Civil service and military pensions in India

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Abstract

This paper describes the New Pension System (NPS), an individual account defined contribution pension scheme introduced for civil servants in India, and the problems faced in implementation of this system. We describe what has been achieved in the implementation of the NPS, and the challenges ahead. We also document the state of military pensions which have not been a part of the reform process.

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1 Introduction

Unlike many parts of the world, where population-wide systems lead the pension reform process, in India, civil services pension reform came first. New recruits, who were traditionally given a defined benefit civil servants pension, were placed into a defined-contribution individual account system called the New Pension System (NPS) from January 2004. By and large, this has been implemented in all parts of government except for three state governments, and the armed forces.

Under the NPS, employees contribute 10% of their salary, matched by a 10% contribution from the employer into pension funds managed by professional fund managers. Withdrawals are allowed from the age of retirement currently set at 60, with a requirement that 40% of the accumulated balance be annuitised.

Civil service pensions, along with occupational pensions administered by the Employees Provident Fund Organisation (EPFO), are the only formal-sector pension programs in India. These two programs cover about 12% of the workforce. Expenditure on civil service pensions, prior to the reform, was 2.31% of GDP in 2004-05 (Shah, 2006) and by one estimate, the implicit pension debt had reached 55.8% of GDP (Bhardwaj and Dave, 2005). High expenditures and low coverage were part of the motivation for the genesis of reform that is now underway.

The reform is significant because it has moved beyond parametric changes to the existing defined-benefit arrangement (for civil servants). At the same time, the institutional arrangements of the NPS are scalable beyond civil servants. Others in the economy can also become part of the NPS. Ultimately, all citizens of India should be able to open an individual account with the NPS, and carry that account with them through their labour-force trajectory, across jobs, sectors and locations. Employers should be able to make contributions (apart from the mandatory EPFO contributions) to their employees accounts as well as governments wanting to run co-contribution schemes for the poor.

At the time of writing, this process has begun for employees of the central government and almost all state governments. The NPS has also been made available to citizens of India on a voluntary basis. Occupational pensions remain with the EPFO.

The NPS architecture is in place. The Pension Fund Regulatory & Development Authority (PFRDA) functions as an arm of the Ministry of Finance

and has the mandate of regulation and development of the pensions sector in India (albeit without the full legal powers of a financial regulator). A record-keeping agency has been appointed, which interfaces with the accounting infrastructure of the central government, and consolidates all contribution information. It reconciles this information with actual funds held in a Trustee Bank. The agency then passes this to the pension fund managers whose sole task is to invest the funds. Several state governments are in the process of plugging into the NPS architecture. The PFRDA has also appointed agencies such as banks to serve as the interface between NPS customers outside of the government and the record-keeping agency.

While the NPS has made several achievements, these have come about at a very slow pace, and the implementation of the NPS continues to be plagued by delays. Political constraints have held up the legislation which would give the PFRDA powers of financial regulation. Several state government payroll processes have not yet been integrated with the NPS architecture. Investment guidelines continue to suffer from weaknesses on access to domestic and overseas equity investment. Voluntary participation from the unorganised sector has, as yet, been minimal.

Despite these weaknesses, the NPS is a fine example of a low-cost, scalable, commoditised fund management system. With about 1.1 million participants, the NPS is a large system by world standards, even though it is a small system by Indian standards. The ideas and the institutional apparatus of the NPS could well play a role in the future reforms of the EPFO.

The NPS comprehensively changed the terms of employment of new recruits into the civil service in almost all parts of government. Pensions for the armed forces, however, have been left unmodified.

This paper is an attempt to describe the New Pension System in India, and the progress that has been made since its introduction in 2004. It then identifies the challenges ahead. It also documents the state of military pensions which have not been part of the reform process.

Section 2 describes the old pension system and the rationale for reform. In section 3 the design of the NPS is explained briefly. Section 4 talks about the various implementation legs of the NPS and the progress that has been achieved. Military pensions are described in section 5 and the way forward for the NPS is discussed in section 6.

Table 1 Characteristics of the TCSP

Type	Defined benefit
Funding	Unfunded, PAYG
Coverage	Government employees
Contribution rate	Zero
Vesting	20 years or 10 years if at the end of service
Benefit	Monthly pension
Commutation Provision	Forgo 40% of the pension and take it as lump sum
	Restored after 15 years of retirement
Max Benefit Rate	50% of wages in the last ten months of employment
Survivor benefit	30% of the monthly pension
Indexation arrangement	CPI

2 Traditional civil servants pension (TCSP)

The most important element of the traditional civil servants pension (TCSP) is an unfunded pay-as-you-go defined benefit pension given to employees of the Central Government.

The benefit is roughly half of the basic pay in the last ten months of employment, computed at around 1/60 for each year of service, subject to a benefit rate cap at 50 per cent.[1] Employees are eligible for benefits after 10 years of service and get the full benefit upon completion of 33 years in service. In addition, the pension promises a survivor benefit, though the benefit drops to 30% and is given till the death of the spouse. A brief description of the TCSP is presented in Table 1.

State governments in India also have defined-benefit programs substantially like the TCSP at the Center, and have been under severe fiscal pressure given their large workforce.

In addition, employees of organisations which are government undertakings are part of the "Central Provident Fund" or the "Government Provident Fund". Both these pay an administered rate of return on contributions, and allow for early withdrawals. Even though they are called provident funds, there is no separate fund and benefits are paid out of the Consolidated Fund of India. These are thus pay-as-you-go programs, but are free of longevity risk. In addition, the size of the payments involved is small. Hence, these problems are of second order when compared with the TCSP.

Civil services salaries are revised every few years by a "Pay Commission"

[1] A 'commutation provision' allows employees to forgo 40% of the pension amount and take it as a lump sum at the time of retirement.

constituted by the Government of India. This implies that the basic salary of all government employees goes through a hike once every few years. Pay Commissions are also known to increase the *pension* payments made to existing *pensioners*; to this extent, the traditional civil servants pension has a wage indexation over and beyond the linkage to the terminal wage.

In the 1970s and 1980s, the size of government expanded rapidly. In this period, payments on the defined benefit pension appeared to be small when compared with the wage bill. From the early 1990s onwards, the headcount of civil servants started declining, reflecting both the austerity measures adopted after the IMF Program in 1991, and a new economic policy philosophy which emphasised a small State. Pension payments to the recruits of the previous decades then started looming large.[2]

The 2009-10 budget estimated a total outflow of Rs.484 billion (approximately US$10 billion or 1% of GDP) on pensions and retirement benefits of central government employees (GoI, 2009b). State government expenditure on pensions stood at Rs.1003.5 billion[3] (approximately US$22.5 billion) in 2009-10 (RBI, 2010). The outflows are expected to rise as the cohort of hires between the 70s and 90s retires.

Bhardwaj and Dave (2005) estimated that the implicit pension debt on account of the civil service pension worked out to roughly 56 per cent of GDP, under fairly conservative assumptions. Thus, even though civil servants made up only 6-10% of the paid workforce (Bhardwaj and Dave, 2005; Garg and Bhardwaj, 2009), their pension provisions were proving to be extremely expensive. It was therefore felt that the country was spending a disproportionate amount of money on a small set of the population, which was relatively better off to begin with.

3 The NPS: Design

In this backdrop of low coverage and fiscal stress, it was felt that reform to a DC system was the way forward.[4]

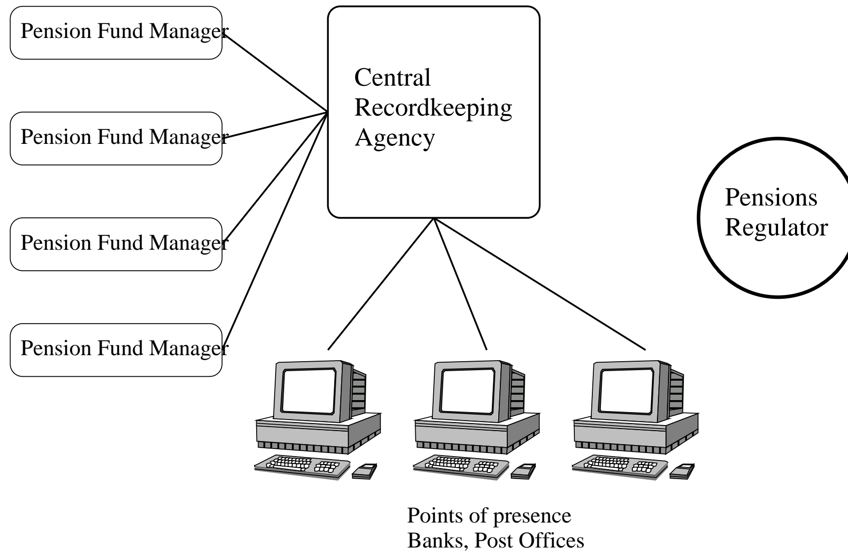
India chose to go with an unbundled architecture where the process of selling, record-keeping and fund management would be managed by different entities

[2] They stood at 2.31% of GDP in 2004-05, the year of the reform.

[3] This also includes expenditure on miscellaneous general services.

[4] See Shah (2006) for a description of the goals of pension reform in India.

Figure 1 NPS Architecture



for reasons of administrative and cost efficiency (Dave, 2000). The NPS consists of the following key participants (See Figure 1):

Points of Presence (POPs) POPs are the access point to the NPS for all customers. The existing network of banks, post-offices, depository participants is used for this function. In the case of civil servants, the existing administrative framework that disburses salaries and other benefits functions as the POPs.

Central Record-keeping Agency (CRA) The CRA is the central agency that is connected to the many POPs spread across the country at one end, and to the fund managers managing the investments on the other. Every day, it calculates and transmits the net value of funds that need to flow to the fund manager.

Pension Fund Managers (PFMs) PFMs purely focus on fund management. They receive a single instruction and funds transfer from the CRA, every day, and this drives their assets under management.

Regulator This process is supervised by an independent regulator.

4 The NPS: Implementation

In 2002, the central government made the decision to phase in the New Pension System by placing all new recruits from 1 January 2004 onwards into the NPS. The NPS requires a 10% contribution rate by the employee and a 10% contribution rate by the government (as the employer). The phasing in of the NPS for new recruits was thus, in effect, accompanied by a 10 per cent wage hike for the new recruits. This large value for the contribution rate – of 20 per cent – was chosen by the political leadership in order to ensure that even if a worker only invested in government bonds, the NPS would generally replicate the benefits of the TCSP.

High GDP growth meant that the government would be able to shoulder the burden of paying benefits for the older civil servants under the TCSP, and paying contributions for the new civil servants under the NPS. Because no benefits were taken away from existing civil servants, and any change in the promises amounted to a change in the employment contract given to a new recruit, there was essentially no opposition from the trade unions to the reform. In addition, there was no population-wide legacy system to begin with. Hence, the political environment surrounding the introduction of the NPS was unusually benign.

However, the NPS implementation fell into stasis when the government that took the decision of implementing the reform lost the general election of 2004, and the new government leaned heavily on leftist parties for political support, who were opposed to the new system.[5]

4.1 Pension Fund Regulatory and Development Authority (PFRDA)

The Department of Economic Affairs (DEA) at the Ministry of Finance in India, notified of a new pensions regulator in August 2003, before the NPS commenced operations in January 2004. The PFRDA bill was lodged in Parliament in 2005, and at the time of writing, is still awaiting approval.

As the NPS had already become operational for government employees, it would have been difficult to enter into agreements with various service providers without a body overseeing the process. In the absence of the legislation, the legal strategy adopted was to setup a network of contracts, between

[5] Dave (2006) provides a detailed account of the odyssey of the NPS.

the government and the array of service providers (e.g. pension fund manager, point of presence, etc). Supervisory functions would then be exercised under contract law. The Government therefore established the PFRDA to play such a development and supervision role, through an executive order.[6]

As the PFRDA functions as an arm of the Ministry of Finance, its role as a regulator is relatively limited when compared with a full blown statutory regulator such as SEBI.[7] In recent years, the PFRDA has performed the following functions:

1. Selected a Central Record-keeping Agency (CRA) through a competitive process.
2. Selected Pension Fund Managers (PFMs) through a competitive process.
3. Set up a Trust called the NPS Trust under the Indian Trusts Act, 1882 to oversee the functions of the PFMs.
4. Appointed a Custodian.
5. Appointed a Trustee Bank to facilitate flow of funds between the central government and the CRA.
6. Opened up the NPS to the informal sector, and launched a group-based scheme, which allows poor workers to contribute as a group, called the *NPS Lite*. In addition, it has also launched a co-contribution scheme called the *Swavalamban Scheme* which grants an incentive of Rs.1000 to accounts opened by people in the unorganised sector.

The NPS architecture as has been implemented is presented in Figure 2.

4.2 Membership

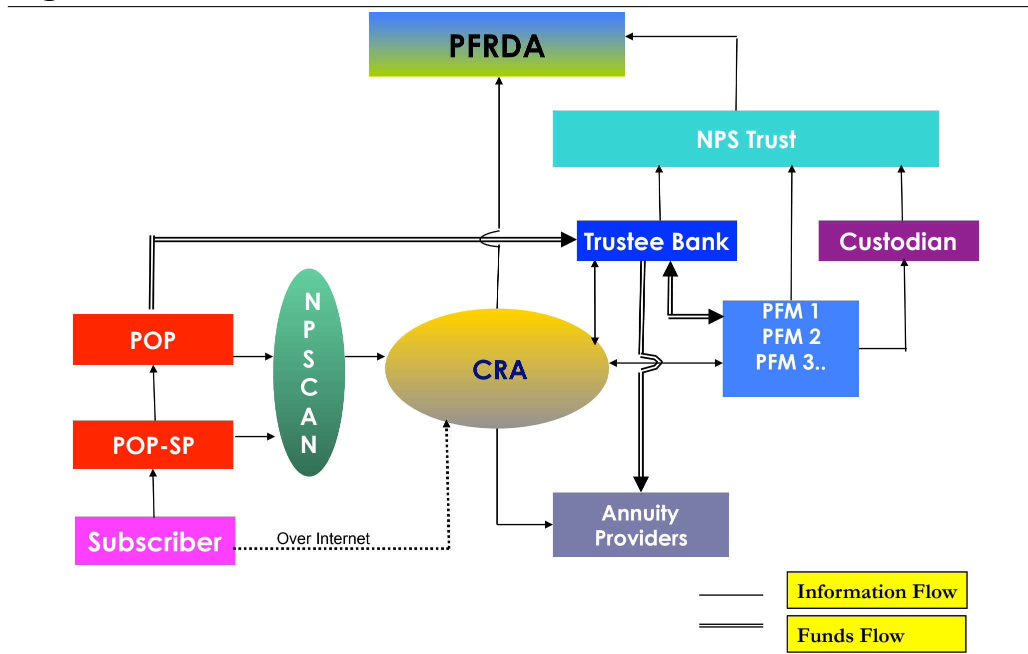
The NPS has a captive population of new recruits to the civil services. In June 2010 the NPS was operational in all accounting formations of Central Governments, and 117 Central Autonomous Bodies (CABs). In addition, 22 State Governments are in the process of integrating with the NPS.[8]

[6] See `http://www.pfrda.org.in/`

[7] SEBI is the equities market regulator in India.

[8] For details on notifications made by the state governments to this effect, refer to `http://www.pfrda.org.in/index2.asp?sublinkid=62`

Figure 2 NPS Architecture



As of November 2010, the NPS had 1.1 million members. It is believed that the central and state governments have not been able to capture information about all new recruits, thereby leading to under-enrolment in the NPS.

4.3 Central Record-keeping Agency (CRA)

The National Securities Depository Limited (NSDL) was appointed as CRA on April 10, 2007 through a competitive bidding process based on technical and commercial criteria. NSDL is the largest depository in the country and also the agency which successfully built and implemented the Tax Information Network (TIN)[9] between 2004 and 2005.

The CRA became operational on 1st June 2008, and was inaugurated on 29th August 2008. The CRA operationalisation has required no capital investment by the Government of India. The service charge model of the CRA is on the basis of *number of investors and transactions* and not on the *value of transactions* as is the case for most other financial intermediaries. NSDL has committed to reducing charges as and when the number of subscribers

[9]TIN was envisaged to integrate primary information of tax payments in designated banks, tax deduction at source and information on high value transactions.

crosses 1 million and 3 million in the CRA system and to holding this charge for ten years.

4.4 Contribution flows and POPs

The smooth flow of participant information and money to the CRA happens through the accounting system prevalent at the central government level. This accounting infrastructure consists of the Principal Accounts Office (PrAO), Pay and Accounts Office (PAO) and the Drawing and Disbursing Officer (DDOs). In addition, the CRA has set up several facilitation centers (CRA-FC) to provide services to the nodal officers or officers under the Central and State Governments.

This contribution flow had to go through in two phases:

- The interim phase, before the CRA became operational (2004-2008).
- After the CRA became operational (2008 onwards).

The interim phase required the Central Pension Accounts Office (CPAO) to keep note of the new employees and their notional account information. Once the CRA was operationalised, this information needed to be ported to the new CRA. One of the early challenges of the reform process was the integration of the accounting infrastructure and the interim measure, to the CRA.

The information flow after operationalisation has been made possible by designating Nodal Offices from the existing PAOs and DDOs, which interact with the CRA. These Nodal Offices are responsible for uploading subscriber information to the CRA. The upload of each file is made possible by the use of the NPS Contribution Accounting Network (NPSCAN)[10], a web based application developed by the CRA for uploading contribution files, and other subscriber information to the CRA.

The process is as follows:

1. The Drawing and Disbursing Officers interact with the employees and certify the employment details, and consolidate the employees contribution details. They also make note of the 10% employee contribution and 10% government contribution and pass on all the information to the Pay and Accounts Office. They distribute the unique id's generated by the CRA to the employees. The DDOs are also responsible

[10] https://npscan-cra.com/CRA/

for forwarding any requests by the employees to switch to a different pension fund, or to change their own details.

2. The Pay and Accounts Office consolidates the details from all the officers under it, and uploads the subscriber information file to the CRA. This generates the Permanent Retirement Account Number (PRAN) for each employee. The PAO also deposits the contribution amount to the Trustee Bank (discussed in section 4.6). This office is thus responsible for the information flow to the CRA and for the flow of funds to the Trustee Bank which then reconciles the information with the CRA before the proceeds are transferred to the pension funds for investment.
3. The functioning of these two legs of the accounting system is overseen by the Principal Accounts Office.

4.5 Pension Fund Managers (PFMs)

The PFMs were also selected by the PFRDA through a process of competitive bidding, based on technical capabilities and costs. To assuage the ideological opposition from the left parties, bids were initially invited only from public sector firms for sponsoring the pension funds. To be eligible, the sponsors were, inter alia, required to have at least 5 years experience of fund management, with average assets under management of not less than Rs.100 billion (about US$2.2 billion) for the month of March 2007.[11]

An independent committee evaluated the interests received from seven entities and selected three of them. Subsequently, four other fund managers were appointed to the system and include private sector entities. These are allowed to manage the contributions coming from voluntary members.

The three public sector entities which manage the funds of government employees have provided a weighted average return of 11.88% between 2008-2010, and the AUM as of December 2010 was around US$1.6 billion.[12] The pension funds have in reality been restricted to making very conservative investments. The approved investment pattern is presented in Table 2.

Thus, the guidelines cap equity exposure at 15% and are heavily reliant on government debt which typically pays very low returns. They also allow for no international exposure. Equity investment is required to be done through

[11] `http://www.pfrda.org.in/indexmain.asp?linkid=174`

[12] Source: PFRDA

Table 2 Approved Investment Pattern

Instrument	Prescribed limit
Government Securities (Central & State)	Upto 55%
Corporate Bonds (PSU, Private corporate debt & Fixed deposit)	Upto 40%
Money market instruments (Includes units of money market mutual funds)	Upto 5%
Equity and equity related mutual funds	Upto 15%

index funds. The pension fund chooses the index it intends to track in advance on a yearly basis.

The default scheme termed "Scheme of various Pension Fund Managers" allows 85% of the contributions to be invested in fixed income instruments, and 15% in equity related instruments.[13]

For non-government subscribers the default life cycle fund adopts an automatic fund allocation between equity, corporate debt and government bonds linked to the age of the investor. The asset allocation ratio is fixed between age 18 to 35. The proportion between equity:corporate debt:government bonds is 50:30:20. Beyond age 36, assets allocated in equity and corporate debt reduce by 2% and 1% respectively, every year. Simultaneously, the asset allocation in government bonds increases by 3% every year.

The initial design of NPS allowed members the flexibility to choose amongst the pension funds. However, this feature has still not been made available to civil servants. Fund allocation to the three funds was initially made on the basis of the fees quoted by them, and subsequently based on their overall performance. Members outside of the civil services do have a choice of investment.

4.6 Trustee Bank and Custodian

Bank of India (BoI), a public-sector bank, has been appointed as the trustee bank to handle the funds. The Government of India (GoI) transfers money to the BoI which then hands it over to the CRA for further investment with the fund manager.

[13] http://www.npscra.nsdl.co.in/modules.php?name=Content&pa=showpage&pid=66

The Stock Holding Corporation of India has been given the mandate to act as custodian of the investment instruments.

4.7 NPS Trust

PFRDA set up a Trust under the Indian Trusts Act, 1882 called the NPS Trust on 24th April 2007. The NPS Trust has been set up in the interest of the beneficiaries and is responsible for oversight on the assets and funds under management. In accordance with the Trust Deed, the trustees supervise the PFMs, and interact with the other participants in the pension system: the CRA, Trustee Bank and others.

4.8 Withdrawal and tax policies

The NPS is subject to the EET tax framework. Income of the NPS Trust is exempted from income tax, and any dividend paid is exempt from the dividend distribution tax. NPS Trust transactions on the equity and derivative markets are also exempt from the securities transaction tax. In order to encourage voluntary contribution to the NPS, self employed persons have also been allowed to avail of tax benefits (GoI, 2009a).

At the time of retirement, it is envisaged that members will be able to take 60% of the accumulation as a lump sum, while 40% will have to be mandatorily annuitised by buying an annuity from a service provider in the market. Annuity service providers have not yet been appointed. No government guarantee has been envisaged, but there might be a provision for private sector providers to sell appropriately priced guaranteed products.

4.9 Costs

The NPS design was motivated by the desire to operate a low-cost pension system. Table 3 provides the costs of the NPS.

These charges have shaped up as amongst the lowest in the world, thus validating key elements of the original conception of the NPS.

Table 3 NPS charges

Head	Service charges in Rs.	in US$
Central Record-keeping Agency		
Account Opening	50	1.12
Annual maintenance	280	6.3
Charge per transaction	6	0.14
Points of Presence		
Initial subscriber registration & contribution upload	40	0.90
Any subsequent transaction	20	0.45
Trustee Bank		
Transaction from a RBI location	0	0
Transaction from a non-RBI location	15	0.34
Custodian		
Asset servicing charges		
Electronic segment	0.0075% p.a	
Physical segment	0.05% p.a.	
Pension Fund Management		
Investment Management Fee	0.0009% p.a.	

Source: PFRDA

5 Military pensions

5.1 Overview of scheme benefits

Armed force personnel are members of a defined-benefit, PAYG scheme financed by the Government of India.

The pension for commissioned officers is calculated at 50% of the average reckonable emoluments drawn during the last 10 months. For Personnel Below Officers Rank (PBOR), it is calculated with reference to the maximum of the scale of pay of the rank and group held for 10 months preceding retirement. Since April 2004, the minimum pension is deemed to be Rs.1913 (US$44) per month and the maximum is upto 50% of the highest pay applicable to Armed Forces personnel.[14]

[14] http://mod.nic.in/welfareschemes/welcome.html

Officers need to be in service for 20 years before being eligible to claim the pension. For the PBOR the minimum required years of service is 15 years. Thus, for officers who join the army at age 18, pension promises are payable from age 38 onwards, for life. This implies that the NPV of lifetime benefits is very large. In contrast, a civil servant retiring at age 38 is not eligible for similar benefits.

In addition, armed forces personnel are permitted higher commutation of their pension at the rate of 43% for officers and 45% for PBOR as compared to 40% for civilians.

In case of death during service or after retirement, a family pension is paid to the dependents at a uniform rate of 30% of reckonable emoluments last drawn subject to a minimum of Rs.1913 (US$44) per month. Those military personnel who leave service and get reemployed in the civil sector, can join the EPFO schemes while continuing to be eligible for the military family pension.

In addition, there are several provisions for disability and war injury pensions.

Total expenditure on military pensions in 2010-11 was about 0.3% of GDP. It is important to note that this expenditure is made on a very small segment of the country's population.[15]

5.2 Issues in military pension reform

The transition from a DB to a DC pension for military personnel is complicated on account of the low service tenure. In the case of the NPS for civil servants, the political bargain was one where employees got a 10% raise, and then contributed 20%, in return for losing the DB pension. If a comparable bargain has to be struck for the military pension, it would have to involve rather different parameters, as the contribution rate required to replace the NPV of benefits payable from as early as age 38 would be very high.

The process of military pension reform now involves (a) Undertaking technical studies about alternative rules for transition, (b) Educating soldiers about the trade-off that is being made and (c) Undertaking consultations with the chiefs of staff.

The portability of a DC pension account is advantageous for relatively skilled

[15]In 2007, the number of defence pensioners were estimated to be around 2.2 million. See `http://mod.nic.in/welfareschemes/welcome.html`.

people in the armed forces, who are able to transition into the private labour market after leaving the armed forces. However, for the more junior soldiers, this factor (portability) does not make a substantial difference. For them, the two choices would have to have a comparable NPV.

6 NPS: Lessons learned and the way forward

When a wave of pension reform swept the world, with a movement from DB to DC systems, at first there was an emphasis on privatisation, on removing pensions from the realm of public finance. After some experience built up with the difficulties of the early systems, the second wave of reformers placed a significant accent upon delivering a low-cost system which delivered strong results to the end customers of the pension system. India's New Pension System, which was planned in the late 1990s, represents such a second-generation pension system design.

By and large, the NPS has delivered on its promise as a low-cost civil service pension system. The key disappointment of the NPS has been the slow pace at which the system implementation came about. On paper, there was a decision that all new recruits of the central government after 1/1/2004 would be in the NPS. However, in practice, there were considerable delays in the process of connecting up the pay offices spread across the country to the NPS.

By early 2010, however, a considerable mass of members and assets under management had built up in the NPS. We list below areas of concern regarding NPS implementation which need to be addressed before the system comes up to the full functionality that was originally envisaged.

6.1 Streamlining government payroll processes

One of the key disappointments of the NPS has been the haphazard integration of the government payroll process into the CRA. This is particularly bad in the case of state governments. Garg and Bhardwaj (2009) provide detailed recommendations for the creation of employee and pension related databases so as to be able to streamline the process of payment of salaries, as well as pension deductions.

Another key effort in this regard is an NPS evaluation report submitted by the Technology Advisory Group for Unique Projects (TAGUP) constituted

by the Ministry of Finance. TAGUP (2011) has recommended:

- Enabling linkages with HR and payroll systems of the Central and State Governments to obtain subscriber contribution details.
- Providing process linking between Government accounting systems and the pensions administration system.

Both these recommendations need to be taken on board by the PFRDA and the central and state governments to enable the complete integration of government employees into the NPS.

6.2 Establishing transparency

PFRDA has, so far, had limited transparency about the NPS. There is a great need for dissemination of daily statistics about the number of members, assets under management, performance of all fund managers in all asset classes, summary statistics about performance of members, information about switching across fund managers and across asset classes by members, and the returns drag introduced by fees and expenses. This data will enable better analysis about how the NPS is faring, and modification of policy positions. The importance of a daily MIS about these facts was also made by (TAGUP, 2011).

6.3 Investment choice

NPS offers no flexibility to the government employee in terms of access to various asset classes or international diversification. This needs to be replaced by an environment where NPS members are able to choose how their assets are placed across domestic and overseas assets, and across the three major asset classes: equity, corporate bonds and government bonds. In each of these areas, NPS members need to be able to choose between multiple fund managers. The NPS 'default option' which is a life cycle fund available only to members outside of civil services needs to be extended to everyone.

6.4 Draw-down phase

The NPS mandates that 40% of the accumulations be used to purchase an annuity and stipulates 60 to be the retirement age.

However, the annuity market in India is not very vibrant, and mortality tables for the entire population are not well developed. Increasing life expectancy may mean that the age of 60 also needs to get revised upwards over the years. Also, while age 60 has worked as the retirement age for those in the civil services and the organised sector, little is known about retirement decisions of those in the informal sector.

As the NPS is still in its early stages, there are many years before the first cohort of NPS entrants retires. However, the PFRDA needs to focus on tackling these issues and be prepared with policies for the time when people start retiring out of the NPS.

6.5 Extensions of the NPS

Extension: Voluntary participation by older civil servants

Now that the basic NPS is in place, there is a role for government to give an *option* to older civil servants – e.g. those who joined before 1/1/1994 – to switch away from the TCSP to the NPS. This would involve offering an initial endowment into their NPS account, to reflect the pension rights that they would step away from. Through this, the benefits of the NPS would become available to more individuals and the economies of scale of the NPS would build up.

Extension: Armed forces

One large group of civil servants - the uniformed armed forces - has remained outside the NPS. Now that the basic structure of the NPS is in place, government needs to bring new recruits into the armed forces also into the NPS. The contribution rate for these employees must of course be fairly different from those used for all others, given the low age at which most soldiers retire.

Extension: Employers outside the government

Firms with 20 or more employees are covered by the EPFO. However, there are a large number of firms with fewer than 20 employees who remain uncovered by any kind of a pension scheme. As well, firms under the EPFO often make additional contributions for their employees as part of the HR policy to attract good staff. The NPS could be extended to such employers, with

tax-deductions on their contributions. Employee contributions to the NPS could also get tax-favoured status such that the NPS moves closer towards the ideal of becoming a portable pension system for all. The Union Budget of 2011-12 has made recommendations for permitting tax-deductions of employer contributions to the NPS. This is a step in the right direction.

Extension: Individual membership

One of the key problems in the NPS has been the low *individual membership* outside of the civil services. This has been seen to be caused by poor incentives for selling the NPS, as opposed to high fees paid by mutual funds and insurance companies for the sale of their products. As a consequence, PFRDA has started thinking about individuals outside of the civil services adopting the NPS as an alternative to mutual funds or insurance companies, and has started moving towards the agent-driven sales model that is in use with mutual funds or insurance companies. Going further down this path would lose the essence of the NPS, which is a low-cost commoditised fund management mechanism. Instead, more effort needs to be put on innovative sales models that would keep the design of the NPS while encouraging individual members to open NPS accounts.

6.6 Difficulties of existing efforts of NPS for low-income workers

An unfortunate feature of the recent years has been an effort by the PFRDA to launch a modified version of the NPS for voluntary adoption by low-income workers in the informal sector (where there are no mandatory pension programs). A separate NPS-like pension system has been created and portability between the two systems has not been assured. Portability is a critical feature of the NPS design, and compromising on it will dilute the essence of the system. The creation of a separate system also implies that economies of scale would not be obtained in both areas.

There has also been a push towards establishing co-contribution schemes (such as the Swavalamban initiative), and giving out licences to groups which will collect small-valued contributions from low-income individuals in their group, and connect to the NPS. While utilising groups is an interesting way to reach out to those whose contribution size is very low, the focus needs to shift from mere achieving of a target enrolment in the NPS to ensuring

that the system of contributions over long-horizons is well understood by the participants.

It is important for the PFRDA to bear in mind that the NPS is primarily a system for pension provision, and the focus on long-term savings to provide for old-age should not be diverted by allowing for early withdrawals and other such measures. Poverty in working life, or contingency claims such as health insurance cannot and should not be solved using the NPS. Looking forward, it is also important to merge all the different strands into a single NPS so as to harness the benefits of simplicity and scale economies.

6.7 The core function of the NPS

The most important role that the NPS can play in India is that of being a supremely efficient and well-functioning individual account DC *pension* system.

PFRDA is now the arena of a political economy problem. Financial firms have an incentive to lobby PFRDA, while NPS participants have no voice. Financial firms are keen to get back to high charges, to revert from an unbundled architecture to a monolithic architecture, and to ideally go back from a DC system to a monolithic DB system run by insurance companies.

The governance challenge that India now faces is that of keeping NPS on track, of keeping NPS close to the original design and vision. NPS needs to get up to world class in terms of service delivery and low cost. This requires clarity and commitment on the part of PFRDA, to stay in tune with the original goals of NPS, and not respond to the lobbying of financial firms.

If NPS is able to achieve its goals, it will help directly in achieving a healthy Indian economy, by solving the important problem of the civil servants pension. It will also help indirectly, by being a role model for the reform of the mandatory pension system for private firms, which is presently run by EPFO in unsatisfactory fashion. Alongside these two main goals, there are many smaller situations where the NPS could naturally be a tool of choice for addressing policy problems in the field of pensions.

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