India. It argues that, contrary to popular perception, India does not need a wide-ranging pension policy blueprint. Instead, it will need to scale down the role of the government in old-age security, abolish distorting tax rules, reduce over-regulation and let markets develop solutions that correspond to the needs and circumstances of the people.

Old-age security in India: the big picture

For period of around 30 years from around 1960, India adopted socialist and protectionist economic policies, which stifled economic advancement and fostered a culture of corruption in the public sector. In terms of old-age security, India is much like other less developed countries (LDCs): there are generous pension schemes for public sector employees and some savings schemes for workers in the private sector, but about 90 percent of Indian workers participate in no formal pension arrangement whatsoever. For most people, old-age security comes as a combination of personal savings and support from the extended family (Goswami, 2002).

Reliance on the traditional family does, in fact, avoid common problems with state pension arrangements such as corruption and free-riding; it is also flexible in responding to changing circumstances. The current policy of the Indian government is to encourage this type of old-age security. For example, the National Policy for Older Persons, formulated in 1999, pictures the family as the most important and emotionally satisfying source of old-age security, and encourages the promotion of family-values in India (Government of India, 1999). The Maintenance and Welfare of Parents and Senior Citizens Bill 2007 also seeks to make it a legal obligatory, under pain of fine or prison, for children and heirs to provide assistance for their elderly parents.

However, the underdevelopment of formal pension schemes is problematic, as pension savings are a valuable source of stability even when the family plays a major role.

Existing pension schemes in a nutshell

The existing arrangements can be divided into three: public sector pay-as-you-go (PAYGO) schemes, a compulsory savings scheme for private sector workers in the organised sector, and a voluntary savings fund for the informal sector.

The schemes for public sector workers were more or less inherited from British colonial times. They were established for civil servants, and were gradually extended to a wider class of workers. These are non-contributory arrangements financed from government budgets, and in recent years they have incurred an implicit debt so large that some commentators say they are crowding out other public services. The Eleventh Finance Commission called state pensions a 'ticking time bomb', and some state

governments have been forced to delay pension payments due to financial difficulties (Hinz and Rao, 2003).[1]

The British also established, in the 1950s and 1960s both in India and elsewhere, so-called 'provident funds' for private sector workers. This was a type of compulsory savings scheme, whereby employee and employers in the formal sector were required to contribute a proportion of their net salary into a fund, which was ordinarily invested in government bonds. The Indian scheme, called the Employee Provident Fund (EPF) unfortunately has a reputation as over-regulated and poorly managed, giving low investment returns and poor customer service.

EPF is only for individuals employed in the 'organised sector', which in practice means larger companies. For the unorganised sector, there is a voluntary pension scheme called the Public Provident Fund (PPF). Its goal is to help individuals to save for old age. It has existed since late 1960, but it seems that less than one percent of the working population chooses to participate. There are good reasons for the lack of enthusiasm among potential participants: the scheme is inflexible and arguably not useful for old-age security purposes, and the funds are in practice not really invested, as they are just distributed to public bodies which pay an interest on them.

There is also the National Old Age Pension Scheme (NOPS), which gives small cash benefits to those over 65 who have little or no other support (see NCEUS, 2007). The system seems to be working relatively well, but of course, the benefits package is very small (less than half the official poverty line income). Kale and Bhandari (2007) also point out that direct cash transfers by the government have been criticised for poor implementation an high ‘leakages’, given the inadequacy of the administrative machinery.

In addition to the foregoing arrangements, the Indian government in 1995 converted parts of the EPF into an unfunded defined-benefit scheme. This may have been a short-term trick whereby existing savings were depleted to pay benefits and the future financing of the scheme was left for future generations to worry about.[2] However, after just 10 years of operation, the 1995 pension reforms have encountered funding problems. There are no minimum funding rules, the central government assumes practically all responsibility, and

1 The extent of the implicit debt is large, just as it is in developed countries (see Record, 2006). Just on account of central (civil) employees and employees of state governments, it was over 50 percent of GDP in late 2004. This is a significant number, given that the explicit internal public debt of the government of India was about 85 percent of GDP in 2004. See Bhardwaj and Dave (2005).

2 Something similar has been done in a score of African countries. For a critical analysis of such transformations, see Tostensen (2004).

there are major problems of evasion (non-payment of contributions) by employers (Hinz and Rao, 2003).

Fortunately, in 1998 the new government called into question that approach to reform. Instead, it started a large project called OASIS (Old Age Security and Income Security), in collaboration with the World Bank. The goal of this project was to create a blueprint for a large-scale pension reform, which would extend pension coverage to those 90 percent of Indian workers presently outside formal pension schemes.

OASIS and the challenge of reform

Project OASIS published a range of studies on pensions in India, and called for a reform along the lines of a comprehensive system of individual savings accounts, based on compulsory contributions and managed by the private sector (see Bordia and Bhardwaj, 2003).[3] The key ideas of this approach were to allow people to benefit from the superior investment returns offered by capital markets and to give people greater financial independence instead of allowing them to rely on politicians. This would be combined with the certainty that all workers save for an adequate pension (and there may also be a small universal or means-tested pension for others, including the long-term unemployed).

The OASIS proposal was taken up as a reform bill in 2003 under the name of New Pension System (NPS). In the course of the legislative process, it was changed in some respects while maintaining the same overall logic. Thus, there would be a system of individual accounts, managed by the private sector; pensions would be based on contributions, not defined benefits financed from taxes; and a new pension fund supervisory agency would be set up to regulate the overall system. A crucial change in the reform bill, however, was that although participation would be compulsory for all new central government employees (and some state government employees) with a contribution rate of 10 percent of net salary, the scheme would be *voluntary* for other employees, including all private sector workers.[4]

3 There are also scores of individual papers available online at http://www.iief.com/downloads.htm. The proposals are consistent with the World Bank's pension blueprint, put forward in such publications as World Bank (1994).

4 This was much debated in the preparatory committee. It seems that compulsion was ultimately rejected on the grounds that managing such a system would not be feasible in a country such as India, and it could give rise to corruption. One should note that there are also reasons of principle for opposing high degrees of compulsory savings, particularly in that they favour one type of retirement arrangement at the

At the time of writing, the proposed NPS has still not been enacted.[5] A change of government in 2004 gave more powers to leftist parties that opposed the NPS as they viewed the reform as a privatisation of pensions. This is unfortunate in the sense that the reform bill had many potential benefits: it would have gradually improved the state of public sector pensions and provided better customer service for private sector pension-savers.

On the other hand, as will be argued later in detail, at the end of the day the NPS would not have made such a major change to pensions in India. It may even have been providential that the reform did not go forward. The bill would have not changed the fundamental features of India's pension landscape, but instead it would have reinforced the centrality of the government (both state and federal) in old-age security, potentially blocking reforms towards a more genuinely free and market-based framework.

Making sense of the current system: The devil is in the detail

It will be shown later that the proposed NPS would not be a genuine market-based pension system, but more like 'planning the market' by government mandate. To see why this is the case, it is necessary to examine in more detail the workings of India's current pension system. A fundamental question to be asked is: why does India have so few genuinely private pension schemes? After all, if the market were free to develop products that match the needs of workers, one would expect to see a growing pensions industry, as the market develops and as companies compete for customers. This is a major question for reformers, because if the market does not provide such products presently, it will be difficult to force companies to do so.

It turns out that, although India has in recent years taken many steps towards opening up their market and liberalising their economy, the financial sector is still heavily regulated and underdeveloped. Moreover, the tax rules of the current regime positively discourage competition and innovation, because the best tax advantages are only available to those arrangements that conform to the draconian investment regulations of the government.[6]

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expense of others – including informal support such as the traditional family – and they block moves towards better alternatives, as a large industry with vested interests grows around the pension system, as has happened in countries such as Chile; even though, as a “second-best” reform, the outturn in the Chilean system has been extremely effective.

5 For a more complete story of the reform attempts from 1998 to 2006, see Dave (2006).

6 The following discussion draws especially on the excellent presentation of Hinz and Rao (2003).

'Exempted funds': quasi-private pension plans

It is not exactly accurate to say there are no private pension schemes – the problem is in the nature of those schemes. The current rules permit employers to opt out of the compulsory EPFO (Employees' Provident Fund Organisation) schemes, and set up their own *exempted funds*. These are employer-specific funds managed privately, just like the majority of pension schemes in the UK.

In practice, however, the exempted funds in India are hardly different from the publicly-managed funds. This is because of the regulatory rules and the lack of scope for differentiation in investment management. Not surprisingly, no professional fund management service provider has emerged to cater for the exempted funds.

The motivation for setting up exempted funds is seen to be purely practical: thus employers can provide better benefit administration service to their employees, as the EPFO is known as a notoriously bureaucratic organisation. Unfortunately, employers complain about the length and difficulty of the process for obtaining an exemption so as to set up their own funds. It is the EPFO that grants the permissions, and perhaps as it may feel threatened as the largest pension scheme operator in India, it has not granted new exemptions for many years.

Distorting tax rules

Another major problem issue is the tax code. The Indian government provides generous tax benefits to mandatory pension schemes. Contributions by an employee are eligible for a tax rebate, and contributions by an employer are treated as tax-free income for the employee, while being deductible expenditure for the employer. Interest received on compulsory retirement savings is also tax-free.

The government further encourages retirement savings through favourable tax rules on voluntary retirement savings. The government-managed Public Provident Fund (PPF) offers the same tax breaks: voluntary contributions by non-salaried workers are eligible for a tax rebate at 20 percent, and all income withdrawn, including interest, is tax-free. It is very commonly used by the self-employed, who see it as a tax-saving device (see Hinz

and Rao, 2003).[7]

Liberal tax rules may sound good to those more inclined towards limited government. Unfortunately, this is not the case in India. There are at least two disadvantages with the tax scheme. One is that the rules are not fair on a social level, because it is mainly the better-off Indians who benefit from the liberal tax treatment of pension savings. Others who cannot, or do not wish to, save this way but rely instead on their family and their work in old age, must in relative terms pay more tax.

Secondly and more importantly for the present discussion, these tax rules discourage competition in the pensions market. Restrictive investment rules are mandatory for all schemes to which the liberal tax rules apply. The PPF is perhaps the most stark example: it is not a pension scheme at all but forms part of government accounts; the government simply declares a variable interest payable on the account balances.

In contrast, genuinely market-based pension products are treated differently. Contributions to pension funds marketed by private insurers do get the same tax benefits as others (eligibility for a tax rebate at 20 percent), but payments from the funds are taxed as income, rather than being tax-free. In light of this it is not surprising that the market for private pension products is so underdeveloped: unfavourable tax rules crowd out private services.

Draconian investment regulations

Investment regulations are also generally seen as highly restrictive and 'draconian'. Essentially, almost all savings are invested in government bonds and bonds issued by government-owned companies. Only 10 percent may be invested in private sector bonds. Funds cannot invest any amount in company shares or mutual funds, nor in real estate, gold or other physical assets. Finally, India enforces strict capital controls and no overseas investments are permitted: recently, the government allowed mutual funds to invest in overseas bonds, but this option is not available to provident funds and pension funds.

7 There are also occupational pension savings, so called 'voluntary superannuation plans'. Contributions by employers are tax-deductible, and income is tax-exempt for the employee, up to 15 percent of salary. Many employers have set up voluntary superannuation plans in addition to the compulsory EPF plans, especially for senior employees. The current tax rules are somewhat inconsistent, however, because benefits under the 1995 pay-as-you-go pension scheme are taxed as normal income. Leaving that issue aside, it is clear that employees who participate in the compulsory pension scheme manage to save a large chunk of their income tax as a result.

Anti-market investment rules result in poor returns. Provident and pension fund returns have been roughly equal to five-year bank deposit interest, although sometimes this has been exceeded by one percentage point. This further underlines the fact that the reason why people save in provident funds (even voluntarily), is not because of their investment returns, but because of the generous tax benefits.

Underdeveloped financial markets: lack of trust, rules and opportunities

One wonders why people working in and around the pension sector have not demanded more investment freedom, as the Indian government has generally been moving towards a market economy. This opens up a bigger set of issues. The main challenge seems to be that financial markets in India are so young and underdeveloped, that most people have little confidence in them. As a result, they are quite content with the low returns provided by government bonds. From a development perspective, the downside with this situation is that restrictive rules coupled with sceptical attitudes can create an institutional lock-in or paralysis.

It may be just a matter of time, of course. India's financial markets are still very young. They were virtually non-existent in 1990. Then, a rapid liberalisation process began, and the government bond market grew fast from 1991 onwards. However, in contrast to government bonds, the corporate bond market is shallow and illiquid (Deutsche Bank, 2007). There is also need for the development of better trading, clearing and settlement practices.

The liberalisation of the equity market also started in 1991, and it has grown faster than corporate bonds, perhaps because of a more laissez-faire attitude from the government (Deutsche Bank, 2007). However, in the midst of rapid growth, the market has suffered several scams and crises, so that individual investors have burnt their fingers time and again. The market is also quite volatile and there have been many booms and busts within a short period. All of this contributes to weak public confidence, leading most individual investors to avoid equities. In fact, the average household in the past years has held almost half of their assets in bank deposits and just 5 percent in capital markets (Deutsche Bank, 2007: 12).

The history of financial market services is even shorter (Hinz and Rao, 2003). For example, until recently, the government-owned Life Insurance Corporation of India (LIC)

was the sole life insurer, and private operators have not yet established any significant market presence. The same is true of mutual funds: most of them were established around 2000. Equity funds are suffering a bad reputation because of the experience of India's stock markets. Bond funds have suffered too, as the Unit Trust of India (UTI), a state-owned mutual fund and the largest fund in India, failed to deliver its obligations, affecting millions of investors. The government responded to the UTI crisis with a bail-out package, but public confidence remains weak.

In theory, there is much potential. India's savings rate is high (about 20 percent of GDP), but it is very conservatively invested. Most households restrict themselves to physical assets such as land, housing and gold, as well as bank deposits, provident funds and pension funds (which mainly invest in government bonds). Scepticism towards financial markets is rooted in genuine risks, and it makes perfect sense for ordinary people not to put their life savings at risk until the system becomes more reliable.

Investing in government bonds: a Ponzi scheme after all?

Concerns have already been expressed about the lack of competition and private provision in India's pension sector; there are also reasons to worry about the future of existing schemes. On the face of it, it appears like it is only the unfunded pay-as-you-go schemes that may cause problems (i.e. public sector employees and the 1995 pension plans). The provident funds and other voluntary schemes are, in theory, funded. However, it is necessary to challenge this assumption and ask whether the provident funds are in practice that much different from pay-as-you-go systems.

The provident fund system may not be sustainable in the long term, because almost all the savings are invested in government bonds. This has created a potential 'debt trap', very similar to the problems caused by pay-as-you-go pension systems: in 2000-01, interest payments constituted almost 40 percent of the state governments' total tax revenues. If the present system continues as it is, it looks like it will only magnify the debt trap and become yet another 'Ponzi scheme'. Effectively the large amount of savings channelled through government bonds provides a large pool of cheap finance of which governments, and government corporations, have taken advantage.

This is not to say the government bond-system is equivalent to a pay-as-you-go scheme. One difference between the debt accumulated in this way and pay-as-you-go

pension debt is that the former is “on balance sheet”, so it is easier to keep track of it. But if the government gets into financial straits, it may have to default on some of its loans. Then, pension savings are partially lost and the system loses its credibility.

There have already been some defaults on the bonds held by these funds. For example, Industrial Finance Corporation India (IFCI), a state financial institution, defaulted on bonds held by the EPFO and a number of exempted funds. Some state government companies have also delayed payments or defaulted on bonds.

One must remember that there is a major difference between a market-based savings system and a government-operated one, namely that the government is not an enterprise. It does not have the same incentives to invest its borrowed assets in profit-making activities (and the ability of state-owned companies to operate profitably is often questionable too). Therefore, the government that initially set up the system was able to gather a large pool of funds, which later governments must handle. At the end of the day, pension benefits must be paid out of tax contributions, and these are relatively low because most well-off Indians pay little tax. It can also be said that the pensions system in India has provided returns that are higher than market interest rates on government bonds and often higher than the rates of return on capital earned by the state companies that have issued many of the bonds. This means that provident funds subsidise scheme participants at the expense of tax-payers in general, even ignoring the generous tax benefits.

Towards sustainable pension reform in India

The likely course of events is that all the pension schemes currently in place in India are going to experience increasing difficulties in the future. Pay-as-you-go schemes are already having problems paying promised benefits, and growing public sector debt will cause difficulties for “funded” pensions sooner or later. Reforms must be made soon because reforming a system in the midst of crisis is rarely a recipe for success.

Defects in the New Pension Scheme

Before moving to specific proposals, let us briefly discuss the New Pension System (NPS). One the positive side, it would clarity a lot of confusion in the current set-up, and it

would help to avoid the looming crisis of public sector employee pensions. Moreover, even if it is not perfect, it can be valuable starting point that can be improved on in the future.

However, there are important issues too. The key problem is that, like the current system, the New Pension System would be highly regulated. The commission that prepared the draft bill was naturally concerned about the unnecessary costs of managing the pension accounts. Its solution was to minimise competition between fund managers, to make things simpler for customers. In practice, the NPS sought to achieve simplicity by limiting the investment alternatives to three types of funds. In addition, the number of pension fund managers would be limited to six, and bidding for the licence to operate would take place every five years, on the basis of offered fees and expenses.

In theory, such a strictly regulated system might result in lower fees and expenses. In the Indian context it is also understandable that investment freedom is not seen as very important, because the majority of funds would still be invested in government bonds and other safe instruments.

However, from an evolutionary point of view, the proposed design creates major risks. Perhaps future governments would have the courage to reduce unnecessary regulations. But there is no guarantee of that, in which case the NPS would stifle competition and market development, and it would make it less likely that India's pension system ever becomes genuinely market-based with good rates of return and risk diversification. One might argue that the system can be freed up later on, when financial markets are more ready for it, but that is a risky proposition, because a highly regulated regime can create strong vested interests (especially among the chosen fund managers) that would oppose genuine liberalisation in the future.[8]

Towards a genuine market-based system

Instead of artificial markets-by-mandate a number of less direct approaches could be taken to reform.

Firstly, special tax incentives to one group of pensions and savings should be stopped so that private providers can compete with the governmental and quasi-private providers. Moreover, it is socially unfair to give overly liberal tax-deductions and

[8] In Chile, the compulsory savings scheme was liberalised somewhat later on. However, there seems to be a problem with strong vested interests that oppose more open competition in the management of pension assets.

exemptions to just one group of savings. It also discriminates against those who cannot, or do not wish to, save financially for retirement and who use within-family transfers for old-age support.

Secondly, the government should remove rate-of-return guarantees for existing pension and saving schemes. The recent case of default on some categories of bonds demonstrates the hidden dangers of the current setup: as the government stepped in to rescue pension savings, it gave a signal to the market that it provides an implicit guarantee. This distorts market behaviour, potentially encourages irresponsibility in government enterprises and, at the very least, subsidises the government-operated savings schemes at the cost of other tax-payers.

Thirdly, capital account controls should be removed to allow all investors and funds to invest in international financial markets. Presently, returns to investments in provident and pension funds are low in comparison with developed countries (below real wage growth). Equity markets in India are underdeveloped, and public confidence in them is low. Most people shy away from the stock market. However, allowing Indian pension providers to participate in international financial markets would provide the potential for better rates of return in lower risk markets through portfolio diversification. As long as the government bond market is the only practicable option for investors, private fund managers do not really have any method of competing with government schemes.

Fourthly, the Indian government should continue to improve the institutional environment. Regulatory red tape should be cut, so that it becomes easier, cheaper and faster to set up businesses, register property and do other simple but essential legal acts without which true entrepreneurship is impossible. India needs better rule of law in all aspects of government and public administration, and it is well to remember that corruption has much to do with over-regulation. Creating a better institutional framework for business in general will become increasingly important when the current system begins to break up and the demand for genuinely market-based alternatives grows.

Finally, we should have trust in the value of informal old-age security, including traditional intra-family arrangements. According to World Bank research, informal systems are still working well, and they have several advantages such as flexibility, adaptability, better information and incentives to act for the common good of all participants (World Bank, 1994: 61-65). Ideally, the informal systems should gradually be combined with better savings and insurance instruments. The way forward is to work on the broader institutional

environment, so that better financial services will develop in the market when the time and conditions are right.

Conclusion

India's current pension system is a complex mixture of funded and unfunded schemes, which together cover about ten percent of the working population. Socio-economic development calls for reform of the pension system. This paper has argued that existing arrangements suffer from too much government involvement and too much regulation. The appropriate solution is not to transform the existing schemes into another grand and heavily regulated plan such as the New Pension System. The NPS may help to clear up the looming crises of public sector pensions, but should not be extended to the whole population. Instead, the government should abolish unnecessary regulations in financial markets, make tax rules fairer and allow markets to provide the services that people need, as their needs evolve and as the economy develops.

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