

## **Civil Service Pension Reform: Time to Act**

*By*  
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The urgency of implementing parametric and systemic reform in the current pension arrangements for the civil servants has been clear to analysts and policymakers for some time now. This is reflected in various official reports commissioned by the Ministry of Finance and the Reserve Bank of India (RBI)<sup>2</sup>.

Existing civil servants receive defined benefit (DB) pension linked to their final salary and number of years of service, which is indexed for both prices and wages. There is an extremely generous commutation provision, which has not been adjusted for increasing life expectancy and morbidity patterns. Family pensions are also provided. Civil servants do not make any contributions towards their pension benefits; and the government has not set up sinking fund or other such mechanisms for orderly payment of pensions. Instead, pension payments are met by current revenue, creating uncertainty over future payment of benefits.

Civil servants are also entitled to a provident fund scheme to which only they contribute. Currently provident fund accumulations are not set aside for accumulating financial and real assets, but are instead used to finance government expenditure. Thus in reality provident fund benefits are also financed from current revenue. Civil servants also receive gratuity; and are entitled to generous leave encashment provisions.

Thus all the retirement related benefits are in effect financed from current revenue. The resulting fiscal burden is considerable, and is expected to grow rapidly.

The combined outlay on the central and state pensions for 12 million civil servants representing 3% of the labour force, was Rs.42,632 crore in 2001-02, equivalent to about 2% of GDP. At the central level, in that year, pension expenditure amounted to 7.2% of revenue receipts. This trend is unlikely to stabilize; as expansion of civil service employment during the 1970s implies bunching up of retirees till the next decade. Moreover, while average life-expectancy of Indians at age 60 is approaching OECD levels, civil servants as a group live even longer than the population as a whole.

The state level situation is more serious. State-wise pension payments as a percentage of states' own revenue receipts increased from an average of 5.2% during 1980-90 to 17.2% in 2001-02; in fact, a Group appointed by the RBI to study the pension liabilities of state governments has predicted that this ratio will rise to over 30% by 2010-11.

There is, however, a large variance around the ratio among different states. As Garg (2004)<sup>3</sup> has indicated, demographic factors, economic growth and revenue efforts are prime determinants of the variations in pension expenditure. In 2001-02, Kerala's ratio to pension payments to total revenue receipt at 20.3% was the highest in the country. Bihar (17.4%), Tamilnadu (16.2%) and West Bengal (15.5%) were in the 15-20% bracket. Some of the states with a ratio of less than 10% included Gujarat (9.4%), Haryana (8.6%), Madhya Pradesh (9.0%), Maharashtra (9.0%) and Uttar Pradesh (9.3%).

Such large pre-emption of state revenues for pension payments on such a small proportion of the total labour force of 450 million people limits the abilities of states to restructure budgetary expenditure towards growth and social cohesion enhancing areas such as infrastructure, education, health and basic social safety nets. The current system, therefore, unless reformed, will lower standard of living of the future generations and encourage distribution-centred politics.

**A Scheme for the New Entrants:** In January 2004, a defined contribution (DC) pension scheme to which the civil servants and the government as an employer contribute 10% of salary each was introduced for new entrants to the civil service. The scheme ensures portability and therefore labour mobility between public and private sectors. It does not permit any pre-retirement withdrawals and provides for compulsory conversion of part of the accumulated balances into an annuity. The scheme, however, does not provide for survivors benefits or protection against inflation and longevity risks. Over time these limitations will need to be addressed in a manner affordable by individual members, by the government as an employer and by the society and the economy as a whole. The scheme is also being applied to central government aided institutions and certain non-financial statutory boards.

The flow of new entrants has slowed considerably in recent years, and therefore the scheme will initially impact very small number of central government employees. If a 3% attrition rate and 1% recruitment rate are assumed then it will be nearly half a century before all civil servants will be on a DC scheme. This slow transition also implies that the impact on the budgetary expenditure will be limited. Indeed, as the government will still have to bear the pension burden of existing employees and pay upfront its share of the DC scheme, government expenditure would initially increase; and it is only after nearly four decades that the positive fiscal impact will materialize. So how to finance this initial increase is an important consideration in shifting to a new system by the states.

Adoption of a pension plan on the lines of the new scheme is particularly critical for the states, where the civil servants outnumber those at the central level by a factor of 2 (IMF estimates indicated that there were 4.6 million civil servants at the centre and 7.6 million in the states in 1998). By November 2004, five states had notified new pension systems for their new employees- Himachal Pradesh (15 May 2003), Tamil Nadu (06 August 2003), Rajasthan (27 March 2004), Andhra Pradesh (22 September 2004) and Chattisgarh (27 October 2004). An attempt is also being made to make the

new pension scheme accessible to the nearly 350 million workers in the unorganized sector.

A welcome recent development has been the Cabinet approval of a bill to give statutory backing to the Pension Funds Regulatory and Development Authority (PFRDA). The bill will be introduced in the winter session of Parliament, commencing on December 1, 2004. The initial priority of PFRDA is to ensure that the new DC scheme is implemented in a professional manner and adopts international best practices to Indian conditions.

It is envisaged that eventually PFRDA will regulate all components of India's pension system including the schemes by government financial institutions, public sector enterprises and occupational pension plans. It will also need to promote the pension funds industry in an orderly and sustainable manner.

The PFRDA, therefore, has a huge responsibility in ensuring retirement security. It should receive commensurate resources, both human and material; and should be subjected to high standards of professionalism, accountability and transparency. Building a trust between PFRDA and its stakeholders would be essential for the success of India's pension reforms. It is to be hoped that it will have a shorter learning curve than other regulators, more so because it can draw on the experiences of well-established regulators such as Securities and Exchange Board of India (SEBI) and Insurance Regulatory and Development Authority (IRDA).

The above analysis suggests that there is an urgent need to extend the new DC scheme to the employees of the state governments as well as public financial institutions. The central government has provided a lead. Each state needs to urgently consider their own version of such a scheme. They can use the infrastructure for performing core functions of a pension scheme including investment management, set up by PFRDA; and be subjected to its regulatory oversight.

The states may consider some modifications to the Centre's DC scheme. They may incorporate survivors' benefits insurance on a compulsory basis, with premiums paid from the contributions. This, along with disability insurance, again to be paid for by the members, will have positive equity and adequacy implications. Provision of moderate amounts of group life insurance to the members, with the premiums paid from the contributions, can also be considered. Incentives also need to be designed to encourage young existing civil servants to switch to the DC scheme.

The current practice of financing all retirement benefits from current revenue is not sustainable; and does not provide adequate assurance of timely payment of benefits to employees. Existing civil servants are faced with a stark choice: whether to continue to insist on current unaffordable pension, gratuity, commutation, leave encashment allowances and be exposed to uncertainty and capriciousness in receiving benefits; or to negotiate sustainable pension (and other benefits), and help establish institutional

and organizational requirements to ensure that pension liabilities will be met. Partial funding possibilities may also be explored.

One such possibility would be to establish a sinking fund to which the governments make regular contributions which are invested in the financial and capital markets according to modern investment practices. The current provident fund contributions should also be similarly invested. This does not preclude investment in government securities, but such investment will be market based. A gradual transition to such sinking fund arrangements would be preferable to provide time for the governments to delink provident funds from direct fiscal operations.

Parametric reforms for existing civil servants are also needed. Suggested areas include:

- Basis of Calculation of Pensions: Lengthen the period for which salary base is calculated and refine the formula to take into account individual ageing and affordability by the state.
- Indexation: The current pensions are adjusted for both price through dearness allowance and wage adjustments through Pay Commission. It is strongly recommended that only 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
- Commutation: This practice requires substantial cash outflow at the time of retirement of an employee, and should be discontinued in the interest of fiscal prudence. 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.
- Unutilized Leave Salary: Government employees are permitted to encash 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
- Family Pension: The 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.
- Pensions and Gratuities to non-government employees such as those in aided institutions and statutory bodies should not form part of civil service pensions.

These institutions and bodies should make their own provisions and be regulated by PFRDA.

Once the scheme is established and well accepted, it may be appropriate to offer a 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.

The rationale for civil service pension reform and the broad nature of reform directions are clear. Such a reform will also provide an impetus to broader administrative reforms at the centre and in some of the states. 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. The time for action is now.

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<sup>2</sup> Two of the more recent reports are Government of India (2002), Report of High Level Expert Group on New Pension System, February (Bhattacharya Committee Report) and Reserve Bank of India (2003), Report of the Group to study the Pension Liabilities of State Governments, October

<sup>3</sup> Garg, Subhash (2004), Challenges and Policy Outlook for State Government Pensions Reforms in India, Paper presented at the 6<sup>th</sup> annual IIEF Pension Sector Summit 2004, New Delhi