Reforming India's Social Security System

Mukul G. Asher
Professor, Public Policy Programme
National University of Singapore
mppasher@nus.edu.sg

Contents

1 Introduction **2**

2 An Overview Of India's Social Security System **3**
2.1 The Employees Provident Fund Organization (EPFO) schemes 4
2.2 Civil service schemes of the Central and State Governments . 5
2.3 Public Sector Enterprises 6
2.4 Voluntary 6
2.5 Public Assistance and other schemes for the life time poor at the Centre and in the States 7

3 Reform Directions **7**
3.1 Civil Service Pension Reform 8
3.2 Varishtha Pension Bima Yojana (VPBY) 11
3.3 The EPFO 11

4 Concluding Remarks **12**

5 References **13**

1 Introduction

The main objective of any social security system is the provision of a socially adequate and equitable retirement protection system on a sustainable basis. This objective should be pursued while minimizing the adverse effects on economic efficiency, fiscal consolidation and flexibility, incentives to work and save and international competitiveness of labor, businesses and the country.

In designing, implementing, and reforming a social security system, it is therefore essential to recognize the inescapable need for trade-offs among the above factors. In particular, two extremes should be avoided. These are focusing exclusively on the needs (or wants) of the provident and pension fund members and the retirees on the one hand and on minimizing budgetary costs of providing retirement security on the other. There are six core functions which any provident or pension fund organization needs to perform (Ross, 2000). These are: first, the reliable collection of contributions, taxes and other receipts; second, the payment of benefits in a timely and correct way without any side-payments; third, the timely repayment in case of pre-retirement loans; fourth, the effective financial management and productive investment of the assets; fifth, the maintenance of an effective communication network, which also includes development of accurate data and records-keeping mechanisms; and sixth, the provision of adequate support for all these activities, including the production of financial statements and reports. The management information reports are tied to providing effective and reliable governance, low transaction costs, fiduciary responsibility, transparency, and accountability.

The provident and pension fund organizations need to approach their tasks in a professional manner and benchmark themselves against best practices prevailing both nationally and internationally. The gap between best performing and worst performing organizations not only internationally but also in a given country is often disturbingly wide. Narrowing this gap should therefore have a high priority. It is important to note that while the investment function is important, it should not be overemphasized nor made overly complex, particularly when there is significant scope for improvement in other core functions. This however does not imply that debt-only investment portfolio is optimal and that a provident or pension fund organization can dispense with the task of developing in-house investment management expertise.

Policymakers and society as a whole have a strong interest in ensuring not only that each provident and pension fund organization is managed professionally and competently, but also that their broader concerns about economic effects and future development of the social security system of the country are also addressed. This requires them to take a system-wide per-

spective to minimize any adverse economic impact of the operations of the provident fund and pension scheme on fiscal (and macro-economic) sustainability, on labor markets, and on international competitiveness. In addition, they have a stake in enhancing literacy in pension economics and issues concerning the stakeholders, including trustees of provident fund and pension fund schemes, the policymakers themselves, the fund members, and the service providers. The educational function and nurturing of the various components of provident and pension fund industry deserve considerable emphasis in the developing countries.

It is in the above context that this paper analyzes India's social security system which has evolved since independence in 1947. India's total population in 2001 was 1027 million, of which 27.7 percent was urban and 72.3 percent was rural. India has now entered the fifth phase of demographic transition characterized by rapidly declining fertility rate. India aims to achieve a replacement level Total Fertility Rate (TFR) by 2010, which would result in a stable population level by the year 2045. The number of elderly (those above 60 years of age) however is expected to increase very rapidly from 72 million (7.1 percent of the total) in 2001 to 177 million (13 percent of the total) by the year 2025 (Government of India, Ministry of Social Justice and Empowerment, 2000). Along with population ageing, India is also experiencing rapid individual ageing reflected in longer life-expectancy. Thus, for the 1992-1996 period, while the average life-expectancy was 60.7 years (66.3 years for urban residents), the life-expectancy at age 60 was 16.4 years (18 years for the urban residents) (India, Registrar General, 1998). For social security purposes, it is the life-expectancy at age 60 which is relevant because it indicates the number of years for which an average retiree will require income support. Individual ageing also have implications for health expenditure which need to be recognized.
The rest of paper is organized as follows. An overview of India's social security system comprising five different components is provided in Section II. This is followed by a brief discussion of the reform directions of India's social security system. The final section provides the concluding remarks.

2 An Overview Of India's Social Security System

India has a complex social security system. It can be broadly divided into the following five components.

2.1 The Employees Provident Fund Organization (EPFO) schemes

The EPFO was set up in 1952 and its schemes are designed for the private sector workers in organizations with more than 20 employees in 177 categories of industries. In 1999-2000, 326.5 thousand establishments, and 24.5 million individuals were members of the EPFO (Singh, 2003, p.137). The data concerning actual contributors in a given period as compared to members are not available.

The EPFO however has not yet instituted full-fledged individual accounts for its members, relying instead on registering the employers, who in turn provide the details of contributions of their employees to the EPFO on an annual basis (Karunarathne and Goswami, 2002). The accounts therefore are not, in practice, portable across employers and therefore across the country. This practice has not only increased the workload of the EPFO as those changing jobs and unemployed are permitted to withdraw all of their balances. This practice also has negative implications for retirement security and labor mobility.

The EPFO does not come under the purview of an overall regulator, but there are three sources through which provident and pension funds in India re regulated (Hinz and Rao, 2002). These are: Income Tax Act of 1961, EPF Act of 1952 and Indian Trusts Act, 1882.

As on March 31, 2001, total balances with the EPFO were Rs.1,126.9 billion (5.84 percent of GDP). The EPFO has a fairly restrictive investment regime, with nearly all of the funds invested in public sector bonds and securities, and none invested in equities. The EPFO does not have any investment expertise as it has for the past 50 years contracted out the investment function to the state-owned banks. The average annual compound rate of return for the 1986-2000 period was 2.7 percent (11.7 percent nominal return less 9 percent annual inflation rate). Even this was made possible generous administered rate of interest paid by the Central government to the EPFO.

EPFO's investment guidelines are not consistent with the guidelines for the pension funds of the insurance companies established by the Insurance Regulatory Development Authority (IRDA). These guidelines permit equity investments, and term loans. The EPFO guidelines are also not consistent with the shift in India's economic paradigm from the state-led to a more market-oriented approach.

The EPFO is an unusual national provident fund because it administers both a defined contribution (DC) scheme called Employees' Provident Fund (EPF), and a defined benefit (DB) pension scheme called Employees' Pensions Scheme (EPS). The EPFO is also unusual in that it not only administers the schemes, but also decides which organizations can be exempted

from the EPF scheme, and then regulates and supervises the exempted establishments, generally fairly large companies. This puts EPFO in a conflict of interest situation. It is therefore essential that its role as regulator should be separated from its role as a service-provider for the various schemes.

The EPF scheme provides for fairly extensive pre-retirement withdrawals. The withdrawal at retirement however is of a lump-sum nature. The EPS aims to provide a replacement rate at retirement of 50 percent, but without any formal inflation indexation. The EPS permits commutation of pensions up to one-third of pension benefits at retirement. Even then, the EPS scheme is widely believed to be under-funded (Palacios, 2001). The EPFO has been reluctant to make the actuarial calculations underlying the EPS scheme public. This lack of transparency and resulting lack of accountability is inconsistent with good governance practices.

The EPFO also administers a life-insurance scheme called Employees' Deposit Linked Insurance (EDLI) scheme. The total contribution rate for the three schemes combined is 25.66 percent. In addition, the EPFO collects from the employer 1.11 percent as an administrative charge. The challenge for the EPFO therefore is to provide services to its members and to ensure overall economic benefits to the society which are commensurate with such high contribution rates.

2.2 Civil service schemes of the Central and State Governments

In 1998, there were 4.6 million employees at the central government level and 7.6 million employees in the States; while the number of pensioners were 3.6 million for the central government (dependency ratio of 78 percent) and 3.7 million for the state governments (dependency ratio of 49 percent). Thus, in 1998, there were 7.3 million civil service pensioners in India (IMF, 2001). In 1998, the average pension to average wage for the civil service was 45.1 percent; and the pension outlays accounted for about a third of the wage bill at the Centre and 22 percent at the State-level (IMF,2001). Even though not mandated, the retirement benefits at the Centre and in States are very similar in their structure, though not in all details.

The main social security benefits for the civil servants are non-contributory, unfunded DB pension which is indexed for both prices and wages, and has fairly generous commutation provisions (upto 40 percent of the pension benefits can be taken in as a lump-sum), and survivors' benefits (called Family Pensions). A civil servant is also entitled to a contributory General Provident Fund (GPF); Lump-sum Gratuity (with a ceiling); Life-Insurance Scheme; and fairly generous Leave Encashment Benefits. For those civil servants who are non-pensionable, there is Contributory Provident Fund (CPF)

Scheme.

The DB pension scheme provides a maximum replacement rate of 50 percent of the average salary during last 10 months of service, subject to minimum and maximum pension amounts. The employees at the Centre are divided into four major sectors (Railways, Telecommunication, Defense, Others) and pension administration is decentralized according to these sectors.

The civil service pension system was set up when the average salary was relatively low. But revision of civil service salaries in 1998, in accordance with the recommendations of the Fifth Pay Commission, has considerably increased the fiscal costs of the pensions at the Centre and especially in the States. This in turn has had an adverse impact on fiscal consolidation and flexibility of the fiscal system to redirect expenditure towards more urgent needs (Asher, 2002a). Automatic and complete linking of the contributions of the GPF and the CPF to finance fiscal deficits has weakened the fiscal discipline considerably. The non-contributory nature of the DB scheme has therefore become unsustainable.

2.3 Public Sector Enterprises

These include insurance companies, Reserve Bank of India, public sector banks, electricity boards, oil companies such as ONGC, industrial entities, etc. which have their own pension schemes, managed by them with little supervision. The details of the schemes of public sector enterprises are not known, and neither is their actuarial soundness. The way pension liabilities of these enterprises are treated in their financial statements is also not transparent. The trustees of the pension funds of these enterprises also do not appear to be accountable to the members. The above suggests an obvious need to regulate them to make them transparent and accountable, with emphasis on fiduciary responsibility, particularly as most of these enterprises are now required to be commercially viable.

2.4 Voluntary

These comprise Post Office Savings Bank Schemes (constituting nearly 10 percent of GDP); Public Provident Fund (PPF); individual and group annuities of life insurance companies (these are currently regulated by the IRDA). Except for the annuities, the other savings schemes have enjoyed administered rate of returns, and some such as the PPF are essentially tax-shelter devices for the high income groups.

India has been liberalizing its financial sector since 1991, and as a consequence interest rates have progressively become more market-determined.

This is also being gradually applied to the provident and pension funds and to small savings schemes.

2.5 Public Assistance and other schemes for the life time poor at the Centre and in the States

These schemes are financed from the government budgets and therefore depend critically on the fiscal health of the governments. As the first four components cover at best about one-sixth of the labor force, with the remaining labor force not being covered by any formal social security schemes. The public assistance and other such schemes are therefore the primary source of income support for the elderly poor who do not belong to any formal schemes.

At the Central government level, the two major public assistance schemes are: National Social Assistance Scheme (NSAS) introduced in 1995 and the Annapurna Scheme introduced in 1999 (Rajan, 2002). The 29 states and 6 union territories also have a variety of schemes to assist the elderly. The coverage of the two central schemes is relatively low, and the amount per beneficiary is also low. Indeed, as of October 2000, eighteen months after the introduction of the Annapurna Scheme, half the states and union territories have not even introduced the scheme (Rajan, 2002). The transaction costs of these schemes at both the Central and State levels are also quite high; and the targeting of the beneficiaries is poor.

3 Reform Directions

The main characteristics of India's social security system are evident from the overview provided in the previous section. First, India's social security system is overwhelmingly welfare-oriented. Therefore, various trade-offs that are needed between needs for social security on one hand and the fiscal and economic implications of the current arrangements on the other, have not been sufficiently stressed. India's need for fiscal consolidation and fiscal flexibility, and its need to substantially increase the employment generation, particularly in the formal sector, has added urgency of explicitly examining the trade-offs

Secondly, the welfare-orientation and relative neglect of administrative and civil service reform in India has meant that there is substantial room for much greater professionalism in the design, governance and organizational structures, and administration of social security schemes under various components. This requires renewed emphasis on efficiency and minimization of transactions costs.

Thirdly, there has been a marked dualism in the provision of social security benefits. This dualism is most evident in the relatively secure and generous retirement benefits of the civil servants without any contributions by them to the DB pension scheme on the one hand, and meager funds for public assistance schemes for the elderly poor on the other. In between are the private sector employees who are covered by the EPFO schemes.

Fourthly, each component of India's social security system has developed separately, without any agency responsible for a system-wide perspective. Thus, there no overall pensions regulator in India.

The above four characteristics strongly suggest urgent need for reforming India's social security system. The direction for such reform is also fairly clear. It is to increase professionalism, including benchmarking against best national and international practices; mitigating dualism to reflect changing roles of public and private sectors, financial sustainability, and for equity reasons; to expand coverage, particularly through public assistance schemes for the elderly poor financed through the budget; to make India's social security system consistent with national objectives through a system-wide perspective.

There has been increasing recognition of the need for reform by governmental and non-governmental organizations, broadly along the lines outlined above. The social security reform in any country is politically and socially quite sensitive. It is therefore not surprising the pension and provident fund reforms in India are only beginning, more than a decade after financial sector reforms were initiated with reasonable success. The provident and pension fund reform is now very much on the public policy agenda. It is essential however to design an implement these reforms with professional level attention to detail as much of the devil in the reforms in this area is in the details.

The remaining discussion in this section focuses on the civil service pension reform, on a new voluntary scheme called the *Varishtha Pension Bima Yojana* (VPBY), and on the EPFO.

3.1 Civil Service Pension Reform

The 2001-02 budget had accepted the principle of pre-funding for pensions of the Central government employees. The Bhattacharya Committee was subsequently appointed in June 2001 to examine this issue. It submitted its report in February 2002. The report however has not been made public. Subsequently, the government announced reforms of the civil service pensions in the 2003-04 budget. The measures may be summarized as follows:

New entrants to Central government (except Armed Forces) on portable DC scheme, with equal contributions from the employer and the employee (the implementation date has not been announced).

Pension Fund Regulatory and Development Authority (PFRDA) to be set up. Initially, it will be under the overall umbrella of the Ministry of Finance.

The contributors will have individual accounts; and specialized pension funds will offer a basket of choices.

Non-Central government employees may join, but the Central government will not contribute or legally guarantee the returns.

Implicit moral liability for those who join voluntarily however will still be on the Central government.

The expected date of operation is end of 2003 or early 2004.

The above features suggest that the new entrants to civil service at the Central government level will entirely depend on defined contribution scheme. International experience suggests that a 20 percent contribution rate should be sufficient to provide a replacement rate at retirement of close to 50 percent. However, the announcement does not indicate how the inflation and longevity protection during retirement, and survivors' benefits will be provided. The exclusive reliance on the DC scheme may also lead to much greater variability in the replacement rates among different cohorts of civil servants. Consideration may therefore need to be given to the provision of a floor (for example, 30 percent replacement rate based on last 10 year's wages, protected for inflation and longevity).

The emphasis is on the accumulation stage, with the resultant emphasis on the investment function and the minimization of the administration and investment management costs. It is also not clear whether the civil servants will be required to buy annuities at the time of retirement (or deferred annuities), and if so, how might these be regulated. As the contingent liability of the civil servants is clearly on the central government, there will be a need to separate the funds of the civil servants from those who join voluntarily. There are many design details, such as the number of pension fund providers, their eligibility criteria, investment guidelines, qualifications of the intermediaries, etc. which are yet to be decided. A meticulous planning and attention to detail, as well as a consensus-based approach is to be preferred rather than meeting any arbitrarily-set deadline.

The governance structure and the staffing of the proposed PFRDA also need to be clarified. The word 'development' in the proposed regulator is appropriate given substantial scope for developing financial and pension economics literacy and financial and capital markets. There will also be a need for close coordination between the PFRDA which will be primarily involved

in the accumulation phase and the IRDA which already regulates the pension products of the insurance companies which are involved in the payout or the decumulation phase. The greater use of financial and capital markets in accordance with the modern investment principles will also require close coordination with Securities and Exchange Board of India (SEBI).

It would be useful to gradually expand the mandate of the proposed PFRDA to include the DC schemes of the public sector enterprises (component 3); and the DC schemes for the civil servants (both for new entrants and the current GPF) at all levels of government. It may be useful if a separate fund and accounting framework is considered for each state for the sake of ease of administration, transparency and accountability.

Once the PFRDA is fairly well established, consideration should also be given to confer powers to regulate the EPFO schemes. The EPFO then would become purely a customer-focused service-provider. This suggests that the EPF scheme of the exempted organization, and voluntary occupational pension schemes should also come under the PFRDA. Once such integration is completed, it would be feasible to address one of the major gaps of the current system, i.e. lack of system-wide perspective (Asher, 2002b). Such integration will also ensure consistent level of professionalism across various components and schemes (Asher, 2002b).

It is important to recognize that the approach in the 2003-04 budget of bringing only the new civil servants under the DC scheme implies a slow pace of fiscal consolidation and flexibility. Indeed, the DC approach will increase the government's cash outlay in the initial period (more so, if the sinking fund concept is also simultaneously adopted for funding existing pension liabilities). There is however several parametric reforms which are feasible and desirable involving existing civil servants. These include the commutation provision, indexation provisions, leave encashment benefits, sharing of life insurance and group insurance costs, detailed provision of family pensions, compassionate pension, etc. The parametric reforms therefore should not be neglected at both the central and state government levels as the rationalization will result not only in fiscal savings but also provide clearer signals of the changing role of government in India (Asher, 2002a).

The initial steps in the civil service pension reform have thus been taken. But as the above discussion suggest, much more remain to be done. If the Centre is able to implement a new scheme (with appropriate modifications) smoothly and successfully, more and more states are likely to join.

3.2 Varishtha Pension Bima Yojana (VPBY)

This scheme proposed in the 2003-04 budget is to be administered by the Life Insurance Corporation of India (LIC). Its main features are summarized below:

1. Under VPBY, any citizen above 55 years of age, could pay a lump-sum, and get a monthly return in the form of a pension for life. The minimum and maximum pensions are pegged at Rs.250 and Rs. 2000 per month respectively. These amounts are not indexed to inflation.
2. There is a guaranteed return of 9 percent per annum for this scheme.
3. The difference between the actual yield earned by the LIC under this scheme and the 9 percent will be made up by the central government.
4. The subsidy therefore is explicit. However, it would have been better to have pegged the guaranteed rate at a small premium to the market rate, rather than at an absolute level.

3.3 The EPFO

Many of the reforms needed for the EPFO such as improving service quality, minimizing administration costs, improving compliance, establishing genuine individual-based accounts, and ensuring that its design details and rules are consistent with international good practices in key areas such as benefit and contribution formulae, actuarial studies, portability and vesting, and investment policies and management, and the need to separate its role as a provident and pension fund administrator from that of a regulator are evident from the discussion in the previous sections. The EPFO's governance structure also needs to be modernized. Thus, independent experts must be invited on its governing board, just as the Companies Act has strengthened the role of independent directors. The EPFO as an organization needs to invest considerably more in information technology and staff training and development. The role of Labor Minister in its functioning needs to be rationalized; and the organizational functioning needs to be made more transparent and accountable. As noted earlier, the challenge for the EPFO is to convince all the stakeholders that the high mandatory contribution rates are commensurate with the quality of services provided and with the positive economic impacts on saving investment intermediation, greater economic security, and work incentives.

The EPFO leadership is aware of the challenges and has initiated organizational reforms. But given that it has had 50 years of existence, it will be judged only on the basis of results and services delivered to its stakeholders and members.

4 Concluding Remarks

India has developed a complex social security system since independence, which is poised for major reforms. These reforms are designed to bring about a better balance between purely welfare orientation which has until now characterized various components and schemes, and the need for fiscal consolidation and flexibility, better functioning labor markets, greater efficiency in transforming pension and provident fund savings into growth enhancing investments, and international competitiveness of India's businesses. The reforms thus will need to explicitly recognize the trade-offs among the above; and will need to enhance professionalism with which provident and pension funds schemes and organizations are designed and governed.

India is among the pioneers in developing Asia in proposing to establish a pension development and regulatory agency. Such an agency has the potential to address one of the major limitations of India's current social security system, i.e. lack of system-wide perspective.

India has repeatedly demonstrated that once a public policy issue becomes a part of the policymakers' agenda, the reforms proceed incrementally and fairly steadily. This results in significant cumulative impact within a decade or so, thereby addressing the issue in a reasonably satisfactory manner. The provident and pension fund reform in India is now at the initial stage. There is now wide-spread recognition of the need for reforms, though there are still differences in the specific ways to reforms various components and schemes.

The major decision in reforming the civil service pensions of the Central government employees has been taken. The EPFO has recognized that it must not only initiate major reforms but also deliver on them. There is every expectation that the reforms in this area will follow the path of relatively successful reforms initiated in the rest of the financial sector. There is however a need to ensure that the focus on pension reform continues to be a priority item on the policymakers' agenda; and that reform are pursued in an equitable and sustainable manner, while promoting consensus and social cohesion.

5 References

Asher, Mukul G., 2003, "Current Issues in Pension Reform", in International Social Security Association, *Social Security Institutions Respond to New Demands*, Social Security Documentation, No. 27, Manila, pp.109-128.

_______, 2002a, "Issues in Reforming Civil Service Pensions in India", Presented in *Policy Roundtable on Design and Implementation of Pension Reforms in India*, organized by Policy Analysis Group, Invest India Economic Foundation, October 15-17, The Oberoi Hotel, New Delhi.

_______, 2002b, "Case for a provident and pension funds authority", in *Economic and Political Weekly*, 378, pp.688-689.

Census of India, 2001, *The Provisional Population Tools*, Web edition: `http://www.censusindia.net/`

Government of India, Ministry of Social Justice and Empowerment, 2000, *The Project OASIS Report,* New Delhi.

Hinz, Richard P. and Rao, G.V. Nageswara, 2002, "Approach to the Regulation of Private Pension Funds in India: Application of International Best Practices", Processed.
India, Registrar General, 1998, *Compendium of India's Fertility and Mortality Indicators,* 1971-1997, New Delhi.

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

Karunarathne, W. and Goswami, R., 2002, "Reforming formal social security systems in India and Sri Lanka", *International Social Security Review*, 55, No. 4, pp 89-106.
Palacios, R., 2001, *India: The Old Age Income Security* (Report No. 22034-IN), Washington, DC, World Bank.

Rajan, S. Irudaya, 2002, "Social security for the unorganized sector in South East Asia", *International Social Security Review*, 55, No.4, pp.143-156.

Ross, S.G., 2000, "Building pension institutions: Administrative issues", in *Proceedings of the Third APEC Regional Forum on Pension Fund Reform* (Bangkok), pp. 120-132.

Singh, Ajai, 2003, "The experience of the Employees' Provident Fund Organisation", in International Social Security Association, *Social Security Institutions Respond to New Demands*, Social Security Documentation, No. 27, Manila, pp.129-148.