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.

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From 1998 to 2005, India made some progress on the important question of pension reforms. It has been a fascinating saga, where at first it appeared that enormous progress had been made, but where - as of writing - it is not clear whether reforms will obtain the requisite support in Parliament.

The ability of a society to execute pension reforms is a litmus test of the quality of governance, since there is perhaps no other area where reforms are as important, but as lacking in immediacy. The demographic transition, and the far-reaching consequences of an ageing population, is simply one of the most important forces at work which is reshaping the world. But yet, pension reforms never feel urgent, because it always feels feasible to let one more year drift by in the status quo. Alternatively, even if one keenly understands that over 5 million people in India retire every year, and over 90% of them lack formal pension provisions, the magnitudes of the task appear so large, and the benefits from action today appear to be so far into the future, that the task of pension reforms appears dishearteningly difficult.

It takes an enlightened polity to appreciate impending problems far out into the future, and to address them in time. India is blessed by being able to draw upon the knowledge that has been thrown up by the mistakes of industrial countries, all of whom blundered when they had a young population. But even if we are informed by their experiences, the fact remains that pension reforms are supremely important, and yet not urgent. It is all too easy for a Parliament to pay attention to more pressing matters, and to exhibit reluctance to take difficult decisions which appear to induce pain in the short run.

This paper is a modest attempt at documenting the pension reforms effort that has unfolded in India from 1998 to 2005. It is also hoped that some useful lessons can be derived from this story, about how to approach reforms in other areas of public policy. The paper is not a self-contained introduction to the economics of pensions; some exposure to the pension economics is required as a pre-requisite. Further, my information is necessarily incomplete, and there are certainly many people and organisations which played a role in India's pension reform who are not mentioned here. I would like to apologise in advance for these errors of omission.

1 Initial conditions

The broad facts about Indian pensions are well known (Shah 2006). There are four main components in the pension system :

1. The Employee Provident Fund Organisation (EPFO) - which is mandatory for private firms with over 20 employees. This is a blend of a defined contribution (DC) system called the Employee Provident Fund (EPF), and a defined benefit (DB) system called the Employee Pension Scheme (EPS).
2. The civil servants pension - which applies for employees of the government. This is an unfunded DB scheme.
3. 'Public provident fund' - this is a tax exempt mechanism for saving that is appealing for tax-paying self-employed individuals. However, owing to rules that permit easy withdrawal, it does not play a role in saving for old age.

4. The uncovered sector, which makes up 87% of the workforce.

The first and foremost goal of pension reforms, is to increase the size of the covered sector. India is at a unique moment in the demographic transition, where large numbers of young people are coming into the labour force. If these individuals can be placed into a modern pension system, they will be able to accumulate pension assets for their old age, and India would then be able to avoid the crises associated with an ageing population that have been seen in myriad other countries.

But in addition, there were structural problems with the EPFO and with the civil servants pension which needed to be addressed. The EPS is supposed to be based on contributions and assets, but is actually underfunded. The expenditure on the civil servants pension was growing at double digit rates, and a recent paper found that the implied pension debt of the GOI on account of civil servants alone is probably above 64% of GDP (Bhardwaj & Dave 2006). Similarly, S. N. Mathur has long written about the difficulties of the pension provisions in Indian Railways.

Thus, the EPFO and the civil servants pension, both imposed insuperable costs upon the exchequer. In addition, owing to flawed policies relating to both investment and early withdrawals, EPFO typically leaves participants without significant income in old age. In other words, participation in EPFO for an entire lifetime generally fails to leave a retired person with income security.

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. This is very difficult to achieve, in practice.

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.

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 come under severe pressure. 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.

[1]One 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 occured 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.

[2]As 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.

3 Stasis at EPFO

The EPFO was created in 1952, when there was very little understanding about pension economics. A major role in the governance of EPFO was given to trade unions. These origins, and the governance structure, has been the root cause of a series of policy mistakes.

As with the erstwhile UTI and LIC, EPFO mixes up all sorts of functions, of policy making, regulation, and monopolistic service provision. In the case of UTI and LIC, now there is a separation where SEBI and IRDA are regulators, and the underlying industries are competitive.

Given the governance structure of the EPFO, and the legislation (of 1950s vintage), and given the conflicts of interest that derive from bundling together of functions, reforms of EPFO are hard to obtain. In the case of UTI and LIC, the intellectual capacity and energy for modernising the regulatory architecture came from the Ministry of Finance.

The Ministry of Labour has lacked the intellectual resources and energy to mount a comparable reforms program. Efforts at strengthening administrative procedures and IT systems were attempted when Ajai Singh was Central Provident Fund Commissioner, but these efforts ran afoul of resistance from conservative elements in the Ministry of Labour and the Central Board of Trustees. Given the failure of EPFO and the Ministry of Labour to mount an internally driven reforms program, change would have to come from outside the Ministry of Labour. As of yet, such a reforms effort does not seem to have come about.

A major event in the history of EPFO was the creation of the Employee Pension Scheme (EPS) in 1995. But while this may appear to be a positive development from the viewpoint of the first generation of workers, there are deep problems with EPS when viewed from the larger perspective of pension reforms. EPS was most probably underfunded right on its first day of operation, and early participants would seize disproportionate benefits at the expense of either the broad population or of future participants.

In summary, there has been no visible progress on EPFO. This stasis is a remarkable outlier when compared with the enormous progress which India has made in myriad other fields of

public policy from 1980 onwards.

4 Initiation

The Indian pension reform saga began in 1998. The policy thinking on perhaps the most important second generation economic reform for India originated in a tiny, and perhaps unlikely part of the Government – the Ministry of Welfare (which was later renamed Ministry of Social Justice and Empowerment, abbreviated as MoSJE).

One of the many responsibilites of this ministry was the care and welfare of destitute old. Given the processes of urbanisation and breakdown of intra-family support structures such as the 'joint family' (cohabitation across generations), income in old age was rapidly becoming a major problem for the Ministry of Welfare. A program named the National Old Age Pension (NOAP) Scheme, which paid a tiny means-tested pension of roughly Rs.200 (US$5) per month to a destitute person above age 65 had been setup (it is proposed to raise this to Rs.400 per month). However, this scheme is plagued by administrative difficulties in means-testing and ineffective delivery.

While India's elderly population had been growing, the ratio of elderly to the overall population of aged persons had been rising at much faster pace. Data for the 1991 census, which was released in 1995-96, induced considerable concern for the then Minister of State for Welfare, Maneka Gandhi, when it estimated that the population of persons over age 60 was at roughly 70 million. Demographic projections also suggested that life expectancy was rising rapidly, and that a person at age 60 in 1998 could be expected to live for another 15 years. Projections by Pravin Visaria showed that India would have an elderly population of 113 million by 2016 and 179 million persons by 2026.

The full annual budget (of roughly Rs.1,000 crore or US$250 million) of the Ministry of Welfare – if exclusively devoted to problems of the elderly – was obviously grossly inadequate to deal with such headcounts of the elderly. This budget was also meant to pay for social assistance for persons from scheduled castes and scheduled tribes, disabled, street children and lifetime poor, as also to counter problems with alcohol and drug abuse, and juvinile justice.

After some years of trying to tackle this situation through traditional approaches, the then Joint Secretary of Welfare (Anand Bordia) had started thinking out of the box, and had started noticing that in other countries, the backbone of handling this problem lay in a system of pension funds with defined contributions.

In December 1997, a financial sector policy conference was to take place in Goa. At the time, relatively little had been written about the field of pension reforms in India, apart from Patel (1997) which had then recently come out. I volunteered to write a paper on pension funds (which later appeared as Dave (1999)). Shankar Acharya suggested that Anand Bordia should be the discussant for this paper. At the meetings, Shankar Acharya urged Anand Bordia and myself to put our heads together and work on these questions.

These discussions led to a 'Project OASIS' being initiated by the Ministry of Welfare in July 1998. OASIS was an acronym for 'Old Age Social and Income Security'. The quest of the

project was to find implementable policy directions through which the great mass of India's uncovered sector could be assisted by a formal pension system, and thus reduce the burden coming upon government systems such as the NOAP, which (in any case) were pitifully small when compared with the scale of expenditure required for a decent existence in old age.

The Ministry was very conscious that this required new kinds of out-of-the-box thinking compared with the traditional government rhythm of creating one more scheme based on the public exchequer. It was understood that there was a considerable gap between the way India was approaching these questions, and the state of knowledge prevalent internationally. Hence, what was setup was a project rather than just an expert committee.

The framework was a unique one. Invest India Economic Foundation (IIEF) was chosen as the executing agency for the project. First, a set of research papers would be commissioned, and discussed in a conference. Then, the expert committee would write a report for the government. Great care was taken to setup a broad-based expert committee, which comprised of C. S. Rao from the Ministry of Finance, the late R. S. Kaushik, who was then the Central Provident Fund Commissioner, Ministry of Labour, Ajay Shah, who was then an academic at IGIDR, and Nalin Thakore, who is an independent expert on pensions. MoSJE was represented by Anand Bordia and Ashok Pal Singh, and Gautam Bhardwaj of IIEF was the member-secretary.

This approach towards building knowledge and then policy proposals worked extremely well. The research papers which were commissioned by the project were discussed at a conference in November 1998, and were disseminated over the world wide web. A set of papers related to Project OASIS appeared as a well-regarded book (Bordia & Bhardwaj 2003).

The role of these research papers and their dissemination in book form, in shaping thinking on pensions in India, must be emphasised. It was only in 1995 that India had walked into the Employee Pension Scheme (EPS), only dimly realising the problems which were being created. Such a policy mistake would, most likely, not take place today, since there has been a quantum leap in knowledge about the subject amongst intellectuals and the policy community. Project OASIS must take some of the credit for the improvement in the state of knowledge.

After the conference (November 1998), the committee spent an remarkably elongated period debating the policy alternatives. The proposals of the report – an individual account DC system, based on modern IT, with an independent regulator, with an aim at achieving voluntary participation from the uncovered sector – are well known and will not be repeated here.

If I may briefly touch upon the genesis of some of these ideas, the foundation of our work was an extensive study of the international experience. We studied the failure of DB systems worldwide, and we studied with particular interest the difficulties faced by the DC systems (which were then relatively recent). Our efforts in this were greatly assisted by Robert Palacios, Richard Hinz, Mukul Asher, Martin Feldstein, Estelle James and David Lindeman.

We did well, standing in 1999, to pickup on the themes of fees, expenses and transactions costs as core issues in going from the broad idea of DC to a meaningful system which addresses old age risk. These issues have come to prominence in the international discourse on pension reforms in the following years. In our quest for low transactions costs, we understood that modern IT systems were the only way through which low-cost transactions could be achieved,

a point that was also emphasised by C. B. Bhave both at the level of principle and by example through the functioning of NSDL.

On the question of nationwide outreach, the achievements of computerised banks, and members of the National Stock Exchange, were then well known. But at the time, there were too few of these electronic outposts in the country. A. P. Singh played a vital role in helping us understand the potential of what post offices could do. We increasingly started visualising a large mass of outlets, throughout the country, comprising bank branches, post offices, and any other branch of a firm with adequate computerisation as well as safety.

On the question of asset management, the rough idea of the equity premium was well known to all in finance. Susan Thomas helped us to visualise the implications of equity investment in an Indian context, using simulations with Indian data (Thomas 1999). Later, Ajay Shah worked out the second-tier issues of the difficulties associated with pension guarantees in an Indian context (Shah 2003).

As emphasised earlier, the mandate of Project OASIS was highly limited: it was about how to improve the outlook for pension provisions for the uncovered sector. In some ways, this is a bleak area, for the international experience (e.g. in Sri Lanka) shows that voluntary participation in pension systems does not easily come about. Individuals seem to be averse to stepping forward to make their wealth illiquid for multi-decade horizons. However, the Ministry of Social Justice and Empowerment helped us to have an extensive engagement with many NGOs all over the country. The feedback we got was extremely positive: numerous NGOs told us that there was likely to be a substantial uptake of a DC pension, without State subsidies, as long as it was simple and the transactions costs were low. In particular, Jayshree Vyas of SEWA Bank played a major role in shaping our understanding of the optimal strategy for dealing with the unorganised sector.

A DC pension system requires that when participants emerge out of their accumulation phase, holding assets in hand, there is an adequate annuities market which can convert a stock of assets into a flow of pensions. The annuities market in India is relatively undeveloped (James & Sane 2003). However, even if we think of customers of age 20 flowing into a new DC system from 2004 onwards, we have a few decades of time in which to address the policy problems so as to achieve an adequate annuity market in time for their retirement. At IRDA, C. S. Rao has been doing important work on strengthening the annuity market.[3]

A first draft of the report was presented by Maneka Gandhi (then the Minister of Social Justice and Empowerment) to Yashwant Sinha (then the Minister of Finance) in February 1999. The report was finalised in January 2000, and presented to the A. B. Vajpayee (then the Prime Minister), who initiated work in the PMO towards implementation.

5 Fresh thinking on civil servants pension

While the OASIS effort was taking place at the Ministry of Social Justice, in parallel, the Ministry of Finance was also working on the problem of the civil servants pension. In October

[3]He has also been instrumental in setting up the new *Morbidity and Mortality Institute* which will collate data from various insurance companies, and release databases which will make possible better pension policy analysis.

1999, a Working Group for 'Assessment of Pensionery Liability of the Government of India' was constituted under A. M. Sehgal, the then Comptroller and Auditor General (CAG).

With E. A. S. Sarma followed by Ajit Kumar, Rakesh Mohan, Jaimini Bhagwati and Urjit Patel in the Ministry of Finance, discussions took place on pension reform. These led to a decision to gradually engage in fundamental reform by shifting new recruits into a DC system. This led to an announcement in the February 2001 budget, by Yashwant Sinha, that new recruits into the civil service would be placed into a new DC system.

In July 2001, a High Level Expert Group (HLEG) was constituted by Ministry of Personnel, Public Grievances and Pensions, headed by B. K. Bhattacharya, in order to operationalise this announcement. The HLEG was given a mandate to design the institutional mechanism for a DC pension system for new recruits. In the event, the report of the HLEG diverged from the mandate given to the HLEG, by proposing that a 50% defined benefit should be retained.

6 The New Pension System

After discussions between Yashwant Sinha and A. B. Vajpayee, implementation work on the OASIS system shifted from the Ministry of Social Justice to the Ministry of Finance. The first thought here was that this work should be undertaken through insurance companies. Hence, IRDA was asked to review the OASIS report, and propose a method for operationalising it. A working group for this purpose was setup, headed by N. Rangachary, in March 2001. Mr. Rangachary was greatly assisted by Ashvin Parekh of Price Waterhouse in this work. The report, which was released in October 2001, proposed that the OASIS system should not be implemented. Instead, it proposed that insurance companies should directly sell DC pensions to individuals without centralised recordkeeping.

In addition, the Ministry of Labour proposed that this system should be built by EPFO.

Thus, there were sharp differences of opinion about whether the OASIS system should be implemented, or not, and about the role of the proposed new pensions regulator, or IRDA, or EPFO. Hence, a Group of Ministers (GOM) was constituted in November 2001, chaired by Dr. K. C. Pant, who was then Deputy Chairman of the Planning Commission.

As is apparent from this somewhat involuted discussion, as of late 2002, there were many proposals which were up in the air:

- *Civil servants pension:* The 2001 Budget Speech had announced a shift to DC for new recruits of the civil service. But there was the HLEG view, which recommended abandoning the 2001 Budget Speech announcement by going back to 50% DB.
- *Uncovered sector:*
    1. There was the OASIS view, which envisaged a new pensions regulator and an individual-account DC system with centralised recordkeeping and full portability.
    2. There was the insurance view that IRDA should be the pensions regulator, and that insurance companies should sell DC pensions, preferably without a central recordkeeping agency. This differed with the Project OASIS proposal, where the

role for IRDA and insurance companies was visualised as that of selling annuities at the end of an accumulation process.

3. There was the EPFO view, that EPFO should run the proposed DC system for the uncovered sector in a manner similar to EPF.

The situation is perhaps typical of the public policy process in an open society. The process of policy analysis and debate had thrown up many alternatives which were competing in the marketplace of ideas. Roughly four years had been spent in simmering these ideas, and exploring their consequences in public discussions. In December 2002, the time had arrived for *decisions.*

Extensive brainstorming on these questions took place between the Department of Economic Affairs (DEA) and the Department of Personnel and Pension Welfare (DPPW). At a political level, this involved A. B. Vajpayee (PM), Jaswant Singh (Finance Minister) and L. K. Advani (Home Minister, who was also handling DPPW). At DEA, the work was led by S. Narayan, who was then Finance Secretary. He was assisted by U. K. Sinha who was the Joint Secretary in charge of the Capital Markets & Pension Reforms division, and Ajay Shah who was Consultant to DEA. At DPPW the subject of pensions was being handled by J. S. Sarma, who was additional secretary. All these individuals were able to work together in a remarkably harmonious and coordinated fashion. Three key decisions were taken:

1. The HLEG proposal about retreating back into defined benefits would not be accepted; instead the intent of the February 2001 speech by Yashwant Sinha would be upheld – to place new recruits into a new DC system.
2. The two problems – civil service and uncovered sector – would be merged into a single institutional structure. There would be only one individual account, defined contribution system, on the lines of the OASIS proposal. Both groups - new recruits into the civil service and the uncovered sector - would be placed into this single system, named the New Pension System (NPS).
3. NPS would be regulated by a new independent regulator, the Pension Fund Regulatory and Development Authority (PFRDA).

The rationale for merging the civil servants problem and the uncovered sector problem was based on two ideas: to harness economies of scale, and to support two-way flows in the labour market between the employment with the government and employment in the private sector. The rationale for an independent regulator was based on the recognition that pensions was the fourth pillar of Indian finance, and as with banking, securities and insurance, required a fourth regulator.

These were the most important few-weeks of India's pension reforms story. Things could conceivably have taken a very bad turn. It could have been that civil servants were given defined benefits and that EPFO/IRDA was given the job of doing the uncovered sector. Instead, an elegant and far-reaching solution was found, where commonalities between the two threads (uncovered sector and civil servants) were identified, and fully utilised in the policy decision.

7 Saga of the NPS

In the case of SEBI, an administrative order for the creation of SEBI was put out in 1988, and the SEBI Act was only passed in 1992. In similar fashion, it was possible for an interim PFRDA and NPS to make considerable progress before the legislation was put into place.

From January 2003 onwards, implementation work on the NPS was disappointingly slow. With the benefit of hindsight, the ideal strategy would have been of putting structures into place - of IT systems, recordkeeping, sending out account balance statements to participants, while (in parallel) designing the legislation required for PFRDA and steering it through Parliament. However, efforts on these two tracks were often fitful, and instead of moving strongly on both tracks at once, it was often felt that progress could only be made on one of the two tracks at a time.

In August 2003, the Union Cabinet approved the creation of an interim PFRDA by administrative order, and the decision to place new recruits from 1/1/2004 onwards into the NPS. New pension and PF rules, reflecting these decisions, were issued in December 2003. Thus, from 1/1/2004 onwards, NPS came into existence as a creature of these rules. Many incremental improvements were made to the policy proposals at the time. For example, Prodipto Ghosh, who was Addnl. Secy. at DEA at the time, clarified the treatment of early retirement and designed the rules for minimum annuitisation.

In 2004, Vijay Kelkar had chaired a "Task Force on FRBM Implementation". This report had highlighted the role of 'EET' tax treatment for long-term savings, where contributions and accumulations would be exempt, but (all) withdrawals taxed as ordinary income. Arbind Modi, who is now JS(TPL) in the Department of Revenue, helped greatly in operationalising these ideas in the pensions context. The implementation of EET for the NPS has helped NPS on a modern footing as far as tax treatment is concerned. This development also links up with the Y. V. Reddy Committee on administered rates, which had recommended that the tax-privileged investment avenues, with above-market rates of return, should be phased out as India starts putting a modern pension system into place.

One piece of important infrastructure building which took place was on the subject of data. As work on PFRDA and NPS started falling into place, it became increasingly clear that remarkably little was known about both the civil service and the uncovered sector in India. As an example, there is no available estimate of the number of employees or number of pensioners in the civil service.

In response, DEA took assistance from Renato Limjoco and V. Subramanian of the ADB, and initiated a household survey, named *Indian Retirement, Earnings and Savings* (IRES). This effort was led by Christopher Butel, who was project leader of a joint team made up from University of New South Wales, IIEF and ACNielsen-ORG-Marg. IRES is a survey of 41,000 households conducted in November 2004. It threw up a powerful quantitative foundation for analysing policy questions in an empirical fashion, and in taking many questions from vague preconceptions and stereotypes to evidence-based policy making.

In January 2004, the interim PFRDA was setup, with Vinod Rai as Chairman. In May, a fuller organisation was setup, with Vineeta Rai as Chairman, and two members: Anand Bordia and P. N. Venkatachalam. In April 2005, D. Swarup took over as Chairman of PFRDA

for a five-year term. As of the time of writing, the three key figures in the future of the NPS are Swarup, K. P. Krishnan (who is Joint Secretary at DEA) and Shashank Saksena (who is Joint Director at DEA).

7.1 State-level civil servants

The fiscal stress associated with pension payments at the state level was even more extreme when compared with that found at the central level. In February 2003, RBI setup a 'Group to Study the Pension Liabilities of the State Governments' under B. K. Bhattacharya.

In parallel, one by one, individual states were mirroring the shift towards DC for new recruits that was taking place at the Centre. The first State to issue such a notification was Himachal Pradesh, which issued a notification in May 2003 that new recruits from 1/1/2004 onwards would be moved into a new DC system. In the following months, numerous states followed the lead of the centre, and shifted new recruits into the New Pension System. For all practical purposes, there is now no concept of policy analysis at the state level: there is only the question of fine-tuning the details of merging into the NPS. As an example, a state like Uttar Pradesh has been a pioneer in deciding that recruits of a few recent *years* will be moved into the NPS, through a recognition formula which has yet to be worked out. The state with the second highest implicit pension debt owing to the civil servants pension, however, is West Bengal, which has (as yet) not moved into the NPS.

These adoptions are particularly important because they increase the number of people in the NPS right at the outset, and thus spread the fixed costs of institutional infrastructure over a larger number of participants, thus driving down the transactions costs suffered by each participant.

7.2 Change in government

In May 2004, general elections took place, and the NDA was replaced the UPA. The new Minister of Finance, P. Chidambaram, embarked on a full re-evaluation of the question of regulatory structure of the NPS, and decided to stay on course with the effort of creating the PFRDA. However, there was a decision to shift gears; to put a greater emphasis on getting the PFRDA legislation in place.

A first effort was based on a Ordinance, which was promulgated in November 2004. However, this was a false dawn. The trade unions, which had thus far watched the work on NPS from a distance, exercised their strength within the leftist parties, and the left parties signaled their lack of support for the PFRDA Bill. Hence, in March 2005, Parliament referred the PFRDA Bill to the non-partisan Standing Committe on Finance, headed by Gen. B. C. Khanduri, for a fuller evaluation.

The basic objections that left parties have is regarding the involvement of the private sector in the management of retirement funds, and in investment in equity. According to them, retirement savings are very precious savings of citizens. It is argued that they should always remain safe, and cannot be subjected to the greed of the private sector. Hence, it is too risky to hand them over to private managers. They also do not favour investment in equity as it is

too risky, and savers might suffer losses at critical moments. It is argued that ordinary people do not understand the intricacies of finance, and hence it would only be prudent to investment in government securities or PSU bonds. Somehow, the left parties are unable to look at the overriding international evidence about the returns to equity over long time-horizons, and how this has benefitted workers. Similarly, the empirical evidence in India, where equity index data is available from 1979 to 2006, is not persuasive to the left parties.

In July 2005, the Standing Committee on Finance released its report on the PFRDA Bill. This report was a strong non-partisan endorsement of the bill: it described the NPS as "an urgent necessity". It proposed a large number of incremental improvements on the draft law. From July 2005 onwards, the UPA has been trying to solve internal dissensions with the left parties, so as to be able to obtain a vote in Parliament on the PFRDA Bill.

8 Unrelated efforts

In addition to the above narrative, for the sake of completeness, some other policy efforts which took place need to be pointed out.

A 'Protection of Old Age' Bill has been proposed, which will seek to make it legally obligatory for children to support their parents. The usefulness of this is highly dubious. It is neither desirable nor feasible for the State to interfere in intra-family altruism. Our real challenge is to setup modern *institutional mechanisms* for old age, through which a person can stand on his own feet, even if intra-family support is not forthcoming.

Periodically, there have been proposals to create an 'unorganised sector social security system'. Some elements which have been talked about for this include: A contribution rate of Rs.1 per day, a benefit rate of Rs.500 per month, free health insurance, and free survivor benefits. Elementary arithmetic shows that such a system is financially unsound, even if transactions costs were zero.

Such efforts need to be repositioned as an effort (in the long run) towards a means-tested unfunded population-wide minimum pension. A concerted policy analysis effort, comparable to that which went into Project OASIS, needs to be undertaken in order to design such a system. The claim that a contribution rate of Rs.1 per person per day implies adequacy of funding is incorrect and needs to be soundly rejected. Such a system will probably cost the exchequer between 1 to 4 percentage points of GDP every year over the next 50 years. A decision to initiate such a system, hence, needs to be taken with the utmost care. The real constraint in building such a system is administration. It is very difficult to create the administrative capacity to run such a system at low transactions costs.

In 2004, when the NDA administration was in operation, the Ministry of Labour had envisaged using the institutional infrastructure of PFRDA and the NPS for the purpose of collecting contributions, having pension fund managers, maintaining centralised records, etc. of such a unorganised sector system. This was a step in the correct direction, since the NPS features a unique set of features aimed at reaching every corner of the country while having tight IT systems and low transactions costs. However, the feasibility of this can only be meaningfully judged after the NPS is in operation, and hard transactions costs data are known.

9 Lessons

At the outset, this paper argued that if political difficulties were put aside, then the "first best" policy mix – standing in 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, India failed to make progress on EPFO.

Fundamental reform for the civil servants pension was initiated, but this would take effect only for new recruits from 1/1/2004 onwards, and thus be phased-in over a 30-year period. In this weak sense, the reforms effort has tried to achieve the third element. If the New Pension System is thrown open to the broad population, then this would address the fourth element. Finally, the New Pension System could possibly supply the institutional infrastructure through which a means-tested minimum pension could possibly become administratively feasible, thus addressing the fifth element.

With the United Progressive Alliance government, it is not clear whether the PFRDA Bill will turn into legislation. If the PFRDA Bill is diluted or is not passed, then it could add up to a comprehensive failure on pension reforms until the next general elections.

Finally, some fragmentary efforts towards an 'unorganised sector social security system' could charitably be titled a path towards a unfunded minimum pension, but much more work is needed before these efforts achieve credibility. At present, the administrative capacity for running such a system is absent. Such an unfunded system will probably cost between 1 percent of GDP and 4 percent of GDP, every year, for the next 50 years: Such calculations need to be clearly shown to Parliament before a system is approved.

What lessons can we draw from this experience, over the period from 1998 to 2005?

9.1 Hope

The first lesson that I draw from the pensions story so far is that of hope: That it *is* possible to embark on complex reforms in India, despite all the difficulties of the policy process, coalition governments, short-termism and populism, well-entrenched vested interests backed by poorly drafted legacy legislation, etc. In the case of pensions, a broad non-partisan consensus about the desirable direction has developed. Finer details now need to be worked out, but considerable progress has undeniably taken place.

On a related note, there is a widespread fashionable cynicism in India, where it is felt that proposing first-best policies is naive and pointless. But in the case of pension reforms, intellectual honesty demanded advocacy of the first-best. Indeed, if second-best proposals had been concocted, it would have been harder to explain them and address criticisms. In the

event, the first-best proposals did achieve remarkable non-partisan acceptance across a spectrum of politicians including Yashwant Sinha, A. B. Vajpayee, L. K. Advani, Jaswant Singh, P. Chidambaram and Manmohan Singh.

9.2 Knowledge matters

A major lesson of the pensions story is the importance of knowledge initiatives. The problems of EPFO, and particularly the creation of EPS in 1995, were clearly related to inadequate homework, and inadequate understanding of pension economics based on first-principles reasoning and a thorough study of international evidence.

Even though Project OASIS began when there was a vacuum in the intellectual community on the subject of pension economics and finance, it was possible to commission a series of papers on various aspects of the problem. A 'pension research community' quickly sprang up, which took interest in the field, and was able to steadily feed knowledge inputs into the policy process. This structure – where "Project OASIS" was made up, first, of a research program followed by an expert committee – could usefully be applied in many other contexts.

On a similar note, the creation of the IRES database, and the research that this has made possible, was another major milestone in contesting preconceptions and political bias, in rising from faith-based policies towards evidence-based policies.

9.3 Open discussion and debate

The next key lesson of the pension reforms story is the importance of discussion and debate *in the public domain.* A little appreciated feature of Project OASIS was an enormous effort of conducting hundreds of consultations and meetings, all across the country. This fed good ideas into the policy process, and helped large numbers of people - all across the country - get engaged in the pension reform process.

The media played a very important role in this process. At first, the knowledge and priorities of the media were much like those of the rest of the country. There was a dull awareness that ageing is a problem and there was an instinctive answer that the government should take care of old people. But over the years, an increasing number of journalists have attended meetings, read committee reports and papers on the subject, and have become passionate participants in the pension reforms process. Extensive reportage and opinion pieces in *The Economic Times*, *Business Standard*, *Times of India*, *Indian Express*, *Business World* and *Hindustan Times* helped to keep pension reforms firmly on the front burner. The idea of a DC individual account system went from being a radical one to becoming the widespread consensus. Through this large-scale acceptance of the reforms, the PFRDA Bill has become a litmus test of the ability of the UPA government to execute economic reforms.

9.4 Use of human capital from outside government

Project OASIS was unique in being contracted-out to Invest India Economic Foundation, which was also (later) a consultant to DEA for the purpose of pension reforms implementation

work. Further, research papers were commissioned to a broad range of scholars from across the system. Several committees, with external experts, played an important role in the reforms process.

These experiences point to the usefulness of extensively using external human capital, and a new participatory style of functioning where tasks within government are performed by utilising expertise outside government.

9.5 Building a consensus

Pension reforms is a complex area, involving a very large number of people. Dozens of individuals have been named in this article, and there are hundreds more who played a role in the pension reforms saga and are not named here. A key lesson of the pension reforms story is the need to build a non-partisan consensus, among intellectuals, bureaucrats, media, politicians and the private industry from all across the country.

The story told in this article meanders across a remarkably large number of individuals and organisations, all of which were important in the evolution of the pension reforms. The full scope of the work in pension reforms was undoubtedly larger than that portrayed here, for the facts here are only the limited set known to me.

The pension reforms story shown here originated with the Ministry of Social Justice and Empowerment, and has made progress through the support of four other ministers (Yashwant Sinha, Jaswant Singh, L. K. Advani, P. Chidambaram) spread across two administrations (NDA, led by A. B. Vajpayee and UPA, led by Manmohan Singh). Without such broad-based support, it would be impossible to make progress.

9.6 Complex reforms are difficult

The last lesson is that such an extrensive effort can possibly take enormous time, and can possibly fail. The story described above has run from 1998 to 2005, and in some sense, has not yet achieved critical milestones. EPFO has thus far been completely unaffected by any serious reforms efforts. The NPS and the PFRDA also have a highly tenuous existence, and it is possible that the UPA might abandon pension reforms.

However, I am a confirmed optimist on the role of ideas in an open society. While the contest between entrenched special interest groups against the larger good appears to be hopeless in the short run, in the long run, the intellectual consensus which has sprung up in favour of the New Pension System will weigh on every Member of Parliament. Even if the UPA fails to enact the PFRDA Act, I am certain that these questions will be reopened after the next general elections, and that India will succeed in achieving substantial pension reforms in time for the demographic transition.

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A Chronology

1998

- Ministry of Welfare (later renamed Ministry of Social Justice and Empowerment) commissioned the task of executing Project OASIS to Invest India Economic Foundation (IIEF) (July).
- MoSJE set up an eight-member inter-ministerial expert committee, termed The Project OASIS expert committee, comprising: Surendra A. Dave (Chairman), Anand Bordia (MoSJE), C.S. Rao (Ministry of Finance), the late R.S. Kaushik (Central Provident Fund Commissioner, Ministry of Labour), Ajay Shah (IGIDR), Ashok Pal Singh (MoSJE), Nalin Thakore and Gautam Bhardwaj (IIEF) (August).
- OASIS Committee commissioned 14 background papers (August); India's first pensions policy conference hosted by MoSJE and IIEF in Goa (November).

1999

- First Project OASIS Report (dealing with improvements to existing pension and PF provisions) presented by Meneka Gandhi (Minister of State, MoSJE) to Yashwant Sinha, then Union Finance Minister of India (February).
- Government constituted Working Group for 'Assessment of Pensionery Liability of the Government of India' under A. M. Sehgal (October).

2000

- OASIS Committee submitted final report to MoSJE (January)
- Meneka Gandhi (MoSJE) submitted final OASIS report to Atal Bihari Vajpayee, then Prime Minister of India (January).
- Second IIEF pensions policy conference on OASIS implementation (April).
- Asian Development Bank (ADB) commissioned a technical assistance project on reform of Employees' Provident Fund Organisation (EPFO) (May).
- A 4-member Government of India pensions mission visited Sweden and USA (June).

2001

- Road-map for a new restructured DC pension scheme for civil servants and the general public announced during the Union Budget by then finance minister, Yashwant Sinha (February).
- Ministry of Finance commissioned Insurance Regulatory and Development Authority (IRDA) to review the OASIS Report and propose a pension scheme for the unorganised sector workforce. As a consequence, a working group on pension reforms for the unorganised sector was set up under N. Rangachary (March).
- A. M. Sehgal Committee report on pensionery liabilities of the GOI submitted to the Government (June).
- High Level Expert Group (HLEG) on New Pension System constituted by Ministry of Personnel, Public Grievances and Pensions under B. K. Bhattacharya (July).
- ADB's EPFO reforms technical assistance report submitted (August).
- IRDA submitted its report on urganised sector pension reforms (October).

- Government referred the OASIS and IRDA reports to a Group of Ministers under K. C. Pant, deputy chairman of the Planning Commission (November).

2002

- HLEG under B.K. Bhattacharya submitted its report on the New Pension System (February).
- Group of Ministers on Pension Reforms held its first meeting (April).
- 3rd IIEF pension conference at New Delhi (October).

2003

- Finance minister Jaswant Singh announced a new DC pension scheme for civil servants and other workers during the Union Budget 2003-04 (February).
- Reserve Bank of India (RBI) set up a 'Group to Study the Pension Liabilities of the State Governments' under B. K. Bhattacharya (February).
- Government of Himachal Pradesh issued a Notification bringing its new employees into a new DC pension scheme from 01 January 2004 (May).
- Government of Tamil Nadu issued a Notification bringing its new employees into a new DC pension scheme from 01 April 2003 (August).
- The Union Cabinet approved the proposal to implement the 2003-04 Budget proposal for introducing a new DC pension scheme for new central government employees (except armed forces) and unorganised sector workers; The Union Cabinet also approved the establishment of the interim Pension Fund Regulatory and Development Authority (PFRDA) (August).
- Government of India issued Resolution and established the interim PFRDA (October).
- The RBI state pension liability report was finalised (October).
- 4th IIEF pension conference (December).
- The DEA notified new pension and provident fund rules effective on a mandatory basis for central government employees recruited on or after 01 January 2004; DEA also notified the features of this New Pension System (NPS) (December).

2004

- NPS introduced (January).
- Interim PFRDA set up; Vinod Rai appointed chairman (January).
- DEA appointed IIEF as consultant for pension reforms and NPS implementation (February).
- Government of Rajasthan issued a Notification bringing its new employees under a new DC pension scheme from 01 January 2004 (March).
- Draft policy document on central recordkeeping and NPS process engineering produced by IIEF (April).
- Government appointed Vineeta Rai as chairperson of the interim PFRDA; Anand Bordia and P.N. Venkatachalam appointed full-time members (May).
- General elections; Change of Government at the Centre (May).
- ADB commissioned a technical assistance project on pension reforms for the unorganised sector to University of New South Wales and IIEF (May).

- Union Budget 2004-05 announcement specified an EET treatment for pensions under the NPS; Announcement made of Government's intent to put in place suitable legislation to provide a regulatory framework for NPS (June).
- IIEF produced a draft policy document on pension fund managers (July).
- Government dismantled the interim PFRDA Board (July).
- P. Chidambaram, union finance minister convenes a meeting with industry associations and independent experts on regulation of the NPS (August).
- Government of Andhra Pradesh issued a Notification bringing its new employees under a new DC pension scheme from 01 September 2004 (September).
- 5th IIEF pension policy conference for state finance secretaries (October).
- Chhatisgarh issued a Notification bringing its new employees under a new DC pension scheme from 01 November 2004 (October).
- The Union Cabinet approved a proposal to promulgate an Ordinence to establish the PFRDA as a statutory regulatory body (November).
- Field work for the IRES database completed (November).
- Government of Jharkhand issued a Notification bringing its new employees under a new DC pension scheme from 01 December 2004 (December).
- Government of Manipur issued a Notification bringing its new employees under a new DC pension scheme from 01 January 2005 (December)
- The PFRDA Ordinence was promulgated (December).

2005

- The Union Cabinet decided to introduce the PFRDA Bill, 2005 in the Budget Session 2005-06 (January).
- The Government of Assam issued a Notification bringing its new employees under a new DC pension scheme from 01 February 2005 (January).
- The Government of Gujarat issued a Notification bringing its new employees under a new DC pension scheme from 01 April 2005 (March).
- The Government tabled the PFRDA Bill, 2005 during the Budget session of the Parliament (March).
- Government of Uttar Pradesh issued a Notification bringing its new employees under a new DC pension scheme from 01 April 2005; GoUP also provided a voluntary option to existing employees with less than 10 years service to switch to this new DC pension scheme (March).
- The Parliament referred the PFRDA Bill, 2005 to the Standing Committee on Finance (March).
- Government of Madhya Pradesh issued a Notification bringing its new employees under a new DC pension scheme from 01 January 2005 (April).
- The Government appointed D. Swarup as chairman of PFRDA for a period of 5 years (April).
- DEA released the Indian Retirement and Earnings Survey (2004) database into the public domain (April).
- The final report of the ADB TA on pension reforms for the unorganised sector was submitted to DEA (July 2005).

- The Report of the Standing Committee on Finance on the PFRDA Bill, 2005 was tabled in the Parliament at the start of the Monsoon Session (July).
- Government of Goa issued a Notification bringing its new employees under a new DC pension scheme with effect from 01 January 2004 (August).
- PFRDA posted draft Regulations on the web for public comments (September).
- Seventh IIEF pension policy conference for stakeholder and state finance secretaries jointly hosted with DEA, PFRDA and ADB (September).
- IIEF circulated a draft policy document on Points of Presence (POPs) for public comments (September).
- Government of Uttaranchal announced its decision to bring its new employees under a new DC pension scheme (September).
- Government of Orissa announced its decision to bring its new employees under a new DC pension scheme (September).
- Government of Maharashtra announces its decision to bring its new employees under a new DC pension scheme (October).
- A. Viswanathan appointed Central Provident Fund Commissioner at EPFO (December).