Indian Pension System: Funding, Privatization and Investments

Abstract

Pension systems world over are passing through a crisis of confidence due to unsustainable rise in the financial burden on state exchequer. Many countries are therefore examining alternative pension arrangements to maintain prosperity in aging societies in a financially sustainable manner. India is also experiencing the negative consequences of its current pension system, which is characterized by low coverage on one hand, and rising expenditure on the other.

Against this backdrop, this study analyzes the performance of the current retirement benefit system in India and examines the suitability of a new pension system. The study builds a simulation model to examine the rates of return obtained from the current public and private pension schemes for various combinations of employment duration and life expectancy. The result shows that public sector workers are earning disproportionately large rates of return from their pension schemes. In contrast, the private sector workers are receiving low rates of returns from their pension entitlements. Next, the study develops a simulation model to project the future expenditure pattern of the public pension scheme. The result suggests that the scheme, in its current form, will put huge pressure on government finances and is unlikely to be sustainable in the future. Further calculation shows that parametric reform coupled with advance funding could help stabilize the scheme.

The study thus shows that advance funding should be the key strategy to reform pension schemes in India. While public schemes should be funded and defined-benefit, schemes for private workers should be reorganized in line with the funded and defined-contribution programs based on personal retirement accounts. Further, a simulation model built to examine the suitability of investing pension assets in diversified portfolios, reveal that balanced exposure to equity and debt can significantly improve the rate of return at acceptable levels of risk exposure. This has different implications for public and private sector pension schemes. The interpretation of the result for the private workers is straightforward – relaxation of portfolio limits could increase the rates of return. For the public, defined-benefit scheme, higher returns from diversification could keep the contribution rate at a sustainable level.

The new pension system should also encourage voluntary retirement savings for the vast self-employed population who are not covered by any formal scheme. The study estimates that there is a large market potential for such voluntary schemes and if adequate incentives are incorporated into such schemes, the old age income protection system will emerge much stronger in India.