Pension Reforms in India: Myth, Reality, and Policy Choices

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ABSTRACT

Escalating costs of the pension system is forcing the Indian Government to reevaluate the formal programmes that provide social security to employees. The government has so far received three official reports (namely, OASIS, IRDA and Bhattacharya), which have examined the issue and suggested several measures to provide a safety net to the aging population. This paper examines the recommendations made in these reports and analyses the potential effects of them. It is organized around five policy questions:

1. Should the reformed system create individual (funded defined-contribution) accounts, or should it remain a single collective fund with a defined-benefit formula? The changeover involves a larger public policy choice issue: who should ultimately bear the risk? Should employees/retirees shoulder those risks alone arising from variations in asset yields and unexpected changes in longevity, or should these risks be shared more broadly across participants, if not society? Choice would depend upon to which group the individual belongs. Financially successful people may believe in individual ownership and choice, while low wage earners may want assured returns because they do not have other resources to fall back upon. Unfortunately most Indians, unlike those in many other countries, are in the latter category which cannot bear any risk, more so in the old age.

2. If individual accounts are adopted, should the reformed system move toward private and decentralized collection of contributions, management of investments, and payment of annuities, or should these functions be administered by a public agency? In privately managed funds, associated problems would be intermediation costs, agency problem (principal-agent fiduciary relationship), and greatly increased costs to administer the plan. Several studies across the world have shown that periodic fee may look deceptively low but, over longer time horizons, the cumulative effect can be dramatic, sometimes reducing the benefits by 30 to 50 per cent.

3. Should fund managers of retirement savings be allowed to invest in a diversified portfolio that includes stocks and private bonds? In recent years equity investments, particularly index investing, have become a favoured strategy. Index funds are subject to tracking error, and being loaded with few big stocks, there are much higher risks in index investing than people perceive. Over the period, real annual return on index funds may be more, but people retire only once. Equity markets are highly volatile and go through long periods of feasts and famine. Guarantees would have to be provided in the form of minimum return or providing minimum basic pension on retirement. World bank studies show that government ends up acquiring conjectural liabilities wherever a pension system based on private providers is mandated. How would that be different from the present system where a government agency (EPFO) provides retirement benefits?

4. Should the government move toward advance funding of its pension obligations for its employees, or should these obligations continue to be financed on pay-as-you-go basis? Studies have shown that a simultaneous implementation of funded, diversified, individual accounts is not a "free lunch" once you properly account for existing unfounded obligations and risk. The Bhattacharya Committee's estimates show that the government would have to pay out more on account of pensions to its employees for the next 38 years before the new scheme starts showing reduced government expenditure. These amounts do not include the tax foregone by the government on the employee's contribution. Several assumptions have been made about the scheme, which the committee hopes would remain valid and that the future governments would behave responsibly. The proposed scheme does not consider intermediation costs and agency risks; in fact, the committee presumes that agents would behave more responsibly than principals.

5. What should be the level of government fiscal support in the form of tax subsidy, foregone tax collections, grants, administrative costs incurred by its agencies, and level of assumed contingent liabilities in case the government guarantees minimum pension? The crucial question is: how much and to whom is this subsidy accruing? Are beneficiaries of the proposed system the ones who need subsidy? Tax treatment of pension is a

critical policy choice. A generous tax treatment may promote savings but may be costly in terms of revenue foregone. Apparently, an exercise in balancing is necessary.

The priority should, therefore, be putting in place a policy vision and road map with specific goals in relation to pre-determined milestones. These should include a tax financed and means-tested system for lower income groups. If government cannot afford it, then it has no moral or political justification to even consider providing further tax benefits to privileged income groups. If there are no government funds for the first pillar in the World Bank recommended multipillar system, the third pillar should remain out of policy discussions. Emphasis should be on strengthening the second pillar. Suggested reforms neither enhance efficiency nor make the social security system more equitable. It would only privatize the gains while costs and risk for the government would increase considerably. It would only help well-off segment of society in availing more tax concessions. Present problem in the government pension system is due to successive governments behaving like Santa Clauses ignoring the cost to exchequer. Fund managers would not be able to solve these problems.

Specific fiscal and other measures for implementing a feasible and viable pension system in Indian conditions have also been suggested in the paper.

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"Will I have enough to live on when I retire?" This question of old age financial security is being asked across the world with growing apprehension. India is no exception. Three reports have examined old age financial security for Indians and are now being studied for implementation by the government. These reports are:

1. Project OASIS Committee Report, December 29,1999 (henceforth referred to as the OASIS Report)
2. Pensions Reforms in the Unorganized Sector – a report prepared by the Insurance Regulatory and Development Authority, October 2001 (henceforth, referred to as the IRDA Report)
3. Report of the High Level Expert Group on New Pensions System, Government of India, February 2002 (henceforth referred to as the Bhattacharya Report named after its chairman)

The first report was prepared and funded by the privately financed OASIS Foundation. The other two reports provide a road map to implement the framework provided by the OASIS report for the unorganized sector and civil servants respectively. The OASIS report itself draws heavily upon the World Bank's recommended multipillar system to provide for old age financial security. The three pillars are:

1. A mandatory, publicly managed, tax-financed pillar for social insurance
2. A mandatory, privately anaged, fully funded pillar for old age savings
3. A voluntary pillar for those who want more protection in their old age

The first pillar resembles public pension plans, providing a social security net for the old and poor, particularly for those whose lifetime income was low or who cannot afford to pay for building a reasonable retirement income. These are based on the principles of social insurance and are wholly financed by the state either out of general tax revenue or by some kind of special tax or cess. The United States, for example, levies a social security tax on all working people to finance this pillar. The second pillar requires that people save mandatorily for old age and benefits are actuarially linked to contributions. It should preferably be privately managed, fully funded, and managed competitively. The third pillar, voluntary savings and annuities, is meant to provide supplemental retirement income for people who want more generous old age pensions. The World Bank suggests that the first pillar providing basic security needs must be publicly managed, and only the second and third pillars are to be privately managed.

MULTI-PILLAR SYSTEM IN INDIA

In India, the first pillar is almost non-existent. The government does have some poverty alleviation programmes but they are too insignificant compared to the country's needs and their implementation is mostly political in nature. In case of need, old people generally rely on immediate family members and private charities. With the breaking of the joint family system, it has become inevitable that people plan for their old age financial security while they are young and working.

All the three reports have extensively referred to the first pillar of social security but none contains any recommendations to provide for it. Some mistakenly believe that pensions paid by the government to its employees constitute the first pillar since they are paid on 'pay as you go basis' (PAYG) from current tax revenue. Pension to civil servants are more akin to deferred wages paid by the employer and according to the World Bank's guidelines should be included in the second pillar of the multipillar pension system.

The second pillar is found mostly in the organized sector and is in the form of employment-linked schemes. Against a working class population of 400 million, only 35 million have access to a pension system. Of these 35 million, 11 million are in civil service (central and state governments) and 24 million are members of various employees' provident fund and pensions schemes.

Employees in Government Sector

The civil service retirement benefit scheme, as it exists, contains two distinct components: a defined contribution element and a defined benefit element. The defined contribution is the General Provident Fund Scheme/ AISPF scheme wherein a mandatory contribution of 6 per cent of emoluments is payable by the employee. Final settlement and withdrawal of full accumulation with interest is allowed upon retirement, permanent disability, or death. Partial premature withdrawals from the accumulated balances are permitted for specified purposes (marriage, house construction, hospitalization, etc.). Thus, provident funds also act as an emergency source of funds while being in service and/or for building permanent assets like a house. The provident fund scheme is supplemented by a defined monthly pension scheme, which the government pays upon the employee's retirement. The defined benefit is totally unfunded and is paid from current revenue.

Employees in Non-Governmental Sector

i) ***Legislated Plans:*** Employees drawing Rs. 6500 and below a month in private establishments having more than 20 employees in specified industries are mandated to subscribe under the Employees Provident Fund Scheme, the Employees Pension Scheme, and the Employees' Deposit Linked Insurance Scheme. The Employment Provident Fund Organization (EPFO) manages these schemes. Some reputed employers are allowed to manage schemes for their own employees (known as exempted funds) within the guidelines provided by EPFO. Presently, some 3000 odd exempted trusts covering 4. 5 million member employees are managing approximately Rs. 40,000 crore in funds. These exempted funds are mandated to equal or better the annual benefits announced by EPFO every year. Employers and employees are mandated to make equal contributions totalling 20 per cent or 24 per cent of the employee's wages. The employee's entire contribution goes to his provident fund account (EPF). From the employer's contribution, 8.33 per cent goes to EPS, while the rest is pooled into the provident fund account of employees. The government contributes 1.16 per cent of wages to EPS. The Employees' Pension Scheme (EPS) offers defined benefits of up to a maximum of 50 per cent of the average of last 12 month's wages. The Board of Trustees invests these pension funds and is responsible for payment of benefits. Thus, this is a publicly managed fund and members are assured of retirement income, devoid of any worry of investment risk, administrative costs, and other kinds of risk associated with pension fund management. In addition to EPS, which is funded by employers' contribution, employees' contributions and employers' contribution of excess over 8.33 per cent are accumulated under the Employees' Provident Fund scheme (EPF). Funds are publicly managed and accumulations are paid to the employee as a lump sum amount on retirement. Premature withdrawals for specified needs are permissible and final settlement and withdrawal of full accumulation with interest are allowed on account of retirement, permanent disability, death, change of job to an uncovered establishment, or after 2 months of unemployment. Thus these mandatory savings also provide for emergencies while being in service and /or building permanent assets like a house. The savings also act as cushion during periods of unemployment in the absence of unemployment insurance and survivors' benefit in the case of death.

ii) ***Employees not Covered under Legislated Plans:*** Firms which are not mandated to join EPFO schemes can voluntarily do so. Other firms and employees who are not in publicly managed funds and/or exempted funds schemes generally participate in the so-called Recognized Provident Funds (RPFs) created under the Income-Tax Act. Participation in RPF provides considerable tax savings. Employers and employees can contribute up to 12 per cent of wages (without any monetary ceiling) in these funds. Employers can claim their contributions as tax-deductible business expenses and employees can get tax rebate on their individual contributions up to Rs. 60,000 under Section 88 of the Income Tax Act. The accumulations including accrued interest are tax free when received by the member employee. RPFs are privately managed; however, to retain tax advantage, they must follow the investment guidelines given in the Income Tax Rules, which are somewhat similar to the guidelines issued by EPFO for exempt funds.

iii) ***Others in Unorganized Sector:*** Employees not covered under any of the mandatory pension schemes can save for old age financial security through the Public Provident Fund (PPF) and/or participate in individual and group annuity plans of life insurance companies. Participation is encouraged through tax incentives.

PPF is an individual account system under which individuals are allowed to open accounts with some designated nationalized banks or post offices. Contributions to PPF accounts are entitled for tax rebate and withdrawals of accumulations including accrued interest are tax-exempt. Periodic partial withdrawals are allowed and are tax exempt. As of March 1998 there were 2.76 million PPF accounts with an outstanding balance of Rs. 50 billion. Employees covered under mandatory schemes also can open these accounts and an individual can open multiple accounts in the name of family members. Thus, the actual coverage of employees in the unorganized sector is unknown. Thanks to the facilities of premature withdrawal and tax breaks, individuals largely misuse this scheme for legitimate avoidance of tax and it does not serve the intended purpose of old age income security. At best it can be termed as a tax efficient saving scheme for individuals.

In pension annuity plans of insurance companies, participation is limited to a very small proportion of the population, though private companies have been aggressively marketing them recently. More often the same employees who are covered under mandatory pensions schemes also participate in these schemes and avail tax breaks. Contributions up to Rs. 10,000 to private annuity plans are tax deductible under Section 80 CCC of the Income Tax Act, however, annuity received on retirement is taxable. No empirical data about actual coverage are available.

To sum it up, a significantly large population in the country does not have access to any pension system. Against a working class population of 400 million, only 35 million have access to a pension system. Out of 35 million, 26 million are covered by publicly managed pension schemes (EPFO), and the balance by other schemes. Thus, in India over 90 percent of the working population do not have access to any pension system. An institutional mechanism has to be set up for people who can afford to save for old age. In the case of the remaining 10 per cent of the working population, there is a vast majority (about 90 to 95 per cent of this 10 per cent category) who can contribute only small amounts and would like to be sure of their pension when they retire. For them it is the first and only pillar. These participants would like a government-sponsored agency to guarantee minimum pension with benefits of social insurance like disability, unemployment, and survivors' benefits. They can neither understand nor care how the schemes are managed, funded, and accounted for. That leaves only roughly about ½ to 1 per cent of the working population (numbering 20 to 40 lakh). Most of these working people have sizable disposable income and accumulate private funds over their working life. Their interests lie in seeking privately managed individual retirement accounts (with substantial tax breaks), which they can leverage with other privately held portfolios.

For regular employees in the organized sector in India, old age financial security consists of two components: a) compulsory savings by employees in the form of GPF/EPF contributions and b) pension in the form of annuity to meet old age expenses.

a) Employees contribute to accumulate funds in their individual account to be used in emergencies while in service or have a lump sum amount available at the time of retirement. These accumulated funds are not converted into annuity to provide for regular income to live on in old age. These funds are publicly managed by EPFO or any other agency under EPFO's supervision. Retiring employees need these accumulated funds to get resettled after retirement. Unlike developed countries, in India wages are not paid in gross amount, but include a whole range of perks, the major ones being housing and conveyance facilities. When a person retires these perks are withdrawn and all of a sudden retiree has to provide for these needs. Salaries in India are comparatively low and, after paying taxes and deductions, disposable incomes are just sufficient to meet daily needs. Building a house or buying a vehicle from disposable income becomes impossible and for this purpose employees tend to rely heavily on forced savings in the form of provident fund contributions. Forced savings with reasonable tax incentives ensure employees a roof over their head when they retire.
b) To provide regular income in old age, the practice the world over has been that the employer sets aside enough funds from current profits and manages accumulated funds astutely so that employees would be paid an annuity for life as compensation for current work in the form of deferred wages. These employers put these funds separately, manage it through employer appointed trustees, or outsource fund management services. For employees it really does not matter, as the pension liability remains that of the employer.

NEED FOR PENSIONS REFORMS IN INDIA

The IRDA report identifies the following reasons for reform in the pension sector (p.27):

- The growing burden of civil services pensions
- Measures needed to meet pension liabilities of the state-owned enterprises
- Liberalization of the insurance sector and entry of potential players who can offer pension products
- Recognition of the need for reforms in the functioning of EPFO

According to IRDA, the need for reforms arises from the following reasons:

1. Government and state owned enterprises as employers are finding it difficult to fund their pensions liabilities and the proposed system will relieve employers from their pension liabilities.

2. EPFO and employers' managed funds are return inefficient, service deficient, and not in a position to meet their liabilities.

3. Private companies, particularly insurance and fund managements, are waiting in the wings at the prospect of handling investible funds and presumably would offer better old age security to retirees for the contribution they make.

Proposed Reforms

To reform the pensions system, the government appointed the Bhattacharya and IRDA committees to make suggestions for government employees and the non-governmental sector respectively. They made the following recommendations.

Bhattacharya Committee Recommendation for Government Employees

1. An unfunded defined benefit, pay-as-you-go scheme (PAYG), or a pure defined contribution scheme is not suitable for government employees; instead a hybrid defined benefit/defined contribution scheme is recommended (para 10.23). This is a two-tier scheme. In the first tier, there is a mandatory contribution of 10 per cent each by employer and employee. The accumulated funds would be used to pay pension in annuity form. The second tier is to promote personal savings and there is no limit for employee's contribution but employer's contribution would be matching and limited to 5 per cent. Accumulated funds can be withdrawn in lump sum or converted into annuity at the time of retirement. These payments would be tax exempt and portable if an employee changes job before retirement.

2. Funds collected in the first tier would be deposited in a separate fund and would be invested in both debt and equity. Some funds can be earmarked for active fund management including for short term trading for better returns. However, irrespective of fund performance, government would remain liable for pension to its employees based on predetermined benefit formula. (paras 10.37 and 10.38)

3. Contribution obtained in the second tier will have a separate institutional structure and the employee would have a choice of funds (income, balanced, and growth) to invest in. Employees may decide to continue, quit, or swap among funds while in service. Government will not guarantee any specific rate of return. (para 10.39)

4. The new schemes would be applicable to new employees only (para 10.42)

IRDA Committee Recommendations for Non-Governmental Sector

The IRDA Committee's recommendations for reforms in the non-governmental sector are largely based on the OASIS report. The recommendations are as follows:

- Establish a system based on privately managed, individual funded defined-contribution accounts. Lump sum payments and/or annuity on retirement would be actuarially determined based on funds available.

- Privatize assets management functions of EPFO and exempt funds and allow private insurance firms to provide annuities. Increase coverage by covering more firms and by eliminating the present salary ceiling of Rs. 6500. Phase out the government subsidy of 1.16 per cent.

- For persons not covered by any scheme, allow a limited number of private asset managers to operate, each offering three investment portfolio options. Participants would have choice among fund managers selected through a competitive bidding process by regulatory authorities.

- Employers' and fund managers' responsibility to participants would be that of 'principal and agent' and fiduciary in nature. Fund managers would work for a fee with no performance guarantee. However, it is hoped that with expert managerial skill and wider investment choice, participants would be better off than presently available through publicly managed funds.

- Government would need to provide tax subsidy to encourage acceptance of privately managed funds. The suggested tax measures are increasing entitlement of contributions towards pension for tax rebate up to Rs. 80,000; and providing for tax exemption on the income earned by pension funds, commuted value, and annuity amount received as pension. Existing deduction under Section 80 CCC of Rs.10,000 should be withdrawn as it only defers the tax, since annuities received from these funds are taxable.

- Government should allow facilitated access to the system through its postal and banking network throughout the country to keep the administrative cost low.

- To supervise and regulate the system, an independent regulatory authority called the Indian Pensions Authority should be set up.

Evaluating the Proposed Pension System

India does not have the first pillar as suggested by the World Bank. The government does not have enough resources to provide a social safety net for the aging population. Funds have to come from the working population who plan their own retirement and, thus, the second pillar is the core programme for the population. Today, most of the employment-related pension schemes (whether in civil service or private sector) are defined-benefit plans and incorporate a collective income protection programme for disability and survivor's benefits. There are proposals that retirement benefits should be converted into defined contribution plans and implemented through privatized individual accounts. Before making the switchover, one should ask what should be the form of the core pension programme.

This part explores the issues arising from the suggested pension system. There are certain public policy issues which need to be explored first before answering the question "Will the new system provide better retirement benefits and greater coverage of the population?"

1. Risks under Different Pension Plans
(Defined Benefit vs. Defined Contribution)

Should the reformed system (particularly, for low wage employees) create individual funded (defined-contribution) accounts, or should it remain a single collective fund with a defined-benefit formula? The important question is how would risk be shared among participants.

The choice between defined benefit and defined contribution schemes is not limited to choice between a funded and unfunded system but is a large public policy choice issue: Who should ultimately bear the risk? One inescapable fact about pensions is that they represent very long-term promises. From start (when contribution begins) to finish (when pension ends) the time span may be more than half a century. When promises span so many years, risks are inescapable. However, defined-benefit and defined contribution plans distribute the risk in very different ways. The effect of unexpected 'pensions-relevant' events and who bears the risk under different plans are shown below:

	Who bears the risk under	
Risk	***Defined Benefit***	***Defined Contribution***
Inflation	Govt./EPFO/Employer	Individual
Longevity	Govt./EPFO/Employer	Individual
Investment Return	Govt./EPFO/Employer	Individual
Interest Rate	Govt./EPFO/Employer	Individual
Recession (no job)	Partly shared	Individual
Extended illness (long absences)	Partly shared	Individual

Participants in defined contribution plans face a variety of risks. Contributions usually depend on salary and duration of employment. Once contributions are made, the rate of accumulation depends on interest rates, dividend payouts, and movement in assets prices. Fluctuation in all three can be large and of considerable variation. While the average over long periods of time shows less variation than year-to-year changes, the pension that a employee will ultimately be able to claim depends largely on the timing of contributions and even more on the timing of purchase of an annuity when one retires. Participants would be particularly concerned about variations from investment choices and the misfortune of retiring when the market value of assets is low or the cost of annuities is high. There are large *inter-temporal* variations in yields (bull and bear phases). To these variations one should add even larger *interpersonal* variations in returns if employees were free to choose their own portfolio.

Uncertainties and risks associated with defined contribution plans do not end when one retires. For pensions that are not indexed, the effect of inflation on pension can be devastating. Then there is longevity risk. This can be avoided if one annuitizes, but then price of annuities is steep, an average of about 15 per cent of the capital sum that is annuitized. It covers account management, investment management, commissions and other selling costs, insurance company profit and the costs of adverse selection (the terminally ill are less likely to buy annuities than are healthy offsprings of nonagenarians). Economies of scale, such as possible in a universal mandatory collective system like EPFO, can drastically reduce these variations and costs. The collective system can also provide disability benefits as well as retirement benefits for previously disabled employees and their surviving dependents (spouses and children). It would be difficult to integrate these benefits in contribution-defined plans. If, for any reason, accumulated funds in individual account are not significant, the employee is more likely to select single-life insurance as against joint-and-survivor annuities. The less fortunate would be forced to fall back on family and/or private charity.

To sum up, under defined contribution plans, variations in assets yields and assets prices or unexpected changes in longevity affect the *pension that will be paid*. Under defined benefit plans, pension-relevant surprises change *how much the defined-benefit will cost*. In the first scheme, the pensioner takes the risk, while in the second, the provider of pension (employer or a public agency like EPFO in India) takes the risk. Risk is inescapable. Question is: who should bear the risk and how should it be shared?

- Should initial employees/retirees shoulder those risks alone or should these risks be shared more broadly across participants, if not society?
- Should social assistance to low earners and less fortunate be provided within the basic pension scheme or should they be left alone to their own fate?

The choice between defined contribution and defined benefit plans depends on more than actuarial and economic outcomes. Individual values play a role as well, since this choice involves a tension between the principle of individual responsibility and the competing principle of collective responsibility that involves sharing of costs and risks. Choice would depend upon to which group the individual belongs. Financially successful people believe in individual ownership and choice. They have many other resources to fall back upon, but low wage earners want assured returns, which would guarantee their well being. Unfortunately, most Indians are in the latter category.

2. *Publicly Managed vs. Privately Managed Funds*

If individual accounts are adopted, should the reformed system move toward private and decentralized collection of contribution, record keeping of individual accounts, management of investments, and payment of annuities, or should these functions be administered by a government agency (EPFO) and employer-managed exempt funds? Related issues need to be considered are:

- Economics of Accumulation: Intermediation spread and other costs
- Agency Risk: Principal-agent fiduciary relationship
- Employers' cost to comply with individual account system

Advocates of privately managed personal accounts and contribution-defined pension plans claim that even if pensioners are subject to greater risk, the returns are so large that virtually everyone will come out a winner. Unfortunately, this is not true. Even if returns in privately managed funds are slightly higher, the reason for return differential has nothing to do with privatization. It has more to do with the restrictions governing investment of funds. If investment patterns are same, there is no empirical evidence which shows that privately managed funds do better than publicly managed funds. In fact, privately managed funds would do poorly for several reasons.

i) Economics of Accumulation- Intermediaries Spread and Other Costs: Intermediation spread is the expense (explicit-implicit, direct-indirect) charged by intermediaries who take responsibility to manage funds. The economic magnitude of the spread is found to significantly reduce the net periodic returns made available to participants, particularly in defined contribution pension funds.

The fund industry in India typically charges 2 per cent as annual assets management fee. In addition, brokers or commissioned sales staff charge marketing or selling fee and then there are entry and exit loads. Further, management often trades too much and generates soft commissions and trading fees. All these costs add up and account for the sub-par performance of actively managed load funds. *Brennan (1993)* argues that the periodic management fee may look deceptively low but, over longer time horizons, the effect of intermediary spread can be dramatic. These costs can effectively reduce the net income available for distribution to members in the form of retirement income benefits. In employer sponsored plans transaction costs can be substantially avoided. The effect of intermediation spread and other transaction costs on accumulated funds are shown in the table below.

Effect of Intermediation Costs on Fund Accumulation

Assumed Assets Management Fee	2.0%	1.5 %	1.0 %
Rs. 100 contributed monthly, assets yield 9 per cent per annum compounded monthly	Rs. 294,178	Rs. 294,178	Rs. 294,178
After charging entry load of 5%	Rs. 279,470	Rs. 279,470	Rs. 279,470
After paying assets management fee	Rs. 171,100	Rs. 192,922	Rs. 217,919
After deducting annuitization cost 15% of capital	Rs. 145,435	Rs. 163,984	Rs. 185,231
Implicit loss	50.6%	44.3%	37.0%
Required total yield per annum on assets to compensate for these costs	11.9%	11.4%	10.9%

The effect of transaction can be gauged from the fact that monthly contributions of Rs.100 over 35 years invested in assets that yield 9 per cent a year and converted costless into annuity would accumulate to Rs. 2,94,178. For an individual account generally there is a front loaded deduction on new contribution called entry load (let us assume 5%), which reduces the accumulated amount to Rs. 2,79,470. If an assets management fee of 2 per cent is accounted for, the sum gets reduced to Rs. 1,71,100. If one accounts for annuitization cost which is roughly estimated to be 15 per cent (consisting 10 per cent for fund management, advertising and other sales costs, clerical costs and company profits; and another 5 per cent to compensate the insurer for adverse selection- the extra costs because those who purchase annuities tend to live longer than average) the sum available to the retiree is only Rs. 1,45,435. All these costs result in an implicit loss of 50.6 per cent. Private assets management companies would have to earn considerable higher return (close to 12 per cent as against 9 per cent) for the same risk portfolio to compensate for intermediation costs. Is this possible?

To reduce the financial intermediation spread and related costs, the IRDA and OASIS reports have suggested that instead of open entry, the government might auction off operating rights to a limited number of investment companies and employees can choose among them. The contract could specify the maximum risk, offer a reward for high returns, and choose the winners based on who charges the lowest administrative fees. Even if by hard bargains the asset management fee is restricted to 1 per cent, accumulated funds would get reduced to Rs. 2,17,919 before annuitization and to Rs. 1,85,231 after considering annuitization costs, still a total implicit loss of 37 per cent. Private asset management companies would still have to earn 10.9 per cent as against 9 per cent to compensate for intermediation costs on a similar risk portfolio (see the table for intermediate fee of 1.5 per cent). Even here, how does one ensure that fund managers would work in the best interests of participants, would endeavour to generate best risk-return pay off, and avoid 'soft commissions' by not indulging in high turnover of the portfolio? Choosing the right fund managers by auction to minimize operating costs does not insulate the investment process from political manipulation, corruption, and collusion.

ii) Agency Risk: Principal-Agent Fiduciary Relationship: The agency relationship has not been explicitly recognized in evaluating the financial performance of pension funds. Financially intermediated services depend upon the difficult-to-describe and validate superior skill and integrity, and thus rely heavily upon the reputation of the supplier. Several studies have shown that active managers engage in distortion of investment behavior, 'window-dressing', and 'lock-in' strategies to earn hefty bonus and trade too often to earn 'soft commission' and 'trading fees' *(Ippolito and Turner 1987)*. Bodie (1990) claims that owing to greater commonality of interest between employers and employees than between financial intermediaries and members, defined benefit pension funds typically earn relatively higher income and incur lower operating expenses than defined contribution pension funds. It is difficult for individuals to monitor the performance of fund managers as compared to the employer (or EPFO) monitoring performance. In the mandatory employer sponsored pension plan, the employer or a combination of employer and union trustees (EPFO) chooses the investment manager. These plans benefit from economies of scale and financial expertise and possibly from lower marketing costs. Since the employer or group of employers chooses the investment manager and bears the risk in defined benefit plans, the principal-agent problem also gets resolved.

To sum up, although the financial industry would gain considerably from the new arrangement, average employees-pensioners would lose. On both equity and efficiency grounds, it is questionable whether the government should compel all employees, including those who are risk averse, to incur these costs with certainty while benefits are uncertain.

iii) Employers' Costs to Administer Plan: If EPFO schemes were to be privatized, employers would face far more formidable administrative problems if employees were free to select among several mutual funds and insurance companies. Further, if employees would be free to change plans periodically, a typical employer would have to remit small sums regularly to a very lengthy and constantly changing list of financial institutions. In fact, the whole process would be so cumbersome, costly, and difficult that honest mistakes would proliferate and abuses would be inevitable. It would be difficult to monitor if employers default on payment or hang on to payment for a few days to earn some interest.

Direct deposits by employers or employees would require substantial regulatory and enforcement costs for the government to ensure that accounts are established and maintained and funds are deposited in a timely manner. Further, most of the privately managed funds require a minimum amount per deposit and balance in the account. The regulatory agency will have to ensure that

a) The same charge in percentage terms irrespective of its size is applied for all accounts
b) All employees who wish to use a particular fund are accepted regardless of the size of these accounts.

This problem can be partly solved if there is a centralized agency to collect contributions and sends them in lump sum with details about each person's contribution to the designated mutual fund. The OASIS and IRDA reports have suggested this solution, but then who will bear the costs of a centralized agency? When comparing different cost estimates for individual accounts, it is important to understand which steps are included in the cost estimate and which are assumed to be performed and paid for separately, whether by government, individuals, or employers. This will help ensure that different cost estimates are comparable in that they are costing the same set of tasks.

One can surmise that if all hidden costs to be borne by government agencies (post office, banks, etc.) are included, it would certainly be not less than what it costs to run EPFO today, and probably would not be more efficient either, given the compliance level of employers.

3. Investment Policy: Portfolio Diversification

- Should mandatory-contributed publicly managed funds (EPFO and exempted funds) be invested in a diversified portfolio that includes stocks and indexed funds or should they continue to be invested only in treasury and approved bonds?
- If individual accounts are adopted, how much choice should employees be allowed in selecting investments, and in the timing and form of withdrawals? Should individual accounts be voluntary or mandatory?
- Should there be a provision for guaranteed minimum return and/or basic minimum pension for all employees irrespective of individual account accumulation?

All three reports suggest that funds available in the pension system should be deployed in equity markets where returns are significantly higher. The proposed pension system would offer three kinds of funds: safe income, balance income, and growth. For the first five years, all domestic equity investments should be made using index funds on the NSE-50 or the BSE-100 indexes. Later on actively managed funds can be offered to pensioners.

In recent years index funds have become a favoured strategy because many of the more expensive active fund managers have failed to beat the indexes. Index funds charge low fee and are devoid of the principal-agent conflict problem. Index funds make it possible to sidestep the complexities of forming contracts and monitoring institutions to govern fund managers. However, index funds are not free of investment problems and inherent risks.

a) Index funds are subject to 'tracking error'. In a developing country like India, the error can be very high for several reasons. The first is frequent changes in the composition of the index. The Sensex, which BSE started compiling and publishing only in 1986 (with base year 1978-79), has already been modified seven times and only 10 of the original 30 stocks are now in the index. Nifty index's history is not long enough, but it has also seen many changes. To readjust the portfolio that is to acquire added securities in right proportion and to sell the discarded ones is not a costless effort in a thin market. To alter an exposure to an asset in cash markets, transactions costs (brokerage commissions) and execution costs (bid-ask spread) are generally high, particularly when everybody is trying to adjust the portfolio in the same direction.

b) Major benchmark indexes around the world are loaded with a few big stocks. There is much higher risk in index investing than people perceive. Float of various securities included in the index for trading in the market varies a great deal (from 30 to 95 per cent), and it is not easy to acquire designated scrips in proportion to market capitalization. Impact cost across securities varies a great deal.

c) There may be relatively low asset management fee in indexed funds compared to actively managed funds; however, most of the other administrative expenses remain same. Experience in many countries shows that competition among funds has failed to curb operating costs. Firms have spent heavily on advertising and agents and if individuals are allowed to switch among funds at their will, these companies get into 'transfer wars' to have a larger assets base. In the end, it is the investor who pays for all these costs.

d) Over the period, real annual return on index funds may be more, but people retire only once. Equity markets are highly volatile and go through long periods of feast and famine. Even in America, where returns have been highest and volatility lowest, there was a 10 per cent chance of getting no return at all from investments in equities held over 15 years. *Pandey (2000)* study shows that even in Indian markets longer holding period returns in equity investments are quite volatile and have been highly contingent on the upward revaluation of the early 90s. The absence of long time series data makes the analysis prone to underestimating the risk in terms of holding period returns.

e) If pensions funds were to be allowed in equity markets where practically no new issues have been made in the last few years, new demand would only drive up the stock prices. Massive inflow of funds to acquiring existing shares in a constrained supply market only increases security prices without much change in fundamental values. It may have a significant impact on relative returns from equity and fixed income securities. Portfolio switch has to be considered in tandem with supply switches.

Employees do not have knowledge of investment to make sound choices (even among the three kinds of suggested growth, balanced, and income funds) and some may not wish to do so. In particular, they are concerned about the risk from poor investment choices and from the accident of retiring when the market value of assets is low or the cost of annuities is high. There will be calls for the government to ensure some returns for mandated savings, particularly after a financial disappointment. Guarantees arranged in advance, including a premium charged for guarantee, are preferable to bailouts. The OASIS report indicates such role for government guarantee in overcoming residual risks.

Minimum Guaranteed Pensions: In principle, guarantees can mitigate the riskiness of individual retirement saving. Guarantee could be in the form of minimum return and/or providing minimum basic pension on retirement. In Germany, financial institutions providing new accounts must offer a guarantee of principal; that is, savers must get back at least the cash value of their contributions. Another type of guarantee is a minimum pension, common in countries such as Chile that have converted the pension system to privately funded accounts. If an individual account delivers a pension income less than a quarter of average earnings, the Chilean government will use tax revenue to top it up to that floor.

A guarantee on the pension fund is like offering a put option (the right to sell something at a predetermined price) to individuals. If returns are disappointing and the retirement account delivers less than the guaranteed level, the guarantor will pay up. The cost of a guarantee depends on what form it takes, how long it runs, and what investments are allowed in the account. Guarantees of principal are cheap because over a long period of, say, 40 years, value of the principal, whether nominal or real adjusted for inflation, shrinks as a proportion of the total expected value of the account which includes cumulative interest and capital gains. In contrast, the cost of guaranteeing a minimum income floor, based on government bond returns, is considerable for a fund that is half invested in equities, and the costs rise with time. Over ten years, it would cost 8 per cent of contributions, climbing to 16 per cent over 40 years. This runs counter to the familiar view that equities become safer the longer you hold them. Average annual returns on equities certainly grow less volatile, but the opposite is true for total returns as the holding period lengthens. This is because investors are exposed longer to the risk of a really serious setback in the stock market (see Smetters 2002).

In short, pension guarantees of principal are cheap, but largely unworkable because they offer little or no benefit over long periods. Minimum-income guarantees offer a substantial benefit, but they are correspondingly expensive.

Heller (1998) points out that government would acquire a conjectural liability when mandating a pension system based on private providers. Implicit in it would be the problem of moral hazard which may distort the behaviour of savers and providers. If policymakers want employees to make investment decisions and want government to provide guarantee, government would have to set certain investment constraints and use its power to monitor and police individual investment behaviour to contain problems of moral hazard. Moreover, conjectural liabilities complicate the assessment of fiscal policy in so far as it increases the hidden cost of pension reforms considerably.

The proposed system must design a suitable guarantee system. What form should it take? How expensive it is? How should it be fitted into the redesigned pensions system?

4. Government Pension Liabilities: PAYG vs. Creating a Separate Fund

For civil service, should government towards advanced funding in a separate fund, or should these obligations continue to be financed on pay as you go basis (PAYG)?

The government as employer in its wisdom decided to have a 'pay as you go system' (PAYG) rather than create a separate fund for its employees. The policy decision may not be as disastrous as it has been made out to be. Since government regularly borrows a large amount of funds from the market, the practice of first paying out to privately managed pension funds and then borrowing them back from the very same agencies does not seem to be cost effective. Policy makers may have thought prudent to avoid agency and transaction costs by not having intermediaries to route and reroute funds. The present problem has arisen when government did not exercise enough discipline in managing its own wage costs and associated pension costs. As a populist measure, successive governments made the benefit formula more and more generous which has resulted in considerable increase in pension payments.The problem has nothing to do with accounting or financial system.

Since government is finding it politically impossible to reduce the promised pension benefits and/or provide funds from current revenues the Bhattacharya report has come up with a hybrid system for new employees. For new employees, benefits would not be reduced considerably; however, employees would be asked to contribute equally along with government to build up a separate fund to be managed by expert fund managers under the supervision of a board of trustees. Further, to enhance the returns, equity investment including short-term trading would be permitted. However, government would remain liable for payment of pension. New pension promises would also include social insurance like disability and survivor's benefits. However, one may note here that a simultaneous implementation of funded, diversified, individual accounts is not a "free lunch" once you properly account for existing unfunded obligations and risk (see Feldstein, Ranguelova, and Samwick, 1999).

The Bhattacharya committee estimates show that the government would have to pay out more on account of pensions to its employees for the next 38 years (Table 8.2, pp.90-92), before the new scheme starts showing reduced government expenditure on account of pension liabilities. These amounts do not include the tax forgone by the government on the employee's contribution to second pillar schemes in which government will match contribution up to 5 per cent of wages. The committee has made several assumptions about the scheme, which it hopes would remain valid and successive governments would not behave like Santa Clauses. The proposed scheme does not consider intermediation costs and agency risks; in fact, the committee presumes that agents would behave more responsibly than principals and fund managers would be able to discipline political masters. Recent media reports do no inspire such confidence in fund managers. So far, privatization has been argued and lobbied by the very same interest groups, which are going to benefit most from the new arrangements. Since these interest groups do not assume any liability for performance, they have nothing to lose. Without bringing much wanted fiscal discipline, the system will end up having one more rentier class without any responsibility for financial results.

Today's pension problem arises largely from the over-enormous increase in pension benefits, and has nothing to do with funding arrangement. The recommended changes are not going to solve the problem by window dressing, and hard decisions like withdrawal and/or reduction in benefits which are not employment related.

Unemployment, disability, and survivors' benefits which are akin to social insurance should be abolished and/or should be funded by employee contributions.

5. Government Fiscal Policy

What should be the tax policy to promote savings for old age security? What should be the extent and nature of government subsidy?

If tax concessions, government grants, and subsidies to meet administrative costs (use of post office and bank branches) are inevitable and government has to guarantee minimum pension, what should be the institutional arrangement? The crucial question would be: How much and to whom is this subsidy accruing? Are beneficiaries of the proposed system the ones who need subsidy?

Tax treatment of pension is a critical policy choice. A generous tax treatment may promote saving but may be costly in terms of revenue forgone. Apparently, an exercise in balancing is necessary.

The process of saving through a funded pension scheme involves three transactions, each of which provides an opportunity for taxation:

1. When money is contributed to the pension fund
2. When investment income and capital gains accrue to the fund
3. When the members receive benefits on retirement.

Present tax provisions for these three stages are as follows:

	1	2	3
Employers' Contribution to PF	E[1]	E[2]	E[3]
Employees' Contribution to PF	T[4]	E[2]	E[3]
Public Provident Fund	T[4]	E[2]	E[3]
Employees Pension Fund	E	E	T
Pension Plan from Insurance Companies	E[5]	E	T

E Exempted T Taxed

1 Tax-free contribution up to 12% of salary allowed as business expenses

2 Interest credited up to 9% per annum is tax exempt

3 Withdrawals allowed only after 5 years

4 20% tax rebate on contribution up to Rs. 60,000 under Section 88

5 Contribution of Rs. 10,000 deductible from income under Section 80 CCC

One can see that various tax benefits are available on contributions made for old age security. Employees can contribute up to Rs. 60000 a year and get immediate tax rebate of Rs. 12000. In addition, interest accrued on this accumulation is tax free when received along with contributed principal. Thus a person contributing Rs. 60,000 a year, for say, 20 years can easily accumulate Rs. 51 lakhs in which his own investment would be only Rs. 9.60 lakh after receiving 20 per cent rebate. The tax subsidy would amount to Rs. 14.4 lakh: Rs. 2.4 lakh (=20%*60000*20years) in the form of immediate rebate and Rs. 11.7 lakh in the form of tax revenue lost on accumulated interest (assuming 30 % tax bracket). In addition, the employee can also contribute to a pension plan and get tax benefits immediately.

Employers' contribution to pension plans and provident fund up to 12 per cent of the salary are considered business expenses and tax deductible. The entire amount received by an employee when he retires is tax-free. This tax advantage does not have a monetary ceiling. This kind of tax exemption/subsidy is not available anywhere in the world. Now many top company officials receive salaries in excess of Rs. 50 lakh a year. Let us take the example of a chief executive officer of a blue chip company who receives a salary of Rs. 1 crore a year (not very uncommon these days after removal of ceilings on managing personnel salary prescribed earlier in the Companies Act). The CEO can easily accumulate Rs. 3.6 crore (assuming 9 per cent interest) absolutely tax-free in retirement benefits totally contributed by the employer, if he works for 15 years in this position. In addition, he would also be accumulating tax-free retirement funds from his own contributions.

Employees in the unorganized sector can contribute to the Public Provident Fund and get tax rebate under Section 88. They can also contribute amounts up to Rs. 10,000 to buy annuity from a life insurance company and get tax deduction for this contribution.

Thus, there are plenty of tax incentives available for employees to contribute for old age. In fact, government tax policies are such that the people in high-end income groups accumulate funds without paying much tax on contributions and accumulations.

This brings us to the question of what should be the rational tax policy, which would promote a healthy and widespread pension market for everybody in the country. A few suggestions are offered below in this connection:

1. Allow Section 80 CCC benefits up to Rs. 20,000. Pension benefits should remain taxable.

2. Abolish and/or alter Section 88. Restrict Section 88 to provide tax rebate to induce/direct/channel savings in a desired sector like infrastructure. Remove the rebate on all small savings schemes of short duration. It distorts the interest rate structure and flows of funds in the economy and is the most inefficient way of raising funds for government.

3. Create another section for accumulation of funds for old age (PPF equivalent). Allow for each participant tax-deductible contribution of 20 per cent (combined employer and employee) of salary. For tax-deductible contribution purposes, there would be a ceiling of Rs. 10,000 a month on salary. Tax advantage would be available on contributions with a ceiling of Rs. 2,000 a month only. These contributions would be sufficient to accumulate funds for old age. Accumulated funds assuming 9 per cent interest after 30 years of service would total Rs. 32.71 lakh. The commuted amount and/or annuity bought from this amount should be tax-free.

These provisions would ensure that government liability on account of providing old age security for its citizens would be rationally determined and appropriately distributed among all income groups. High-end income groups would not corner major part of the tax subsidy. Tax forgone is a form of indirect tax subsidy, which must be recognized in framing tax policies. Retirement benefits available from accumulated funds under sections 80 CCC and 88 would be more than what would be required for an average citizen to lead a dignified life. However, people with high resources can build their own third pillar by accumulating funds on their own private account, but government need not provide any tax subsidy here. When the government cannot provide the first pillar for want of resources, it should also not squander money (lose tax revenue) on building the third pillar for a select few.

FUNCTIONING OF EMPLOYEES PROVIDENT FUND ORGANIZATION (EPFO)

There has been great deal of criticism of EPFO in handling its responsibilities (see *IRDA Report,* pp. 21). This section analyses the role played by EPFO and evaluates its functioning.

To protect employees from fraud and bankruptcies of firms in the non-government sector, employers were required to remit periodically employees and their own contribution to a government agency (EPFO) which administers the scheme. EPFO manages these funds and assures a minimum pension based on the employee's years of service and some other factors. The scheme runs on collective insurance basis and the rate of contribution and benefits are periodically adjusted based on revised actuarial estimates.

Several questions have been raised about the working and financial viability of EPFO. The OASIS and IRDA reports do not inspire much confidence in EPFO working. The IRDA reports states that EPFO has high contribution rates, low returns, and deficient services. As a result the scheme is not an effective vehicle for retirement savings. Further, there are doubts about the viability of EPFO's pension scheme. It would run out of funds to pay for its assumed pension liabilities. Fears are aroused that EPFO is bound to default like the Unit Trust of India (UTI) and government would not bail it out.

There have been many responses to these comments.

i) EPFO may be technically as efficient as the private sector in providing administrative services to its members; however, this deficiency arises from delay in technology upgradation of its offices and training of its officers and has nothing to do with being publicly or privately managed. EPFO management does not have the luxury of starting from scratch unlike privately managed funds. Technological upgradation is taking place all around and services are bound to improve. (For example, see gains made by LIC, some banks, and even EPFO in providing account services online and on phone.)

ii) Even if it is true that EPFO is *technically not efficient* in providing administrative services to its members, it is *economically efficient*. The contribution rates for services EPFO provides is not very high. For new government employees, the Bhattacharya report based on recent estimates has proposed a combined contribution of 20 per cent of wages to provide the same level of benefits which is currently being provided by EPFO. High rates of contribution are partly the result of forced savings for reasons that go beyond old age pension. They provide for lump sum withdrawals, unemployment insurance, disability, and survivors benefits. The OASIS and IRDA reports do not provide any rational and/or quantitative figures to justify their comments.

iii) EPFO provides employees what they are looking for: assured return with disability and survivor' benefits at a reasonable rate of contribution. EPFO may not be earning as good a return as privately owned funds. However, since pensions are assured, funds are usually and understandably invested conservatively. Moreover, comparisons are made using gross returns, and not adjusting for intermediation costs and associated agency costs, which may eat up earned returns considerably.

iv) Some feel that the EPS 1995 scheme's aggressive actuarial and benefit assumptions make the scheme unviable. EPFO fund trustees believe that this is not true. Annual actuarial valuations have certified the sustainability of the scheme. Whom should we believe? Anyway one can always recheck the sustainability of the scheme. The scheme has been in operation for only seven years and it may be early to make judgement. Even if the fears are true, the system can be tuned, figures can be reworked and made more realistic, but we do not have to throw the baby with bath water.

v) Is the private sector willing to provide the services currently offered by EPFO? So far no package has been offered. Only vague promises with no underwritten liability have been put forward. Would employees prefer private sector lofty promises or government-backed guarantees for their pension benefits? Probably a demand survey of employees is required before making major policy decisions regarding privatization, which does not provide return guarantee. None of the two reports has done any demand survey.

CONCLUSION

Indians do not have the first pillar funded and supported by government and, therefore, the second pillar becomes the basic pillar – a core retirement plan. In this plan people are looking for secured income when they retire, and, therefore, as recommended by the World Bank the plan should be publicly managed. Problems with privatization include the following:

1. Current retirement benefits are barely adequate and a retiree wants a reliable source of income. Privatization contains no social insurance components like disability and survivors' benefits. Retirees would have to buy them separately. Benefits may be reduced by as much as 30 per cent in some cases.

2. Having individual retirement accounts in private pension funds would be prohibitively expensive to administer. In some cases where contributions are small (say Rs. 100 a month), administrative costs may be as high as 25 per cent of contributions.

3. Privatization gets the employer off the hook. Risk shifts from corporations to employees. Most employees prefer the stability of pension plans to higher volatile monetary value of the fund. For less wealthy, assured income has always been economically better than higher but volatile and uncertain financial wealth.

4. There would be the added problem of agency risk, which has not been taken note of. Government would have to add a so-called '0 pillar' that will guarantee a minimum pension to employees whose own defined pension falls below a specified minimum. Along with tax subsidy, policy makers should factor into the cost of government providing guarantees for policyholders.

The priority should, therefore, be putting in place a policy vision and road map with specific goals in relation to pre-determined milestones. These include the tax financed and means-tested system for lower income groups. If government cannot afford it, then it has no moral or political justification to even consider providing further tax benefits to privileged income groups. If there are no government funds for the first pillar, the third pillar should remain out of policy discussions. Emphasis should be on strengthening the second pillar.

Pension reforms would not occur overnight. Thus, the focus should be on improving existing systems rather than replace them with new ones. Efforts should be made to find ways of supporting new systems that may supplement existing systems. Since the tax-paying population is small, an exclusive focus on tax incentives as a vehicle to encourage savings is misplaced. Proper estimate of the " tax expenditure" (that is, forgone revenues) that results from current tax preferences for retirement savings and explicit decisions about the appropriate size and progressivity of these preferences need to be made. Government's contingent liabilities on account of minimum pension guarantee also need to be taken into account before any change in policy is made. Participants' interests and associated government costs in the form of government grants, administrative costs by its agencies (EPFO, post office, bank branches, etc.), and funds required to guarantee minimum pension should all be taken into account in recommending any institutional arrangement.

Sound pension planning can be achieved only by obtaining continuous, uninterrupted accumulation and sound fund management (not necessarily private fund management). The challenge in building a pension system lies in low administrative costs, nationwide collection, and adequate simplicity for participation by millions of people with highly limited financial sophistication. What is needed is a careful design of government institutions for diversified investment in order to help shield fund accumulation, portfolio decisions, and corporate governance from political pressure. The existing system need not be discarded; it only needs tuning up with technology-savvy administration.

In the government sector, reforms should focus on strengthening the existing PAYG system through adjusting the system parameters. Pension outlays can be lowered by reducing the replacement rates, that is, the ratio of pensions to wages, or by moving toward less generous pension indexation formulas that give less weight to wages and more weight to inflation, raising the retirement age in line with life expectancy, and rationalizing disability, survivors' benefit, etc.

Private firms, particularly insurers and fund management companies, may be lobbying hard to acquire new business or being hired by EPFO to manage its Rs. 500 billion corpus without guaranteeing anything in return except lofty promises. However, government must be cautious about these moves. In privatizing the basic pension system for its citizens, intermediation costs and agency risk cannot be ignored. Since politicians cannot stop being playing Santa Clauses and causing havoc with government finances, one should not imagine that fund managers would discipline them and solve the problem. Given so many scams in the past, it is more likely that they will join the bandwagon in sharing the spoils at participants' and/or government expense. All this serves to spotlight the role that the government must play in creating a pension system with appropriate safeguards for inherent risks and ensure that appropriate parties bear them. If private fund managers are willing to guarantee performance, it may be worth trying. EPFO finances need closer scrutiny to examine its viability and to provide efficient services it must have trained manpower and technology savvy administration. If other publicly managed insurance companies can do it, why not EPFO?

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