INDIAN PENSION SYSTEM: PROBLEMS AND PROGNOSIS

Ranadev Goswami*
Fellow, Indian Institute of Management Bangalore

Abstract

This paper reviews the current state of the Indian pension system. The Indian experience could potentially influence policy decisions in other developing countries, especially those with similar reliance on the national provident fund system. Institutional features of various retirement benefit schemes are highlighted and their deficiencies are discussed. It is argued that low coverage level, underperformance of provident fund schemes due to investment restrictions, and financial difficulties in administering unfunded public pension programs have rendered the current system ineffective and unsustainable. The failed experiments with ad-hoc reform initiatives in recent past further emphasize the need for a structural and lasting change. The paper concludes with some policy directions for reforming the Indian pension system.

* Address: Plot 96 Road No. 2 Banjara Hills, Hyderabad 500033 India E-mail: ranadevg@tanning.com

1. Introduction

The debate on the pension system reforms is intensifying in India. The ongoing financial sector reforms have made significant progress in the spheres of banking, capital and currency markets and now provides an opportunity to revamp the hitherto untouched sectors like insurance and pension. While insurance sector reform is already underway, the effect of which to a certain extent is expected to percolate to the private pension market - a comprehensive policy for pension system restructuring is yet to be undertaken.

A variety of problems plague the pension system in India. The gradual collapse of the traditional old age support mechanisms and the rise in elderly population highlights the need for strengthening the formal channels of retirement savings. The imperative, more proximate reasons for pension reform are also well known - skewed coverage of the existing benefit schemes favoring organized workforce while informal employment is on the rise, worsening financial situation of government pension schemes against a background of rising system expenditure, unfair treatment of private sector workers vis-à-vis public sector employees, an under developed private annuity market, and finally the need to increase the domestic rate of savings through higher contractual savings.

Major retirement savings schemes like provident and pension funds predominantly cover workers in the organized sector, constituting only about 10 percent of the aggregate workforce. The majority of workers, around 90 percent of the working population are engaged in the unorganized sector and have no access to any formal system of old age economic security. This skewed coverage is further shrinking as informal workforce is growing while the size of formal workforce has remained more or less stagnant.

Additional impetus for pension reform comes from the fragmented nature of the existing benefit schemes. Inspite of its limited scope and size, the Indian pension system in its current form, can at best be described as an extremely complicated and fractured one inducing distortion in the labor market. A large number of occupation based retirement schemes with wide diversity in plan characteristics and benefit provisions are in existence, and have created a wedge of disparity between public and private sector workers. While private sector workers are aggrieved with low returns from their benefit schemes, public employees are privileged with generous pension provisions.

In recent years, there have been attempts to address these problems. These efforts, however, have largely been piecemeal. The diverse and often conflicting set of problems faced by the Indian pension system requires a more serious and coherent approach. For example, on one hand, there is an urgent need to contain the escalating expenditure on public pension programs while there is also an urgency to extend the coverage to the unorganized sector. The government[1] initiatives in recent years like advancement of retirement age for its employees, partial conversion of provident funds into pension schemes for private workers and introduction of new means-tested social assistance schemes for the poor have met with limited success, further underlining the need for an early and lasting reform of the current system.

The remainder of the text is organized as follows. Section 2 reviews the structure of the current pension system. In section 3, the motivations for reforming the current system are discussed. The recent institutional developments pertaining to the pension sector is described in section 4. Next, in section 5, the study assesses the major issues that need to be addressed for a

[1] Unless specifically mentioned otherwise, "government" refers to the central government and not the governments of the individual states.

comprehensive reform of the Indian pension system. Section 6 provides concluding comments including a summary of the discussion.

2. Structure of the pension system

India, like most other developing countries, does not have a universal social security system to protect the elderly against economic deprivation. Perhaps, persistently high rates of poverty and unemployment act as a deterrent to institute a pay-roll tax financed state pension arrangement for each and every citizen attaining old age. Instead, India has adopted a pension policy that largely hinges on financing through employer and employee participation. This has however restricted the coverage to the organized sector workers - denying the vast majority of the workforce in the unorganized sector access to formal channels of old age economic support.[2]

Notwithstanding the limited size and scope, India has a long tradition of pension and other forms of formal old age income support system. The history of the Indian pension system dates back to the colonial period of British-India. The Royal Commission on Civil Establishments, in 1881, first awarded pension benefits to the government employees. The Government of India Acts of 1919 and 1935 made further provisions. These schemes were later consolidated and expanded to provide retirement benefits to the entire public sector working population. Post independence, several provident funds were set up to extend coverage among the private sector workers.

[2] The distinction between the organized and the unorganized sector is based on state recognition and regulation. Broadly, the residual of the organized sector is referred to as the unorganized sector. The Indian National Accounts Statistics (NAS) defines the unorganized sector as a collection of those operating units whose activity is not regulated by any statutory Act or legal provision and/or which do not maintain any regular accounts. Thus, the difference between the two sectors can be explained in terms of whether or not the employing enterprise is registered under the Factories Act, 1948 but related to this is also a complex set of regulation pertaining to the definition of the unorganized sector, of product categories and of exclusion from industrial legislation. Since employee size determines whether an establishment should be registered or not, small enterprises (20 employees in factories without power, 10 in factories with power) are typically considered as part of the unorganized sector.

Today, major retirement schemes in India include provident fund, gratuity and pension schemes. The first two schemes provide lump sum retirement benefit while the last one makes payment in the form of monthly annuity. These schemes are characterized by the following common features i.e. they are mandatory, occupation based, earnings related, and have embedded insurance cover against disability and death. Table 1 elaborates salient features of the major provident fund and pension schemes.

The central government, states and union territories provide pension benefits to the public employees. In addition, a large number of public and local bodies and autonomous institutions run their own pension schemes guaranteed by the government. The central government alone administers separate pension programs for civil employees, defense staff and workers in railways, post, and telecommunications departments. 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. Full superannuation benefit is a monthly pension fixed at fifty percent of the average monthly earnings during the last year of service. The pension is indexed to provide a real annuity to the retirees. Public employees, in addition to their pension benefits are also covered under the General Provident Fund (GPF) scheme. The GPF is a non-contributory program where only workers themselves contribute a minimum of six percent of their monthly earnings. The accumulation under the GPF account is returned to the worker in lump sum at the time of retirement.

Private sector workers are less fortunate and until recently had access only to a provident fund system for their old age income security. Provident Fund is a defined-contribution, fully funded benefit program providing lump sum benefit at the time of retirement. The provident fund system, consisting of the Employees' Provident Fund (EPF) and a number of smaller provident funds is the largest benefit program operating in India.[3] Together, the schemes provide retirement benefits to about 10 percent of the labor force. Workers (and private employers) contribute between 10 - 12 percent of monthly earnings, to be returned to the worker in a lump sum payment at retirement, including accumulated interest at a rate currently set at 11 percent. In 1995, the government partially converted the EPF scheme and introduced the Employees' Pension Scheme (EPS).

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 fulfill 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.

These schemes are largely the privilege of the organized sector workers. Workers in the unorganized and informal sectors[4] have access only to a few voluntary schemes like Public Provident Fund and pension plans offered by the Life Insurance Corporation of India. Organized sector employees can also subscribe to these schemes to augment their retirement savings.

---

[3] The other relatively smaller provident funds are Coal Mines Provident Fund Scheme (1948), Assam Tea Plantation Provident Fund Scheme (1955), Jammu & Kashmir State Provident Fund Scheme (1961) and Seamen Provident Fund Scheme (1966). All these funds offer benefits that are similar to the Employees' Provident Fund with minor variations.

[4] The unorganized sector is often described as the informal sector, although there exists a fine distinction between the two. According to Kelles-Viitanen (1998) the concept 'informal' is more appropriate when emphasizing a sector of employment (informal versus formal), whereas the term 'unorganized' is better suited when reflecting the employment conditions (regulated or unregulated). Even though the workers in the informal sector are mostly unorganized, the unorganized are not only found in informal sector. Casual workers in the formal (i.e. organized) sector are a good example of the last category. Hence, workers without regulated employment conditions in the formal sector should also be considered 'unorganized' if we use the two terms interchangeably.

For people in the lower end of the economic strata, there are several central as well as state government-run means-tested, targeted, social assistance programs and welfare funds. The criteria of eligibility varies, but generally the destitute, the poverty stricken and the infirm aged 60 years and above are provided pension at rates ranging between Rs. 30 and Rs. 100 per month. However, the combined coverage of these social assistance schemes is insignificant and covers anywhere between 5 and 10 percent of the total elderly population. 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.

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 organized sector employees; the middle tier is comprised voluntary retirement saving schemes for the self-employed and unorganized sector workers while the lower tier consist of targeted social assistance schemes and welfare funds for the poor.

3. Motivations for reform

The steadily worsening demographic and labor market trends provide the strongest impetus for restructuring the pension system in India. Additional motivation for reform comes from the fractured nature of the existing pension schemes, creating a sharp dichotomy between public and private sector labor force. The precarious financial position of public pension programs, against a background of rising generosity and falling proportions of workers to pensioners, and inadequate benefit levels for private sector workforce are among the major factors necessitating reform of the old age pension system in India.

3.1. Population aging

Improvement in life expectancy and decline in fertility rate are leading to a significant change in the population age structure. The old age population (aged 60 years or more) has risen from about 19.8 million in 1951 to 56.7 million in 1991, resulting in an increase of the proportion of the elderly in the total population from 5.5 to 6.9 percent. According to the World Bank (1994a) estimates, the percentage of old people is expected to rise further to 10.3% by 2020. In absolute terms, the number of elderly citizens is anticipated to nearly double between 1996 and 2016, from 62.3 million to 112.9 million. Figure 1 shows the population-aging trend between 1990 and 2050. As per the projections, in next 50 years the median age of the population is expected to rise by 17 years – from the current level of 21 to 38 years. Given the continuing trend of erosion of the informal support channels for the elderly, the population aging underlines the need for appropriate formal mechanisms for old age economic security.

3.2. Skewed coverage - focus on the organized sector

Existing pension schemes in India predominantly cover the organized sector workers, constituting about 10 percent of the aggregate workforce. Exclusion of the majority of the workers engaged in the unorganized sector is therefore a serious limitation of the current system. In the private organized sector, the Employees' Provident Fund (EPF), the largest retirement support scheme, covers around 23.12 million workers. The other smaller provident fund schemes for coalminers and tea plantation workers cover another 1.25 million workers. In the public sector, there are 11.14 million covered employees working in central, state and union territories. Together, the covered workforce is therefore only about 35.51 million representing just 9.54 percent of the aggregate labor force of 372 million as on March 1997. In contrast, the number of covered workers in the unorganized sector is merely 2 million - less than 10 percent of the covered organized sector workers and just 1 percent of the total unorganized sector working population.[5]

Table 2 provides a sector wise breakup of the workers under various categories. The proportion of self-employed persons alone accounts for 56 percent of the aggregate labor force as on 1991. The near absence of statutory benefit provisions for the unorganized sector workers thus poses a serious challenge. The recent labor market trend suggests further shrinkage in coverage, given the low growth in organized labor force while unorganized employment is on the rise.

The absence of a formal system for retirement income support for the unorganized and informal workers has resulted in high incidence of elderly participation in the labor force. Table 3 shows the historical elderly participation rate in the labor force. As per the 1991 census, 39

[5] Jain (1997)

percent of the people aged 60 years or more continue to be in the labor force. Of the total working population, about 5.26 percent are aged 60 or above. An overwhelming majority of these elderly workers are either self-employed or engaged in casual work.[6] The elderly participation rate is significantly higher in the rural areas where the incidence of poverty is greater compared to the urban areas.

3.3. Dichotomy in formal pension schemes - inequity within the organized sector

Further fragmentation of the current pension system has occurred due to the disparate benefit levels within the organized sector where public sector employees are treated rather generously vis-à-vis the private organized workers. A striking characteristic of the current system is the varying range and level of benefits within the organized sector. Besides a self-contributory provident fund, a lavish defined-benefit pension rights offering superior protection against longevity and inflation risks cover public workers. In contrast, pension benefits for the private sector employees have been financed primarily through mandatory, defined-contribution provident fund schemes. The accumulated balances are paid in lump sum, and thus do not cover for inflation and longevity risks.

The recent enactment of the Employees' Pension Scheme (EPS) in 1995, partially converting the Employees' Provident Fund Scheme (EPF) scheme, has however granted pension rights to private workers. Interestingly, there are allegations that the new pension scheme has increased the dichotomy between public and private workers. In comparison to the public pension schemes, the EPS provides a significantly lower level of replacement income due to a variety of factors like ceiling on maximum pension, lack of indexation, etc.

3.4. Problems with provident funds

[6] Visaria (1998)

The Indian provident fund system has many shortcomings - some of which are inherent to the schemes while others have emerged due to poor plan administration. According to Vittas and Skully (1991), in a provident fund system, the income replacement, investment and inflation risks are borne by the plan participants. According to the principles of social insurance, provident fund is not an ideal substitute for pension. The ILO (1997) argues that provident funds have serious limitations in alleviating old age poverty because it does not provide protection against the whole length of the contingency.

The experience of provident fund schemes in India also suggests some practical limitations of a pure provident fund arrangement. First, the inability to ensure that lump sum payments are used to provide old age protection is a serious draw back of the current system. Majority of the workers being low wage earners has little additional savings and much of the lump sum amount is spent in meeting essential needs after retirement. Second, the provision of liberal non-refundable withdrawal facility from provident funds to meet various contingencies during the employment period significantly reduces the quantum of benefit at retirement. For example, the EPFO distributed average terminal accumulations of less than Rs. 25,000 per member during 1997-98. In the same year, the EPFO allowed an average premature withdrawal of Rs. 17,000 per member (OASIS, 2000).

Low investment yields from provident funds, due to conservative investment norms, further complicate the problem.[7] According to World Bank (1994a) estimates, the average real rate of return from the EPF scheme was below 1 percent in the 1980s. The annual returns from EPF for more recent period are shown in Figure 2. The average annual real rate of return between 1985 and 1997 is only about 2.63 percent. These returns are too low to generate a sizeable terminal accumulation of pension assets, and they further encourage premature withdrawal of funds allowed under certain defined circumstances as mentioned earlier.[8]

3.5. Rising financial burden of public pension schemes

The rising number of retirees and the increasing generosity of the public pension programs are rapidly jeopardizing their long-term financial sustainability. Pension schemes of the central as well as various state governments are facing acute financial crisis due to lavish benefit provisions. Figure 3 shows the trend in yearly expenditure by central and state governments. Between 1995 and 1999, the pension expenditure by the central government has increased at an annual rate of 18 percent. The annual growth rate in pension expenditure for different states has varied between 22 and 34 percent in the corresponding period. Asher (2000) observes that unless the current system is adjusted, the public pension schemes will be financially unsustainable in the near future.

---

[7] Provident fund assets are predominantly invested in government securities. This could be because of the government's dependence on retirement assets as a captive source of financing the fiscal deficit and/or safeguarding the pensioners against market related risks. The net result is, however, inadequate rates of return that has consistently trailed rate of wage growth (Bhatt 1996, Patel 1997, Fox and Palmer, 1999).

[8] Shah (2000) argues that although the EPF account is portable, low returns from accumulations and tax-exemption on withdrawals (including premature withdrawals) induce individuals to withdraw accumulation upon resignation. For example, in 1995-96, only 17.7% of EPF disbursements were on account of retirement, illness or death. The remaining 82.3% were premature withdrawals of which a major fraction is accounted by withdrawal upon resignation.

The Railways Pension Scheme can best illustrate the seriousness of the risk of the looming financial insolvency awaiting the public pension programs. In absolute terms, there has been a fourfold increase in the number of pensioners from 0.27 million in 1984 to 1.05 million in 1999-2000. As a result, pension payment by the Indian Railways has increased 50-fold from Rs. 1060 million in 1980-81 to Rs. 53120 million in 1999-2000. With deceleration in recruitment of fresh employees, the dependency ratio i.e. the ratio of pensioners to workers for the railways has increased sharply from 0.17 in 1980-81 to 0.66 in 1999-2000. As a result, the share of pensions in the working expenses of the railways has risen from 4.65 percent in 1981 to 13.3 percent in 1998 (Mathur, 1998). If the current system remains unchanged, the pension expenditure will put further pressure on railways accounts, given the likely scenario of further rise in number of retirees in the future.

The other public pension programs too show similar experience of rapidly rising pension burden as witnessed by the Indian Railways. The annual expenditure incurred by major central government administered pension programs is reported in Table 4. The combined expenditure of central and state run pension programs is already significantly high (about 1-1.5 percent of GDP) and accounts for almost a quarter of the fiscal deficit. There are several reasons for such escalation in the pension bill. First, with increase in longevity, retirees are living longer and collecting more benefits than ever before. Second, generous wage settlement by Pay Commissions in recent times with retrospective adjustment in benefits have further increased the pension burden.[9] Third, decline in fresh recruitment and increase in the number of retirees is pushing up the

[9] An important feature of the Indian public pension programs is that the pensions are wage indexed apart from being price indexed. Wage indexation is done to maintain parity between early and recent retirees. Asher (2000) observes that such generosities are rare elsewhere in the world.

system dependency ratios. For example, in case of the defense pension scheme - the largest pension expenditure program, the dependency ratio is already greater than unity (OASIS, 2000). Such high dependency ratio, coupled with generous benefit provisions, is resulting in closing the gap between aggregate wage payment and pension expenditure. If the trend continues, yearly benefit disbursement by public pension programs may soon surpass the annual wage bill.

3.6. Government control

The current pension system is heavily regulated by government agencies. State control and interference in administration and supervision has only hindered the growth of the pension system. The government virtually controls all aspects of major retirement saving schemes like participation criteria, benefit entitlements, investment guidelines, etc. The conservative regulatory environment, leading to lack of transparency and public accountability, characterizes the present system.

In recent years, there has been widespread recognition that the current regulations are impeding the growth of the pension system. Many claim that greater autonomy for the provident and pension funds, supported by an environment of prudential regulations, are essential for pension reform in India.[10] Such a regulatory regime should enhance transparency and public accountability, enforce internationally comparable accounting and disclosure standards and develop superior record keeping facility.

There is also a need to remove the monopoly status of the Life Insurance Corporation (LIC) of India in the private pension business. The total hegemony of the LIC in the annuity market has further undermined the efficacy of the provident fund system. Upon retirement,

---

[10] The issue of poor governance of Indian pension schemes is widely reported in literature. The major limitations of the current regulatory structure are lack of transparency and accountability, poor record keeping, low administrative efficiency and distortions in tax treatment, etc. See Agarwala and Sharma (1999), Dave (1999), OASIS (1999), Asher (2000), Shah (2000) for details.

subscribers to the fund, face the problem of investing their accumulations due to lack of suitable annuity products.[11] Malhotra (1994) and more recently OASIS (2000) therefore suggest liberalizing the private pension market to bring in greater efficiency.

3.7. Problems with public assistance schemes

Finally, lack of formal old age income support for the financially impoverished classes, is another serious deficiency of the current system. For some time, the social assistance programs, administered at the state level, has remained the main apparatus for alleviating poverty among India's elderly population. In recent years, however, the central government has significantly increased its involvement with these schemes. Still, the efficacy of these means-tested state pension programs is highly doubtful because of low coverage and meager benefit levels. The inefficiency in administration, as witnessed in a number of states, has further hampered these programs. Wadhawan (1989) therefore observes that these measures of support through public assistance schemes have been somewhat restrictive, minimal or cosmetic in their impact and approach, circumscribed as they are by a variety of limitations and constraints.

4. Recent trends in pension reform

The last decade has been a witness to sweeping reforms in the financial sector in India. Coinciding with reforms in the other spheres of the financial system, there have also been some reform initiatives in the pension sector. However, unlike comprehensive reforms undertaken in banking, capital and currency markets or more recently in the insurance sector, a significant degree of inconsistency and elements of ad-hocism mark pension reform during the past ten years. The low priority that is accorded to pension system is perhaps intentional and reflects the sequencing of the overall financial sector reform process. Such sequencing is however not surprising given the complex nature of pension reform.[12] The linkages of pension system with fiscal and tax policy, labor markets, health and insurance sectors, and financial markets in general reflect the multi-dimensional character of pension reform. The pension reform process can therefore be painstaking and long drawn, with potential to jeopardize or slacken the pace of the overall reform procedure.

Hence, in recent times, the limited initiative to restructure the pension system is marked by a lack of sustained commitment or application of prudence. With the exception of partial conversion of some of the provident funds into pension schemes, most of these reforms are practically minor adjustments of the current system. Incidentally, such minor adjustments are most frequent in case of provident funds. From time to time, provident funds have been subjected to changes in eligibility criteria, contribution and benefit structures or revision in investment norms.

By the early eighties, there was a growing perception about the limitations of a pure provident fund arrangement among the organized private sector workers. In 1986, labor bodies formally approached the Central Board of Trustees (CBT) of the Employees' Provident Fund (EPF) scheme for partial conversion of the scheme in favor of a pension arrangement. Following some further persuasion, the CBT appointed a committee with the mandate to restructure the EPF scheme in 1990.

---

[11] Besides the LIC pension schemes, the retirees have a limited choice of annuity products offered by the Postal department, the Unit Trust of India and other public financial institutions.

[12] Vittas (1995) argues that pension system reform works more efficiently when it is adequately supported by other institutional reform and regulatory changes. Such reforms are, however, not undertaken to facilitate pension reform but for a variety of other reasons. Mitchell (1998) also asserts that a sequenced restructuring of the financial and labor markets together with strengthening the legal, accounting, and regulatory apparatus could facilitate successful reform of a pension system.

While the committee was developing the framework for a new pension scheme within the EPF, in a related development in November 1993, the government introduced pension schemes for nationalized banks and insurance employees. There has been a long-standing demand for pension benefits from labor bodies representing these institutions. That the government acceded to the demand in 1993 is significant as it coincided with the banking sector reform - giving rise to some speculation that the move was to appease the agitating employees.

The two schemes, known as the Bank Employees' Pension Scheme (BEPS) and the Insurance Employees' Pension Scheme (IEPS) were created by diverting the accumulated employers' contribution to the provident funds. The schemes are financed by the employers' contribution to the provident fund contribution, which is equivalent to 10 percent of the basic wage. Separate pension trusts were created to administer pension schemes for each institution. The benefit structure of these schemes replicated the existing pension schemes for the government employees offering defined-benefit pension on superannuation, death or disability. The main superannuation pension provides a replacement income of 50 percent of the final earnings. The pension is indexed to inflation. Participation is mandatory for the new workers but optional for the existing workers.

Meanwhile, the recommendations of the expert committee on EPF were out for public scrutiny. In a stark contrast to the smooth transition of provident funds into pension schemes for bank and insurance employees, the draft legislation for EPF stirred a hornets' nest among the workers. The controversy surrounding the draft bill soon snowballed into an intense debate, both inside and outside the Parliament. Consequently, the government made some concessions and the original draft legislation was amended. Most of these labor bargains were aimed at retaining the provident fund nature of the scheme like liberal withdrawal facilities, commutation provisions, etc.[13] Even then, it failed to mollify every labor group. Finally, in August 1996, the Parliament, amidst some opposition, approved the legislation creating the new pension scheme with retrospective effect from November 1995.

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 EPS program has replaced the erstwhile Family Pension Scheme (FPS). The balance amount of about Rs. 90,000 million in the FPS was transferred to the EPS as the initial corpus. It is financed by diverting 8.33 percent of employer's monthly contribution from the EPF and government's contribution of 1.17 percent of the worker's monthly wages. However, participation to the EPS program is voluntary for the existing workers as on 1995 but mandatory for the new workers whose monthly pensionable earnings do not exceed Rs. 5000.

The debate surrounding the EPS however continued unabated with many trade unions filing litigations against the scheme. 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 it replaced. The ceiling on the benefit level and absence of indexation further depressed the return from EPS. Chatterjee (1996), the principal actuary behind the EPS program, however observed that index linking of pension is not feasible in case of EPS since there is a high level of pooling of private employers. In 1997, in an effort to placate the workers, the contribution rate for the EPF scheme was enhanced to 12/10

[13] Many claim, that despite the compromises made in the design of the EPS program, it is a significant step towards reforming the provident fund system. See Beattie (1997), Singh (1998) for details.

percent replacing the earlier rates of 10/8.33 percent of monthly wages.[14] Table 5 elaborates the changes in the contribution structure in the EPF after introduction of the EPS. The total contribution rate for EPF scheme thus rose significantly and is estimated to be anywhere between 21.92 and 25.92 percent.[15]

As already discussed, the EPF scheme is often criticized for inadequate rates of return. Recognizing the need for increasing the yield from the EPF scheme, the investment norms have been progressively liberalized in recent years, especially after 1993. Table 6 reports the periodic changes in the investment norms for the EPF. A distinct trend has emerged which permits investments in debt instruments of public sector undertakings and public financial institutions. This percentage has since then been progressively raised and has reached 40 percent in 1997-98. In practice however, there has been very little application of discretion and the bulk of the funds, between 80 and 92 percent, has been invested in special deposits with the government, which has provided a yield of 12 percent since 1986.[16]

In recent times, however, the interest rates on provident funds have attracted a fair deal of attention. Over the years, the annual interest rate on provident funds has been progressively increased. The last revision, made in 1989-90, set the interest rates for various provident funds at 12%. However, with a general drop in interest rates in recent times, it was increasingly becoming difficult to maintain such a high rate, thereby initiating some contemplation over reduction in the

---

[14] Following the proposal made in the union budget for the year 1997-98, the contribution rates for five industries were raised from 8.33% to 10% in May 1997. Later, in September 1997, the contribution rates for the remaining one hundred and seventy two industry categories were enhanced from 10% to 12%.

[15] The difference of four percentage points in total contribution rate in EPF can be explained by the dual contribution structure. Whereas the employer and employee both pay 10% of monthly earnings into EPF, aggregate contribution rate is 21.92%. However, for most scheduled industries, the contribution rate is 12% for the employer as well as the employee. As shown in Table 5, the aggregate contribution rate in such cases is 25.92%. Note that if gratuity payment is also considered, which is about 4.16 percent of the final wage, the total contribution rate is even higher.

[16] See Dave (1999) for details.

provident fund interest rate. As a first step, the government reduced the interest rate on the Public Provident Fund (PPF) scheme from 12 to 11 percent in January 2000. Soon, a similar cut was effected in the interest credited to government employees on their General Provident Fund (GPF) deposits, triggering speculation on a similar cut in the EPF interest rate.

The Central Board of Trustees (CBT) of the EPF, however, opposed such a cut and requested the government to keep the interest rate unchanged. In April 2000, the government slashed the interest on the Special Deposit Scheme (SDS) from 12 to 11 percent. Considering, that over 81 percent of the outstanding EPF holdings of Rs. 4,75,630 million (for unexempted establishments) as on March 31, 2000 was invested in the SDS account, it was expected that this would force the CBT to reduce the EPF interest rate correspondingly. The CBT, however, decided to dip into the EPFO's reserves to maintain an interest rate of 12 percent during 2000-01. The unfolding drama finally came to an end in June 2000 when the Government reduced the interest rate on EPF deposits from 12 to 11 percent with effect from April 1, overruling the recommendation of the Central Board of Trustees (CBT) of the EPFO.[17]

Meanwhile, the most sweeping reform took place in the private pension market. Private pension business is a part of insurance business in India. After nationalization 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 which studied the insurance sector, suggested opening up of the insurance industry. Following the committee’s recommendations, the government liberalized the insurance sector in the year 2000. As a result, private corporations including foreign entities are now permitted to enter the private pension market. The IRDA, the

[17] This is the first instance in the history of EPF when the government has overruled the recommendations of the CBT.

newly formed apex regulatory body overseeing the insurance sector, has recently released investment norms for insurance firms intending to enter the private pension market. [18]

All these reforms were centered around the EPF scheme. Although, mounting pension expenditure was straining government finances, there was no effort to control it due to political compulsions. Finally, in 1998-99, faced with an escalating pension burden, the central government took the most politically favorable step of increasing the retirement age from 58 to 60 for its employees. The attempt to contain pension expenses has however failed due to upward revision of benefits awarded by the Fifth Central Pay Commission. Recently, the Ministry of Finance has set up a working group to examine pension reform options for the government employees. The expert group is reviewing the extent of coverage and liabilities under the existing pension schemes and is also examining the merits of switching over to a funded pension arrangement [Asher (2000)].

Learning from the experience of these disjointed efforts to reform the pension system, the government is increasingly realizing the need to undertake a comprehensive reform policy. However, there is still a lack of cohesion and coordination among different ministries which have stakes in social security for the aged, and each one is formulating its own blue-print for pension reform.

In August 1998, the Ministry of Social Justice and Empowerment, commissioned a national project titled "OASIS" (an acronym for "Old Age Social and Income Security") by appointing an expert committee. In its directive to the committee, the Ministry expressed concern about the whole package of welfare to the elderly. The committee was given the task to prepare a reform plan for the pension system with a special emphasis for the hitherto uncovered unorganized sector. The committee submitted two reports, an interim one in February 1999 and the final one in January 2000, outlining comprehensive reform policies for the pension system.

Central to the reform proposal was creation of a separate regulatory body (Indian Pensions Authority) to control the pension system. The new pension system should be fully funded, defined-contribution and based on portable individual retirement accounts. The existing schemes like EPF and EPS should either be merged or restructured in line with the new scheme. The most radical suggestions were made in case of investment management, including appointment of professional fund managers, permission to invest in equity stocks, subscribers right to choose portfolio composition and freedom to select fund manager based on performance. Further, to protect the retirees against unfavorable circumstances, the committee suggested offering contribution protection insurance and relative returns guarantee. It was also suggested that the retirees be given a real annuity, although the modalities of which were not discussed in details.

In a parallel initiative, the Ministry of Labor also set up a taskforce to examine various social security schemes. The report of the committee (Wadhawan Committee), submitted in May 2000, has called for replacement of the existing social security schemes with a single integrated comprehensive scheme. The committee recommended the unification of the Employees' Provident Fund (EPFO), Employees' State Insurance (ESIC) and the Employees' Pension Scheme (EPS) under the administration of a single agency.

5. Major issues for reform

[18] For details regarding the insurance sector liberalization and the new regulatory environment, see http://www.irdaindia.org and http://www.irdaonline.org.

The preceding discussion highlights the limitations of the current structure of the pension system and brings some critical issues pertaining to reform into focus. Growing perception about the deficiencies of existing pension schemes have prompted the government to initiate some reformatory steps in recent years. However, as described, these reforms were mostly initiated in an ad-hoc manner and therefore met with limited success. In some cases, like the Employees' Pension Scheme, the reform has probably caused further deprivation.

The failure of these limited reform initiatives therefore underlines the need for a lasting reform, adequately supported by a systematic approach. The question is how to structure the reform and what are the critical issues that need to be addressed. Three key issues emerge from the preceding discussion. First, the immediate challenge for India is to design and implement a pension reform strategy capable of restoring the long-run financial viability for public schemes. Equally important is to provide better returns to private workers through relaxation of investment norms. And finally, the exclusion of the vast majority of unorganized and informal workers under the current system is a serious drawback.

The escalating trend in the expenditure pattern of the defined-benefit, non-contributory, pay-as-you-go, public pension programs needs to be checked. Generous pension benefits together with health benefits provided to the retirees are threatening the financial sustainability of these schemes. Re-examination of the contribution and benefit structures including switching to advanced-funding and/or rationalization of benefits could ensure actuarial and fiscal sustainability of public pension programs.

Secondly, it is also evident that without reforms in investment policies and performance of provident and pension funds, it will be difficult to provide adequate replacement rate in a sustainable manner for the current and future retirees. Also, there is a need to review policies concerning withdrawal of accumulated balances. Present system of liberal non-returnable lump sum withdrawal often results in inadequate provision during the old age. Thus, limiting withdrawal facilities and some form of mandatory annuitization needs to be given serious consideration.

Outside the scope of the current system, a larger issue of extension of coverage to alleviate poverty among the elderly remains to be addressed. The pertinent question here is that can we move towards a universal publicly managed social security system covering every citizen attaining seniority? The answer is probably no. There are several reasons.

First, public pension schemes are already under great financial pressure due to lavish benefit patterns. Second, problems of persistent poverty, unemployment, low tax base and tax evasion imply that ability and willingness to contribute in a collective system may have limited appeal. Together, the argument suggests that the prospect of extending the publicly managed first pillar of pension system is bleak.[19]

Hence, there is a need for a pragmatic approach to expand pension coverage. Such approach essentially requires appropriate strategy to strengthen the second and third pillars of the pension system. Indeed, coverage can be spread through institution of mandatory individual account based and defined-contribution pension schemes and/or voluntary retirement saving schemes to supplement retirement income.[20] The government alone is unlikely to deliver such income support programs. Hence, there is a need to encourage the participation of private

---

[19] According to Sen (1996), the publicly managed first pillar of pension is well beyond the capacity of the Indian social insurance system. The attractiveness of the privately managed second pillar for coverage expansion is also limited - as it is tied with employment growth rate in the formal sector which has been rather low in India.

[20] Vaidyanathan (1999) asserts that if voluntary pension schemes were developed with appropriate incentives like flexibility in contribution and benefit structure, favorable tax treatment and better returns through portfolio liberalization, a significant proportion of the self-employed population would have been covered.

institutions. The recent opening up of the private pension business suggests that India is moving in that direction.

6. Conclusion

Indian pension system is passing through a crisis of confidence. The economic, demographic and labor market trends of the current system are moving in troublesome directions. The problems that the system is confronting now are quite well known:

- *Demographic aging:* The age structure of the population is changing drastically with increasing life expectancy and declining birth rates. The result of such demographic transition will be a larger proportion of older people.
- *Changing social mores:* Collapse of joint family system coupled with pressures of urbanization and migration are also leading to deterioration in traditional means of support for the elderly.
- *Skewed coverage:* Existing schemes predominantly cover the organized workers leaving the bulk of the workforce with little access to any formal system of old age income security. The coverage is further diminishing due to stronger growth in unorganized employment.
- *Inequity in benefits:* Within the organized labor force having access to some kind of formal retirement income system, generous treatment of the public workers vis-à-vis the private workers is resulting further fragmentation of the pension system.
- *Pressure on public finances:* The spiraling expenditure pattern of the non-contributory, unfunded public pension programs are putting increasing pressure on government's budgetary allocations. Unless this trend is arrested, these schemes will be financially unsustainable in near future.

- *Low returns from provident funds:* Conservative investment norms for provident funds, ostensibly to safeguard the workers' interest, have resulted in inadequate rates of return from these schemes.
- *Under developed private annuity market:* Lack of pension annuities and health insurance cover further complicates the old age economic security.

In recent years, growing realization about these deficiencies has prompted the government to take reformatory steps to overcome these problems. However, most of these reforms are initiated in a piecemeal manner. The failure of such ad-hoc initiatives suggests that there are no shortcuts to address these problems. The policy makers, therefore, need to take a fresh view and develop new mechanisms to rejuvenate the pension system. A mix of policies like austerity on benefit promises, reliance on greater funding, relaxation of investment norms, encouraging private participation, enhancing system efficiency and developing regulatory capacity could help avert the looming pension crisis and promote better economic security for the aged. The benefit of such a pension regime is also likely to foster aggregate rate of savings and accelerate capital market development.

References:

Agarwala R. and Sharma R.K. (1999) "India's Pension System Reform: Challenges and Opportunities", paper presented at the International Conference on Social Security Policy: Challenges before India and South Asia, New Delhi, November.

Asher, Mukul G. (2000), "Reforming Civil Service Pensions in Selected Asian Countries", paper presented at World Bank EDI conference in Kuala Lumpur, Malaysia, March.

Beattie, Roger (1997), Reform and Development of Pension Systems in Asia and the Pacific, ILO, Geneva.

Bhatt, Gita (1996), "Reforming Pension Systems: An Idea Whose Time Has Come?", Economic and Political Weekly, June 22, 1570-1571.

Chatterjee, Bhudev (1996), Journey From My Provident Fund To Our Pension Scheme, Employees' Provident Fund Organisation, New Delhi.

CMIE (1993), Basic Statistics for Indian Economy, Centre for Monitoring Indian Economy, Mumbai.

CMIE, Public Finance, Centre for Monitoring Indian Economy, Mumbai, various issues.

Dave, S.A. (1999), "Restructuring Pensions for the Twenty-First Century", in James A. Hanson and Sanjay Kathuria (ed.), India A Financial Sector For The Twenty-First Century, Oxford University Press, New Delhi, pp.305-333.

Fox, Louise and Edward Palmer (1999), "New Approaches to Multi-Pillar Pension Systems: What in the World is Going On?", World Bank.

ILO (1997), Ageing in Asia: The Growing Need For Social Protection, ILO, Bangkok.

Indian Labour Year Book, various issues, Labour Bureau, Ministry of Labour, Government of India, New Delhi.

Jain, Shashi (1997), "Social Security for the Informal Sector in India: Feasibility Study on Area-Based Pilot Projects in Anand (Gujarat) and Nizamabad (Andhra Pradesh)" in Wouter van Ginneken (ed.), Social security for the Informal Sector: Investigating the Feasibility of Pilot Projects in Benin, El Salvador, India and Tanzania, Issues in Social Protection, Discussion paper 5, ILO, Geneva.

Kelles-Viitanen, Anita (1998), "Social Security for Unorganized Women Workers", in Wouter van Ginneken (ed.), Social Security for All Indians, Oxford University Press, New Delhi, 115-130.

Malhotra, R.N. (1994), Report of the Committee on Reforms in the Insurance Sector, Ministry of Finance, Government of India, New Delhi.

Mathur, S.N. (1998), “Greying of Indian Railways”, Asian Institute of Transport Development, New Delhi.

Mitchell, Olivia (1998), Building an Environment for Pension Reform in Developing Countries, Human Development Network, Social Protection Group, World Bank.

OASIS (1999), The Project OASIS Report Part I, Ministry of Social Justice and Empowerment, Government of India, New Delhi.

OASIS (2000), The Project OASIS Report Part II, Ministry of Social Justice and Empowerment, Government of India, New Delhi.

Patel, Urjit R. (1997), Aspects of Pension Fund Reform: Lessons for India, Economic and Political Weekly, September 20, Vol. 38, pp. 2395-2402.

Rajan, S. Irudaya, U.S. Mishra and P. Sankara Sarma (1999), India’s Elderly Burden or Challenge?, Sage Publications, New Delhi.

Sen, Kasturi, (1996), "Old Age Security and Pensions in India: A Critique of the Current Paradigm", in Peter Lloyd-Sherlock and Paul Johnson (ed.), Ageing and Social Policy: Global Comparisons, London School of Economics, pp. 105-122.

Shah, Ajay, (2000), Issues in Pension System Reform in India, Indira Gandhi Institute for Development Research, Mumbai, India.

Singh, Parduman (1998), Protection for the Elderly, the Disabled and the Survivors in India at the Threshold of the 21st Century, Friedrich Ebert Stiftung, New Delhi.

Vaidyanathan, R. (1999), Retirement Benefits Schemes for the Self Employed (Bhagidari) in India: Prospects and Constraints, Working paper 4, Centre for Insurance Research and Education, Indian Institute of Management Bangalore.

Visaria, P. (1998), Demographics of Ageing India, mimeo, Institute of Economic Growth, New Delhi.

Vittas, Dimitri (1995), Sequencing Social Security, Pension And Insurance Reform, Policy research working paper 1551, World Bank.

Vittas, Dimitri and Michael Skully (1991) Overview of Contractual Saving Institutions, Working paper, Country Economics Department, WPS 605, World Bank.

Wadhawan, Sahdev K. (1989), Social Security for Workers in the Informal Sector in India, ILO, Geneva.

World Bank (1994a), Averting the Old Age Crisis; Policies to Protect the Old and Promote Growth, Oxford University Press, New York.

World Bank (1994b), World Population Projections – Estimates and Projections with Related Demographic Statistics, Johns Hopkins University Press, Baltimore.

Table 1: Characteristics of major retirement benefit schemes

	Employees' Provident Fund (EPF)	Employees' Pension Scheme (EPS)	Government Employees' Pension Scheme (GEPS)
Characteristics	Defined-contribution and fully funded	Defined-benefit and pay-as-you-go	Defined-benefit and pay-as-you-go
Coverage	The scheme covers workers in the private organized sector.	EPF members with monthly earnings not exceeding Rs. 5000.	The scheme covers government employees.
Contribution	Employees contribute 10% or 12% of monthly wage. Employer also provides a matching contribution, out of which an amount in excess of the EPS contribution is credited into the worker's EPF account.	Out of the employer's contribution into the EPF, 8.33% of earnings is diverted into EPS. Maximum earnings for EPS contribution is Rs. 5000 per month. The government also makes 1.16% contribution.	Participants make no explicit contribution but they forego the employer's contribution into their provident fund accounts.
Pension Formula		Pension = wage x t/70 Where t is the service period. 2 years service credit is granted for 20 years or more service.	Pension = 0.5 x wage x max(t,33)/33 Where t is the service period.
Vesting Period	Nil	10 years	10 years
Benefit Payout Pattern	Paid in lump sum at the time of retirement.	Monthly annuity	Monthly annuity
Minimum and Maximum Benefits	EPF has neither upper nor lower limits on benefits.	EPS has a floor and ceiling in its benefit formula. The minimum monthly pension is Rs. 250 and the maximum is Rs. 5000 adjusted by the length of service.	The minimum monthly pension floor for GEPS is Rs. 1250. There is no explicit cap on maximum pension amount.
Indexation	Since EPF offers lump sum benefits, there is no scope for indexation.	EPS does not have any guaranteed indexation benefit.	GEPS is indexed to CPI. The indexation benefit, known as dearness relief, is revised twice a year. Greater indexation are provided to the low income groups.
Commutation	Since benefit is paid in lump sum, there is no question of commutation. EPF, however, offers liberal non-refundable withdrawal options during working life.	Commutation up to one-third amount of the pension is permissible under EPS.	Maximum commutation of 40% is permissible.
Risk Coverage	Does not cover longevity and inflation risk.	Partially covers longevity risk but not	Covers longevity and inflation risk.

		inflation risk.	
Insurance coverage	EPF offers protection against death or disability.	EPS offers protection against death or disability.	GEPS offers protection against death or disability.

Table 2: Workforce structure by employment status (million)

	1981	1991
I. Wages and Salary Earners	96.5	121.6
Organized sector	22.9	26.8
Public	15.5	19.0
Private	7.4	7.9
Unorganized sector	73.6	94.8
Agricultural workers	55.5	73.8
Non-agricultural workers	18.1	21.0
II. Self-employed	126.0	157.3
Cultivators	92.5	107.1
Non-cultivators	33.5	50.2
Total	222.5	278.9

Source: CMIE Basic statistics for Indian Economy (1993)

Table 3: Work participation rate among the elderly*

	1961	1971	1981	1991
Rural	52.04	45.48	43.13	43.10
Urban	35.20	31.48	27.54	24.29
Total	49.50	43.16	40.08	39.13

* As percentage of total elderly population

Source: Rajan, Mishra and Sarma, (1999)

Table 4: Expenditure pattern of major public pension schemes (Rs. million)

	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01*
Civil~	9341	11081	14250	19500	28000	33000	38650
Defense	27210	31970	38630	49470	72700	110240	120000
Railways	16860	20900	26150	33670	34250	35690	53120
Post	2540	2900	3650	5341	7000	7300	8500
Telecom	1640	1850	2650	3600	4000	4100	5700

* Budgeted estimate

~ Central government employees only

Source: CMIE Public Finance (various issues)

Table 5: Contribution structure for EPF

EPF is an umbrella scheme offering social security to the participants against various contingencies. Until 1995, EPF comprised Employees' Provident Fund (EPF), Family Pension Scheme (FPS) and Employees' Deposit Linked Insurance (EDLI) Scheme. It has been restructured in 1995, and Family Pension Scheme (FPS) is replaced with a more comprehensive Employees' Pension Scheme (EPS). Subsequently, the contribution rate has been raised.

	Old system*				New system**			
	EPF	FPS	EDLI~	Total	EPF	EPS	EDLI	Total
Employee	8.83	1.17	-	10	12	-	-	12
Employer	8.83	1.17	0.5	10.5	3.67	8.33	0.5	12.5
Government	-	1.17	0.25	1.42	-	1.17	0.25	1.42
Total	17.66	3.51	0.75	21.92	15.67	9.5	0.75	25.92

* The old system was in force till 1995. Total contribution rates for certain classes of industries were 8.33% of wage.
** The new system has come into effect since 1995. Total contribution rates for certain classes of industries are 10% of wage.
~ The employer and the government pay additional 0.01% and 0.005% of wages respectively towards the administrative charges for EDLI.

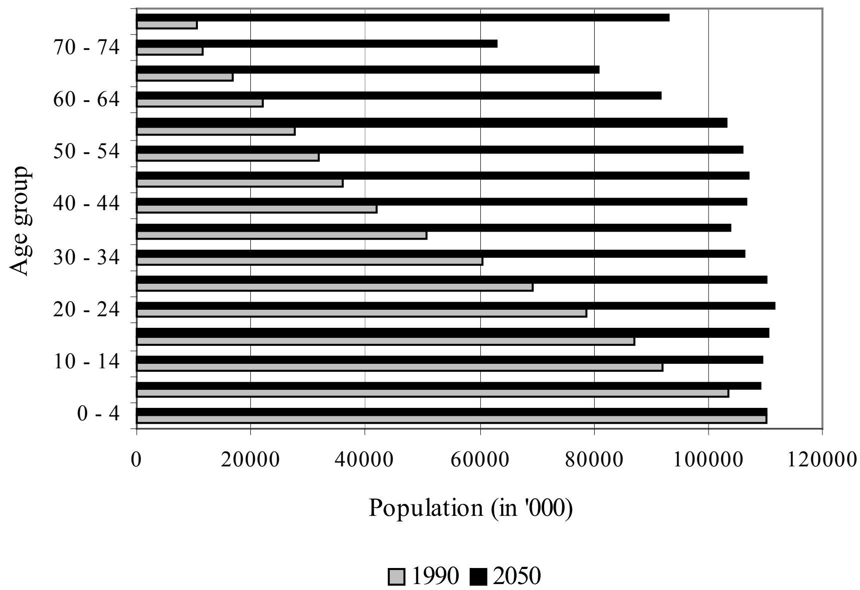
Source: Indian Labour Year Book (various issues)

Table 6: Prescribed investment pattern for EPF

	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99
Government and government guaranteed securities	>= 15	15	40	40	40	40	40
Special deposit scheme of Government of India	<=85	70	55	30	20	-	-
Public sector undertakings' bonds and securities of public financial institutions	-	15	30	30	40	40	40

Source: Dave (1999)

Figure 1: Age structure of Indian Population



Source: World Bank (1994b)

Figure 2: EPF interest rates

Annual nominal interest rate declared and the real interest yield for EPF scheme between 1985 and 1997. The real interest rate is computed using the Consumer Price Index for Industrial Workers (CPI-IW). While the nominal interest rate for EPS has mostly remained constant at 12 percent, the real interest rate has varied between –1.5 and 7.8 percent during the period. The average annual real yield from EPF is about 2.63 percent.

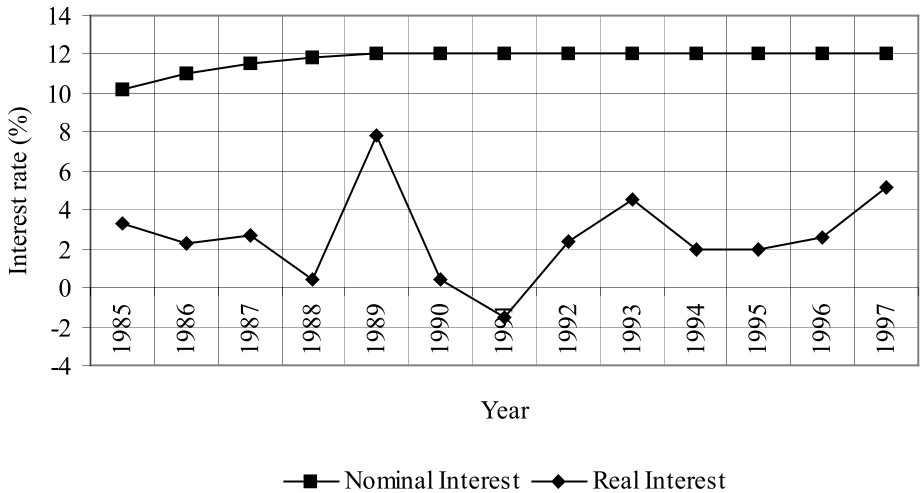
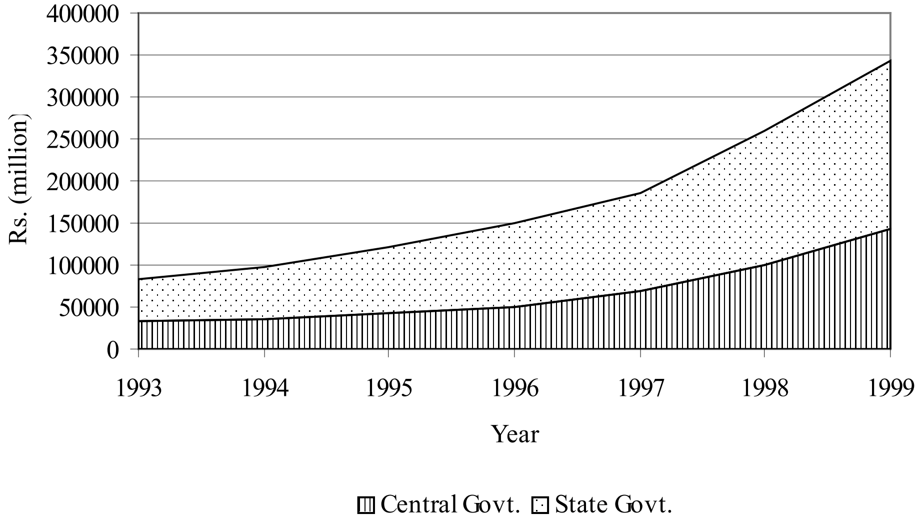


Figure 3: Pension expenditure trends for central* and state governments



* Includes civil and defense pension

Source: CMIE Public Finance (various issues)