The Importance of a Deep & Wide Pension System in India

Narayan Ramachandran
Chairman
Unitus Capital

India is a famously young country. Its median age is about 28 years and the number of people in their "thorties" – thirties and forties – is about 26% of the population, which is a very healthy percentage for supporting a society, as long as livelihood opportunities exist in the economy. Until the pandemic struck in March of 2020, India was making material progress towards poverty alleviation and the mitigation of absolute poverty. Since reforms began in 1991, about 300 million people have been lifted from poverty, an impressive feat, second in human history only to that achieved in China.

Even as much work remains to be done for the further mitigation of poverty, India is beginning the gradual phase of aging. Nearly 8% of the population or over 100 million people are now over the age of 60. India now has the second largest old age population in the world after China. While the issue of jobs and livelihood for the young population is an important one, the problem of old age poverty and care co-exists. In a typical senior citizen household today much of the expenditure goes towards housing (imputed rent), daily living and both chronic and episodic health care expenses. This expenditure is met through family savings or more often than not remains unmet because of the suddenness and magnitude of some expenses.

From an altogether different perspective, the price-setter in today's capital market – both listed and private – is a foreign investor. This investor sets the price by investing in India through foreign portfolio investment (FPI) or foreign direct investment (FDI). Risk capital in India is disproportionately from outside the country and this results in foreign capital setting prices on the margin for Indian assets. This makes the path of our asset prices volatile and hostage to crises that may not have anything to do with India.

The seemingly unrelated issue of old age poverty (and the consequent need for social security) and foreign capital dominance have a common solution – a functioning, wide and deep pension system in India. India would do well to focus on pensions as one sector for a major reform and innovation effort. Pensions are periodic payments paid out to a person who has retired from work -- the Latin etymology suggests payment for past services rendered. Most modern economies choose to "collect" some taxes in the form of employment or income taxes and some part of that is returned to those who retire from the work force in terms of pensions. The mechanism of the return transfer is often a tax exemption. EEE pension systems are exempt on contributions, exempt on gains and exempt on withdrawal. Some pension systems are EE and are taxed on withdrawal but allowed to grow tax deferred. Pension systems are also distinguished on whether they are defined benefit (DB)– pay out a percentage of final salary – or defined contribution (DC) – contributions are made by the individual that typically grow tax deferred. Given the increasing life expectancy, most pension systems around the world have become DC systems.

India's pensions are regulated by the Pension Fund Regulatory and Development Authority (PFRDA), an agency that was born in 2003 and formalized by an Act of Parliament in 2013. PFRDA supervises the National Pension System (NPS) which became the primary DC pension vehicle for Government Officers from the year 2004. NPS was extended to all citizens in 2009. NPS and the Employment Provident Fund scheme (EPFO), established much earlier in 1951, together cover much of the pension system today. The problem is that while that covers Government employees and some portion of the formal corporate sector employment, most informal workers are unaware and unregistered on these systems. The size of EPFO is about Rs. 12 Lakh Crores ($160 billion) and is said to administer about 50 million workers (or 10% of the labour force, though many are dormant accounts) and the size of NPS is about Rs. 3 Lakh Crores ($40 billion) and is said to administer about 12 million consumers.

The NPS system is a Government to Employee/ Consumer (G to C) system, while the EPFO functions as a Government to Business Employer to Employee/ Consumer (G to B to C) system. In each case the agency, PFRDA or EPFO, collect the money from the consumer/business and invest in the markets (primarily in debt instruments). The return to that portfolio of debt instruments, net of frictional cost of management, is passed back to the consumer in a non-taxable way at retirement.

Among emerging markets, Chile was the first to modernize its pension system in 1981. Chile introduced a fully funded DC system with individual capital accounts to replace the older pay-as-you-go social security system. The reform was "sweetened" by reducing the contributions in such a manner that most workers increased their take home pay. The investment framework for these funds, managed by private fund management companies, is set

by law, but is updated often. Over time, Chilean managers have been allowed to invest in domestic and foreign equities, domestic real estate and domestic private equity. This has created a long-term domestic pool of capital that makes the Chilean market the least volatile and most domestic of the Latin American Countries.

There are three main issues with where we are today in India 1) The pension system does not cover enough of the workers, particularly from the informal sector (not wide enough); 2) The pension system is largely DC in orientation so it is not clear if it will meet the retirement needs of those who have it (not sufficient in magnitude/ not deep enough) and 3) the assets of EPFO and NPS are extremely constrained towards debt instruments.

The first two limitations restrict the width and depth of coverage, while the third one results in lower (real) returns and does not aid in the development of capital markets from a domestic point of view.

Addressing the third issue first, NPS and EPFO must be allowed to diversify their investments in a calibrated way. Explicit allocations to domestic private equity, longer term mortgage bonds and real estate funds should pave the way to deepen these asset classes in India. A self-funded pension system like Chile's has a material impact on domestic financial savings over time. Even in developed countries, the advent of pension reform, like ERISA (1973) in the USA, has had a meaningful impact on specialization, returns, domestic financial savings and asset class development. If India can look forward to pension assets growing from about $200 billion to about $2 trillion in 10 years, then the impact on the housing sector (through long term bonds), private equity and real estate will be significant. The marginal price setter in the capital market will then become the domestic pension fund.

On the issue of width and depth, the NPS is actually a very nicely designed system, with EEE benefits. What it lacks is an awareness mechanism and an incentivization scheme that would make it attractive to invest in and lucrative for intermediaries to sell. EPFO has already made it mandatory to use Aadhaar cards, the NPS must do the same. The Indian payment system facilitated by Unified Payment Interface (UPI) is now truly world-class (as well as inter-operable) and must be integrated with the Aadhaar numbers to make up the backbone of the NPS system. The Chilean model also comes con-joined with disability insurance and term life insurance. These additional features add benefits at the same time as when the pension system is being attended to.

As Ajay Shah said in his seminal work , A Sustainable and Scalable Approach in Indian Pension Reform (2005), "pension reforms should be a centerpiece of second-generation reforms. Planning for old age is directly material to the empowerment and well being of millions of workers. A pension system where workers are able to manifestly able to see substantial levels of their own personal pension wealth is one where workers will be more comfortable in coping with the ordinary competitive processes of the market economy."

The topic of pension reform does not occupy the front-pages of newspapers. It is not even widely discussed in scholarly forums today. It is time that pension reform be brought to the front of the line. India's elderly and indeed the entire market economy will benefit.

Narayan Ramachandran is Chairman of Unitus Capital. He is the former Chairman of RBL Bank and former Country Head of Morgan Stanley, India. He writes a fortnightly column called "A Visible Hand" in the Mint Newspaper.