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Seminar on Voluntary Pension System - Prospects and Future Challenges

Issues and Measures to Reform Pensions in Pakistan

by

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Actuaries make Financial Sense of the Future

We will discuss the following topics:

 # Basic Pensions for all working Pakistanis.

Main recommendation: step wise expansion of EOBI scheme into National Minimum Pension Scheme should be Government Priority No 1. Will benefit over 40 million working persons, compared with perhaps 400,000 under VPS.

 # Employer sponsored retirement schemes.

Main recommendation: consider co-opting Provident Funds into pension system. If done, will cause huge jump in number of people getting pensions

 # VPS

Main recommendations (a) VPS at present is appropriate for individuals, subject clarification that 25% lump sum is tax free and not merely exempt from with-holding tax (b) Not in employees' interest for VPS to cannibalise existing Provident or Pension Schemes. (c) If various tax holes repaired, VPS may be a good thing as an additional employee benefit for employers who do not have a pension scheme.

First, a quick look at our working population. Figures are from Labour Force Survey 2003-2004.

Points from Labour Force Survey 2003-2004, based on 18,912 households

 # Est Total Population on 1 Jan 04: 148.72 million
 # Total Employed Persons: 41.75 million (34.69 males + 7.06 females)
 # Total Un-employed Persons: 3.48 million (2.44 males + 1.04 females)
 # Total Civilian Labour Force: 45.23 million (37.13 males + 8.10 females)

 # Distribution of employed persons aged 10 or more by monthly income:

Monthly income group	Percentage of all employed persons aged 10 or more
Up to Rs 1,500 pm	18.13
1,501-2,500	24.80
2,501-4,000	27.64
4,001 and above	29.44
Average monthly income	Rs 4,088.49

The highest paid group, male urban, had average monthly income of Rs 5,108

 # Most Pakistanis live from hand to mouth. Capacity to save is limited or zero. When they cannot work, depend on children or family members, or charity. Dire poverty for many.

 # 1.171 million tax returns filed up to 15 Oct 2005. 95% or more filed by individuals. For fiscal year 2004-2005, income tax paid by individuals, salaried and non-salaried, was Rs 63.4 billion (Rs 13.5 billion by salaried and Rs 49.9 billion by non salaried). Overall average about Rs 50,000 per head. But distribution almost certainly highly skewed, within salaried and non-salaried individuals. Average for non-salaried probably much higher, for salaried probably much lower.

According to Mr Jeremy Gadbury, experience in developed countries is about 40% of eligible individuals actually bought voluntary individual pensions. Anybody's guess how many of these 1 million or so individual tax payers are potential VPS buyers. Potential market for VPS is probably between 200,000 to 400,000 people.

 # This is nothing compared to Labour Force of 45 million.

 # In this larger human, rather than financial, context of pension reform, VPS is not very relevant.

Growth of informal sector

 # Informal sector grew from 65% in 2001-2002 to 70% in 2003-2004.

This is not place to discuss reason for this growth. But Labour Survey says:

> **“However, inhibiting influence of government’s long held predilection to generate revenue by hook or crook cannot be discounted altogether as a reason for the surge in informal activities”**

Basic Pensions for all working Pakistanis

Employees' Old-Age Benefits Institution (EOBI)

 # If we are talking about reforming pensions, then surely highest national priority is to provide subsistence or basic pensions to all working Pakistanis when they attain a particular age. This is first pillar of the famous World Bank Report on Averting the Old Age Crisis[1]. This has to be Defined Benefit Scheme costed on an open group basis. But benefit definition should not depend on individual's own salary history. It should define a basic or subsistence pension.

 # The most practical way, in fact the only way, this can be done is by a phased expansion of the EOBI scheme.

 # The Finance Act, 2005, made an important step forward in simplifying the EOBI scheme and paving the way for its expansion, by de-linking the pension from the individual's own salary, and linking it with minimum wage defined in Minimum Wages for Unskilled Workers Ordinance, 1969. That minimum wage raised to Rs 3,000 pm from 1 Jan 2005.

[1] Many aspects of "Averting the Old Age Crisis" are controversial, but this recommendation as to a basic subsistence pension is sound.

 # Subject to minimum contribution of 15 years, EOBI pension commences at age 60. It is not means tested or dependent on retirement. Pension is 2% of Minimum Wage for each contribution year, with minimum pension of Rs 1,000 pm. Theoretically pension could be Rs 2,520 pm if contributions are made for 42 years, from age 18 to age 60. If 25 years contributions are made, pension would be Rs 1,500 pm. Widows and Invalidity Pensions also provided.

 # Pensions will increase with increases in Minimum Wage. One hopes this will be increased each year at least in line with official Consumer Price Index.

 # Currently EOBI pays old-age, spouses, and invalidity pensions to 200,000 people. This is small fraction of people over 60, widowed and invalid persons who in civilised society, according to our own Constitution's direction, should be getting minimum subsistence pensions.

 # About 1.5 million individuals working in 33,000 establishments are currently insured, and stand to get pensions eventually. This is only 3.5% of Labour Force.

 # Remaining 96.5% or 40.25 million are also human beings. Do they have to wait another 50 years for a subsistence pension?

 # EOBI is and will remain pension scheme with largest coverage.

 # BUT great majority of Working Pakistanis remain out in the cold.

 # Scope of EOBI remains same as in 1976. Only establishments with at least 10 employees are covered. And there are huge exemptions: Government Servants, Defence Personnel, Employees of Autonomous and Semi-autonomous statutory corporations, of banks, of all establishments with less than 10 employees, self-employed persons, agricultural workers.

 # I repeat: ONLY way to provide minimum subsistence pension for working Pakistanis is to expand EOBI scheme, and convert it into National Minimum Pension Scheme. **A Govt Commission, a Govt Committee and some individuals have made do-able recommendations on EOBI's phased expansion to cover entire working population.** But there has been zero action.

 # For example, on 19 Jan 1993, at seminar arranged by EOBI and attended by representatives of workers, employers, government and EOBI itself, I proposed following step-wise programme for EOBI's expansion:

1. Remove exemption of administrative and professional persons.

2. Reduce thresh-hold for covering establishments to 5 employees instead of 10.

3. Remove all exemptions including exemptions of Government Servants, Defence Services etc. At the same time, their pension schemes should be amended to ensure deduction of EOBI pension from employer provided pensions.

4. Extend scheme to every Pakistani who is paid by an employer other than agricultural employers, even if only one employee.

5. Extend scheme to all self-employed persons including casual labourers and craftsmen, and thousand's of people who work part time for more than one employer.

6. Finally, agricultural workers and land-owners would be covered.

"Clearly this programme cannot be implemented overnight. It may take around 20 years to reach the final stage. We must set our sights on this distant goal and work towards it".

These proposals were welcomed by seminar participants, especially representatives of employers. They said "why wait for 20 years? Let's do it now".

12 years have elapsed. Only Step 1 has been implemented. As stated earlier, a Commission and a Committee set up by later Governments made very do-able recommendations for EOBI's expansion. Nothing has been done.

هر چاره گر کو چاره گری سے گریز تها

ورنه همیں جو دکھ تهے بہت - لا دوا نه تهے

(فیض)

#EOBI's expansion requires political will, and a real concern for the average Pakistani. Let us hope this political will and this concern can be generated in future.

Rest of this presentation will not refer to pension and "general provident fund" schemes run for Federal and Provincial Government Servants, Railways, Defence personnel and certain other government, autonomous or semi-autonomous bodies. Rest of presentation relates primarily to other categories of employed persons, and self-employed persons, in so-called "formal sector". As noted above, this covers less than 30% of workforce. The terms "many" or "large" used in rest of presentation should be understood with this limitation in mind.

Employer sponsored retirement schemes

It is not right to talk only of pension schemes. Provident Funds and Gratuity schemes should also be considered in totality. A distinguished person, opening Karachi Conference of 11 Aug 2005 said that these are not really retirement schemes, because benefits can be paid out well before retirement age. I respectfully disagree. A great many persons who retire from work at age 60 or thereabouts depend on these schemes as provision for retirement. Bringing them into consideration will enhance realism of our discussions. If we can co-opt Provident Funds into the pension system, it will be a huge step forward,

GRATUITY SCHEMES

With very rare exceptions, Pakistani gratuity schemes are Defined Benefit (DB), and gratuity is defined in terms of last drawn basic or gross salary.

(a) Statutory Gratuity under the Standing Orders: Every industrial or commercial establishment in which 20 or more "workmen" are employed must, if "Standing Orders" apply to it, pay a gratuity of 30 days' last drawn gross wages for each year served, on cessation of "workman's" service, other than by misconduct.

BUT if there is a Provident Fund to which Employer's contributions equal those made by workmen, no gratuity applies to period for which Provident Fund has existed.

(b) Non-statutory gratuity schemes: A very large number of employers have set up gratuity schemes outside Standing Orders. These apply to employees who are not workmen governed by Standing Orders. They may also apply to workmen who do get a Provident Fund, but for whom Employer has in addition provided a gratuity, either voluntarily or as a result of collective bargaining.

There is no legal requirement to fund a gratuity scheme. But income tax law encourages funding, from both employee and employer's points of view. Many schemes remain un-funded or Book Reserve. But many employers have set up Income Tax approved Gratuity Funds, which are Trust Funds governed by the Trusts Act, 1882.

PROVIDENT FUNDS

 # These are Defined Contribution Schemes, in form of Trust Funds recognized by Commissioner of Income Tax (CIT).

 # Employee can contribute up to 10% of basic salary only. He gets no income tax relief on this, and the contribution comes from his after-tax income. Law does not require Employer to contribute. But under all Provident Funds set up outside Government and Defence Services, with some exceptions, Employer matches Employee contributions.

 # Contributions are invested, and investment income is credited to employee's individual account.

 # There are very many Provident Funds, covering a large number of employees.

PENSION SCHEMES

 # Pension schemes have been set up for decades by progressive employers under Income Tax Act, 1922, and corresponding provisions of the Income Tax Ordinance, 1979, and Income Tax Ordinance, 2001.

 # No statutory requirement to Fund pension scheme. But with rare exceptions, all existing Pension Schemes are run as Trust Funds Approved by the CIT.

 # As in case of Gratuity Schemes, whether funded or not, and Provident Funds, there are no statistics on number of Pension Funds, their total size and total number of employees covered.

Total number of Provident, Pension and Gratuity Funds, their total size and coverage

 # This question is of great interest. Unfortunately, information is buried in files of Income Tax Department, Central Directorate of National Savings, Banks, listed companies, mutual funds and other organisations. Nobody has extracted and collated this data.

 # One can only guess at the total.

 # The number of Funds is probably well into 4 figures. Total number of employees probably well into 6 figures, perhaps even into 7 figures. Total size of these Funds is probably well over Rs 100 billion. And total amount they have to invest each year, including new money and maturity of old investments, is probably well over Rs 10 billion.

 # Also, there are a large number of un-funded gratuity schemes

Tax treatment of existing Provident Fund, Pension and Gratuity Schemes

Provident Funds

 # As stated above, the employee gets no income tax relief on his contribution. And he has to make a contribution, because the Employer's contribution cannot be more than his own. The employer's contribution is a tax-deductible business expense, and this is totally right. Any expense of doing business has to be deducted when assessing the taxable business income. But employer's contribution is not added to employee's current taxable income.

The build up is tax free, and the lump sum benefit is tax-free. So, it should be regarded as (½T + ½E)EE.

Theoretically, it can be made EET, like the VPS. But the hue and cry will be so great that Government will probably have to back down.

 # It is extraordinarily hard to earn a positive real return, net of inflation, in investment grade debt securities. If the gross return is taxed, then a positive real return is virtually impossible. So (½T + ½E)EE is probably better in most cases than EET, though EET is perhaps easier to market. But there is no marketing problem for Provident Funds, so let them remain (½T + ½E)EE.

Gratuities

 # Employees never contribute to Gratuities.

 # If there is an Approved Gratuity Fund, Employer contributions to an Approved Gratuity Fund are tax deductible business expenses, which is right and proper.

 # Accruals to balance sheet provisions are not tax deductible, but a gratuity paid by an employer is a tax deductible business expense. There have been cases in India and Pakistan where courts have held that accruals to balance sheet provisions are tax deductible if calculated actuarially. (These cases followed an English case relating to tax deductibility of balance sheet provisions for pensions). However, such accruals are not currently tax deductible.

 # Tax treatment of gratuity in hands of recipient depends on whether it is a tax approved funded scheme or not. In former case, gratuities payable on death or retirement are tax free. In latter case, generally gratuity above a certain limit is taxed at employee's average rate during last three years.

Pension Schemes

 # A reasonable minority of pension schemes require employee contributions. He gets no tax relief on them. Employer contributions are tax-deductible business expense, which seems right and proper. But they are not added to employee's current taxable income.

 # The build up is tax free, and the pension is tax free (subject to some conditions)

 # So it is somewhere between TEE and EEE, depending on the weight of employee contributions.

As a retirement benefit, Income or Pension is superior to Lump Sum

 # During employment, employee received monthly income. He or she knew how to handle it. His or her spouse knew how to handle it.

 # Except for a few financially knowledgable persons, most employees do not know how to handle large Lump Sums.

 # If a retiring employee is handed a large Lump Sum at retirement, many times monthly salary, there is a big chance that it will not be well invested, or that it will be frittered away. The retired employee could be reduced to penury.

 # The annuity market in Pakistan may develop in future, but at present it is virtually non-existent. People are living longer. Therefore even if carefully invested, there is a good chance that the retired employee will out-live his Lump Sum.

 # The monthly salary during service is like a drug injection. The employee becomes an addict. Stoppage will cause "withdrawal symptoms". Continuation by way of pension, even if much less than salary, will be good for him or her.

 # There may be some legitimate lump sum needs at retirement.

- BUT despite the conceptual superiority of pensions, employees are attracted by a large Lump Sum. Pakistani Gratuity and Provident Fund schemes provide lump sums by definition. Pension schemes often permit the whole or part of the pension to be commuted as a tax-free lump sum, subject to permission from the Income Tax Department. Virtually 100% of retiring employees opt for the maximum commutation permitted by the rules of their pension scheme.

Reform of Provident Funds to co-opt them into the pension system

 # IF a root and branch reform can be carried out, then having regard to the superiority of income over lump sum as a retirement benefit the following reforms can be considered:

A. Under present law, an provident fund member who leaves an employer's service has right to leave his provident fund with that employer's provident fund, subject to trustees' consent. This right is rarely exercised. Income Tax Rules could be amended to provide that if his new employer does not have a provident fund, then an employee who leaves before attaining 60 must choose one of following options:

(1) leave his provident fund with his present provident fund, until age 60. At age 60, he will have one of following options:

(a) Take the accumulation of his own contributions as a tax free lump sum. This follows from logic that this is TEE. Leave rest with the Provident Fund, or put it into an individual account with a pension provider or life insurer. About 85% of the amount left will be drawn as tax free income under an annuity certain for 30 years. 15% will be left to accumulate, to buy a tax free joint life and survivor annuity for him and/or his spouse should they survive for 30 years.

If one of them dies within 30 years, the income under the annuity certain would continue in full to the other. If the second also dies within 30 years, the 15% set aside for a joint life and survivor annuity, with accumulated investment income upto time of second death, PLUS the lump sum equal to the annuity certain for the remaining period out of 30 years, would be paid to their nominees/heirs.

30 year annuity certain would be calculated at a low "real" rate of interest, perhaps 2% pa, and member would be entitled to an investment income surplus credit if investment income rate is more than 2%.

The sacrifice of income compared with an immediate joint life and survivor annuity would probably be about 12%. Given favourable outcome for heirs if both die within 30 years, this would probably be socially much more acceptable, and more realistic considering un-developed Pakistani annuity market. The income sacrifice may in practice be less than 12%, if regard is had to insurer's expense, safety and profit loadings in immediate joint life and survivor annuity.

(b) Take accumulation of his own contributions as tax free lump sum. Buy tax free immediate joint life and survivor annuity out of rest, with a guaranteed period or other features. Likely that most will opt for (a)

(2) transfer his balance to an individual account with a pension provider or life insurer. No income tax relief would be allowed on this. At age 60, he will have options similar to those in A(1), *mutatis mutandis.*

B. If his new employer has a provident fund, then the present law gives the employee the right to transfer his balance to the new employer's provident fund. Again, this right is rarely exercised. The transfer could be made mandatory if he is aged less than 60. At age 60, he would have similar options to those under A.

 # Many details would have to be filled in. For example, adjustments would be needed if non-repayable withdrawals have been taken for housing, or after age 50 without cause.

 # This root and branch reform would probably be a good thing in principle. But it would have to be "sold". Abrupt implementation would violate an old military adage "Never make a frontal attack on an entrenched position". If Government is serious about it, much time would have to be spent on preparing the ground for it. It cannot be done over-night. This is especially true where a provident fund is provided as an alternative to a statutory gratuity under the Standing Orders.

Alternative to annuitisation

 # People are reluctant to buy annuities, and rightly so.

 # If longevity risk is transferred to insurer, then it means parting with capital, leaving nothing for their children.

 # UK press carried many protests against compulsory annuitisation at age 75, despite highly developed annuity market.

 # Pakistan annuity market is almost non-existent.

 # Annuities are difficult business for life insurer, in view of uncertain longevity risk and investment income risk. Any fixed annuity safe for insurer is likely to be un-attractive for annuitant. Variable annuities can indeed be designed, to reflect changing investment mortality and investment conditions. But these would be hard to explain and market.

 # On current mortality trends, probability of a person aged 60 reaching age 75 is 65% to 75%. Probability of reaching age 90 is 10% to 20%. System proposed above would minimise annuity problem, and also respond to societal desire to leave something to heirs.

Stop cannibalisation of Provident Funds by life insurance organisations

 # At present, life insurance organisations cannibalise provident funds by persuading contributors to buy life insurance policies financed by their provident fund.

 # Employee will almost certainly be worse off than if he had left the money to accrue in his Provident Fund.

 # It could be "unreasonable advice" under Rule 31 of SEC (Insurance) Rules 2002. Read with S. 95 of Insurance Ordinance, 2000, could lead to large compensation claims against life insurers 10 or 20 years down the road, when employee compares what he gets under life insurance policy with what he would have got from provident fund.

 # The experience of British Life insurers who persuaded people to leave their company pension scheme and buy individual pensions is there. They had to pay more than ten billion pounds in compensation for mis-selling.

 # Even if it infuriates life insurers, this cannibalisation should be stopped. It is recommended that IT Withdrawal Rules be amended to provide that no new policies should be financed from Provident Funds after a certain date. Of course, old policies will have to continue.

Some points on VPS

 # On grounds of marketing appeal, the EET tax regime for VPS purchased by individuals seems correct. However, although the 25% lump sum will suffer no tax deduction at source, it is not exempt from tax. On the face of it, it will have to be offered for tax in the individual's return. This conforms to EET, but is it the intention?

 # As pointed out by several speakers at the earlier Conferences, the tax regime for VPS purchased by an Employer for his employees seems to be an after thought. There are several holes in the tax treatment which have to be repaired.

 # It is not in the employees' interest for an ongoing recognised provident fund or a pension scheme sponsored by an employer to be wound up and replaced by a VPS scheme, or to be cannibalised in the interest of VPS. A VPS has to be charged with marketing and other expenses, and the throughput to the employee can never compete with the employer's own Provident Fund or Pension Scheme. However, these employer run schemes can certainly take investment advice from the long list of investment advisers approved by the SECP, provided this advice is at an arm's length and on a "fee for service" basis. Or they could delegate some part of their investments to be managed by asset management organisations.

 # If an employer does not have a pension scheme, then VPS could be a simple way of providing pensions for his employer, transferring the entire burden of administration to the VPS. This will be an additionality, not a cannibalisation of existing schemes. This is subject to the holes in the tax law being repaired.

 # As mentioned in earlier VPS conferences in Karachi and Lahore, the compulsory annuitisation is a weak point in the VPS scheme, considering un-developed Pakistan annuity market.

 # Instead of present rule permitting income draw down upto age 75, and then compulsory annuitisation, the alternative proposed above should be considered, i.e. 90% of the amount not withdrawn in cash to be paid out as a tax free annuity certain for 30 years, and 10% to be left to accumulate with investment income to purchase a joint life and survivor annuity at the end of 30 years.