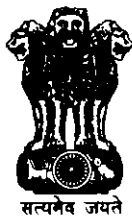


First Report of the Expert Committee for Devising a Pension System for India

February 1999



**Ministry of Social Justice and Empowerment
Government of India**



towards a society for all ages
International Year of Older Persons 1999

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Introduction

The least noticed of the destitute in India are the elderly. Millions of elderly in India are trapped in misery through a combination of low income and poor health.

The traditional support structure of the family, is increasingly unable to cope with the problem. In a world where the joint family is breaking down, and children are unable to take care of their parents, millions of elderly face destitution. The emerging demographic profile and socio-economic scenario of the country indicate that matters will worsen dramatically in the years to come.

While there is a need to initiate poverty alleviation programs designed to support the elderly, the gigantic dimensions of the problem, defy an easy solution. The steady elongation of life expectancy and declining birth rates are inexorably taking us towards an India where there will be such a large number of aged persons, that a poverty alleviation programme, which aims to pay even a modest subsidy would require a staggering expenditure much beyond the capacity of the government.

In this situation, the Government realises that poverty alleviation programmes directed at the aged alone cannot provide a complete solution to the problem. Faced with such large numbers, it is apparent that the problem will have to be addressed through thrift and self-help, where people prepare for old age by savings accumulating through their decades in the labour force. The role that the Government can play in this enterprise is to create an institutional infrastructure to enable and encourage each citizen to undertake this task.

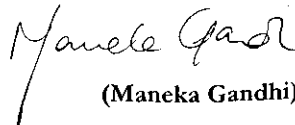
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Project OASIS, the first comprehensive examination of policy questions connected with old age income security, took birth in this background. The basic mandate of the Project is to make concrete recommendations for actions which the Government of India can take today, so that every young person can genuinely build up a stock of wealth through his or her working life, which would serve as a shield against poverty in old age.

It is interesting to note that India already has a high contribution rate to the provident fund system from amongst salaried employees in large establishments. The challenge therefore is not so much to ask workers to save more but to convert high saving rates into old age security. To this end, the Report of Phase-I of the Project recommends: (a) limit early withdrawals, (b) deploy superior financial portfolio management and information systems, so as to obtain higher rates of return, (c) expand the coverage of existing provident fund systems so as to reach more workers, and, (d) improve the customer service of the existing provident fund systems.

The topicality of the Project OASIS is enhanced by the fact that 1999 is being observed as the International Year of Older Persons. The Chairperson of the Committee, Dr. Surendra A. Dave, former Chairman of Unit Trust of India, and the members of the Committee have done well to have produced the Report of the first phase of Project OASIS in a short time-frame. The Project is being ably co-ordinated by the Invest India Economic Foundation.

Project OASIS is a project of national importance and we should all put our minds and energies to the task of rapidly converting the Committee's recommendations into reality.



(Maneka Gandhi)

Minister of State (IC)

Ministry of Social Justice and Empowerment

Government of India

01 February, 1999

Foreword

India is in the phase of a rapid demographic transition. Life expectancy is increasing while birth rates are on the decline. The share of population above the age of 60 is growing at a rapid rate. Those who cross the age of 60 are expected to live till or beyond the age of 75. This has not sufficiently dawned in the minds of our people. They tend to be myopic and are not saving sufficiently for old age, a period of 15 to 17 years beyond the age of retirement.

There is a serious threat that persons who were not below the poverty line, might sink below the poverty line in their old age, since not enough savings have been made by them. On the other hand, they have to incur heavy expenditure on health, neglect of which will only worsen their quality of life. Destitution and ill health could lead to rampant devastation of life of aged people under such circumstances.

India has been among the enlightened nations which recognised the need for social security during old age quite early. The Provident Fund Act was introduced way back in 1925 for select public enterprises. We have the Employees Provident Fund and Miscellaneous Provisions Act (EPFMP) of 1952 which covers 177 industries today. From 1995, workers covered under the EPFMP Act, 1952 are also covered by the Employees Pension Scheme. While these have been laudable steps, and are serving the working class well, their coverage is woefully small, with only 11 percent of the working population in India covered by them. There is also the Public Provident Fund (PPF) scheme for self employed and those not covered by the EPFMP Act. Though good in intention, the PPF has not been well publicised, and as a consequence, its clientele is basically confined to large cities. It is not easily accessible either.

We are grateful to the Ministry of Social Justice and Empowerment, Government of India for initiating Project OASIS, Old Age Social and Income Security, for

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focusing on this vital and emerging area of concern, and to comprehensively examine the existing institutional mechanism and make recommendations for concrete action that the Government should undertake.

I was asked to chair the Project OASIS Expert Committee comprising of the following members: Anand Bordia, Joint Secretary, Ministry of Social Justice and Empowerment; R.S. Kaushik, Central Provident Fund Commissioner, Ministry of Labour; C.S. Rao, Joint Secretary, Ministry of Finance; Ajay Shah, Indira Gandhi Institute of Development Research; A.P. Singh, Deputy Secretary, Ministry of Social Justice and Empowerment; and Nalin Thakor. Gautam Bhardwaj of Invest India Economic Foundation served as the Member-Secretary of the Committee.

The Committee sponsored some research studies by experts on various aspects of a social security system and organised a technical conference to discuss these findings by inviting experts in the profession, senior executives from financial institutions and the government, and practitioners in the industry. The conference was also attended by experts from The World Bank. These research studies will shortly be published in book form.

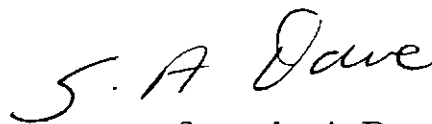
As the work progressed, we realised the enormity of our task of making social security comprehensive as well as adequate. Hence we decided to break the Project into two phases. The first phase will cover existing mechanisms for social security – provident funds, pension schemes and Public Provident Funds. The second phase will cover other issues, including a new voluntary pension system, individual choice of diverse funds and fund managers, Regulatory Authority for the Pension Fund industry and need for a Redistributive Pillar.

We are overwhelmed by the remarkable reception that Project OASIS has received from all quarters. Everyone we met recognises that this is a very important problem and needs to be addressed soon. We have a lot to learn from the kind of reforms that other countries have adopted and from their experiences. We should not turn a blind eye to the experiences of the countries

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that have conspicuously brightened the lives of their old. Our myopic wisdom and failure to see what has happened or what can happen beyond a few years should not prevent us from breaking away from some of our past policies and take new initiatives.

We are immensely grateful to Industrial Development Bank of India (IDBI), ICICI Limited, Unit Trust of India (UTI), and Life Insurance Corporation of India (LIC) for providing financial support for this project. I am also thankful to all Committee members for their efforts and to all those who have actively interacted with the Committee. We trust we have provided a feasible and acceptable blueprint for action in this Phase-1 Report of Project OASIS.



Surendra A. Dave

Chairman

Project OASIS Expert Committee

01 February, 1999

Background

1. Populations, worldwide, are ageing. In India, while the total population is expected to rise by 49% (from 846.2 million in 1991 to 1263.5 million in 2016), the number of aged (persons aged 60 and above) is expected to increase by 107%, from 54.7 million to 113.0 million, in the corresponding 25 year period. In other words, the share of the aged in the total population will rise to 8.9% in 2016 (from 6.4% in 1991). Population estimates further suggest that the number of the aged will rise even more rapidly to 179 million by 2026 – or to 13.3% of the total Indian population of 1331 million.
2. Today, males and females in India at age 60 are expected to live beyond 75 years of age. Thus, on an average, an Indian worker must have adequate resources to support himself for approximately 15 years (and his wife for an even longer duration) after his retirement.
3. Traditionally, governments and societies provide economic security during old age through pension provisions. Sound pension systems form a social safety net for reducing poverty during old age. However, a rise in the number of older persons often causes a corresponding increase in government expenditure on non-contributory pensions and health services – since health and pension spending rise together. Higher government spending on old age security has often been at the cost of expenditure on other important public goods and services and has increasingly been a serious drain on government finances.
4. As per the 1991 Census data, India has an estimated 314 million workers (9.4% employed in the organised sector and the balance 90.6% employed in the unorganised sector). Of the working population, 15.2% (47 million) are regular salaried employees while over 53% (166 million) are self employed and 31% (97 million) are casual/contract workers.

5. Of the salaried employees, approximately 23% (11.1 million) are presently employed by the Central, State and UT Governments and Departments (including post & telegraph, armed forces and railways) and are eligible to a non-contributory, defined benefit pension, funded entirely by the State. Government spending on non-contributory pensions is an enormous strain on revenues and will only increase over time with an ongoing increase in benefits as well as increasing life expectancy of the population (including current and potential pensioners).
6. Approximately 49% (23.18 million) of the salaried (non-Government) workers in the formal sector are covered by Provident Funds. These mandatory, employer centric, defined contribution plans (including EPFO, Coal Miners Fund, Seamen Fund, et al) cover only 177 industries and classes of establishments notified by the Government. In addition, within these specified industries, only establishments employing 20 or more persons need to provide provident fund benefits to employees. Further, employees drawing a monthly salary of 5000 or more have the option to opt out from contributions to PF.
7. Over 28% (13 million) of the salaried employees and approximately 89.2% (280 million) of the workers (including self-employed and farmers) are not covered by any pension scheme that enables them to save for economic security during old age. Though the Public Provident Fund (PPF) was introduced in 1968-69 to provide a facility to self employed persons to save for old age, it today serves only as a medium term savings instrument with liberal withdrawal facilities and tax benefits. Thus, the present formal provisions for old age income security in India cover less than 11% of the estimated working population.
8. However, even for these individuals, incomes generally fall below poverty line during old age despite the high levels of contribution (over 20% – among the highest in the world) prevailing in India. This is primarily due to low real returns and generous withdrawals. For instance, in 1996-97,

- Rs.2047 crore was prematurely withdrawn by 1.20 million provident fund members to fund marriages, illness, housing and purchase of insurance policies. In the same period, a total of Rs. 3306.15 crore was paid out to 1.32 million outgoing provident fund members on account of retirement, death or leaving service – indicating an average lump-sum accumulation of Rs. 25,000 per member.
9. Over the last decade, provident funds in India have earned a return of little over 2.5% over inflation for their members (as against 11% in Chile). On the other hand, the long-run average rate of return on the equity index in India is 18.5%, which has the potential to revolutionise the wealth accumulation over a worker's lifetime. The average wealth that is obtained by investing Rs. 5 per working day into the equity index, from age 25 to age 60, works out to Rs. 36,00,865. Over such a long term horizon, there is a 99% chance that equities outperform bonds.
 10. While we witness an increase in the number of aged, and insufficient accumulations for old age, the traditional, informal methods for income security, such as the joint family system in India, are increasingly unable to cope with the enhanced life span and medical costs during old age. There is growing stress in the family system and there is an immediate need for introduction of formal, contributory pension arrangements which can supplement informal systems. This problem is particularly important in India, which will enter its demographic transition into increasing number of aged persons at lower income levels than those seen in other countries which have since long introduced systems to cope with the problems of an ageing population.
 11. The research studies commissioned by Project OASIS suggest that a pension provision for India, considering the huge diversities in income, savings capacity, literacy and the variety of employment categories will necessitate the formation of a multitude of pillars including the existing, mandatory, defined contribution provision of the Provident Funds, the

voluntarily funded PPF, as well as a new contributory pillar (primarily for those not presently covered by any other formal pension provision).

12. However, most individuals are myopic during their earning lifetimes with regard to saving for their old age and may thus be reluctant to save adequately for their old age income security in a purely voluntary environment. We must educate people that old age is inescapable and that saving for old age could be a painless process if started early in life. It is thus desirable for the prevalent mandatory, contributory pillar – provident funds, which have been performing a singularly significant and sustained role in enabling employees to save for their old age – to increase its coverage, improve returns and reduce its potential dependence on any (non-funded) government subsidies.
13. The research and recommendations under Project OASIS have been segregated into two phases. The Report of Phase-I has concerned itself with rationalising and further improving existing provisions of the Employee Provident Fund (EPF), the Employee Pension Scheme (EPS) and the Public Provident Fund (PPF). The recommendations are aimed at enabling these provisions to more effectively fulfil their objectives of providing life long economic security during old age to their members and better realise their full, intended potential by removing systemic distortions and discriminations. The Phase-I report also recommends the formation of a National Senior Citizen's Fund for encouraging, catalysing and complimenting private sector efforts for betterment of life of senior citizens in the country and for advocacy, research and new initiatives.
14. Phase-II will focus on research and recommendations for:
 - a) Non-contributory Government pensions (Central and State Governments, railways, armed forces as well as post and telegraph).
 - b) Occupational and private pension plans.

- c) A new, fully funded, contributory pension provision for the balance (uncovered) workers including casual/contract workers, self-employed, farmers, etc.
- d) Consolidation and strengthening the existing, publicly funded social welfare schemes like the NSAP.
- (e) A blueprint for establishing cost-efficient and effective institutional infrastructure mechanisms for India's pension provisions with the objective of (a) regulating and monitoring, (b) easy and universal access, administration, service, and delivery, (c) advocacy, and (d) regular evaluation of the system's performance.

Problems and Diagnosis

1. Economic security during old age should necessarily result from sustained preparation through lifelong contributions. The government should encourage fully funded old age income security systems that emphasise the values of thrift and self-help. The government should step in only in case of those who do not have sufficient income to save for old age.
2. The existing provident fund or pension programs accessible to Indian workers do not adequately solve the problem of income security in old age. For an individual retiring at age 60 with the prevailing balances (average Rs. 25,000), the provident fund system can only be a minor aspect of income security in old age.
3. The contribution rates of India's workers are already amongst the highest in the world. There is hardly any scope to transform income in old age by raising the contribution rate.
4. The central factor which should be at work in saving for old age is the steady compounding, at the highest possible rates of return, of contributions through a person's working life. This steady accumulation, without any withdrawal, can generate a stock of wealth at retirement which may be entirely out of line with common intuition. For example, saving Rs. 5 per working day from age 25 onwards leaves the worker with Rs. 6,78,307 (measured in 1999 rupees) at age 60 at a nominal return of 12%. These numbers remind us that low contribution rates are not the essence of the problem. Today, in India, a contribution rate of Rs. 5 per working day is possible for everyone above the poverty line and a person at age 60 with a stock of wealth of Rs. 6,78,307 would not be destitute.
5. The terminal wealth at age 60 is highly sensitive to the rate of return. An improvement of one percentage point in the rate of return – i.e. from 12% to 13% – yields a corpus at age 60 of Rs. 8,74,065. This is an increase of

29% as compared with what is obtained at 12%. If the interest rate goes up from 12% to just 14.75%, it yields a doubling in the corpus at age 60.

Improving rate of return by such percentage points, without sacrificing long-term safety of funds, is possible by appropriate modifications in investment guidelines, and by entrusting funds to professional managers.

6. Such accumulation requires two ingredients: (a) high rates of return and (b) steady accumulation, without either withdrawals or interruptions to savings. The challenge lies in finding institutional mechanisms where individuals actually do save steadily through their working careers, and earn the highest possible rates of return for their wealth, so that the corpus created at age 60 is able to offer income security during old age.
7. The weaknesses of existing schemes lie in these two directions: low rates of return and poor accumulation. The rules governing withdrawal are excessively permissive, thus generating poor accumulation of wealth and a failure to harness the benefit of compounding over decades and provide enough for old age. When workers view their contribution as an escape from tax rather than savings that they benefit from, they would have strong incentives to withdraw early.
8. A similar problem is faced after age 60. We are increasingly in an environment where a worker at age 60 can expect to live beyond age 75. If wealth is rapidly spent away, then individuals may be destitute late in their lives. This process could be checked by access to a competitive market for annuities.
9. Systemic distortions and preferential treatment to certain provisions is undesirable and we need to strive towards creating an equitable environment and simplified provisions to encourage universal coverage both for employed persons as well as self-employed persons. Presently, contributions as well as interest earned of them are not taxed both in case of pensions and provident funds. But pensions, in the hands of receivers are taxed whereas provident funds (including PPF) are not. This is a

disincentive for contributory pensions and needs to be rectified. There is also a strong justification to tax receipts of accumulated provident funds.

10. Once the core problems of the system, which lead to poor accumulation of wealth at age 60, are adequately addressed, the incremental expansion of the coverage of the system would help raise the number of workers who save for old age in this fashion.

Empowering Provident Funds and Members

3.1 Encourage Accumulations

1. Contribution rates to provident fund, pension and other social security systems (Employees Social Insurance Scheme and Employees Deposit Linked Insurance Scheme) are already quite high. The Committee is of the opinion that there is no need to step them up further.
2. Premature withdrawals should only be permitted in the event of permanent disability, death, or for specific purposes relevant for old age income security (e.g. housing). Individuals who opt for self-employment or take up employment at an establishment where provident fund provisions are absent, should be discouraged from withdrawing their accumulations before age 60. They may transfer their accumulations to an Individual Retirement Account.
3. Premature withdrawals (before age 60) should attract a flat, 10% withdrawal tax, deductible at source. This disincentive will also encourage members to consider alternative fund sources (banks, housing finance companies and medical insurance) to supplement their savings for other needs. Provident fund withdrawals should also be taxed at the rate of 10% after retirement over and above an initial exemption of Rs. 1,00,000.
4. The portion of accumulations at maturity that are used for purchasing an annuity (from annuity providers registered with the IRA) or for other investments specified in Section 54E, should however be exempted from the 10% withdrawal tax. The annual income from annuities should however be taxed at prevailing rates.
5. Delayed receipt of provident funds should be permitted. While a member may stop contributing to the provident fund from age 60, he should be allowed to accumulate till the age of 65 – thereby enabling the member's

accumulations at age 60 to further benefit from compounded returns – resulting in a larger annuity at age 65, should he decide to opt for it.

3.2 Improvement in Rate of Return

1. The present concept of limited, assured returns should be abolished. Instead, returns should be determined from year to year depending upon annual earnings. This will remove the upper limit for returns over a multiple decade investment horizon to members and also eliminate the need for any potential government subsidy.
2. To encourage maximisation of returns on investments during accumulation, the present tax on earnings over 12% should be abolished.
3. Fresh provident fund accretions, as well as earnings from investment of existing funds should be managed by professional, competing fund managers registered with the Securities and Exchange Board of India (SEBI).
4. All exempted establishments should be mandated to engage a professional fund manager registered with SEBI, to manage their existing and incremental provident fund accumulations for superior returns and better risk management, and more effective governance.
5. Investment guidelines for exempted and non-exempt provident funds should be prudently liberalised and investment portfolios further diversified in order to obtain superior returns and better risk management. Trading of securities in the secondary market should be permissible. Initially, investment guidelines for fresh accretions as well as earnings from investment of the existing fund should be modified to allow investment of up to 20% of the funds into investment grade corporate debt and up to 10% in domestic equity. Domestic equity investments should initially be permitted only through index funds on either the NSE-50 or the BSE National indices.
6. The Boards of Trustees of exempt and non-exempt provident funds should be made more compact and effective. The Boards should generally not be larger than 15 persons, of whom at least one-third should have an advanced

degree and/or experience in finance or economics.

3.3 Increase in Coverage

1. The existing restriction limiting provident fund contributions to 177 industries/ classes of establishments should be abolished. All establishments should be covered by provident funds.
2. The minimum number of employees in an establishment (to be eligible for Provident Funds) should be lowered from 20 to 10, and eventually to 5.
3. The wage ceiling of Rs. 5,000 should be abolished; all employees in eligible establishments should be covered.
4. Intensive efforts should be undertaken to educate people about the need for, and benefits from, security schemes, and not to resort to early withdrawals.
5. These steps will collectively increase the number of establishments covered by provident funds by 0.26 million – thereby benefiting an additional 6.25 million individuals who will become eligible for provident fund and the employee pension scheme.

3.4 Others

1. Each provident fund member should be allotted a unique identification/ account number spanning across all Provident Funds – for comprehensive portability of account during job changes and temporary unemployment.
2. Lump-sum contribution both by the employer and the employee for the last 3 month's instalment (before retirement of employee) should be made mandatory to facilitate timely completion of administrative procedures and prompt disbursement of accumulations on retirement.
3. The “Provident Fund Account” should be renamed “Employee Retirement Account (ERA)” to clarify its true objective.

Empowering the Employee Pension Scheme

1. The system of using competing professional fund managers, prudently liberalised investment guidelines, and improved governance covered in the previous chapter, should also be applied for pension funds. This will introduce specialised agencies for fund management (professional fund managers registered with SEBI) and for annuity provision (annuity providers registered with the Insurance Regulatory Authority).
2. The presently limited, assured returns should be replaced by market-determined rates of return.
3. The Government's contribution of 1.16% towards pension accruals should be gradually withdrawn over a period of maximum three years. In the interim, this contribution should be credited to the National Senior Citizen's Fund.
4. The vesting period for pensions should be 10 years. Breaks in contribution should be permissible – provided they are made up later with the correct interest penalty. Lump-sum topping-up by individuals, in case of a shortfall in the minimum contribution period, should be permitted.

Empowering the Public Provident Fund

1. The “Public Provident Fund” should be renamed “Individual Retirement Account (IRA)” to focus on its objective.
2. The provident fund system of using competing professional fund managers, prudent liberalisation of investment guidelines, and improved governance should also be applied to the Public Provident Fund. A professional Board of Trustees should be appointed to oversee the investment and administration of the fund.
3. The 10% tax on early and final withdrawals on provident funds should be applied to all permissible withdrawals from the PPF as well. As in the provident funds, this tax should not be levied on the portion of accumulations retained in the IRA for purchasing an annuity at age 60, or invested in approved instruments under Section 54E.
4. The rate of return should be market determined and there should be no tax on it.
5. The limit on the tax-free annual contribution should be raised to Rs. 1,20,000, less contribution from an employer, if any. This would make the PPF equitable with PF (which allows Rs. 60,000 tax-free contribution from the employee and a matching tax-free contribution from the employer. In fact, tax-free contribution from the employer could even be higher). This would remove discrimination in tax-treatment of self-employed persons vis-a-vis employed persons.
6. Branches of all commercial banks should be allowed to serve as PPF collection centres. A comprehensive publicity programme should be initiated to enhance awareness regarding the details and benefits of the revised scheme.

7. PPF should provide for an optional contribution for insurance against death and permanent disability.

8. A Public Pension Scheme (PPS) should be initiated under the Public Provident Fund. 10% of contribution to the PPF should be mandatorily earmarked for this new Public Pension Scheme (PPS) with a minimum contribution of Rs. 500 a year. The first Rs. 500 contribution to PPF every year will go towards the mandatory Public Pension Scheme. Those desirous of contributing higher percentages can contribute more. As in the case of the Employee Pension Scheme (EPS), the vesting period should be 10 years. As recommended for EPS, breaks in contribution should be permissible and lump-sum contributions in case of short-fall in the minimum contribution period, should be permitted. Those who are members of any other pension scheme, on submission of documentary evidence, may be exempted. The quantum of pension would be determined by the accumulation to the credit of the subscriber at the time of retirement, death or permanent disability.

Annuities

1. Presently, the function of accumulating wealth and selling annuities are both bundled into existing provident fund institutions.
2. Annuity provision will be more efficiently achieved by a market with competing annuity providers registered with the Insurance Regulatory Authority. The Government should work towards obtaining a thriving, competitive annuity market where private, public and foreign firms compete in selling the cheapest annuities to India's citizens.
3. At age 60, the worker would accumulate a stock of wealth. On the principle of avoiding double taxation, the part which is put into an annuity should be tax exempt. The remainder, subject to the exemption limit, should be taxed at a 10% rate. The annual income obtained from the annuity should be a part of taxable income.

National Senior Citizen's Fund

1. There is growing awareness and concern about the case of elderly persons in society. If at all, the problem appears to worsen in future if timely measures are not taken in present. The problem, geographically, is all pervasive and of large magnitude. This should be a concern of all individuals, corporates, the private sector, as well as the government. The government should take a lead in galvanising all these efforts. Towards this end, it is proposed to set up a National Senior Citizen's Fund with a view to encouraging, catalysing, and complimenting all private sector efforts for the betterment of life of senior citizens in the country. The Fund can also be utilised for educating individuals about various security schemes, conducting research into areas concerning senior citizens and building infrastructure relevant to the social security industry.
2. The present contribution of 1.16% by the Government of India to the Employees Pension Scheme should be channelled into this fund as initial corpus till this contribution is gradually withdrawn. A part of the withdrawal tax on provident funds may also be transferred to this fund annually.
3. The fund should be monitored and administered by a Board of Trustees appointed by the Ministry of Social Justice and Empowerment.

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