India:
The Challenge of Old Age Income Security

Yvonne Sin
World Bank

February 14, 2002

I. Report summary

- Informal/family transfer system dominates but there is a growing need for formal alternatives
- Existing formal sector schemes do not provide effective vehicles for long term savings or longevity insurance for fraction covered
- Increasingly, these schemes are having a negative impact on the rest of the economy
- There is strong rationale for reforms along the lines being developed by the Government
- Reform should take an integrated approach

EPFO-governed schemesb

- Compulsory savings rate is very high but a large portion is used for non-pension purposes
- Withdrawals combined with low, long-term returns result in insufficient savings for old-age
- EPS is underfunded and leaves inflation risk
- Poor design with redistribution flaws and actuarially unfair
- <u>Conclusion: EPF/EPS not effective as a savings vehicle or for longevity insurance</u>

Civil servants' pension scheme

- Annual spending on central government pensions more than 15 percent of tax revenues
- Unfunded pension liability of state and federal estimated to exceed 1/3 GDP
- Pension liabilities of enterprise sector unknown but significant (e.g., power sector)
- <u>Conclusion: existing system unsustainable</u>

Voluntary schemes

- Low coverage skewed to high income
- Tax treatment does not favor true contractual savings schemes (e.g., PPF) and is inconsistent across products
- Lack of post-LIC regulatory framework
  - Who will regulate private pensions?
  - What kind of products should be allowed?

Indirect negative economic impact

- Distorts labor markets through lack of portability, high contribution rates etc.
- Channels long term savings away from private capital markets
- Impedes other reforms such as privatization (e.g., power sector)
- Large and growing demands on fiscal

II. Pensions and fiscal policy

- Civil servants’ pension liability
  - Federal
  - State
- EPS growing liability, EPF yields
- Public enterprise pension liabilities
- Unfunded PPF/GPF schemes
- Tax expenditures on voluntary schemes
- Social assistance
- Farmers’ scheme

Assessing unfunded liabilities

- Growing recognition around the world of implicit pension debt (IPD)
- First step is to assess the scope of the existing problem
  - Federal government level
  - State government level
  - Enterprise sector
  - EPS
- Independent actuary

Emerging pension reforms

- Government initiatives:
  - Introduction of defined contribution scheme for federal civil servants
  - Implementation of OASIS
  - Review of PPF
- Further reforms:
  - Introduction of defined contribution schemes for state level civil servants, enterprise workers
  - New investment regime for EPFO
  - Eliminate unfunded liability at EPS
  - New regulatory framework for pensions

Two key reform challenges

- Design a new set of institutions and regulations for the new funded schemes
  - Objectives: safe, efficient, low cost, portable, easy to regulate
- Finance the transition from PAYG to FF

Design funded schemes

- Defined contribution
- Professional asset management
- Investment portfolio options
- Tax treatment
- Regulations
- Supervision

Financing the transition

- Changes to existing schemes that reduce the unfunded liability
- Tax financing including employee contributions
- Borrowing (also from pension funds)
- Earmarked privatization proceeds
- Controlling the pace of the transition
  - Who is covered? How much of prior liabilities are amortized and how quickly? How quickly are investments allowed in private sector securities?

An integrated approach to reform

Central government civil servants

State government civil servants

State enterprise employees

Members of tax-favored Voluntary schemes (PPF)

Unorganised sector – OASIS

Regulatory framework

Pension supervisor

Defined contribution scheme providers

EPF

Concluding thoughts

- Pension reforms are needed, partly to control size of unfunded pension liabilities
- Best to take integrated approach that results in a seamless regulatory and institutional framework
- Most of the reforms imply a shift from unfunded to funded arrangements
- A global transition financing strategy must be developed but… deceptive fiscal accounting should not inhibit reforms