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The National Pension System and the Future of Old-Age Social Security in India

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Abstract

This paper traces the evolution of the pension system of India over time, with a focus on the performance and potential of the latest and biggest pension schemes: the National Pension Scheme, Atal Pension Yojana and NPS-Lite, in the context of providing old-age income security for a highly heterogeneous workforce of varying socio-economic backgrounds. The paper is intended to shed light on the ongoing limitations of the scheme as well as its successes and tries to provide some solutions of the given limitations. It is observed that although there has been significant growth in pension corpus as well as in the number of subscribers, when looked at the response in terms of share of the total workforce and the performance of other old-age income security options like the EPF and the PPF, the performance is rather lukewarm. A likely cause for the same can be attributed to the inferior tax treatment vis-à-vis its substitutes, high penalties for irregular payments in case of APY, and poor marketing of the schemes, especially NPS Lite, to the financially excluded, low-income workers.

Keywords: *NPS (National Pension System), Informal Sector Old Age Income Security and Fiscal Expenditure on Pension.*

1. INTRODUCTION

Old-age income security is an important issue with respect to the fact that the proportion of elderly population in India, which is 8% as per 2011 Census, is expected to rise to 12.4% by 2026 (GoI 2011), to 20% by 2050 (Bloom et al 2010) and to around 37% by 2100 (Narayana, 2015). A significant proportion of the working population is engaged in the informal sector, and elderly population is more vulnerable in economically weaker households, as the elderly are dependent on younger family members where, apart from economic factors, support is more difficult to get in today's age of modernisation and nuclear families, and hence arises the need for a comprehensive pension system which can also cater to informal sector workers, to tackle to the increase in the dependency ratio.

A Robust Pension System consists of three Pillars of Comprehensive Schemes

Pillar 1

This includes non-contributory basic pension schemes, mostly financed by the government. It can be universal or targeted. In India, such schemes are mostly targeted, especially the targeted unconditional cash transfers such as the Indira Gandhi National Old Age Pension Scheme (IGNOAPS), which have been observed to be quite effective, although small [Dutta et. al., 2010].

Pillar 2

Occupational contributory pension schemes, where contributions are made by the

employee and the employer, and can be defined-contribution or defined-benefit. Prior to the implementation of the NPS, this category consisted of the Employees Provident Fund (EPF), which is for private sector employees only, and is mandatory for any organisation with more than 20 employees.

Pillar 3

It includes schemes that are voluntary and completely privately funded, like the PPF.

The importance of a Defined-Contribution pension scheme wherein both the employee and employer would contribute to the pension fund, is also imperative as studies have time and again pointed to the fiscal stress of providing a strictly Pillar 1 pension scheme, completely funded by the government. The reasons for such a pension system to be unsustainable in India is due to the increase in life expectancy of government employees, thereby increasing the future liabilities of the government manifold. There had already been cases of pension payments being delayed or pension accounts getting deactivated on account of shortage of funds with the government at a given time. Such a situation, which is also referred to as the „policy risk" of a Pillar 1 scheme, is the primary cause of governments shifting to a Pillar 2 form of pension system, consequently easing the fiscal stress arising out of the provision of pension.

This brings up the question about how successful can a contributory pension scheme be for an economy like India's where, as of 2019-20, around 43.2crores employees out of the total of 53.5crores workforce work in the informal sector, with a significant portion of it not having regular incomes, to be able to contribute to the pension scheme, that too for a long time. Experience from other countries show that the per capita income of the economy is the most important factor in determining the success of a contributory pension scheme, that is, the overall corpus amount and their corresponding returns. As suggested by economic theory that an individual has a negligible propensity to save of out of income when the wages are close to subsistence levels. Therefore, it is prudent to be sceptical about the potential of such a scheme, in the context as to how much of coverage will happen for informal sector employees. This is precisely the rationale for having separate schemes for low-income informal workforce and the rest, as one possible way to tackle the issue of coverage.

Hence, keeping in mind about the unaffordability of a fully state-sponsored pension programme due to fiscal constraints and India's large population, a „Defined Contribution" pension scheme becomes imperative, whereby, a pension fund is created for wealth generation from contributions of both the employee and the employer, along with greater coverage including informal sector workforce. However, it must also be considered that the fiscal relief due to the implementation of NPS would implicitly mean a greater room for the expansion of Pillar 1 schemes which can be targeted as per socio-economic factors, given their effectiveness, lower leakages and their importance to their recipients despite being low amounts.

Research Methodology

Present study builds on existing research and methodologies.

Objectives

To examine the evaluation of pension system in India

To evaluate the performance of the National Pension System

To analyse the future prospect of pension system in India

Data Source

Keeping in view the broad objectives of the paper, the study is purely based on secondary data of Indian economy. The data will be collected from different national sources such as financial services, PFRDA & International labour organisation. The methodology used for data collection will be consistent with objectives of my paper.

Software: Excel and Tableau

Statistical tools: Average, percentage, ratio, correlation, tables (pivot table), graphs (Line chart, Scatter plot, Histogram)

2. LITERATURE REVIEW

Sane & Thomas, 2014, they argued that PFMs are freed from the role of collection of contributions from individuals and maintenance of records, since they receive a single instruction and cheque from the CRA. They can thus focus purely on fund management. Fund managers are only required to do passive management, which is another approach to lower fund management costs. The numbers of pension fund managers are limited, as are their product offerings. This simplifies the product offerings, making the NPS universally accessible to both financially sophisticated and unsophisticated customers.

Rajasekhar et al, 2017, they explained that a large segment of low-income workers in the informal sector are highly vulnerable to workplace injuries, accidents and disability, the APY scheme should have a more compassionate approach and not deny them the benefits of social protection."; and, most importantly, benefits not being indexed to inflation.

Pension Reforms

Pension reforms and the consequent introduction of NPS, have been of prime importance due to two factors: fiscal stress and absence of pension for informal employees. In order to tackle the problem of fiscal stress, arising out of the previously existing unfunded and Pay As You Go(PAYG) scheme for pension payments to central and state government employees, the expenditure of which was consistently increasing, the government shifted to a contributory scheme, with its focus on building a pension corpus over a long period of time. Continuing with the old system would have implied provision of old-age income security at the cost of the rest of the economy, that is, the younger workforce paying for the pension of the retirees.

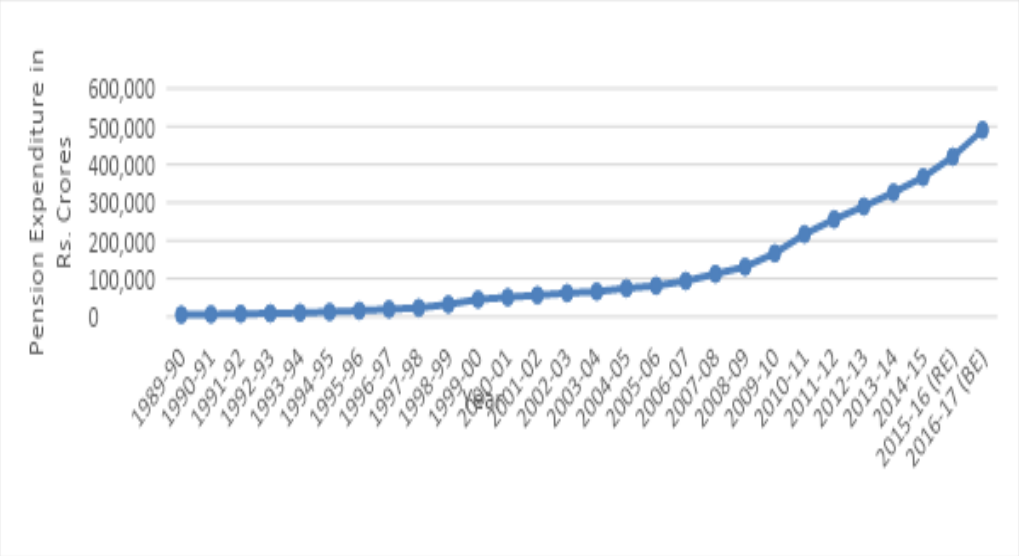
India already had a contributory pension scheme: the Employee Provident Fund (EPF), but its coverage was only limited to the employees of the private organised sector. A policy response to the problem of lack of formal means of income security was the setting up of the OASIS Committee in 1998. The committee recommended the designing of a system that:

Increases coverage on the large area, population and diversity of India
Is low cost
Is accessible to unsophisticated participants
Provides choice of investment
Is backed by sound regulation
Has long-run sustainability.

The recommendations of the committee took the form of the National Pension System (NPS) when it was implemented."[Shah, 2006].

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Chart 1: Pension expenditure of Centre and States 1990-2017



Data Source: data.gov.in

As can be seen from the above chart, government expenditure on pension has been on rise since 1990, and the rise has been steeper post 2008. This rise can be attributed to rise in price levels due to increasing incomes, as well as, increase in the number of pensioners. Despite the implementation of NPS in 2004, savings for the government arising out of it has not been realised yet, as those enrolled in NPS aren't expected to retire in the next 10 to 20 years at least. Given the trends, the imperativeness of a Pillar 2 pension scheme is quite clear.

The National Pension System

The key participant of the infrastructure of the NPS includes:

Points of Presence (PoPs)

PoPs make up a network of access point to the NPS for all customers. These include banks, post offices and depository participants. In the case of civil servants, the existing administrative framework that disburses salaries and other benefits function as the PoPs.

Central Record-keeping Agency (CRA)

The CRA is the agency that is connected to the POPs spread across the country at one end, and to the fund managers managing the investments on the other. Every day, the CRA receives funds from individual accounts at POPs, calculates the aggregated value of funds that need to flow to each respective fund manager. The key contribution of the CRA to the design goals is to lower transactions costs by lowering costs of record keeping and funds flows. This is expected to result in a higher return of the NPS to contributors.

Pension Fund Managers (PFMs)

PFMs are freed from the role of collection of contributions from individuals and maintenance of records, since they receive a single instruction and cheque from the CRA. They can thus focus purely on fund management. Fund managers are only required to do passive management, which is another approach to lower fund management costs. The numbers of pension fund managers are limited, as are their product offerings. This simplifies the product offerings, making the NPS universally accessible to both financially sophisticated and unsophisticated customers. [Sane & Thomas, 2014].

These participants make up the central part of NPS, responsible for the day-to-day execution of the NPS. Other than them there is the PFRDA which is the regulatory body for the NPS.

NPS Lite and Atal Pension Yojana (APY)

The general setup of the NPS was seemingly expected to not be able to cater to the low-income informal sector workforce. Consequently, two central schemes have been implemented to serve the purpose of coverage to the said workforce. The key attributes of the two schemes are as follows:

NPS Lite

In 2010 the PFRDA came up with a new variant of the NPS called the NPS Lite, the first contributory pension scheme for consumers with low and irregular contributory capacity, with a lower amount of contribution required, for example, Rs100 as initial contribution instead Rs500 in case of NPS. A special feature to attract subscribers was the Swavalamban Scheme as per which the government would contribute Rs1000 to those subscribers‟ accounts who manage to contribute at least Rs1000 per annum. This is a rather imperative feature as else this scheme would be remaining a Pillar 3 pension scheme.

Despite these features, the scheme was not able to attract much subscription due factors such as poor marketing, aggregators focusing less on workers with irregular incomes, and low overall awareness among the low-income workers about the features and benefits of the scheme. Apart from that the scheme wasn't adequately oriented towards worker welfare, as low-income workers would be expected to prefer current consumption over savings. The exit criterion of only 20% of the corpus being allowed to be taken as lump sum defeats the welfare purpose in that context.

Atal Pension Yojana

The PFRDA in 2015 came up with another pension scheme aimed towards the coverage of low income informal workers, the Atal Pension Yojana (APY), which differed from NPS Lite on some key aspects: Different joining age and minimum contribution; minimum pension of Rs1000 onwards given in APY unlike NPS where pension amount is variable; stringent default penalties as well as penalty for late payment in APY, whereas no penalties exist in NPS Lite; exit criterion for APY allows for 100% lump sum withdrawal before 60, unlike NPS.

Overall, there are a few aspects where APY comes out as more welfare friendly than NPS Lite. The major drawback of APY over NPS Lite is the existence of penalties for late payments and defaults, in the absence of which it would be a rather comprehensive pension scheme for the low-income unorganised workforce.

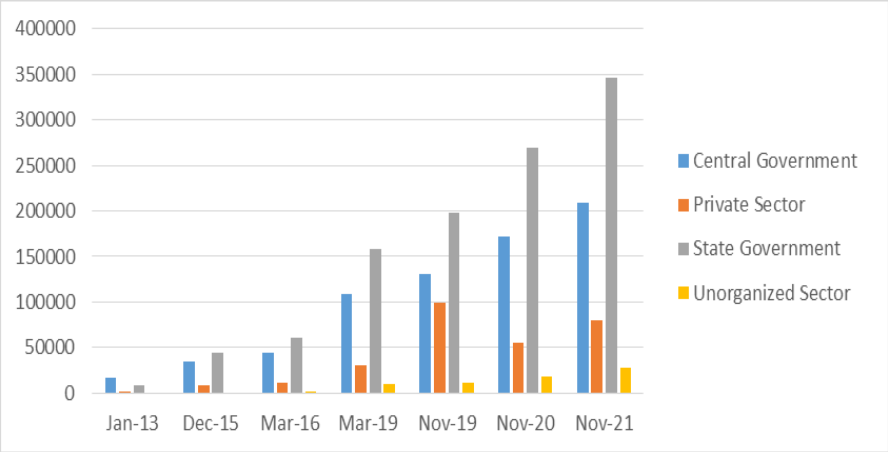
Success of the Scheme

Initial response to NPS was quite lukewarm. As on 2010, only 0.005% of the working population had joined the NPS voluntarily (PFRDA 2010, 2011). Although growths in corpus and subscribers have been happening consistently, relative to the total workforce, coverage is still not much. As of 2022 approximately 9% of the informal sector workforce is enrolled in APY/NPS Lite. Hence it can be said that despite the drawbacks and economic setback of the pandemic, rise in coverage from less than 1% to 9% in 12 years points to sustained growth in coverage. As per Mohanty, 2022, enrolment in APY/NPS Lite has risen by 335.5% in the last 5 years from 2017-2022, which points an increase in the pace of coverage most likely among

low-income households.

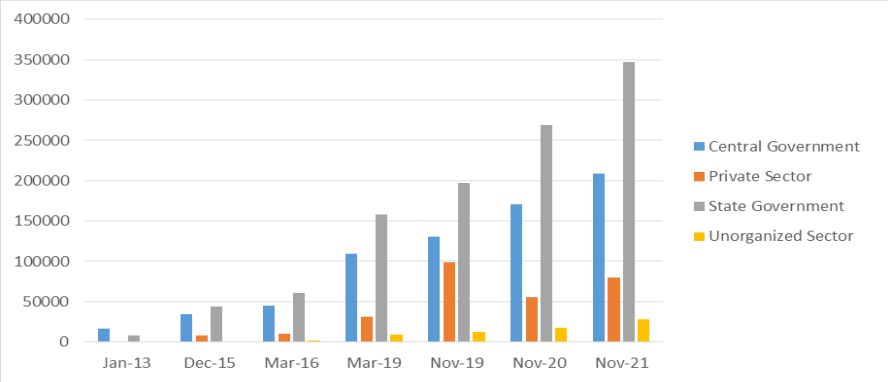
Hence one of the key objectives of the NPS, to provide coverage to the informal sector workforce has seen a start. Although, there is not enough data to say with certainty as to how many of the subscribers are indeed low-income workers, as well as the fact still remains that bulk of the informal sector workforce – approximately 91% - is still outside the purview of the NPS.

Chart 2: Growth in enrolment of NPS:



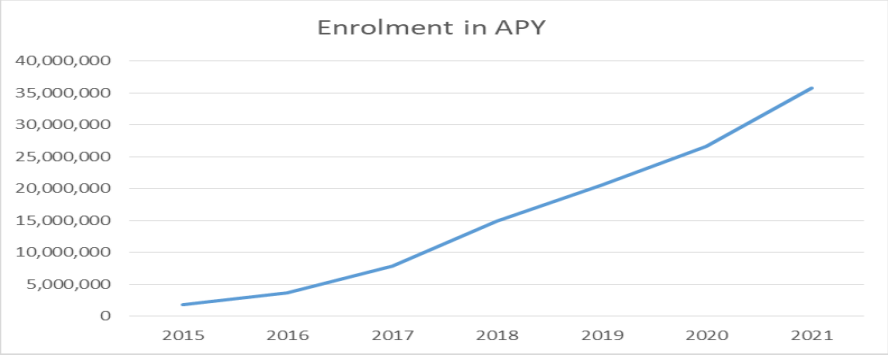
Data Source: Financial Services

Chart 3: Growth in Assets under Management of NPS:



Data Source: Compiled from Financial Services annual reports

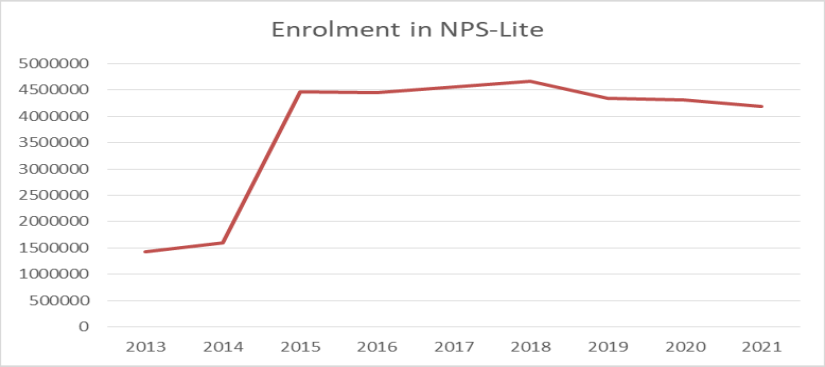
Chart 4: Enrolment in AP



Data Source: Compiled from Financial Services annual reports

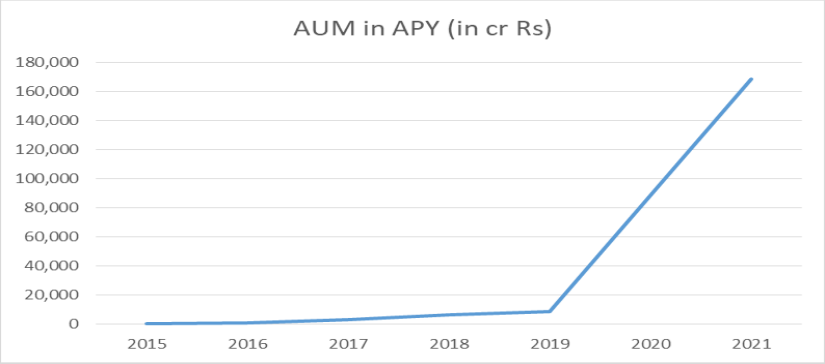
Chart 5: Enrolment in NPS-Lite

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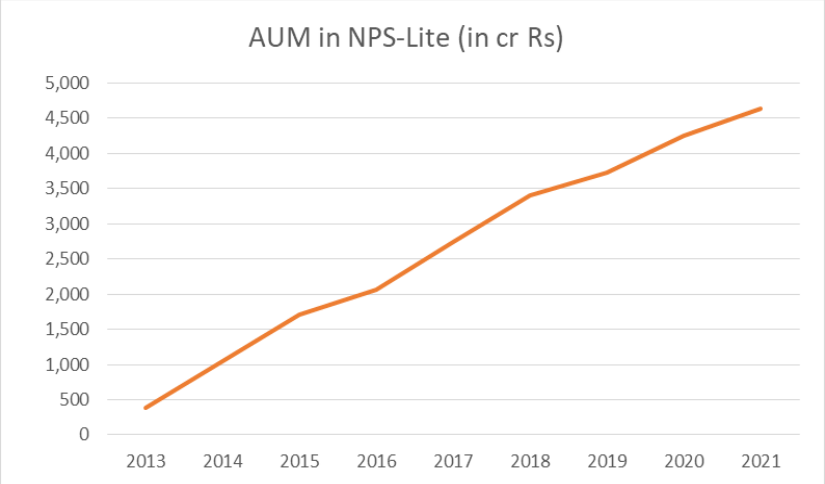
Data Source: Compiled from Financial Services annual reports

Chart 6: AUM in APY (in cr Rs)



Data Source: Compiled from Financial Services annual reports

Chart 7: AUM in NPS-Lite (in cr Rs)



Data Source: Compiled from Financial Services annual reports

As per data compiled by International Labour Organisation (ILO), in 2016 and 2020, 25.2% and 42.5% respectively, of the persons above 60 years of age received pension from some kind of federal programme. Hence, it can be concluded that, at least in the last 5 years, there has been significant improvement in coverage of pension programmes. On the other hand, it is also true that majority of the old age population is yet not covered by any kind of pension scheme, and are thereby likely to be dependent on savings, which are expected to be low for the economically weaker, implying a dependency on family.

Policy Drawbacks

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The limitations of the NPS are assessed better for formal workers and informal workers separately, given the dualistic nature of the economy:

One of the major drawbacks of the scheme is multiplicity. Given that India being a developing economy which still hasn't reached a middle-income per capita income level, and that a significant portion of the population still is employed in traditional sector of the economy, the dualistic nature of the workforce, above the other socio-economic heterogeneities makes it implausible to come up with a single pension system uniform for everyone, while providing extensive coverage. Hence, two separate pension schemes in sync with the dualistic nature of the economy seem like a rational choice. However, at present there are about four different pension schemes within the NPS architecture. The presence of multiple variants leads to a number of problems such as damages economies of scale reduces quality of policy analysis and making decision-making at the household level hard due to absence of simplicity.

Apart from that, absence of a minimum pension in the NPS makes it very undesirable, as returns to investments depends on annuity markets and the economy in general, meaning the whole risk being borne by the contributor, causing welfare loss to the investor, thus making it a poor substitute of the EPF, which provides for a minimum pension.

The NPS also suffers from an inferior tax treatment, whereby withdrawals are not tax exempted, unlike other programs such as "the Contributory Provident Fund (CPF), Employees Provident Fund (EPF), superannuation, Public Provident Fund (PPF) all of which are EEE, i.e. contributions are exempt, accumulation is exempt, and withdrawals are exempt" [Sane &Thomas, 2014]. This can be attributed to be the primary cause of low take up rate of NPS among corporates, despite giving higher returns than EPF.

The NPS also fails to establish a low-cost system, essential for building up of wealth across several decades. Low cost was to be achieved by economies of scale; a principle violated due to multiplicity. Along with that, there has been a consistent increase in the fund management fees. On one this increase has been correlated with an increase in returns on funds as well, since fund managers for long had pointed out the management fees being much lower than they would require making profits, and had asked it to be raised to 0.25%. This is actually an outcome of a fragmented pension structure, made worse with a higher number of fund managers, further damaging the economies of scale. Although the management fees were never raised to 0.25%, present management fees numbers are mentioned below.

A rise in management fees has also been accompanied by an increase in administrative costs of the NPS too. In 2022 alone, several charges and hikes were introduced by PFRDA on services provided by Points of Presence (POPs):

> *Initial subscriber registration - Previously, the charge was set at Rs 200 now the range is increased between Rs 200 and max Rs 400 which is negotiable within this slab.*
>
> *Initial contribution and subsequent contribution - If an individual invests Rs 5,000 in an NPS account through POP, POP should charge Rs 12.50 (0.25 percent of Rs 5,000), but it will charge a minimum fee of Rs 20. According to the PFRDA circular, the maximum cost collected by the POP will not exceed Rs 25,000 previously. Now with new POP charges, if an individual invests Rs 5,000 in an NPS account through POP, it will charge Rs 25 (0.50 percent of Rs 5,000), but it will charge a minimum fee of Rs 30. The maximum cost collected by the POP will not exceed Rs 25,000. However, it is*

negotiable within the slab.

All non-financial transactions - The charges for all non-financial transactions are increased to Rs 30 from Rs 20.

Persistency fee - Earlier, the persistency fee was capped at Rs 50 per annum with no limit on the amount. "Persistency is payable to POPs for each subscriber whose account has been opened by them and who contributes a minimum of Rs 1000 in a financial year. The subscriber should be associated with the POP for more than six months in a financial year," according to PFRDA notification. Now the same has been set to Rs 50 per annum for annual contribution between Rs 1000- -Rs 2999, and the method of the deduction would be through the cancellation of units. For amounts between Rs 3,000 – Rs 6,000 persistency will be Rs 75 and Rs 100 for above Rs 6000.

The central goal of the NPS, being enhancing coverage is also violated due to the very design of the policy, which limits its adoption among unorganised workers. They include stringent default penalties: "if an APY subscriber misses up to six consecutive contributions, his/her account is frozen, after 12 months their account is deactivated and beyond 24 months their account is permanently closed. Considering that the APY has been designed for unorganised workers with irregular income streams, this feature is likely to dissuade such workers from enrolling in the scheme and existing subscribers from availing its post-retirement benefits."; limited government co-contribution: "Since less than 1% of the total unorganised workforce in the country is currently participating in the APY, a large section of the target population who join the scheme in the coming years will remain excluded from this incentive."; lower flexibility in exit and withdrawal: "exit option was given to the beneficiary if she/he gives up government's contribution and interest earned on his/her contributions.

Considering that a large segment of low-income workers in the informal sector are highly vulnerable to workplace injuries, accidents and disability, the APY scheme should have a more compassionate approach and not deny them the benefits of social protection."; and, most importantly, benefits not being indexed to inflation. [Rajasekhar et al, 2017]

3. CONCLUSION

The pension sector of India has started to grow with the introduction of NPS. The NPS has certainly managed to fill the legislative gap that had existed hitherto, leading to unsustainable pension expenditure for the government as well as lack of pension for unorganized sector workers, highly affecting the lives of the economically weaker ones among them. As far as fiscal stress arising out of pensions was concerned, the NPS has been successful in providing a defined contribution pension scheme. As far as the low take up rate among corporate employees is concerned, the inferior tax treatment can be easily done away with.

Despite significant increase on a yearly basis in the subscriber base and corpus of NPS, NPS Lite and APY, coverage for informal workers has been low at around 9%. The main factor can be attributed to the said drawbacks of the very schemes, both NPS Lite and APY. Better marketing of NPS Lite, especially to workers with irregular incomes, as well as, doing away with the default penalties and late payment penalties of the APY, thereby making it more welfare oriented, would certainly lead to significantly higher coverage. Increase in coverage is also part of the process of financial inclusion for poor households, and studies have found that members from these households are keen on investing in a long-term state-

run savings program. Hence, better marketing to workers with irregular incomes will bring about significant increase in coverage of these schemes.

Apart from that, the government must focus on MSMEs and the manufacturing sector as they are the drivers of employment growth. A push in these sectors of the economy will automatically raise the income levels of unorganized workers leading to an increase in their capability to contribute to pension schemes. Given that bulk of the increase in the NPS corpus is led by government employees and the corporate, such measures will lead to higher corpus and consequently higher Assets Under Management for NPS Lite and APY.

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