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from the ringside

Pension: Thinking into the future

The panic about pensions is rising around the world. The United States, Europe, Japan, China and other countries are seeing the graying of their populations, and the steady march of the demographic bulge towards pensionable age. There are attempts to stem the long-range fiscal drain by fine-tuning the basic inter-generational contracts, while other countries are revamping their systems entirely, with substantial short-term transition costs. In comparison to this scenario, India's demographics are enviable: the population is ageing, but slowly. Nearly 12 per cent of the world's ageing population lives in India (making it a potentially lucrative market for pension fund managers), but nearly 17 per cent of the world's total population also lives here.

Nevertheless, demographics are not the full story. The fiscal impact of the pension system depends on the demographics of those covered by pension plans as well as the structures of guarantees. The social benefits of having a pension system depend on its coverage. And here India looks weak. Government workers, the main group covered by pension plans, are relatively older than the general population. Their 'demographic bulge' came from hiring patterns: central government recruitment grew by 57 per cent between 1957 and 1971. These soon-to-retire workers' pension funds are defined-benefit, and are generous. The Government's total liabilities are now estimated at Rs 23,629 crore (up from Rs 5,000 crore in 1995) for the Centre and an additional Rs 30,000 crore for the state governments. Expenditure on central government pensions alone increased from 0.67 per cent of the GDP in 1993-4 to 1.67 per cent of the GDP (12.6 per cent of net tax revenue!) in 2003-4 even as the economy's growth sped up.

The Government also defines the interest rates for private workers' main pension options: the Public Provident Fund (PPF), the Employee's Provident Fund (EPF), and the shorter-term Post Office Monthly Income Scheme (POMIS), three options for tax-free savings with varying degrees of flexibility in contribution. Such schemes need not create a drain on public resources. In practice, however, the Government-set interest rates for the funds have been higher than the Government's general borrowing costs. The Special Deposit Scheme, in which the EPF is invested, for example, dropped from 9.5 to 8.5 per cent this year (with recent pressures to reverse this) but is still higher than the 6-7 per cent interest rate on which the Government can otherwise borrow.

As for coverage, here too India falls short. Only 35 million of the 380 million labour force is covered by a pension plan. The Pension Bill solves only part of the fiscal problem, and does not address the larger social issue. It introduces a new defined contribution pension plan offering subscribers a choice of fund management options and mandates that central government civil service workers who entered after January 1, 2004, subscribe to this plan. There is no guaranteed minimum payout, but actual payouts could be higher than under the existing scheme. The Bill also sets up the Pension Fund Regulatory and Development Authority (PFRDA) as an interim body, now likely to be put into place by ordinance after being approved by the Cabinet last month. Nevertheless, the Pension Bill is only a start. First, we still need a plan for working out the existing liabilities. Where will these resources come from? Second, we must take another look at the liabilities created by the EPF and PPF. In addition to the direct drain on public resources due to the high interest rate, tax-free savings option also distorts bank deposits and lending rates. And it is not clear that these ‘‘subsidies’’ are going to the poorest—the low balances suggest that the funds are not being used to build up savings for retirement, but rather as tax-saving vehicles. The new pension system offers an important improvement, but there is little incentive for workers to shift away from the tax-free, high-interest rate accounts.

Third, simply repairing existing pension plans overlooks the fact that coverage is limited. The remainder of the population depends on within-family, inter-generational transfers. Economic changes, however, put pressure on this traditional model. Migration has put more physical distance between generations. Urbanisation has changed the way that tasks were shared. The tasks each member of the family contributes to household welfare can evolve in rural areas, but industrial jobs may not be as flexible. Longer life expectancies also increase the burden that within-family inter-generational transfers create for children. The current life expectancy of those over 60 is now 15 years and is expected to go up to 20 years by 2020.

From a fiscal perspective, given the many demands on public resources, it makes sense to do as much as we can to encourage private pension schemes to expand coverage. The establishment of the PFRDA is one step towards creating an attractive investment environment, but we need to make sure that it enacts and enforces credible regulation that takes into account best practices from around the world. Opening the pension sector to foreign participation would also be a step in the right direction. Nevertheless, there will remain a need for the public sector to be involved in providing at least minimal pension for the poor and potentially some kind of guarantee for corporate pensions.

The first challenge would be how to ensure that there is minimal leakage of pension funds. A loosely targeted pension fund discourages independent savings among those who could afford to finance their own retirement and thus creates a substantial fiscal burden. India has time on its side. But time passes and the current young will age, and any weaknesses built into the system now will only be perpetuated. We must be careful about the commitments we make now, as they will be kept in the future. Reforming pension systems is near impossible when the majority of voters are beneficiaries.

The second challenge would be to make sure that the presence of the government guarantee does not encourage risky behaviour on the part of corporations. The corporations' actuarial assumptions must be carefully monitored to ensure that they do match their workers' current life expectancy profile. The actuarial assumptions would preferably be regulated by an independent regulator rather than subject to political pressure. Striking a balance between being too safe (and thus low-return) and too risky (which is potentially high return but imposes large contingent liabilities) is a challenge for pension systems around the world. Pension reform is in the interest of 'all ages'.

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