Reforming pension system

Pak-Eco.
Dawn
17.2.05

By Shahid Kardar

THE need for reforming the current system of pensions for government employees is now widely accepted among policymakers in Islamabad. Hence, not only has an exercise for the actuarial valuation of the pension liability of current employees but also the revision of its structure that would apply to new entrants has been launched.

The existing pension system covers close to 3.5 million government employees (of which 0.6 million are in the armed forces. Pension payments to them, because of their shorter working lives, account for more than 45 per cent of total pension expenditure), representing a mere two per cent of the population and under 10 per cent of the labour force.

Civil servants receive what is called a defined benefit. After 25 years of service they are paid a particular pension per month, which is linked to salary drawn at the time of retirement and the number of years they were in service. This amount is then revised periodically to adjust for inflation. Under the pension entitlement rules, they can 'commute' 80 per cent of their pension in lump sum at the time of retirement. This is a generous benefit, since the amount paid as commuted pension is not discounted to adjust for the interest cost borne by the government for the advance payment of an amount that the retiree would have received as the monthly pension over several years in the future.

This provision is, in fact, even more liberal, since the amount commuted can be restored, after 15 years of having availed of the

of these countries. Hence, the reforms being proposed in most countries to shift from this PAYG system to one fully or partially funded system based on contributions of both the government and its employees.

In our case, the annual burden of just pension payments has ballooned, having touched the Rs.55 billion mark, and threatening to become unmanageable as large cohorts of civil servants retire, largely owing to the bunching that is expected to occur of retirees recruited first in the 1970s and then in the latter half of the 1980s and the early 1990s, during periods of civilian rule.

It is also interesting that in the armed forces there are now more pensioners than active personnel. Moreover, as average life expectancy rises, government functionaries as a group will live even longer than the rest of the population. This will push up the future pension payment bill even further. The burden of pension payments is particularly worrisome for provincial governments which have a large workforce on their payrolls and scarce resources from which to finance them.

Therefore, the proposed new system of a contributory pension scheme to which both the government and the employee will make equal contributions to the retirement of an employee is a move in the right direction. It is proposed to be mandatory for new employees and voluntary for the existing ones.

Under this system employees will have individual pension fund/retirement accounts, rather like the current individual provident fund account. The details of withdrawals that would be allowed from such accounts, what will have to be retained in these accounts so that individuals are able to buy commuted can be restored, after 15 years of having availed of the commutation, to the pension receivable per month, as if no amount was ever paid as commutation to the retired employee. Family pension is also payable to the spouse or dependent children after the death of the civil servant, although at a reduced rate.

On retirement civil servants are also paid a gratuity, equal to 40 times the last drawn salary. Under the current pension system, existing civil servants are not required to make any contribution to their eventual pension or gratuity benefit. Their cost is borne entirely by the government. Moreover, the government has not built up a fund that it has invested in income-generating assets from which it can settle its pension obligations or the gratuity that it pays to its employees in a routine manner.

Instead, it settles its liability for gratuity payable to its employees and the annual pension payments from the revenues generated during each year, not the most reliable and prudent manner of discharging these liabilities.

Civil servants are also entitled to a provident fund to which only they contribute, but on which they have historically been paid an interest rate that was substantially higher than even the interest rate that the government paid to public investments in instruments like the Defence Savings Certificates. It is instructive that even the contributions to their provident fund made by employees, which the government holds essentially in the capacity of a trustee, are not set aside and invested in a separate fund but used to finance annual government expenditures and paid to retiring employees from the revenues for the year.

In many countries the system of pension prevailing in Pakistan, generally referred to as the Pay As You Go (PAYG) system is in serious trouble. This writer understands that even in countries like Germany, France and Japan the net present value of social security benefits not set aside in the form of specific funds to discharge such liabilities was more than 100 per cent of the national incomes of each

> The proposed new pension system to which both the government and the employee will make equal contributions is a move in the right direction. It is proposed to be mandatory for new employees and voluntary for the existing ones.

annuities/arrange for a specific monthly stream from insurance companies (since if full withdrawal were to be permissible, it would defeat the purpose of the new pension system) and the tax incentives that would be on offer for encouraging savings into retirement schemes will have to be worked out to provide an incentive for this shift, although this fiscal incentive would not attract those civil servants who do not earn enough to be liable for income tax.

However, the natural rate of attrition/retirement being under three per cent it will take almost 40 years before any change in the scheme will apply to all civil servants, even if younger existing civil servants are incentivized to switch to the new scheme in which they will also be contributors and the provision relating to the restoration of commuted pension is also withdrawn.

In other words, a slow rate of transition into any new scheme will not ease the pressure on the budget of pension payments. So, the immediate future does not look propitious and perhaps the only pragmatic way open to the government to discharge its obligations pertaining to commutable pensions to retiring civil servants would be tradable interest-bearing bonds.