

# **Civil Service Pension Reforms in Asia: Implications for India**

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# Organization

Reasons for Civil Service Pension Reform

Broad Strategies

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Malaysia

Thailand

Implications for India

# Reasons for Civil Service Pension Reform /1

The core objectives of any pension system for both individuals and government is smoothing consumption over lifetime, insurance (particularly against longevity and inflation risks), income redistribution, and poverty relief. These have to be traded off against economic growth and labor market efficiency

There is no single pension model or a package of reforms which are appropriate for all countries. Customization and long term focus are essential. Policy makers have the option to choose among several reasonable set of pension reform packages

# Reasons for Civil Service Pension Reform /2

**Fiscal consolidation and flexibility**

**Mitigate dualism (i.e higher levels of benefits, no or small contributions by beneficiaries, protection of most retirement risks for civil servants as compared to private sector employees)**

# Reasons for Civil Service Pension Reform /3

## Improve Labor Market Efficiency

There are four types of relevant labor movements:

From one firm to another, from one geographical area to another, **from the state to the private sector**, and from the uncovered (rural) to the covered (urban) sector

India's rebalancing of the State-Market mix and its needs for job creation has made improving labor market efficiency an important priority

# Reasons for Civil Service Pension Reform/4

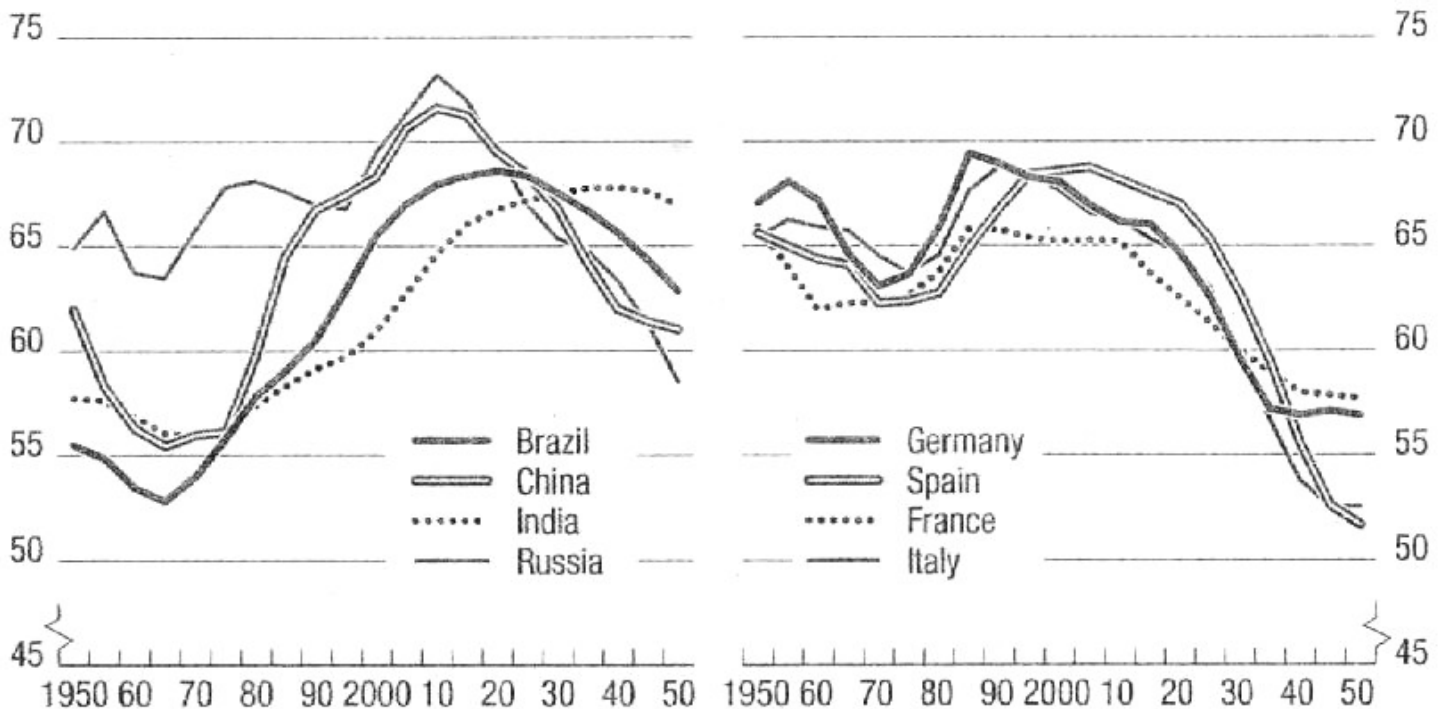
## Growth Strategies, Labor Market and Savings

Figure 1A shows the turning point in  
working age population for selected  
countries

# Figure 1A

## Working age population share

In selected developing and developed countries (% of total population)



Sources: IMF; UN

Source: World Economic Outlook, IMF, September 2004

# Reasons for Civil Service Pension Reform/5

As Figure 1A shows, India is entering demographic gift phase. The challenge will be to actually translate this “gift” into competitive advantage as Southeast Asia and China have done

In 1980, working age population share was 57%; is currently 63% and expected to go to 68% in 2035

Besides absence of world class tax system and threat of HIV AIDS (Vijay and Sujata Kelkar, Indian Express, October 16, 2004) the lack of professionalism with which EPFO and the civil service schemes are being managed represent major constraints in taking advantage of the demographic gift

# Reasons for Civil Service Pension Reform/6

## Core Functions of any Provident or Pension Fund

3. Reliable collection of contribution/taxes, and other receipts
4. Payment of benefits for each of the schemes in a correct way  
In case of pre-retirement loans, ensuring their timely repayment
5. Secure financial management and productive investment of provident and pension assets

# Reasons for Civil Service Pension Reform/7

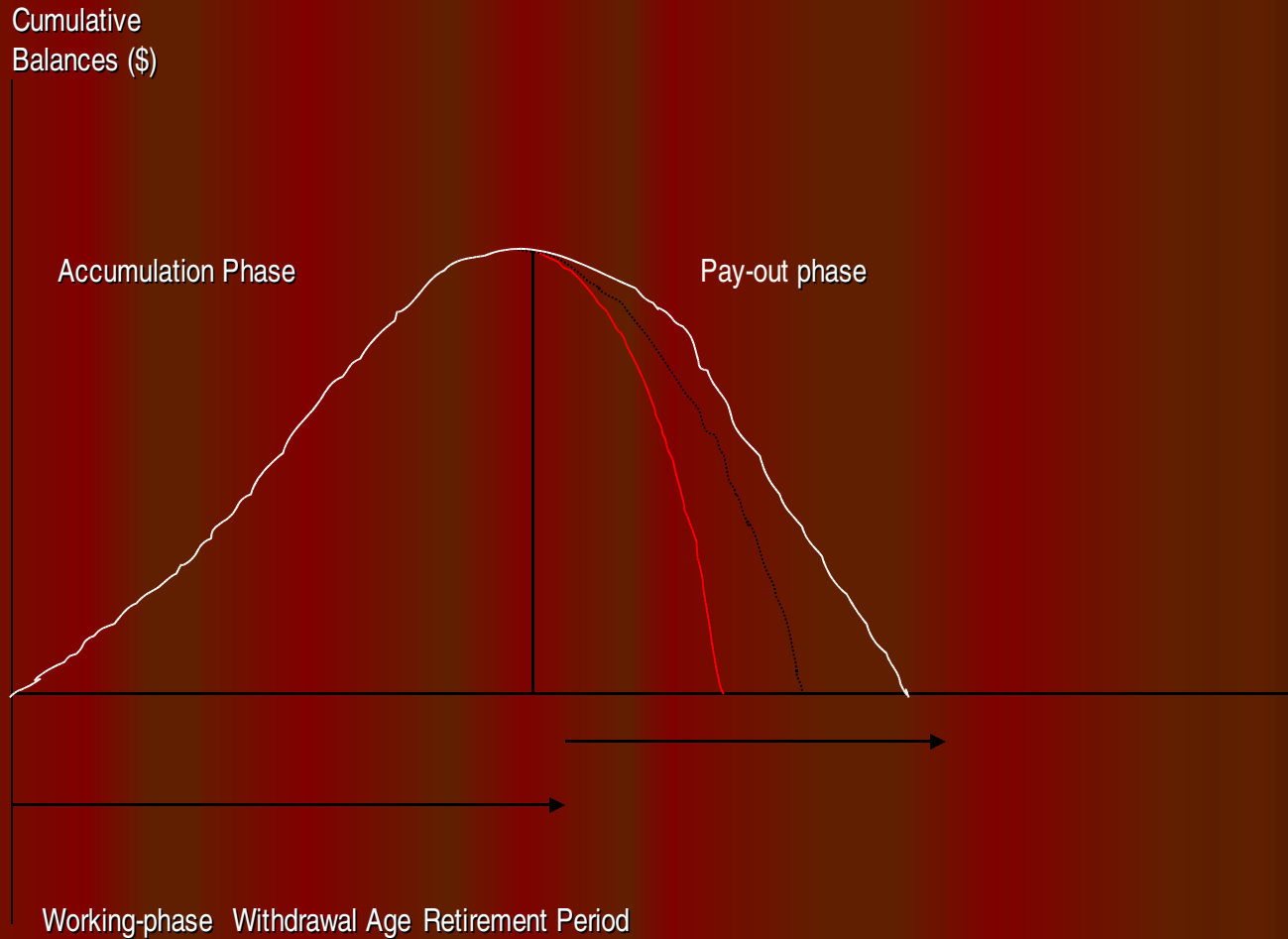
1. Maintaining an effective communication network, including development of accurate data and record keeping mechanisms to support collection, payment and financial activities
3. Production of financial statements and reports that are tied to providing effective and reliable governance, fiduciary responsibility, transparency, and accountability

# Reasons for Civil Service Pension Reform/8

To perform these functions satisfactorily, Professional Level attention to design, Laws and Implementing Regulations, and IT and other Enabling Technology are needed. The Governance Structure should enable Accountability and Transparency of the Provident and Pension Funds

The above is particularly important in countries such as India

**Figure 1B**  
**Accumulation and decumulation phases of DC schemes**



Cumulative Balances = Net contributions (contributions minus withdrawals), plus interest credited on accumulated balances.

**Decumulation phase:** the funds accumulated can be spent rapidly or slowly. Death may occur before the funds are exhausted or reverse is also a possibility. So need to protect against longevity risk. As it is the purchasing power of the funds that is relevant, protection against the inflation risk is also desirable.

Source: Author

# Broad Strategies /1

The Civil Service Pension Reform strategy

Options:

Fundamental Structural Reform i.e changing the philosophy (DB to DC or vice versa); funding levels (unfunded to funded or vice versa)

Parametric Reform i.e changing key parameters of the existing system such as retirement age, pension benefit formula, family pensions provisions, and indexation provisions

# Broad Strategies /2

In practice, both will be needed as any system in need of fundamental reform would have accumulated substantial design, governance and implementation provisions which are counter-productive in achieving desired goals

The above point is even more valid when fundamental structural reform is confined to the new entrants to the pension scheme (Of course, if the existing members are brought into the new scheme, transition financing and other arrangements become of major importance)

# Broad Strategies /3

As the new entrants as a proportion of the total members of the scheme are likely to be small, unless parametric reforms in the scheme for existing members are undertaken, the fiscal and labor market impacts are likely to be small; while transition time will be quite long.

Rebalancing of the state and the market implies that the state sector will not be the major generator of new jobs

The above is also applicable in the case of India's Civil Service Pension

# Selected Case Studies

## I. MALAYSIA

# Malaysia /1

## **Main features of Civil Service pensions in Malaysia**

**Financed from current expenditure, without any employee contributions**

**Longevity risk protection, and survivors' benefits, but inflation protection through periodic discretionary rather than automatic changes**

# Malaysia /2

**Retirement age 55 years (Life expectancy at age 60 is 19 years for men, 17 years for women)**

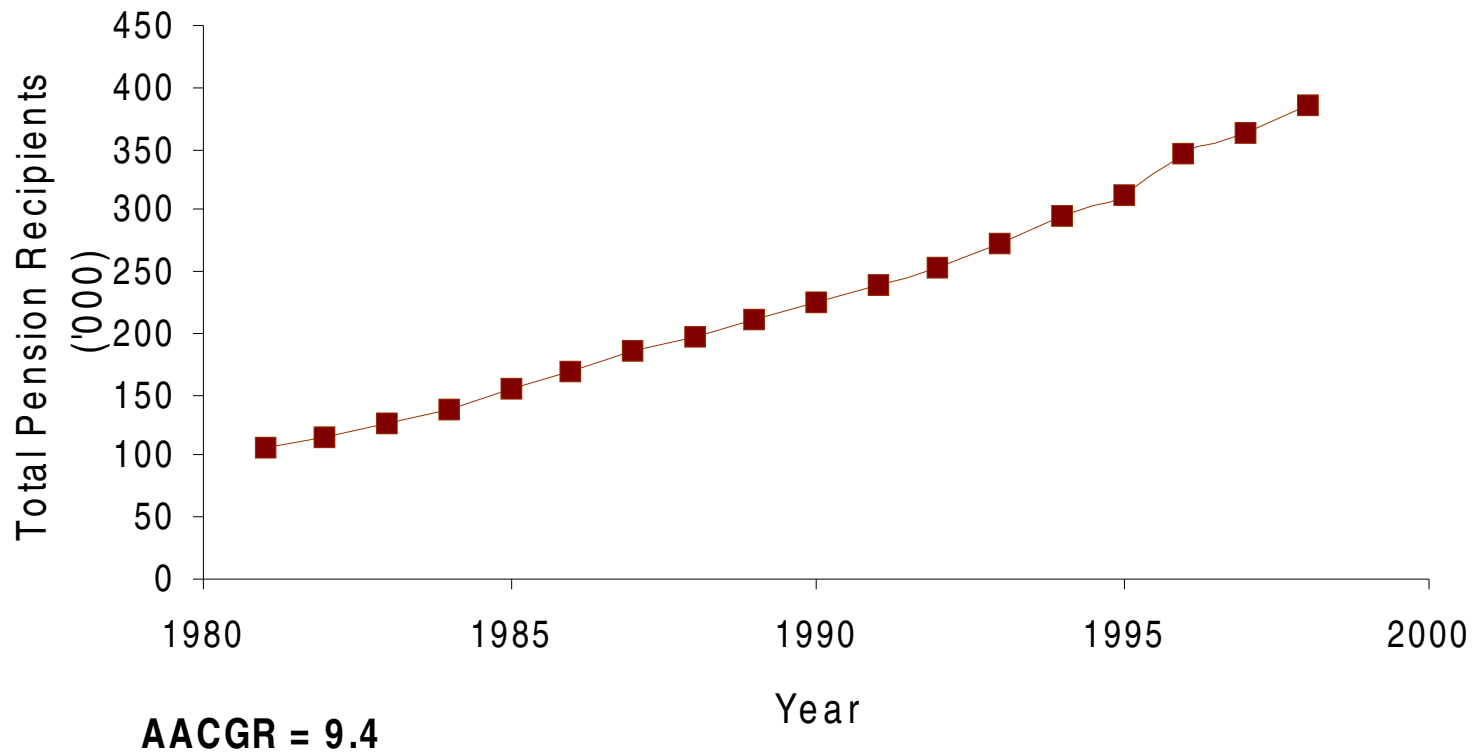
**Replacement rate at retirement of 50 % of last drawn salary. Lack of full indexation would imply declining replacement rate during retirement period**

**Pension is not portable**

**If an employee leaves before retirement age, he loses all pension. So pro-rating provision**

# Malaysia/3

**Figure 2A:**  
**Malaysia: Total Civil Service Pension Recipients**



# Malaysia/4

The Pension Formula is

$\frac{1}{600} \times \text{Total Completed Months of reckonable service} \times$   
Last Drawn Salary

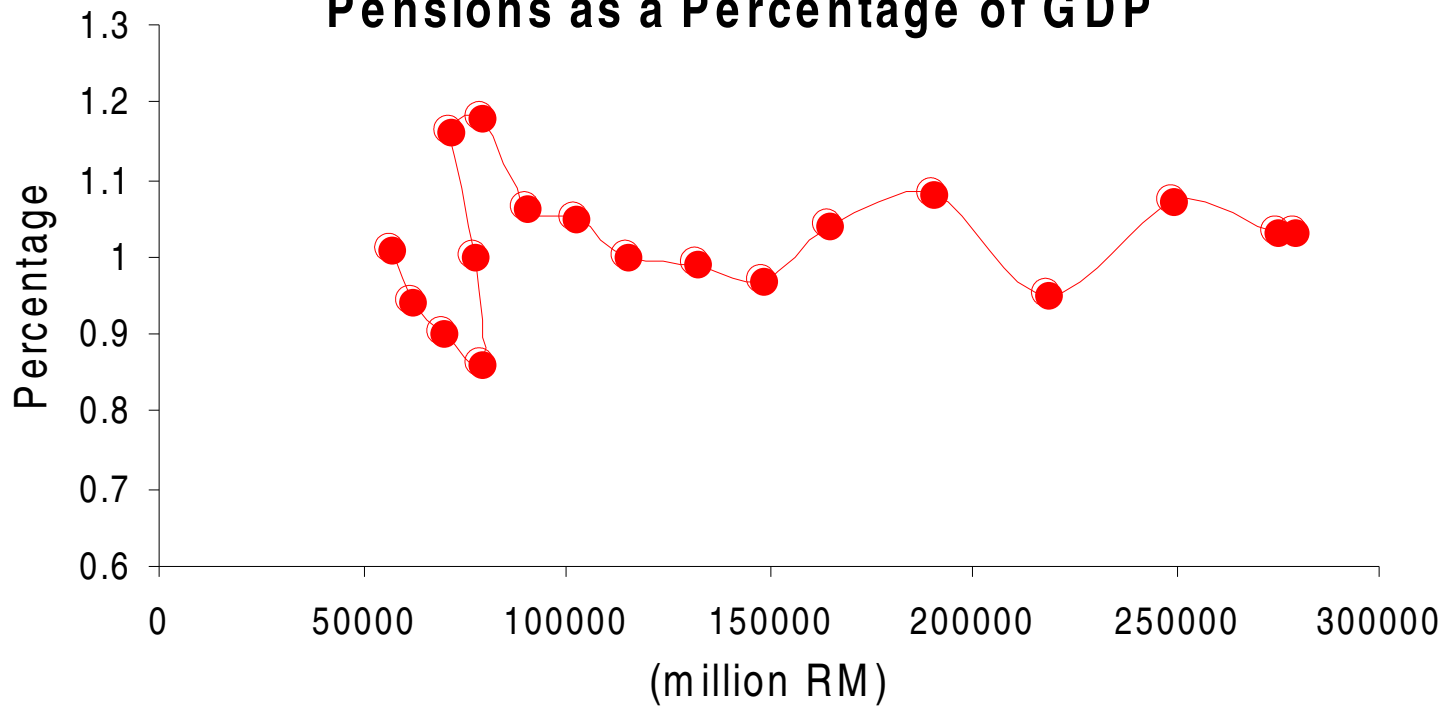
The amount, however, cannot exceed 50% of last drawn salary

A Pensions Trusts Fund (PTF) set up in 1991 to help pay the civil service pensions. Its operations are not transparent and therefore an assessment cannot be made

Setting up of the PTF, however, does not change the non-contributory nature of the scheme

# Malaysia /5

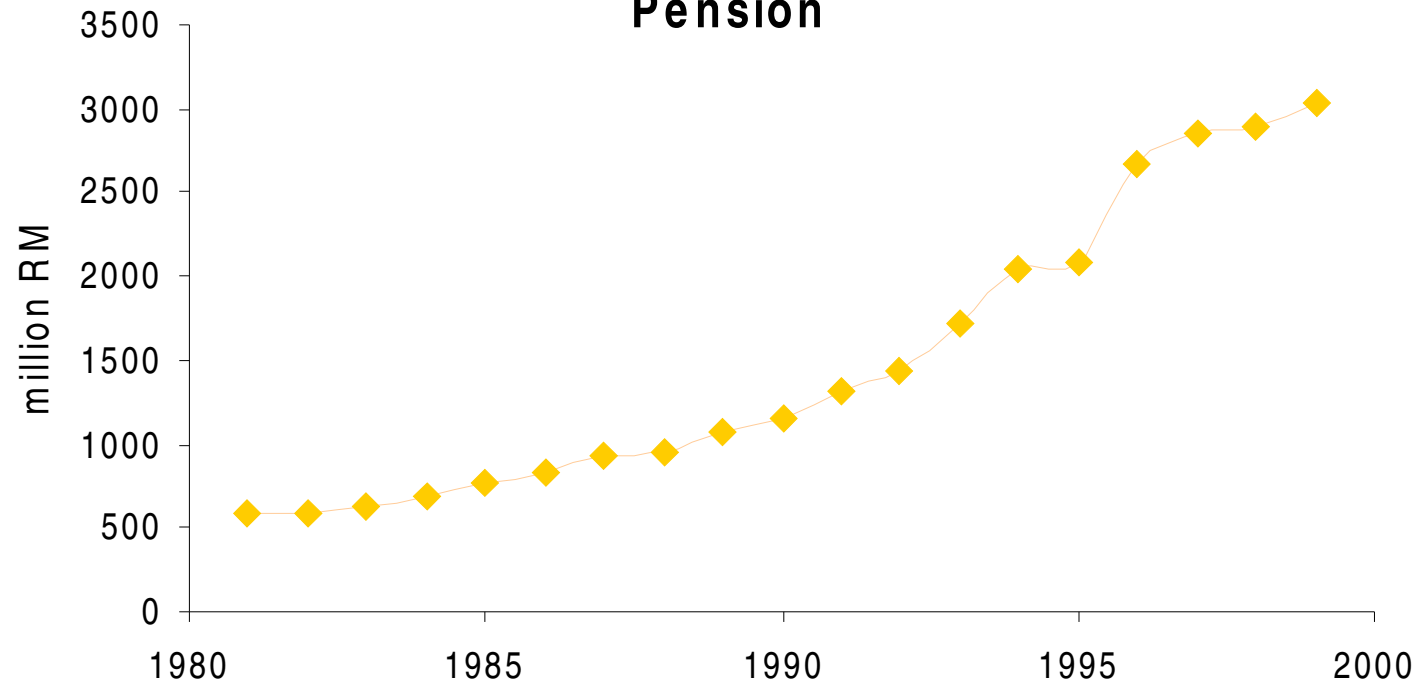
**Figure 2B:**  
**Malaysia: Total Expenditure on Civil Service Pensions as a Percentage of GDP**



**AACGR = 11.0 (for Nominal GDP)**

# Malaysia/6

**Figure 2C:**  
**Malaysia: Total Expenditure on Civil Service Pension**



**AACGR = 10.4**

# Malaysia /7

**Malaysia has experienced strong growth and fiscal health. Even then moderation of growth, increasing life expectancy, and non-contributory civil service pensions are expected to put considerable pressure on its efforts at fiscal consolidation and flexibility**

# Malaysia /8

**For many other countries not in Malaysia's position concerning economic growth and fiscal health, the consequences of not undertaking civil service pension reforms will be even more serious.**

# Malaysia /9

## Key Messages

Malaysia has certain design features in its civil service pensions (such as no automatic indexation, and 50% replacement rate) which limit the fiscal burden even without any structural or parametric reforms

Malaysia's overall macro-economic management has been reasonably successful

Malaysia, is, nevertheless, currently reviewing all the components of its pension system including civil service pensions

## II. THAILAND

# Thailand/1

## Main features of Civil Service pensions in Thailand

**Applicable to government officials, including university and school teachers and members of armed forces**

**Retirement Age for Full Pension Benefits is 60 years (Life Expectancy at age 60 is 21 years for men and 18 years for women)**

**Early Retirement Provisions with pro-rated benefits are available**

**Pensions are not automatically indexed**

**Pension benefits consist of two components**

# Thailand/ 2

The First Component is a Defined Benefit component, non-contributory for the employees and financed out of budget allocations. It provides a maximum replacement rate of 60% after 30 years of service

Civil Servants also have the option of receiving health benefits during retirement for themselves and their families without making any contribution

# Thailand /3

The Second Component is a Defined Contribution (DC) component, with 3% of wages each contributed by employer and employee (no wage ceiling for contribution). With the launch of the DC component, the benefits under the DB component was reduced to 60% replacement rate at retirement

The DC Component is mandatory for officials joining after March 27, 1997; and voluntary for earlier recruits

Accumulated balances are returned as a lump sum retirement benefit

# Thailand/4

In addition, there is a voluntary DC Scheme for permanent government employees who are not classified as officials; which entitles them to a lump sum retirement benefit

Local Government employees have a partially funded DB Scheme

Portability between all these schemes is largely absent

# Thailand/5

The Government Pension Fund (GPF) is responsible for promoting contractual savings, and providing greater certainty of pensions for government officials

The GPF performs the functions of both fund administration and fund management

The GPF has over one million members who are officials of the Royal Thai Government and over USD 5.2 billion assets under management. All investments must be in domestic assets, but the GPF has sought permission to invest abroad as Thailand's financial and capital market depth is limited

The nominal rate of return for distribution to GPF members has consistently exceeded the inflation rate, the benchmark rate set by the GPF, and the bank deposit rate

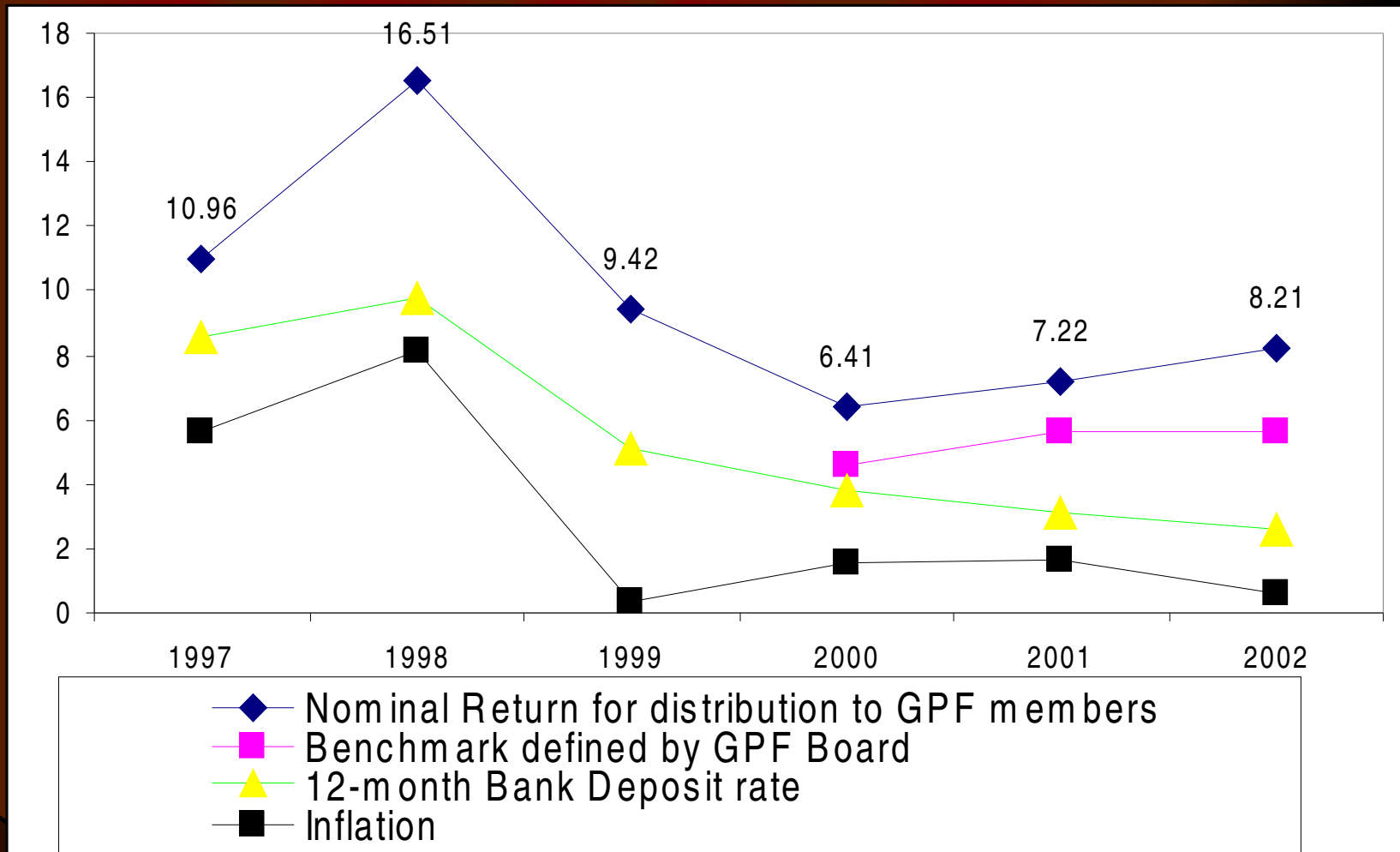
# Thailand /6

## Asset Allocation of GPF as of 31 December 2003

<b>Asset</b>	<b>Million Baht</b>	<b>% of total</b>
Bank Deposit and Cash	38479	18%
Govt. and State enterprise bond guaranteed by the Ministry of Finance	65494	31%
Debt issued by Financial Institutions and Corporate Debentures	58125	27%
State enterprise not guaranteed by the Ministry of Finance	6366	3%
Stock and Warrant	33533	16%
Property Fund	6366	3%
Unit Trust and other Investment	1944	1%
Alternative Investment	3829	2%
<b>Total</b>	<b>214134</b>	<b>100%</b>

# Thailand/7

Fig 3A Rate of Return to GPF members as at December 31, 2002



# Thailand / 8

## Key Messages

Thailand has partially shifted from non-contributory to contributory civil service pension financing

The GPF is professionally staffed and remunerated, and uses financial and capital markets in a manner consistent with modern investment management

But the control of GPF remains with the Ministry of Finance. So accountability and fiduciary responsibilities still need to be improved

Features such as commutation and indexation arrangements are designed in such a way so as to keep the pension expenditure under reasonable check

# Implications for India

# Implications for India /1

The experience of Asian Countries suggests that affordability by the country should be an important consideration in designing civil service pensions. In India the current Civil Service Pensions are simply not affordable, particularly by many of the states

The combined pension outlays in 1998 were already 1.3% of GDP (Table 4A), while the pensioners to wage earners ratio is already quite high, and so is pension outlay as a proportion of wage bill (Table 4B)

# Implications for India /2

Table 4A

India: Civil Service Pension System, 1998

	Number (thousands)	Wage Bill			Pension Outlays			
		In Billions of Rupees	In Percent of GDP	Average Wage	Number (thousands)	In Billions of Rupees	In Percent of GDP	Average Benefit
Central government	4,648	340.9	2.25	6,113	3,603	111.4	0.73	2,576
Railways	1,564	107.4	0.71	5,723	1,060	35.1	0.23	2,758
Telecommunication	852	57.4	0.38	5,609	235	7.5	0.05	2,657
Defense	1,036	87.8	0.58	7,059	1,844	49.5	0.33	2,236
Other	1,195	88.3	0.58	6,161	464	19.3	0.13	3,473
State governments	7,600	396.1	2.61	4,343	3,673	86.1	0.57	1,954
Total	12,248	737.0	4.86	5,014	7,276	197.5	1.30	2,262

Source: International Monetary Fund. 2001. *India: Recent Economic Developments and Selected Issues*. Washington, DC: International Monetary Fund. Country Report No. 01/181, p132.

The IMF Report sites Shah (2000) and estimates of the Fund as its sources.

# Implications for India /3

Table 4B

India: Parameters of the Civil Service Pension System

	Pensioners/ Wage Earners	Average Pension/ Average Wage	Pension Outlays/ Wage Bill
Central government	77.5	42.1	32.7
Railways	67.8	48.2	32.7
Telecommunication	27.6	47.4	13.1
Defense	177.9	31.7	56.3
Other	38.8	56.4	21.9
State governments	48.3	45.0	21.7
Total	59.4	45.1	26.8

Source: International Monetary Fund. 2001. *India: Recent Economic Developments and Selected Issues*. Washington, DC: International Monetary Fund. Country Report No. 01/181, p132.

The IMF Report sites Shah (2000) and estimates of the Fund.

# Implications for India /4

State-wise Pension Payments as a percentage of revenue receipts has increased from an average of 3.2% during 1980-90 to 11.0% in 2001-02

State-wise Pension Payments as a percentage of states' own revenue receipts has increased from an average of 5.2% during 1980-90 to 17.2% in 2001-02

Rapid escalation of pension liabilities in just ten years has seriously impacted fiscal flexibility and fiscal consolidation in the states. As Table 4C shows, the situation is likely to get much worse if no corrective action is taken

# Implications for India /5

**Table 4C: Projected Pension Payments of State Governments (2010-11)**

Year	Pension Payments (Rs.crore)	As % of total revenue receipts	As % of states' own revenue receipts
2001-02 (Actual)	28197	11.0	17.2
2010-11 (Projected)	188,000*	20.1*	30.3*
	189,000**	22.3**	33.8**

\*Based on historical growth rate of 23.5% in pension payments during 1980-81 to 1995-96

\*\* Based on historical growth rate of 23.6% in pension payments during 1980-81 to 2001-02

Source: Report of the Group to Study the Pension Liabilities of State Governments, RBI, 2003

# Implications for India /6

Currently, only the new entrants to the Central Government Service have been shifted to a contributory DC Scheme. The current scheme, however, has placed the investment longevity and inflation risks almost solely on the individual member, while the gender issue has not been addressed

Since the 20% contribution rate is relatively on the higher side when compared with international rates, it may be useful to consider providing survivors' benefits insurance on a compulsory basis, with premiums paid by the contributors. This, along with disability insurance, again to be paid for by the members, will have positive equity and adequacy implications

# Implications for India /7

It may be useful to provide group life insurance (of moderate amount) to the members, with the premiums paid from the contributions. This should replace the current provisions in this area

Once the scheme is established and well accepted, it may be useful to consider sustainable replacement rate guarantee.

Such a guarantee may apply for minimum 33 years of service, and could be relatively low yet meaningful (e.g. 30 percent of the average monthly salary over last 5 years of service). For less than full service, an actuarially fair reduction in the guarantee should be mandated

This may be necessary for psychological reasons.

# Implications for India /8

Parametric reforms in the pensions for existing employees are essential for fiscal consolidation and flexibility

RBI report (2003) on pension liabilities of state governments also emphasizes the importance of parametric reforms

Not only will parametric reforms in the Schemes for existing civil servants be needed, but the transition provisions to the new Scheme will also need to be closely considered

Incentives need to be provided to encourage at least young Civil Servants to shift to the new scheme

# Implications for India /9

Stark choice for existing civil servants: continue to insist on current unaffordable pension, gratuity, commutation, leave encashment allowances and be exposed to uncertainty and capriciousness in receiving benefits;

OR

They could negotiate sustainable pension (and other benefits), and help establish institutional and organizational requirements to ensure that pension liabilities will be met

A sinking fund type arrangement to pay pensions to existing employees, with the funds invested in financial and capital markets, subjected to PFRDA regulations and supervision is an option which is worth a careful study

# Implications for India /10

The GPF for the existing employees needs to be de-linked from automatic use for budgetary expenditure. Over a 5-7 year period, the central government and all the state governments must create a separate fund (or use the regulatory and investment management structures set up for the central government's new pension scheme), with professional management, governance and investment policies and practices.

The government and public sector securities can still be bought, but in a fairly transparent and market-related manner, and subject to PFRDA guidelines

# Implications for India /11

Examples of some of the parametric reforms include:

## **Basis of Calculation of Pensions**

Essentially lengthening the period for which salary base is calculated and refining the formula to take into account individual ageing and affordability by the state

# Implications for India /12

## Indexation

The current pensions are adjusted for both price through dearness allowance and wage adjustments through Pay Commission

It is strongly recommended that only the price adjustment to pension benefits be provided and that wage adjustment be discontinued. This is the normal international practice and India's level of income and fiscal health will mean that even price indexation will be a major burden on the rest of society

# Implications for India /13

## Commutation

This practice requires substantial cash outflow at the time of retirement of an employee. Given the urgent need for fiscal consolidation and fiscal flexibility, commutation should be discontinued. Gratuity and GPF should be enough provision of cash benefits at retirement

At the minimum, the commutation formula should be made actuarially fair, reflecting that civil servants as a group, on an average live longer than the population as a whole. Restoration of commuted pension should be abolished

# Implications for India /14

## Unutilized Leave Salary

The government employees are permitted to encash their accumulated leave ranging from 240 to 300 plus days.

For all new civil servants, there should be no encashment of unutilized leave; they must complete their leave before retiring so that their leave balance is zero at retirement.

For existing employees, a phased reduction of leave encashment period should be instituted. Each year the leave encashment period should be reduced by 10 percent; so that in 10 years time the leave encashment period for existing employees is also zero

# Implications for India /15

## Family Pensions

Provision for double the normal amount of pension benefit if employee dies while in service, and if pensioner dies before reaching 65 years should be abolished. Police and security personnel who die in service should have more targeted welfare schemes

Age of eligibility for family pension of children should be reduced from 25 to 21 years wherever applicable

# Implications for India /16

Pensions and Gratuities to non-government employees such as those in aided institutions and statutory bodies

As a general rule, employees in these type of institutions should not be included in the civil service pensions. These institutions and bodies should make their own provisions and be regulated by PFRDA

# Implications for India /17

## Others

The discretionary powers have generally been used to provide ad-hoc and generous benefits even to those civil servants who have been found to be negligent. These and other aspects need to be tightened

# Implications for India /18

It is important to revamp the existing laws and implementing regulations as these relate to the pension and provident fund provision

The rationale for civil service pension reform and the broad nature of reform directions are clear. Technical capacity to move in these directions exists

What is lacking is the political will and ability to focus on making rapid progress on India's two over-arching objectives: achieving 8% plus growth and creating productive sustainable jobs on a large scale

Time for action is now