Government Pensions

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Ministry	No. of Employees	Percentage
Railways	15,64,043	37.30
Defence (Civil)	5,81,498	13.87
Posts	3,86,809	9.23
Telecommunication	4,65,544	11.10
Home Affairs	5,93,103	14.15
Revenue	1,37,807	3.29
Others	4,63,931	11.07
Total	41,92,735	100.00

Table 1: Distribution of government employees

Organisation	Estimated number of pensioners (lakhs)
Defence (including service personnel)	18.44
Railways	10.60
Central (Civil)	4.64
Posts	1.75
Telecommunications	0.60
Total	35.43

Table 2: Central government pensioners

1 Introduction

The Government of India runs a defined benefit pay as you go pension scheme for its employees. Over the years, there has been a serious concern about the ability of the government to finance such payments. This paper takes a holistic look at the state of the government pensions and makes recommendations for reform.

2 The state of government pensions

According to the data published by the Department of Expenditure, Ministry of Finance there are 41.93 lakhs central (civil) employees. If an estimated 10 lakhs defence services personnel also were to be included, the number of central government employees would be nearly 52 lakhs. (See Table 1 for the ministry-wise distribution of government employees.)

The number of pensioners has risen steadily over the years. (See Table 2 for distribution of central government pensioners). Two factors have mainly accounted for this trend.

1. There was heavy recruitment to government services during the period

1951-75 which will result in a larger number of retirements until about 2009-10.

2. The life expectancy of government servants at the time of retirement has also been increasing. In 1951 (when the second Pay Commission recommended an increase in the age of superannuation from 55 years to 58 years) the life expectancy at the age of 50 years was reckoned as 15 years; in 1990 the same had gone up to 27 years; and in 1994, the World Bank in their seminal work 'Averting the Old Age Crisis' had placed life expectancy in India at the age of 58 years as 19 years. It would, therefore, be safe to assume that with the current age of superannuation of 60 years, the average life expectancy of a retired government employee will be around 17 years.

With a workforce of 52 lakh employees and an estimated 35 lakh pensioners, the dependency ratio[1] in respect of civil servants in India is 66 per cent. Stated simply, the pension expenditure on every 3 retirees is being met out of the earnings or productivity of 5 working employees thus imposing a great burden on the younger generation. Even though the pension payments by the government in India are made out of the general revenues unlike several other countries where a payroll tax is imposed on the working employees, the government may be forced to levy higher rates of direct or indirect taxes in order to garner additional revenues for meeting the increased pension liabilities, thereby reducing the income of the current workers. Alternatively, it may lead to curtailment of expenditure in other priority areas so as to accomodate the increased expenditure on pensions. Under the PAYG system, therefore, an inter-generational transfer of income does take place irrespective of who makes the contribution; the size of the contribution continues to grow as the proportion of retirees to those working rises.

Table 3 demonstrates how the expenditure on pensions in the various central government departments and ministries has been rising during the past decade.

As can be observed, not only has the financial burden for the government been increasing, but also there is very little predictability about the amount that needs to be set apart from the revenues to meet the statutory liability towards pensions.

[1] In pension literature, dependency ratio denotes the percentage of retired employees to those who are still working. In a pay-as-you-go (PAYG) system the higher the dependency ratio, the larger is the amount required to be contributed by current workers to pay for the pensions of those who have retired. It is, by now, well established that with dependency ratios lower than 30% a low contribution rate can sustain a high rate of pension, but as the dependency rates increase, there are serious pressures on the viability of PAYG schemes.

Year	Civil	Telecom	Railways	Defence	Posts	Total
1990-91	480	85	886	1670	150	3271
1991-92	583	103	1040	1840	182	3748
1992-93	701	117	1251	2313	204	4586
1993-94	818	142	1488	2531	227	5206
1994-95	934	156	1686	2704	253	5733
1995-96	1103	199	2117	3197	312	6925
1996-97	1425	252	2509	3683	384	8253
1997-98	1948	413	3509	4947	558	11376
1998-99	2803	452	4144	7270	677	15346
1999-00	3286	427	4018	11024	682	19447
2000-01 (BE)	4021	575	5167	10539	815	21117

Source: Working Group on Pensionary Liability, Department of Expenditure, Ministry of Finance, Government of India, June 2001.

Table 3: Pension expenditure of Central government (in Rs.crores)

3 Impediments to reform

In the absence of any scientifically conducted actuarial studies, it is difficult to chart a growth profile of the number of central government pensioners and the annual expenditure on their pensions. By the same token, it cannot also be prescribed what percentage of the employees' salary needs to be placed in a pension fund (if at all such a fund can be established) every year to enable the government to pay them a pension with defined benefits. Conducting an actuarial study will also be time consuming since data on the age profile of pensioners, the rates of mortality and withdrawals, the average age at entry of current workers into different grades, the number of entrants and retirees every year for the past period (dating back to when the currently active workers may have joined service) is not readily available. Surprisingly, even the Central Pension Accounts Office (CPAO), despite extensive computerisation having been introduced in its working, does not have the basic statistics of the total number of central government civilian pensioners, apparently because there is no system of real-time transmission of data from the disbursing banks to the CPAO.

The inadequate and incomplete database of pension statistics has also been commented upon by the Working Group on Assessment of Pensionary Liability of the Government of India (June 2001). Specifically, they have pointed out the non availability of data relating to the age profile of both serving employees and pensioners, the distribution of pensioners over Groups A to D, and changes in status of pension drawn, i.e., switch over from superannuation pension to family pension or discontinuance of pension altogether. This made it difficult for the Working Group (WG) to make projections of

Year	Civil	Telecom	Railways	Defence	Posts	Total
2001-01	3560	486	5317	10238	870	20471
2001-02	3701	613	5754	10393	908	21368
2002-03	3844	750	6221	10544	945	22303
2003-04	3992	838	6720	10701	983	23234
2004-05	4138	922	7253	10854	1022	24188
2005-06	4288	1024	7824	11003	1061	25200
2006-07	4448	1143	8433	11148	1101	26273
2007-08	4615	1266	9083	11305	1135	27405
2008-09	4785	1398	9778	11459	1175	28595
2009-10	4976	1571	10519	11608	1216	29981

Source: Working Group on Pensionary Liability, Department of Expenditure, Ministry of Finance, Government of India, June 2001.

Table 4: Projected expenditure of the Central Government (in Rs.crores)

the future pensionary liabilities of GOI on a scientific basis. Nevertheless, within these limitations, and based on certain assumptions, the WG made an attempt to project the expenditure on pensions upto the year 2009-10. See Table 4 for the year-wise projected expenditure (the annual rate of inflation is assumed as 6 per cent):

4 Reforming government pensions

What, then, must be done to minimise the financial strains which inevitably follow the unabated growth in the number of pensioners? The inability of the government to cut down on the level of pensionary benefits is obvious, given the stiff resistance that any such move will receive from the workers' unions; besides, it will also be a politically unpopular move. An increase in the age of retirement does help to some extent but can act only as a temporary reprieve. Moreover, the age of superannuation cannot be tinkered with too often: in fact, we have seen only three such revisions in the past sixty years.

Building up retirement funds in advance, i.e., through a funded pension system, brings in a variety of economic benefits. It increases the savings rate, making money available for investment in more productive capital stock. It can avert the high tax rates needed to fund a PAYG system when the number of pensioners is high relative to the number of active workers. Longer life expectancies will leave relatively fewer active workers to support the growing number of pensioners, and fulfilling the commitments made to today's workers will therefore, require higher taxes from tomorrows. The alternatives are either to raise the retirement age or to cut back on pension benefits. The work recently carried out by Kotlikoff and Leibfritz tries to measure the present value of net future taxes (i.e. taxes to be paid minus benefits, such as pensions) for future generations. Their findings reveal, for instance, that future Americans collectively will have a 50% higher tax burden than those born today. For Germans and the Japanese these percentages are even higher - 90% in the case of former and 250% in the case of latter. These are alarming numbers, but are sensitive to assumptions about demographics, productivity and interest rates.

Implicit pension debt

The largest pension obligations are those incurred by governments that make unfunded promises to pay defined benefit pensions. The concept of the implicit pension debt (IPD), introduced by the authors, Kane and Palacios in their paper written for the World Bank (June 1996), recognises that workers and pensioners have claims on current and future governments not unlike those of government bond holders. Liabilities have grown rapidly with the proliferation of publicly managed, defined benefit pension plans throughout the twentieth century. Today they are found in more than 150 countries and probably cover more than one half of world's labour force. Calculating the value of the IPD is a useful step when a country's authorities are considering the implications of ending a PAYG scheme.

Measuring defined benefit pension obligations is not always easy, and there is no universally acceptable methodology to calculate the actuarial value of the defined benefits which a government is obligated to pay to its employees in the future years. Most formulae involve multiplying a certain 'accrued' factor by the number of years of a worker's service and then multiplying the result by an average of the worker's wages towards the end of his or her career. When a similar exercise is to be carried out for a vast multitude of employees, it should be even more difficult to evaluate the liabilities of all workers covered under the scheme and to compare these with the assets of the pension plan. Nevertheless the estimates of IPD are necessary inputs for any debate on pension reforms and will provide important indicators which policy-makers can use to compare results of different reform proposals. Kane and Palacios compare the pension debt to a country's external debt. Just as in the case of the latter, the cash flow requirements are measured by the country's debt-service ratio, in the case of pensions one can measure cash flow requirements by using the ratio of pension expenditures to the wage bill of employees covered by the pension system. In the case of a contributory funded plan, if this ratio is higher than the statutory contribution rate the alternatives will be either transfers from general revenue, or a higher contribution rate or a lower pension benefit.

It can be an useful input for a policy formulation by the government. Once the IPD estimates have been made they will provide the government with an objective indicator to measure the impact of increasing the retirement age or revising the benefit formula. The unfunded pension liabilities of the government may also have an impact on its cost of borrowing, and may reinforce the case for pension reforms. In the meantime if PAYG schemes remain operative, and demographic pressures continue to build-up, the implicit pension debt would continue to grow.

Building a pension fund

In order that the government reduces its PAYG liability, it must think of contributing a percentage of workers' wages to a specially designated fund. Even though under a fully funded scheme the contribution rates may be higher from the start (unlike the PAYG plans where contribution rates remain low in the early years), the government can avoid getting hit by exploding liabilities later on. The rate of contribution will, however, be determined by government actuaries so that the amount invested over the working life time of the employee, generates returns large enough to pay a pension of at least equal value in real terms to the basic pension at present being paid by the government. The actuarial assumptions are often complex. The future rate of return on assets determines the growth, while inflation and year of retirement determine future obligations. None of the variables is known with certainty.

A fully funded scheme for existing government employees may not be easy to implement. The accrued liability for the years of service already put in may be too large for the government to be made explicit (i.e., funded) either at the inception of the plan or amortised during the remaining years of service of the employees. On their part the employees would also resist any demand for a contribution since they are already used to the government bearing this burden.

Two alternatives could merit consideration.

1. Partial funding of future pension liabilities of all employees, both for the present workers as well as the new entrants, so that the PAYG liabilities get progressively reduced. The benefits will, of course, materialise only after 25 to 30 years, but in such situations there can be no short-term solutions.

2. Full funding only for the new entrants, in which case even though the total financial burden will be much higher for the first 30 to 35 years, since the PAYG scheme will continue alongside, in the long run the government will be paying a much smaller annual contribution as a share of total wages. For instance, the pension outgo today works out to about 22% of the government's wage bill; under the proposed system this may come down about 15 per cent.

Pressing the case for pension reforms further, the government could divest itself altogether of the responsibility of administering pension for its employees and may act only as a regulatory authority to ensure that the funds are properly managed. The pension funds can be allowed to be operated by non-government agencies, much like what has been successfully introduced in Chile. So as to ensure that the funds are managed only by those who are best in the business, the government may grant approval only to a limited number of agencies which have an unblemished record of managing pension funds. Competition among the fund managers could also drive down the administrative cost. This may also lead to faster and more efficient processing of pension payments, thus bringing relief to the multitude of central government pensioners who often find the bureaucratic procedures irksome and tedious. In this era of privatisation and out-sourcing of government activities, this could be one important step. This will also help the government in curtailing its revenue expenditure by pruning its staff strength and administrative costs relating to management of pensions. This change over may require numerous legal amendments, including creation of a strong regulatory body, but it will at least prevent government's profligacy with the pension and provident fund moneys and will result in more efficient allocation of resources.

Regulation of the funds

Not everyone agrees that a fully funded pension system is desirable, for it may expose pensioners too much to financial-market risk, besides the possibilities of mismanagement of the pension fund. However, this problem could be tackled through tougher regulation and a guarantee of minimum pension by the state.

Models for enforcing regulations are already in place in countries like Chile, Netherlands and Indonesia and could be adopted with advantage in India. The government may also have to ensure that the workers earn a minimum pension after they retire, and could perhaps offer a guarantee to that effect, on the lines of what is being done in USA. This would, no doubt, create a contingent liability for the government, which may be difficult to estimate, but the current PAYG system also entails an implicit pension debt which remains undefined when government's financial picture is drawn. The employees could also be motivated to increase their contribution to the fund - upto a prescribed extent - in case they wish to earn a higher pension. A scheme with a defined contribution from the employees, guarantee of a minimum pension and the possibility of earning returns higher than required to buy an annuity which would provide more than stipulated 50% of the final wage during the retirement period, should be welcomed by all government employees.

In order that the employees receive this scheme well, the government may even consider giving back to the new entrants (where the funded scheme is to be limited to new entrants only) an amount not exceeding what the government would have contributed had there been a contributory provident fund scheme in existence. On the one hand, this will lessen the financial burden on the employees and on the other by not contributing its share directly into the fund but only providing a subsidy to the employees, the government will be leaving to the employees the responsibility of obtaining best possible returns on pension contributions instead of undertaking this responsibility on itself.

The regulatory framework to ensure that the funds are properly managed and that the earnings of the workers do not run the risk of being misused will, of course, have to be firmly put in place. Strict guidelines need to be established for the pension funds' investment accounting and reporting standards.