

India's pension reform: A case study in complex institutional change

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Abstract

Pension reforms is one of the most important and yet the hardest component of India's "second generation" economic reforms. The field of pensions involves complex questions of political economy, and interlocking considerations spanning finance, labour markets, demography, public finance, macroeconomics and behavioral science. For these reasons, pension reforms worldwide have been difficult to execute, and often achieve second-best or third-best outcomes.

India embarked on pension reforms in 1998. In this article, we briefly survey India's saga of pension reforms, which spans many agencies and has made remarkable progress in laying sound foundations of a modern, well designed pension system. We conclude by attempting to draw some lessons about what worked and what did not.

2 Reform options

By the late 1990s, it was possible to draw upon enormous knowledge and experience that had been developed internationally in the field of pensions. In numerous countries, defined benefit systems which appeared politically attractive at initiation had collapsed owing to the demographic transition. While there was a worldwide movement towards defined contribution systems, there were strong concerns about fees and expenses of the system, and the viability of individual account systems for poor people.

When thinking about the reform options, and about India's stance towards the alternatives, a key question which arises is about the appropriate role for defined benefits.

2.1 Defined benefits

When DB pension systems are considered, or when legacy DB systems cannot be removed, a key question that arises is that of parametric reforms aimed at achieving solvency. By now, there is considerable empirical experience with the breakdown of DB pension systems, and hence there is a widespread belief that DB systems are inherently infeasible. Such a belief is *technically* incorrect.

There is a recipe through which a DB system can be sustainably solvent, over multi-decade horizons:

1. As a working proposition, in most countries, the contribution rate is held fixed. Benefit rules are adjusted over time, so as to ensure solvency.
2. Every year, an independent consulting firm should be recruited for assessing solvency. The key features of this firm should be a world-class professional competence on pension economics, and complete political independence in terms of the domestic political system. For these reasons,

it generally makes best sense to recruit a international consulting firm with an expertise in pensions.

3. This firm should compute the market value of assets in hand; the present value of future contributions; the present value of future benefits paid out, in the light of mortality projections. Through this, estimates would be obtained of the NPV of assets and the NPV of liabilities.
4. The report of this agency should be immediately released into the public domain.
5. If the NPV of assets is atleast 50% higher than the NPV of liabilities, then the system is solvent, and nothing needs to be done. Such a 50% buffer is required to cope with unexpected negative shocks in the future, such as improvements in mortality, a drop in asset prices, etc.
6. If the NPV of assets is worse than this solvency condition, then benefit rates need to be cut by a sufficient amount, so as to ensure that the NPV of assets are 50% higher than the NPV of liabilities.

If this process is repeated every year, and every step carried out in an impartial and professional fashion, then it is possible to have a solvent DB system over multi-decade horizons.

There are two problems with this picture. First, because benefits are regularly adjusted to reflect future asset prices and future mortality rates, the system should no longer be called a “defined benefit” system. In this subtle sense, the quest for solvency is fundamentally incompatible with a fixity of benefits. It may be perhaps more appropriate to shift from the term ‘defined benefit’ to ‘provisionally projected benefit’.

Second, in the real world, political forces are rarely able to execute the steady reduction in benefits that is required owing to elongation of mortality and reduction in interest rates. Hence, *for all practical purposes*, DB systems everywhere in the world have failed to adapt to the demographic transition, and have gone bankrupt. Even though it is *technically* feasible to have sound DB systems, it is *practically* infeasible to enable them to run properly.¹

Such political problems appear likely to arise in the decision processes of the Indian State, and have arisen in the case of both DB systems - the civil servants pension and the EPS. In the Indian case, given the quest for addressing the gigantic uncovered sector, mistakes in funding are of extreme importance, for a small unfunded gap per worker will translate into many percentage points of GDP when applied to hundreds of millions of workers. Such fiscal costs can simply not be borne by the fragile state of public finances.

For these reasons, the consensus in pension economics today is that defined benefits is a pandora’s box which should best not be opened. This consensus is not based on a doctrinaire opposition to defined benefits. It is based on a realistic judgment that the recipe of policy elements required to obtain a sustainable and solvent DB system, shown above, are unlikely to be accepted and consistently applied, year after year for decade after decade, in the political process in the real world.

¹One remarkable facet of the difficulties of soundly executing a DB system is weaknesses in information about the DB scheme, and of the statistical system in the country at large. While these appear to be peripheral issues, in practice, weak data is a prominent problem impeding sound policies.

2.2 Menu of choices

Standing in 1998, a comprehensive menu of choices for reform consisted of the following possibilities:

Parametric reforms to EPF One possibility lay in an institutional transformation of EPFO, so as to have IT systems, modern investment guidelines, multiple competing fund managers, a range of investment alternatives, and reduced administrative costs.

Parametric reform of EPS Parametric reform of EPS would involve bringing in adequate transparency and measurement of the funding gap, and reducing benefits so as to bring the system back to solvency.

Fundamental reforms to EPS Fundamental reform of EPS would involve phasing out defined benefits, and merging the contribution flow to EPS into EPF.

Parametric reforms to the civil servants pension Many scholars such as Mukul Asher have emphasised that enormous progress on the civil servants pension is possible through careful, common-sense parametric reforms (Asher 2000).

Fundamental reform to the civil servants pension Fundamental reform of the civil servants pension would involve phasing out defined benefits, and building a structure with individual accounts, defined contributions, multiple competing pension fund managers, and modern investment guidelines.

A population-wide DB system One possibility could have India replicating the mistake of myriad other countries, and starting a population-wide DB system. This would look fine for roughly 10 to 15 years,² but then setup India to replicate the fiscal and political disasters that have occurred in other countries.

A population-wide mandatory DC system One possibility consisted of trying to have a mandatory population-wide DC system, but this would be very difficult to enforce since the administrative capacity does not exist to obtain contributions from all workers spread all across the country – most of whom are self-employed.

A population-wide voluntary DC system To the extent that individuals in the uncovered sector would voluntarily participate in a DC system, this hurts nobody and is Pareto superior. However, the international experience suggests that obtaining participation is difficult, and that when there is only a small number of participants, the transactions costs prove to be insuperably high.

Means-tested minimum pension, unfunded The last policy alternative consists of the creation of a minimum pension, at the poverty rate, to be delivered based on testing the means of the recipient (so as to ensure that the rich do not collect it). By definition, this would need to be an unfunded system.

²As Ashok Desai and Ashok Lahiri observed in the Project OASIS research conference in November 1998, since India faces the prospect of an *improving* dependency ratio for the next 10 to 15 years, for this period, a population-wide DB system will actually appear very attractive. However, after this, India would inevitably suffer the painful consequences of the demographic transition. Further, India's ageing is likely to be compressed over fewer years as compared with that seen in most existing industrial countries. Hence, the pain of the demographic transition will be acute.

If political difficulties were put aside, then the “first best” policy mix – as of 1998 – would have consisted of:

1. Parametric reforms to EPF,
2. Fundamental reforms to EPS,
3. Fundamental reform for the civil servants pension,
4. A voluntary population-wide DC system, and
5. A means-tested minimum pension (unfunded).

In the event, over the 1998-2005 period, India has evolved along a very different trajectory as compared with this ideal combination. The process of pension reforms is, of course, as yet incomplete, and it is conceivable that in coming years, we could go closer to this “first best” solution.