

Can India Afford to Retire?

India's EPFO needs urgent fundamental, structural, administrative, governance and design reforms, says **Mukul G Asher**

India's EPFO (Employees' Provident Fund Organisation) was set up in 1952 to provide retirement income security to the organised labour force in the private sector. While the initiative is commendable, in its current form, India simply can not afford the scheme. It is neither suitable for the present workforce, nor sustainable. It is no surprise therefore, that the EPFO is under subscribed and unable to adapt to the new realities of the work force. There exist fundamental, structural, administrative, governance and design flaws that must be rectified. It is only if these issues are addressed in a timely manner that the EPFO will be made relevant to millions of private sector employees. The need for reform is urgent.

Overview of the EPFO

A caveat on data quality is important before I list potential problems. Essentially, data on EPFO scheme suffers from considerable time lag and is highly aggregative in nature. This compromises analysis in obvious ways. Yet, with this noted, we can still make some inferences and shed light on areas that need change. I begin by analysing the design and performance of three schemes of the EPFO. Table 1 summarises the contribution rates and benefits for these schemes of the EPFO.

Of the three schemes in the EPFO, the Employee Provident Fund (EPF) scheme, established in 1952, is a defined contribution (DC) scheme to which 61 percent of the contributions are directed. It covers establishments employing more than 20 workers in 181 designated industries. Under

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the scheme, at the end of retirement, individuals receive their accumulated balances in a lump sum. The Employees' Deposit Linked Insurance (EDLI) scheme, begun in 1976, is intended to provide death benefits while in service. Its current usefulness is negligible as it duplicates similar benefits by employers at higher costs. The Employees' Pension Scheme (EPS) is a defined benefit (DB) scheme to which 37 percent of the contributions are directed. It is the only EPFO scheme to which the government contributes. It became operational in 1995, and applies to workers entering the labour force since then. It provides pension at a rate of 1/70 of salary drawn in last

Table 1: Contribution Rates for the Schemes of the EPFO

Contribution [% of wages]	EPF (1952)	EPS (1995)	EDLI (1976)	Total
Employer	3.67	8.33	0.50	12.50
Employee	12.00	nil	nil	12.00
Government	Nil	1.16	nil	1.16
Total Contribution Rate	15.67	9.49	0.5	25.66
Administrative charges paid by employer [un-exempted sector only] (as % of assets)	1.10	Paid out of EPS Fund	0.01	1.11
Inspection Charges paid by employer (as % of assets) [exempted sector only]	0.18	n.a	0.005	0.185
Benefits	Accumulation plus interest on retirement, resignation, death. Partial withdrawals permitted for specific purposes	Monthly pension on superannuation, retirement, disability, survivor, widow/widower), children	Lump sum benefit on death while in service	

Notes: 1. As of March 2007, the wage ceiling for mandatory EPFO membership was Rs 6500 per month. A member however must contribute on full wages.
2. The figures in brackets refer to the year in which the scheme was introduced.

Source: Employees Provident Fund and Miscellaneous Provisions Act, 1952, as amended



12 months, preceding the date of exit, subject to a maximum of 50 percent. There is also provision for pensions to survivors. The EPFO thus is an unusual national provident fund in combining a DB and DC scheme.

The EPFO is under subscribed. After 55 years of operations, the scheme has been able to bring under its purview only about 400,000 establishments (about the same number as Employee Provident Fund of Malaysia with a population of 24 million), and about 40 million members (though due to multiple accounts and inactive membership the actual contributors in any given month is only about 20 million, equivalent to 4.3 percent of India's 460 million labour force). The EPFO thus represents only a small fraction of the labour force (Table 1).

The total contribution to the three mandatory schemes is 25.66 per cent of basic salary plus dearness allowance. Only those employees who begin their employment with a salary of less than Rs 6,500 per month (this amount has been revised upwards periodically)

are mandated to join the EPFO. Those beginning employment with a salary above Rs 6,500 per month, can join voluntarily. All contributions, even for those joining voluntarily, are exempted from income tax, and so are the interest earnings and withdrawals. This has turned the EPFO schemes into a tax shelter for high salary earners, reducing the income tax base.

The EPFO levies administrative charges of 1.11 per cent of total assets (equivalent to 4.4% of the contributions); and inspection charges on EPFO exempt but regulated funds at 0.185 per cent of assets. Specifying administrative charges in advance does not provide organisational or individual incentives for efficiency.

The impact of outmoded design features such as high pre-retirement withdrawals permitted by the EPFO and the low real returns is evident in data on members' balances. The average final withdrawal from the EPF scheme is about Rs 30,000, an amount too low for any retirement income security.

The data inadvertently released by EPFO for 2000 suggest that 85 percent of the members had balances of less than Rs 20,000, accounting for 17 percent of total balances, with an average balance of only Rs 3,133; while there were only 86 members with balances above Rs 50 lakhs, with an average balance of Rs 54.5 lakh. Any interest or other subsidy therefore disproportionately accrues to those with large balances.

Governance Structure

There are several governance issues plaguing the EPFO. Firstly, operational authority is not clearly defined. While the EPFO is governed by a 45-member Board of Trustees, headed by the Union Minister of Labour, administrative matters are under the control of the Central Provident Fund Commissioner, who is the Chief Executive Officer of EPFO. Thus, while the Board has a bureaucrat at its head, the Central government appoints all the members, and a Cabinet minister has the final authority on all critical



policy and personnel decisions. Further, internationally, several countries appoint a professional as the chair person of their national provident fund. In India, a politician heads the scheme. In doing so, the Labour Ministry has disregarded this preferred system and not recognised that short-term political office holders do not make good candidates to head statutory boards – that oversee long-term financial contracts.

Secondly, the EPFO is both a service provider and a regulator of over 3,000 exempt funds. This dual function in one organisation is contrary to good governance practices.

Thirdly, as a statutory body, the EPFO should be required to be audited by independent auditors; and all its actuarial and audited reports should be made public. Presently this does not happen.

Finally, the current EPFO Board structure is ill-equipped to handle concerns over cross-border social security agreements. There are a large number of Indian citizens working abroad who contribute to social security systems of the host countries. Most individuals however do not work long enough in these countries, particularly in the US, to receive social security benefits. The key constraint of the EPFO is its inability to effectively implement such

agreements. The EPFO is also unable to keep abreast of new developments in the retirement financing industry, as its organisational culture is not open to independent experts with specialised knowledge.

Design Issues

The EPFO Act, 1952 and its subsequent amendments are not in conformity with the complexity of India's economy and current dynamics of its labour market. India's overwhelming task is to create more jobs to benefit from the unique one-time demographic advantage phase. The traditional long term employee-employer relationships are becoming less of a norm, but the EPFO's design and administration are unable to cope with this change. Jobs creation is hampered when accounts of workers with high mobility are not efficiently administered.

Additional examples of the counter-productive nature of the EPFO practices are given below.

First, a large number of pre-retirement withdrawal schemes for health-care and housing purposes have made the EPFO almost like a bank, increasing staff load and reducing the retirement benefits which can be obtained. It is estimated that nearly 80% of EPFO's workload is devoted to handling non-

retirement related activities.

Second, establishments defaulting on provident fund dues owe more than Rs 25 billion as on March 31, 2006. EPFO has staff strength of 20,000 people, but is unable to even collect contributions from nearly 80,000 or one in five establishments; or to establish proper individual accounts, resulting in large balances in the suspense account.

Third, some individuals are able to withdraw full amounts when they change jobs, defeating the purpose of retirement savings; others lose their balances due to inefficiencies of the EPFO to transfer them when they change jobs; or due to ignorance.

Fourth, the EPFO as regulator requires that the exempt funds must have the same investment pattern, and pay at least the same interest rate as the EPFO. Yet, some of the well-managed exempt funds are able to generate better returns and quality of service at lower transaction costs than the EPFO. Higher returns than EPFO by exempt funds attract income tax, encouraging inefficiency and stifling financial innovation.

Fifth, the EPS scheme is badly designed, as it fixes (defines) both the benefits and the contributions. This is mathematically impossible. As parameters of the scheme change over time, either benefit formula and/or contribution must be changed for financial sustainability. If both are fixed, then the scheme cannot be sustainable.

This also has the effect of adversely impacting on EPFO's finances if the wage ceiling is increased. While higher ceiling will increase EPF contributions, the outgo on account of pension benefits under the EPS will be even higher.

The EPS does not provide automatic inflation indexation, though benefits are increased on an ad-hoc basis. Inexplicably, the EPS permits members to withdraw balances and yet retain pension benefits when later contributions are made. Given nearly Rs 250 billion actuarial deficit in the EPS, equivalent to one-third of its total assets, the scheme should be drastically overhauled with benefits brought in line with anticipated net receipts.

The EPS must practice asset-liability matching over a 70 year period.

The alternative would be to close the EPS scheme and pay the accrued benefits, particularly as the main challenge of paying promised pension benefits under the EPS, including family pensions to survivors, lies in the future.

Non-Investment Related Core Functions

Acknowledging the administrative deficiencies, the EPFO has formulated a "Reinventing the EPFO" plan. But its politicised decision-making and outmoded human resource policies have prevented desired progress. In particular the following areas need to be urgently addressed:

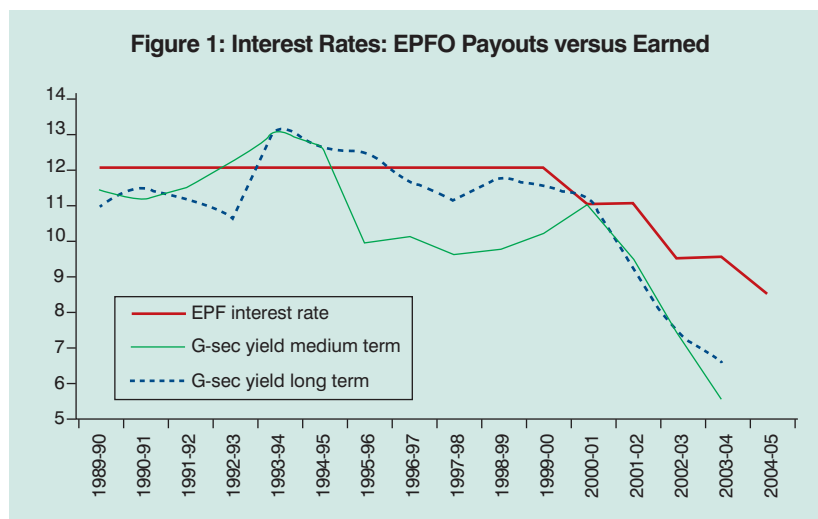
- Accounting system – moving towards accrual and double entry system
- Provision of unique identification number to members
- Increasing connectivity among its officers across the country
- Developing treasury management expertise
- Revamping human resource development policies and organisational culture consistent with financial service provider

The Investment Function

In any defined contribution scheme, the accumulated balances primarily are a result of the power of compound interest, rather than contributions. Substantial pre-retirement withdrawals from the EPFO therefore must be addressed.

As on March 31, 2006, EPFO's total balances under the three schemes were Rs 1749 billion, equivalent to only 4.95% of GDP. In addition, there was Rs 575 billion, equivalent to 1.63% of GDP, with the exempted funds. The level of pension assets is pathetically low.

The EPFO invests primarily in government and public sector fixed investments. As of March 2006, EPFO invested 54% of its assets in special deposit schemes, 18% in bonds of state-run companies, 15% in Central government bonds, and 11% in bonds of state governments. The EPFO Board has not invested in equities, even



The EPFO needs a mindset change, with appropriate governance structure and leadership, to transform itself into an employee-focused organisation



though the Ministry of Finance has given its permission.

It is astonishing that the EPFO does not have a professional investment or treasury department for managing funds. It has always outsourced the investment function, first to the RBI (Reserve Bank of India), and then to SBI (State Bank of India). Recently the EPFO Board has called for a technically competent financial analysis firm to study the investments made by SBI last year. The Board however must realise that providing a monopoly of investment management to one firm hides information about what alternative fund managers can do.

Figure 1 provides data concerning EPFO payouts in comparison with the yield from government securities for 1989-90 to 2004-05 periods. The data suggests that the EPF payouts

have exceeded yields from medium and long-term government securities. The difference has widened considerably since 2000-2001. Since all of EPFO investments are in government securities, the implication is that the EPFO has been paying interests in excess of the yields from investments. This is clearly unsustainable. It is imperative that the EPFO learns to earn through modern portfolio investment techniques, and pays what it earns. (Figure 1)

In conclusion, EPFO is India's largest non-bank financial institution, but it is run as if it were a welfare organisation, that does not require professionalism, expertise, and long-term sustainability. A pre-requisite for reforming the EPFO is a mindset change, with appropriate governance structure and leadership, to transform EPFO from an employer-focused to employee-focused organisation, conforming to international standards. The longer the reforms are delayed, the less relevant and affordable will the EPFO become for its members, and for the country as a whole. The current government and the EPFO leadership should be judged harshly if they fail to begin the transformation process with determination and vision. ■



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