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The political economy of pension reforms in India

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SUMMARY

India's far-reaching civil service pension reforms in 2008 provided its fragmented and diffuse pension system a unifying organizing framework. The design and architecture of the reformed civil service program, the National Pension System, was subsequently extended to those employed in private formal and informal sectors. The article assesses India's pension reforms and identifies challenges for the National Pension System in providing old-age income security. The article also presents estimates for universal social pension scheme and argues that its implementation is constrained by political factors and not necessarily by fiscal constraints.

Keywords: pension reforms; National Pension System (NPS); civil service pension reforms; India

Introduction

As many countries in developing Asia, including India are expected to age at relatively low incomes, financing retirement expenditure is a significant policy challenge. However, ensuring retirement income adequacy for an increasing number of elderly has received limited attention in policy debates in India. Estimates suggest that in 2050, the two largest population cohorts in India will be women aged 70 years and older followed by men aged 70 years and older (United Nations, 2010). The number of elderly (defined as those 60 years and older) will more than triple between 2010 and 2050, from 93 million to 296 million; while as a share of the population, it will increase from 7.7 per cent in 2010 to

18.3 per cent in 2050. The number of elderly (and near elderly) for whom retirement income security will become economically, and politically significant will increase sharply.

Moreover, other factors such as urbanization, migratory and informal labor markets, lack of social safety nets, and reduced economic growth and fiscal space to finance social expenditure in the aftermath of the economic crisis also portend many challenges for India's elderly. Although India's labor force is predominantly informal, current pension arrangements cover only those employed in formal private and public sectors. Thus, the elderly have been forced to rely on voluntary savings and traditional familial structures and institutions to finance their retirement expenditure.

India's civil service pension program is perhaps one of the most generous programs available to civil servants across low-middle economies. The non-contributory program offers benefits that are indexed to current wages and provides protection against inflationary, longevity, and survivors' risks. Not surprisingly, the fiscal cost of the program exceeded 2 per cent of gross domestic product (GDP) in 2012–2013. Primarily driven by fiscal pressures, the government initiated far-reaching civil service pension reforms in 2008, moving all new civil service personnel recruited after January 2004 to a defined contribution (DC) program called the National Pension System (NPS), supervised by an independent regulatory authority. The design of the NPS included portability of benefits, centralized recordkeeping, investment exposure in varied asset classes, and innovations in the design of the payout phase and was a significant departure from the traditional civil service pension scheme. In 2009, the government extended the NPS architecture on a voluntary basis to those employed in the private (formal and informal) sectors.

The focus of this article is to assess India's pension reforms, focusing on the architecture that undergirds the NPS. This article will argue that as most governments implement reforms to integrate generous civil service pension programs with the national pension arrangements, India's far-reaching civil service pension reforms have come to be a focal point to anchor fragmented pension arrangements for the rest of the society, including those in the informal sector. Efforts to expand coverage are encumbered by a predominant informal labor force and resistance from the erstwhile monopoly provider and regulator of pension products to the private sector, the Employees Provident

Fund Organization (EPFO). The efficacy of India's pension reforms lie in its ability to overcome EPFO and extend the NPS design to formal private sector, to maintain high density of contributions of its co-contributory scheme for the informal sector, and to expand the role of social pensions. The article concludes by projecting the fiscal cost of a universal social pension, and argues that its implementation is constrained by political factors rather than fiscal or institutional constraints.

The rest of the article is organized as follows. The next section reviews the various components of India's pension system. Assessing India's Pension Reforms Section assesses recent pension reforms, followed by challenges faced by NPS in the Existing Challenges Section. The last section concludes the article.

AN OVERVIEW OF INDIA'S PENSION SYSTEM

India's pension system has evolved over time without an overarching universal program and with limited regulation, governance, and coordination (Asher, 2009). There are three major components of the pension system, namely, the mandatory EPFO, which covers those employed in the formal private sector firms with more than 20 employees; the *Civil Service Pension Scheme*, which covers central and state government employees; and lastly, diffuse arrangements by central and state governments to cover the *Elderly Poor and Informal Sector Workers*.[1] Each of these components is in turn discussed below.

Employees Provident Fund Organization

The EPFO is an unusual national provident fund as it administers two separate schemes, combines the roles of service provider with regulatory functions in one organization, and finally because it constitutes one of the largest non-bank financial institutions in India. The two schemes are the following: (i) a DC scheme, Employees' Provident Fund, and (ii) a defined benefit (DB) scheme, the Employees' Pension Scheme (EPS). The contribution for the EPS is 9.49 per cent of the covered wage and is shared by the employer (8.38%) and the government (1.16%). The benefits are based according to a formula that takes into account average salary of the last 12 months and the length of service. As

both the contributions and the benefits are defined, adjusting long-term assets and liabilities of EPS is a challenging task. The combined contribution rate for all EPFO schemes is 25.7 per cent of members' wages (EPFO, 2012), which is considered to be relatively high.

In March 2012, after being in operation for 60 years, the EPF scheme covered 691 000 establishments and had 85.5 million members, of whom about half are considered to be active members, those contributing regularly during any given year (EPFO, 2012). The active members would hence constitute about one-twelfth of the labor force. The annual contributions to EPFO schemes in 2011–2012 were INR 700bn, equivalent to only 0.79 per cent of GDP (EPFO, 2012).

The EPFO combines the role of provident and pension fund administrator with that of a regulator of funds that are exempted from the EPFO Act.[2] Those corporations seeking exemption from the EPFO are usually large with above average wage rates. There is a conflict of interest in EPFO as a service provider granting exemptions as the exempted funds could provide competition with regard to the EPFO in investment allocation and management, and in quality of services provided to members.

The EPFO, for example, requires that the exempted funds allocate balances in exactly the same manner as the EPFO and that they provide at least the same rate of return to members as the EPF. Such requirements work against innovations in asset allocation strategies, which could benefit the members. The EPFO is among the largest non-banking financial institutions in India with assets of over INR 5461bn in 2011, equivalent to 6.1 per cent of India's GDP (INR 88 558bn) (EPFO, 2012).[3] While its absolute size is large, given that it has been in existence since 1952 and considering its high contribution rates, EPFO's pension assets as share of GDP are relatively small.

The nominal interest rate on EPFO balances averaged 10.49 per cent per annum during the 1990–2011 period. The real rate of return per annum during the aforementioned period was, however, 3.51 per cent, implying doubling of real balances every 20 years. EPFO's assets are primarily in public sector debt instruments. A provident fund that invests nearly all of its assets in gilts (government bonds or treasury bills that pay a fixed rate of interest and are considered low risk) and does not take advantage of trading opportunities will forego prospects to benefit its members by more professional

portfolio management. This may lead to a reduction in national savings to the extent that such a practice may weaken the government's fiscal discipline because of the availability of cheap funds. This defeats one additional objective of mandatory saving schemes, which is to facilitate the placement of these savings into productive investments that, in turn, can drive up the trend rate of economic growth, which further strengthens retirement income security (Barr and Diamond, 2008).

As the coverage of the EPFO was very low and covered only the formal sector, in 1998, the Ministry of Welfare of the central government initiated the Old Age Social and Income Security (Project OASIS) to study options to expand coverage to those in the informal sector (Dave, 2006). Project OASIS recommended portable individual DC accounts, centralized recordkeeping, and a new independent regulator to ensure prudential oversight (Bordia and Bhardwaj, 2003). The EPFO lobbied the Ministry of Finance that it should implement the proposed DC scheme to cover the informal sector. In the final negotiations at the Ministry of Finance, the OASIS recommendations were not implemented, and individuals were encouraged to purchase DC pension plans from private firms (Dave, 2006).

Civil service pension schemes

Since India's independence in 1947, pension arrangements for civil servants (at all levels of government) have followed the DB method, with no contributions required from the employee (civil servants). The pension benefit is about half of the basic pay, payable on retirement upon reaching 60 years of age, and is indexed annually to prices.[4] Every 10 years, when the Pay Commission, a statutory body, reviews remuneration of civil servants, the pension benefits are adjusted. If a pensioner dies, survivors receive reduced benefits until death of the spouse.

The pension expenditure of the central government increased from INR 101bn (0.5% of GDP) in 1999–2000 to INR 632bn (0.6% of GDP) in 2012–2013, and the corresponding increase in the pension expenditure by all states combined increased from INR 251bn (1.2% of GDP in 1999–2000) to INR 1464bn (1.5% of GDP in 2012–2013).[5] Thus, the combined civil service pension expenditure in 2012–2012 was 2.1 per cent of GDP for an estimated 17.5 million civil servants employed across

central, state, quasi-government, and local bodies. While there is no data available on the number of retired civil service personnel, it is estimated that the total pool does not exceed 5 per cent of the labor force. Financing such large expenditures is particularly challenging for state governments with lower fiscal capacities.

In addition to pension benefits, civil servants receive gratuity payments[6], and they contribute to a provident fund, whose accumulated balances they can withdraw in a lump sum at retirement. Neither gratuity nor provident fund contributions are accumulated in separate funds designed to meet future liabilities. Instead, they are paid from current revenues, encouraging a soft budget constraint and inadequate recognition of the lifetime cost to the taxpayers of hiring additional civil servants. These arrangements imply that those government entities with limited fiscal capacities will find it particularly challenging to meet their pension and other liabilities. Because they must meet these liabilities as they are statutory, without reforming the current arrangements, there will be opportunity costs in terms of government expenditure foregone on priorities such as infrastructure, education, and health sectors.

At the same time while the recommendations of Project OASIS were being deliberated, in response to these rising fiscal costs, the Ministry of Finance in 1999 instituted a High-level Expert Group to study the pension liability of the Government in India. Although the OASIS recommendations were dismissed, similar recommendations emerged for reforming civil service pensions were announced in 2003. In 2004, an interim regulator, the Pension Fund Regulatory Development Authority (PFRDA) was established; however, it failed to receive legislative support in parliament till 2013 because of sharp political opposition from members of the then coalition government.[7]

On 1 April 2008, the Government of India formally introduced the New (subsequently changed to National) Pension Scheme (NPS), which is a DC scheme as compared with the previous DB scheme, for civil servants joining service from 1 January 2004. The trade-off is that the phasing out of the previous DB scheme will occur over several decades as civil servants that joined prior to 2004 retired.

The expectation, which has since been realized, was that once the Union government introduces the NPS, the state governments would also adopt the scheme. As states have differing fiscal capacities and were under pressure to finance current pension expenditure, they vociferously embraced the NPS. As of August 2013, 26 out of 28 states have notified their version of the NPS for their civil servants, but only 23 of them have been made operational.

The total contribution rate for mandatory NPS is 20 per cent of monthly earnings, split equally between the employee and the government (as employer).[8] The design of the NPS differed considerably to existing pension programs on many dimensions: the NPS was co-contributory (by both employers and employees), it allowed portability of benefits, permitting power of compound interest through long-term accumulation of funds, and offered a combination of lump sum and periodic income (through mandatory purchase of annuities for at least 40% of the accumulated balances) in retirement (Kim *et al*., 2012).

Although there was opposition from political parties to the NPS as discussed earlier, there was remarkably little opposition from newly recruited civil servants being placed on the NPS. As of August 2013, there were 1.2 million Union government and 1.8 million State Government employees in the NPS for a total of 3.0 million mandatory members, constituting little more than one-eighth of the total government employees. The current accumulation of balances in the mandatory scheme is rather low, only about 0.3 per cent of GDP (Government of India, 2013b). However, as the number of contributors and their density of contributions (number of monthly contributions divided by the total lifetime covered months) increase, these assets will increase rapidly.

The NPS offers a range of investment choices through indexed funds varying with risk–return preferences, including a default life cycle plan, which adjusts exposure in asset classes with age. While the pension is still payable at age 60 years, the NPS differs from the earlier scheme in its payout phase arrangements and restricting pre-retirement withdrawals. At least 40 per cent of the accumulated balances must be used to purchase an annuity, while the rest can be withdrawn as a lump sum.[9] The NPS scheme therefore requires a robust annuity market, with appropriate financial products (such as long-term bonds) to match assets and liabilities in a prudential manner.

Arrangements for elderly poor and informal sector workers

Given that the formal sector schemes at best covers about a quarter of the work force, and perhaps a fifth of the elderly, an important avenue for broadening social protection coverage in India is through social pensions, benefits that are non-contributory and financed from the budget. Currently, the Indira Gandhi National Old Age Pension Scheme (IGNOAPS) is a means-tested scheme available to individuals older than 60 years of age and is financed by the central and state governments. The central government pays INR 200 per month for individuals older than 60 years and younger than 80 years and INR 500 per month for those older than 80 years. State governments' top–up ranges between INR 200 and 1000 per month and varies with the fiscal and administrative capacities. The National Social Assistance Program indicates that in 2012, 16.8 million individuals or approximately 16 per cent of individuals older than age 60 years received the IGNOAPS.[10]

The IGNOAPS provides a very low benefit level and is less than 5 per cent of per capita income. For a universal social pension targeted to those older than age 60 years, which provided a benefit level of 25 per cent of per capita income, the fiscal cost is estimated to be less than 2 per cent of GDP and about 12 per cent of average tax revenue. This is discussed in the Existing Challenges Section in greater detail. If coverage were to be expanded through a universal social pension, more fiscal funds would have to be mobilized. The administrative capacities to effectively implement a universal social pension in India would also need to evolve, suggesting that timing and expansion of the program must be calibrated with such capacities and with fiscal affordability.[11]

As discussed earlier, the OASIS recommendations to increase coverage for the informal sector workers were not implemented. However, in 2009, the NPS design and architecture with suitable modifications was made available to all Indian citizens on a voluntary basis, whether in the formal or informal sector. Because the formal private sector is under the ambit of the EPFO scheme, the voluntary NPS is largely targeted to the informal sector workers.[12] To encourage participation in the voluntary NPS, the government launched the *Swavalamban* scheme, with co-contributions by government for low-income individuals. As of end August 2013, Swavalamban had 2 million

members (about two-fifths of the total NPS membership) but a total balance of only INR 6.5bn, less than 2 per cent of total balances in NPS.

The efficacy of social assistance and pensions as well as co-contribution schemes depends on the fiscal capacity of the central government and the states and the efficiency with which individual state governments can deliver pension benefits. Thus, fiscal and public sector governance reforms are intricately linked with the broader use of such pension programs.

ASSESSING INDIA'S PENSION REFORMS

There are at least three nested levels at which pension reforms can be assessed. The first is at the system level and relates to the extent to which pension reforms contribute to overall *policy coherence* and *coordination* with other instruments in the social protection system. Policy coherence refers to mutually reinforcing and compatible policy actions by various agencies across different levels of governments,[13] and coordination refers to the overall clarity in objectives, goals, and instruments used. In this context, India's pension system is also discussed vis-à-vis the World Bank five-pillar framework, a common underlying theme in this symposium.

The second level relates to the extent to which the *functional goals* of any pension system are being met, that is, to smooth lifetime consumption, mitigate old-age poverty, and provide coverage against longevity, inflationary, and survivors' risks (Barr and Diamond, 2008). Lastly, at an *administrative* and *operational level*, the extent to which reforms lower administrative costs and improve efficiency in performing the core functions of any provident or pension fund can be assessed. The core functions of a pension or provident fund are the following: (i) reliable collection of contributions; (ii) payment of benefits; (iii) financial management and productive investment of provident and pension fund assets; (iv) recordkeeping mechanisms to support collection, payment, and financial activities; and (v) preparing of financial statements that can be audited (Ross, 2011). This section assesses India's pension reforms at three levels discussed here.

Policy coherence and coordination

Consistent with India's federal structure, its pension system has evolved gradually with individual programs being added in an *ad hoc* manner by both central and state governments (Asher, 2009). The pension system has lacked a universal program or national arrangement that undergirds the system. There has been limited regulatory or prudential oversight on various components of the pension system. This has resulted in limited coverage both in terms of the number of individuals and the level and range of risks covered. Presently, programs are administered by both central and state governments and by competing government agencies including the Ministry of Finance, Ministry of Labour, and Ministry of Rural Development.

In 2005, the World Bank published a multi-pillar (5) framework for pension systems and reform (Holzmann and Hinz, 2005). The objective of this framework was to provide a holistic approach to old-age income security. It essentially built on their three-pillar framework, which had largely ignored the needs of those employed in the informal sector and those with low lifetime earnings. The five pillars refer to the following: (i) 'zero pillar', a social pension financed from budgetary sources; (ii) 'first pillar', a mandatory contribution-based DB scheme; (iii) 'second pillar', a mandatory DC plan with individual accounts; (iv) 'third pillar', a voluntary contribution plan; and (v) 'fourth pillar', comprising of informal support systems. The multi-pillar framework envisions a complementary role for each of the pillars in providing economic security for the elderly.

A limitation of this framework is that even after adhering to it in designing a system, it does not say much about the efficacy or adequacy of these arrangements.[14] This resonates with the Indian reform experience. Prior to the NPS reforms, those working in the formal private sector had access to the mandatory EPFO (first pillar), whereas larger organizations had their own pension plans that were exempt from the EPFO. Those employed in the military, government, and public sector enterprises had access to *non-contributory* DB schemes. While in principle, members could also contribute to optional DC-based pension products such as the Public Provident Fund (third pillar), these products play a very small role in India's pension system.

Schemes for the informal sector such as voluntary community-based micro-insurance schemes also played a limited role (Shankar and Asher, 2011). Although there has always been a skeletal framework of some form of social assistance, through means-tested non-contributory social pensions, the benefit levels are meager. Moreover, as these are state schemes, there is considerable variation in the monetary value of the pension benefit.

Effectively, India has relied on the first and fourth pillar in its pension system. Poor management of the public monopoly pension provider, the EPFO, has reduced efficacy of arrangements for the formal private sector, and the poor design of plans for public sector personnel resulted in ballooning statutory government expenditure: the government's pension bill was nearly three times its spending on healthcare services in 2012. India has traditionally relied on informal social support through large joint families, undergirded by filial piety, for old-age income security. However, with increasing urbanization, migration and declining fertility rates, the efficacy of these informal institutions is declining. Moreover, although informal mechanisms can supplement formal arrangements, they are not a substitute, as they were perceived in India.[15]

The evolution of India's pension system mirrors reform experiences in many developing countries. Historically, similar to most social protection programs, pension coverage has increased at the margin, covering the most ‘effectively organized’ groups of people, at each iteration of the reform process. The most cohesive groups are the first to galvanize political attention and have their interests advanced. For example, elected public officials, bureaucrats, civil service personnel, employees of public sector organizations, teachers, railroad workers, and so on have historically been part of national pension arrangements in the initial years in most countries. However, the vast majority of India's population is employed in the informal sector, where extending pension coverage is challenging.

While civil service pension programs are relatively more generous than similar occupational programs for those in the private sector across developing economies, there have been recent efforts to integrate the civil service pension program with the national pension arrangements (Asher and Bali, 2011; Takayama, 2011).[16] However, in India, absent of any unifying national pension arrangement, the NPS

architecture provides a much-needed platform to anchor its diffused and fragmented pension system. This is important as the NPS integrates civil service schemes for central and state government employees as well as those employed in the private formal and informal sectors. As participation in the NPS is voluntary for those employed in the private sector, the efficacy of the voluntary component in increasing retirement income security will depend on the number of individuals the NPS can enroll from the private sector and the density of their contributions. Although the NPS has tried to incentivize informal sector coverage through co-contribution schemes, it does not address concerns of the poor. This is discussed in the Existing Challenges Section.

An important governance issue that needs to be addressed for greater coordination is the regulatory structure of India's pension system. The interim PFRDA has been made a statutory body in 2013 with the passing of the PFRDA Act in parliament with the mandate to provide systemic regulation and oversight of all components of the pension system (Asher, 2013). However, the EPFO is currently exempt from the ambit of the PFRDA. EPFO members should be given the option to participate in NPS. This would improve contestability of the EPFO and provide competition to the underperforming monopoly provider of pension products to the formal sector.[17]

Functional goals: equity, adequacy, and sustainability

Equity

The fiscal cost to state and central governments for financing the pension expenditure of their retired personnel exceeded 2.1 per cent of GDP in 2012–2013. To put this spending in context relative to other economies, the average civil service pension spending in high-income Organisation for Economic Co-operation and Development (OECD) economies and non-OECD economies was 2.0 and 1.2 per cent of GDP in 2006, respectively (Palacios and Whitehouse, 2006). Such high levels of spending were of course not only sustainable for a low middle-income economy such as India but also highly inequitable as civil servants accounted for less than 5 per cent of the labor force. The reforms will move all newly recruited civil servants to a DC scheme, which will therefore reduce the fiscal

cost of the scheme in the long term and ameliorate the disparity between pension benefits for civil service personnel and for those employed in the private sector

However, even under the current pension arrangements, the EPFO organized schemes enjoy favorable tax treatment relative to the NPS. The EPFO operates under an exempt-exempt-exempt structure, whereas the NPS receives an exempt-exempt-tax treatment. This uneven playing field can make the NPS potentially less attractive to buyers of pension products.

Another aspect of equity relates to gender and the differing pension provision for women and men. Indian women have a lower labor force participation rate and do paid work for fewer years than men (Sastry, 2007). This trend is evident in both the formal and informal labor markets. If pension provision is indexed to wages or contributions without a system of risk pooling, it necessarily follows that women would have lower replacement rates than their counterparts. Aggravating this is the higher life expectancy of women, as a group, relative to men. The reforms do not do much to address the old-age economic security of women.

Adequacy

Adequacy of pension arrangements can be viewed by the number of individuals covered and by the range of risks that they are insured against. The traditional pension arrangements for civil servants insured its members against longevity, inflation, and survivors' risks. The NPS requires mandatory annuitization of a significant share of the balances at retirement, which helps insure against longevity and mitigates some survivor risks. However, India's annuity market is relatively underdeveloped (Bloom *et al*., 2010; Asher and Vasudevan, 2011). Till the late 1990s, India's insurance market was dominated by government monopolies, which played a very conservative role in deepening India's capital and financial markets.

The adequacy of the civil service pensions is in sharp contrast to those employed in the private sector. The EPFO, despite being in existence for nearly 60 years, covers less than 10 per cent of the population and less than one-sixth of its total labor force (EPFO, 2012). Although no official or other projections are available, it is a reasonable assumption to make that even when benefits from both

EPF and EPS are combined, the expected replacement rates (ratio of pre-retirement to post-retirement income) for most of the members will be substantially lower than the 66–75 per cent recommended by the experts. For example, the average balance per member as at end March 2012 in the EPF scheme was INR 42 000 (only about three-fifths of per capita income).[18]

A welcome initiative is the co-contribution, Swavalamban scheme to encourage voluntary participation in the NPS by those employed in the informal sector. Although the number of those who have enrolled in this show considerable promise, ensuring high density of contributions is a major challenge. As majority of the India's labor force is employed in the informal sector,[19] both the voluntary NPS and the targeted co-contributory scheme for the informal poor will help increase pension coverage.

Sustainability

There are two issues with regard to sustainability in pension programs. The first relates to financial sustainability or the long-term matching of assets and liabilities. The second relates to economic sustainability or the capacity of the economy to finance projected liabilities without sacrificing economic growth or other priorities. In this context, the most important macroeconomic variable, which undergirds economic sustainability of pension programs, is the long-term trend in economic growth (Barr and Diamond, 2008).

Sustainability in any DC-based pension system is intricately linked with adequacy of pension benefits. This is because in a DC system—in which contribution obligations are defined but the benefits depend on the accrued balances of contributions, interest income earned, extent of pre-retirement withdrawals, and outcomes of conversion of accumulated balances into a retirement income stream—individual members bear the investment and macroeconomic risks, such as unemployment, relatively stagnant wages, or higher-than-anticipated inflation.

Under the traditional civil service pension program, pension benefits were paid out of current government revenue and represented large unfunded contingent liabilities. Budgetary accounting practices that do not recognize accrued liabilities and make provisions to finance them essentially

encourage a soft budget constraint and fiscal profligacy. It is also important to distinguish that prepayment does not necessarily imply that a pension system is *funded*. The extent to which increased mandatory savings by provident and pension funds crowd out or are the expense of voluntary savings, and results in lower national savings, it could undermine the economic sustainability of the pension system. A DC pension system can be understood to be funded when the contributions accumulated increase national savings and investment rates and foster higher economic growth (Barr and Diamond, 2008, 2009).

The EPS run by the EPFO sustained large actuarial deficit in the EPS over the past decade. The latest report of the Expert Committee on the Employees' Pension Scheme suggests that the actuarial deficit in 2006 was INR 226bn, and this will increase substantially, if the current contribution rates and investment returns are maintained, while benefits are increased as a result of inflation indexing (Government of India, 2010). Similarly, the EPF announces its annual dividend (the administered interest rate it will credit on member provident fund balances) ahead of the close of the fiscal year. Both these practices are deleterious to the sustainability of the pension arrangements.

Administrative and operational level

Central to the NPS architecture is the extensive use of information technology and centralized recordkeeping, which has enabled portability of pension benefits. This is a significant achievement as under the EPFO framework individuals maintained multiple accounts resulting from changes in their employment, thereby increasing transaction costs. Moreover, centralized recordkeeping allows harnessing both economies of scale and scope and may further reduce administrative costs.

As fund managers of NPS are no longer constrained by regulation to maintain similar investment portfolios and can vary asset class exposure across funds, this allows fund managers to compete for customers and may result in lower fund management costs (Asher, 2013).

EXISTING CHALLENGES

As discussed earlier, the fiscal challenges of the civil service pension scheme and lack of arrangements for the informal sector were primary drivers that precipitated the NPS reforms in 2004. As newly recruited civil servants are placed on the NPS, over time, the current liabilities of the erstwhile-unfunded DB scheme will reduce. The voluntary co-contribution scheme, with portability of benefits, has improved informal sector coverage. The adequacy of these arrangements however will depend on the density of contributions into the NPS by its members. The two main challenges the NPS face, from a systemic perspective of safeguarding old-age income security in India and to achieve universal coverage, relates to expanding coverage to those employed in the formal private sector, as well as provide income security for the informal poor, through social pensions.

As NPS aggressively explores avenues to expand coverage to the formal private sector, it is encumbered by the EPFO, whose membership is compulsory. The EPFO is a large self-perpetuating organization with over 20 000 employees administering a highly inefficient and ineffective pension scheme. It has an unwieldy governing board of 45 members with limited access to expertise in pension economics or finance. Its financial decisions are heavily politicized and have resulted in large actuarial deficits in the EPS (Government of India, 2010). These deficits can be overcome only by increasing the contribution rate or by reducing benefits or by improving investment performance or a combination of all. The former are not politically feasible, and the latter is not economically possible given its investment portfolio is in entirely in fixed-income securities. If members are given an option to choose between the EPFO and the voluntary component of the NPS, it reduces the monopoly power of the EPFO and will could benefit its members.

Extending social security coverage to the informal sector is challenging even in advanced economies (Holzmann *et al*., 2009). Although the co-contributory voluntary NPS has been well received, the total assets accumulated so far are relatively low. While the share of those employed in the informal sector accounted for 40 per cent of NPS members, their share in total balances was less than 2 per cent. Therefore, the need for targeted non-contributory transfers or social pensions merits consideration to help mitigate old-age income poverty (Pal and Palacios, 2011; Asher, 2012;

Barrientos, 2012). The current benefit levels of social pensions are too low for them to meaningfully mitigate old-age income poverty. However, governments across developing countries remain skeptical of implementing social pension schemes as they are thought to be prohibitively expensive.

What would the fiscal cost of a universal social pension be? Table 1 presents estimated fiscal costs of a hypothetical universal social pension scheme under the following assumptions. First, the scheme is not means tested and is universal to all Indian nationals older than age 60, 65, or 80 years. Second, the GDP is projected to grow in *real* terms at 6 per cent per annum. Third, the benefit level for variant A is 15 per cent per capita income, and 25 per cent per capita income in variant B.[20] Fourth, the projections do not include any administrative or transaction costs. Fifth, the estimates do not take into account differences between rural and urban income levels, and demographic data uses the medium variant of the United Nations Population Forecast.

The direct fiscal costs vary according to the benefit level and the number of beneficiaries. A targeted or means-tested scheme would be cheaper as the number of beneficiaries would be smaller; however, it may have higher administrative costs. Another option is to make the social pension taxable at certain income levels to gain a *claw back*. The purpose of this estimation is to meaningfully engage with the debate on extending social protection to the informal poor and to suggest that it is not prohibitively expensive.

The political economy of social policy reform holds valuable implications. Ramesh (2000), building on regime survival theories, has argued that governments increase social spending when they perceive threats to their regimes in a contestable society. This resonates with the social policy reform experiences in India. Over the past decade at key electoral junctures, India has committed (through Acts of Parliament) to pay for generous rural workfare and food security programs in excess of the conservative estimates in Table 1 (Bhalla, 2013; Jha and Gaiha, 2013).[21] This suggests that the issue is more political than constrained by fiscal capacities. The elderly poor are not a cohesive group that are able to galvanize political support to advance their interests. The government is more focused on palpable electoral problems such as health, food security, and education.

Any major national pension reform is a complex and challenging endeavor. It is important to underscore that buy-in for the NPS was secured from state governments as it reduced their future fiscal costs and from unions immediately as it was only applicable to future employees. The only political opposition to it stemmed from left-of-center members of the incumbent coalition government, which did not agree with unfettered exposure to equity funds and doing away with the government guarantee. The efficacy of India's pension reforms lies in the extent to which it can overcome the EPFO and attract private formal sector employees and galvanize political support to finance the social pension scheme.

CONCLUSION

As India prepares to finance the retirement expenditure of its elderly (100 million in 2010 and projected to increase to 300 million in 2050), it will need a robust and modern pension system, which integrates programs for both public and private sector workers and the informal sectors. The NPS is a step in the right direction: Its design incorporates the best practices in pension economics and finance. Efforts to expand coverage are largely encumbered by the EPFO and low accumulation of funds in the targeted government co-contributory NPS schemes for the informal poor. To this extent, there is merit in considering a social pension to be introduced as part of the NPS architecture. Progress on this front maybe stymied for political rather than fiscal reasons. Avenues to generate fiscal space to finance these social pensions also need to be part of the public policy debate on pension reforms in India.

1. Other programs such as microfinance and community-based insurance cover a negligible share of the population. Shankar and Asher (2011) and Sadhak (2013) discuss these individual programs at length.
2. The Employees Provident Fund Organization (EPFO) Act permits an organization to seek exemption from the EPF scheme of the EPFO, provided it follows the regulation set by the EPFO, including at least the same level of dividend declared by the EPFO.
3. As at August 2013, $1 = 60 INR.
4. Employees that leave the government service before reaching the institutional retirement age are eligible to receive a reduced pension benefit, which varies with the number of years in service.
5. Estimated from RBI (2012): Table 1, 112; and Government of India (2013a)
6. Gratuity is a benefit paid out to civil servants and employees of public sector organizations at retirement or on completing a minimum number of years of service. It is governed by the Payment of Gratuity Act, 1972. As of October 2013, the maximum gratuity payable was INR 1m.

7. The political opposition was from left of center parties, which did not agree with investing pension funds in equity markets, and moving away from a government guaranteed return on member balances (Dave, 2006; Asher, 2009; Government of India, 2011).
8. The scheme was extended on a voluntary basis to all Indian nationals in 2009. This is discussed further in the succeeding texts.
9. The lump sum withdrawal may be deferred by 10 years, and the annuity purchase by 3 years.
10. The program's website is http://nsap.nic.in/.
11. The aforementioned text are static costs; once demographic, behavioral, and political economy considerations are taken into account, the costs are likely to rise.
12. Formal private sector workers constituted less than 5 percent of total National Pension System membership.
13. See OECD Policy Initiative for Development – http://www.oecd.org/pcd/publicationseriesthedevelopmentdimension.htm (Accessed, April 5, 2014)
14. Moreover, the framework does not consider other age-related expenditure such as healthcare, which can erode the real value of pension income and undermine old-age income security. This is particularly important in many developing countries where healthcare expenditure is financed, privately without risk pooling, largely through out of pocket spending.
15. This is important as social security not only represents a social contract between the state and its citizens but also has many macroeconomic impacts.
16. In other advanced economies, civil service programs are being reformed to lower the fiscal cost to the exchequer. See IPSPC (2011) for a discussion of the Hutton Commission's recommendations to reform civil service pension arrangements in the UK.
17. The Employees Provident Fund Organization, through its parent organization, the Ministry of Labour, had lobbied the Ministry of Finance to be the agency implementing both the recommendations of project Old Age Social and Income Security and the National Pension System . However, this proposal was dismissed as the architects of the National Pension System argued that the Employees Provident Fund Organization did not have the requisite capacity to deliver such punctuating reform (Dave, 2006).
18. As the membership number of 85.5 million reported appears overstated because of multiple accounts and inactive members, the average balance would be higher (EPFO, 2012). It will however still be quite inadequate to contribute significantly to retirement income.
19. The statistical tables in Government of India (2013c) provide a break up of India's labor force by occupation.
20. As the benefit level is indexed to share of per capita gross domestic product, it aims to mitigate relative and not absolute poverty.
21. The oldest political party in India, the Indian National Congress, has been in power in most 49 out of 67 years of India's independence. It last lost the central elections in 1996, to return to power in 2004. It consequently won the 2009 central elections.

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Table 1. Estimated fiscal costs of a hypothetical universal social pension

	Variant A (15%) (years)			Variant B (25%) (years)		
	>60	**>65**	**>80**	**>60**	**>65**	**>80**
2015	1.38	0.86	0.13	2.31	1.44	0.21
2020	1.65	1.05	0.25	2.74	1.75	0.26
2025	1.93	1.26	0.18	3.22	2.1	0.3
2030	2.24	1.48	0.21	3.73	2.47	0.34