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The politics of pensions

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Pension systems across the globe face major headwinds that will weigh heavily on governments, policy makers and members of the public. Demographic pressures created by ageing workforces and longer lifespans, the increasingly small world of a global financial economy, and government promises of retiree benefits and services are coalescing to place retirement policies at significant risk in the years ahead. How governments respond to address the steadily weakening underlying structures will have a major effect on the future of programs that support workers in retirement.

This article explores the reasons government intervention in the pension system can be expected, using Australia as an example.

Interventionist by design

The evolving modern pension systems typically are based on a system of three pillars:

- Social security, which provides a minimum level of government support.
- Mandated savings for the working population.
- Voluntary savings by those able and willing to defer consumption and with the capacity to save amounts over and above any mandated threshold. A related fourth pillar, also for those able to do so, is longer working patterns.

Government policies typically provide a range of incentives to encourage members to participate beyond the initial layers of the system. Doing so is aimed at getting workers to have savings sizable enough to be self-sufficient and thereby reduce their reliance on government benefits in retirement. These incentives come in many forms (e.g., reductions in rates of taxation or tax deferral) and are needed to counteract the natural tendency for people to focus on short-term gratification in place of their long-term needs. Most people, in the absence of an incentive, will prefer to spend today rather than save for tomorrow. These incentives often result in an opportunity cost via short-term losses to government coffers, but can be justified by their expected reductions in long-term costs to the public in supporting larger numbers of retirees.

Unfortunately, governments can also suffer from short-termism, as demonstrated by recent budgetary changes to Australia's compulsory retirement system (superannuation). In an Australian

The Australian superannuation system in brief

- Employers make a compulsory minimum contribution of 9% (increasing to 12% in 2019) of a worker's salary to each employee's superannuation fund account (with the amount counted as part of the employee's compensation package).
- Contributions in excess of the mandated amount can be made by the employer, the employee, or both, subject to certain limits.
- Superannuation contributions and investments receive concessional tax arrangements prior to vesting, at which point a tax-free pension or lump sum is available.
- Government provides a safety net via a means tested age pension.

Some key statistics

According to the Actuaries Institute white paper, *Australia's Longevity Tsunami*:

- Government spending as a percentage of gross domestic product is expected to increase from 4% to 7% for health, and from 2.7% to 3.9% for pensions based on age as a result of the ageing population.
- By 2050, almost a quarter of the population will be over age 65, compared with 14% now.

context, whilst the design of the mandatory superannuation system was originally to foster a self-sufficient base of retirees, the policy has struggled to achieve this outcome. The recent budget approved by the Australian government was decried by all sectors of the superannuation industry for the changes it imposed. Labelled as another piece of tinkering with the domestic pension system, industry participants pointed to the ramifications that frequent adjustments are expected to have on workers' confidence and trust in the system that was created to provide for their retirement. Additional changes to the system also have drawn attention, fuelling the view that superannuation presents a potential honey pot for the government. With a majority of workers currently projected to be reliant on some form of government support in retirement, the Australian government may find balancing long- and short-term objectives difficult due to the nature of the political system.

These concerns are not unique to Australia and further highlight the political issues in the pension world. Pension market participants also will need to get used to an increasing amount of government oversight and policy framework interventions, both as a result of internal and external pressures.

Governments: The ultimate stakeholder/guarantor

Because modern defined contribution retirement systems are being built on the foundation of a government pension, or social security, this makes the government–the taxpayers, really–the ultimate stakeholders funding retirement benefits through social security, aged care and other public services designed to support an ageing population. Without an increased proportion of self-sufficient retirees, taxpayers will be required to meet any retirement system funding shortfalls. This concern and liability potentially becomes substantial within the context of an ageing population as the dependency ratio increases.

Ultimately, in an unfunded, pay-as-you-go system, the government (and future taxpayers) will be responsible for funding these obligations. This could potentially lead to a loss of fairness between generations. And because the Baby Boomer cohort is the largest group of retirees the world has ever seen, its ability to leverage its voting power into policy may make shifting the cost burden away from younger generations difficult for future governments.

Demographic pressures

The numbers game that is the retirement of the Baby Boomers means that the governments/taxpayers face increasing pressure on public finances. Although Australia has led the world in the development of a compulsory superannuation retirement system, the timing of its establishment and the evolution of the structures have resulted in many current employees retiring with meagre balances. Combine a rising dependency ratio–the proportion of the nonworking population to the working population, which in Australia is increasing from around 50% currently to 70% in 2050–with the fact that roughly 80% of retirees are accessing the age pension by age 75, the fiscal impact becomes clear. Longer life expectancies are the final straw, lengthening the time over which social security will need to be paid. Longer life spans also have implications for additional costs that are necessary to support services for the aged, such as long-term care, medical expenses and so on.

Financial pressures on government coffers

The deterioration in global financial circumstances has added to the strain on many governments' balance sheets. Assuming that a government can find ways to bolster its budget, there will be increasing demand for services and potential imbalances as the ratio of taxpayers to retirees falls dramatically over time without any measures to address this. Increasingly, private industry and governments will have to work in tandem to solve many of these issues with the appropriate balance of commercial and social considerations.

The changing industry structure

Private industry is already in the early stages of evolving to address some of these problems. The market participants are reacting, driven by the need to provide better outcomes for workers and retirees. Whilst embryonic in many cases, examples of these activities include:

- **Greater segmentation of members and their needs**, e.g., the trend to review one-size-fits-all investment models (or *default funds*) in place of developing investment strategies that are more focused on individual objectives and that take a holistic view of members financial affairs.

- **Offerings that target these segments, including product, advice and distribution**, including the development of lifecycle investment options, personalized overlays and other longevity products (e.g., variable annuities), as well as emerging advice models that range from single-issue advice to intrafund and holistic approaches.

- **New models emerging such as self-managed and direct investment alternatives**. Whilst this trend has arguably come about in part because of the perceived failings of large institutional pension plans, the trend towards greater control and individual tailoring has been established and many funds now appear to be developing the capability to offer similar solutions to their membership.

Improved efficiency, competition and choice in the retail provision of retirement benefits could further lessen dependency on governments by creating a more educated and informed member. Armed with knowledge about saving, investing, spending and other retirement planning information, members should experience improved decision-making and outcomes (i.e., mitigate behavioural risks that lead to mismanagement of pension assets).

Policy principles

Industry competition and other developments in the private sector alone, however, will not be capable of solving the impending funding issues. Government intervention will occur and will produce both positive and negative results.

As the Australian Actuaries Institute recently opined, a government with an appropriate long-term view can facilitate positive changes within the industry. Government action may include:

- Incentivising lifetime income streams over lump-sum benefits;
- Introducing retirement income options into government frameworks for default superannuation arrangements;
- Removing barriers to post-retirement product innovation;
- Eliminating impediments that discourage older Australians from working; and
- Updating access ages to social security and adjusting the ages for superannuation to be in line with improvements in life expectancy.

However, there is a natural tendency for legislators to focus on the near term, given the nature of the electoral cycle (in Australia general elections are held every three years). The myopic view creates a temptation for politicians to make adjustments to long-term policy outcomes in order to meet short-term budgetary pressures. In Australia, examples include the reduction in tax concessional contribution caps and an unwillingness to deal with the issues faced by women with broken working patterns.

As this debate on long- and short-term government policies continues to evolve alongside the rapid pace of demographic changes, reforms focused on parts of the population with less political influence can be expected. Given this, consideration should be given to the following high-level principles when developing policy:

- A focus on appropriate incentives over compulsion;
- Preservation of fairness between generations (i.e., young vs. old), as well as social segments (i.e., rich vs. poor); and
- Flexibility within the policy framework to take account of the individual nature of retirement and the capacity for a retiree's circumstances to change.

Nothing is sacred

Unfortunately, in an environment in which politicians are unable to effect the policy changes required, they will ultimately be forced to adapt as the underlying pressures rise. This will result in a need for faster and deeper budget cuts and more radical changes to reduce financial pressures on the economy. This will also be likely to occur under a backdrop of social change driven by the gradual shift in voting power to younger generations from the elderly; an existing policy framework that skews benefits to retirees, thereby increasing the burden on taxpayers; and technological changes and more informed workers and retirees.

In an extreme environment where fiscal pressure builds and there is a short time frame within which to address it, previously sacred policies or concepts are likely to be revisited and reviewed, often with adverse consequences to the original policy aims. Potentially at risk are policies covering:

- Tax-free pensions;
- Means testing for retirement benefits;
- Retirement ages (working longer);
- Freedom and flexible use of retirement funds (i.e., compulsory annuitisation);
- Death taxes;
- Taxation of property that is used inefficiently (e.g., encouraging retirees to downsize their homes); and
- The public/private nature of the entire retirement system.

Ideally, governments will join the private sector in developing a productive retirement system reform agenda before it is too late.

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Exploring benefit programs in India

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India presents a unique conundrum for human resource managers who are looking for innovative ways to attract an increasingly mobile and skilled workforce that offers the talent needed in the global marketplace. Although there are employment opportunities galore and prospective employers are waging an open war for available talent, Indian companies historically have provided employee benefits targeted towards a generation who believed in and adhered to the concept of lifelong employment. Benefits provided under retirement and health programs are undergoing changes to attract and retain a new generation of workers, many of whom are under the age of 25.

This article explores some of the employee benefits and practices that are commonly found in India, focusing on retirement and health programs. Separate, government-run social security programs that have implications in the employment-based setting are beyond the scope of this article.

Retirement programs

The most common retirement plans in India are a combination of programs sponsored by a government entity called the Employees Provident Fund Organization (EPFO). The EPFO administers and supervises two large funds: the Employee Provident Fund (EPF), a defined contribution, interest-guaranteed retirement plan; and the Employee Pension Scheme (EPS), a defined benefit scheme supervised by the EPFO. Employers can usually choose to participate in both schemes or apply for a firm-wide exemption. (Under the EPF, an employee-level exemption is also possible, even if the rest of the firm participates.)

The contributions to both plans are collected together based on the following schedule, according to the EPFO 2010-2011 annual report. The contribution rates shown for both the employee and the employer are based on the employee's basic salary, whereas the administration charges are based on total wages.

	EMPLOYEE		EMPLOYER	
DETAILS	EPS	EPF	EPS	EPF
CONTRIBUTION	-	12.00%	8.33%	3.67%
ADMIN CHARGES	-	-	-	1.10%
TOTAL	-	12.00%	8.33%	4.77%

Employees participating in the EPF must contribute a minimum of 12% and can elect to increase this rate to 24%. The employer contribution rate, regardless of the employees' increased election, is fixed at 12%. Being an interest-guaranteed plan, the EPF annually credits the employee's account interest at a rate that is determined by EPFO each year in consultation with the government. Below is a table from the EPFO's report and subsequent update, showing the last 10 years of interest credited to the employee's EPF account:

FINANCIAL YEAR	INTEREST RATE
2003-2004	9.50%
2004-2005	9.50%
2005-2006	8.50%
2006-2007	8.50%
2007-2008	8.50%
2008-2009	8.50%
2009-2010	8.50%
2010-2011	9.50%
2011-2012	8.25%

A majority of employers prefer to participate in the EPFO plans rather than seek exemptions and set up trusts to sponsor private provident funds or pension plans. The EPFO is generally viewed as not providing satisfactory service to members, mainly because of inefficient administration, excessive bureaucracy, and, in some cases, investment rates not keeping up with inflation over a long period. Consequently, a few companies (and some employees) go through the cumbersome process of seeking EPFO approval, as permitted by statute, to opt out of the plan and establish a private retirement trust. But even if successful in this endeavor, the employers establishing a private retirement trust must match the EPFO's gross annual interest-crediting rate. To be clear, the comparison is made between the EPFO gross rate and the trust fund interest rate, reduced by investment management fees credited to employee balances. This makes the gross interest to be earned by the private trust very difficult to achieve without the employer assuming significant investment risk. Besides the bureaucracy, this guarantee is a major deterrent to employers setting up private provident fund trusts.

The EPFO also sponsors another plan, called the Employees Deposit Linked Insurance scheme (EDLI scheme), that provides life insurance benefits to employees. Employers pay 0.5% of employees' basic pay to buy insurance from the EPFO for their employees and an additional 0.01% for administration fees. Participation is optional, as long as the employer offers a plan with greater benefits than the EDLI scheme.

In addition to the private retirement trusts, other types of private retirement plans available in India include:

- **Superannuation plans** – These plans are optional and are often offered to selected employees, typically as *long-term incentive* benefits for middle and senior management. The plans can be defined benefit or defined contribution in nature. They are not very popular with rank-and-file employees, because they are not portable, they have a long vesting period (e.g., 20 years of service or attainment of age 45 with 10 years of service), and the funds cannot be withdrawn before a certain age (e.g., before age 45 or an early retirement age). Employers usually have the flexibility to limit the coverage to certain employees and to define a vesting schedule and withdrawal rules. Funding for these plans is usually through insurance products; the insurance companies take care of the administration, compliance, and investment management. Recently, the insurance regulator issued instructions prohibiting coverage of new members until revised regulations are released. The insurers will have to restructure their products to be in compliance before employers can offer these plans to new employees.

- **Pension plans** – Legacy pension plans in India are limited to certain industries (such as banks, mines, plantations and railways) or were created in response to union pressure. Very few private companies sponsor pension plans in India.

- **Gratuity plans** – This is a statutorily mandated defined benefit plan that provides a minimum lump sum of 15 days' pay for each year of service. All employers with more than 10 employees are required to provide this benefit. Payments are tax free up to 1 million rupees (Rs), approximately US$20,000. Payment of this benefit is available only when the employee leaves or is terminated from service and cannot be encashed in any other event. The employer can either book reserve for the benefit or establish a fund. If funded, the employer can claim contributions as allowable deductions against taxable income, subject to certain overall limits. Funding can be arranged using a trust or an insurance policy. Most employers prefer insurance policies; the administration and documentation are simpler than establishing a trust. Around 60% of employers in India fund the gratuity obligation.

Health programs

Health benefits are one of the most common and expensive employee benefits that an employer provides to its employees. The benefits may include group health insurance coverage, reimbursement of pharmacy and outpatient bills, an on-site doctor on call or discount arrangements with healthcare providers. In India, there is a gradual shift from the traditional, all-expenses-paid inpatient indemnity health coverage to alternate methods of risk or cost sharing, such as co-pay health insurance plans or high-deductible plans.

Most employers fund hospitalization coverage via an insurance policy that is primarily an indemnity product, with annual limits on amounts covered. The health plan may cover just the employee or may include his or her spouse and children. Some employers cover the employees' parents as well. The limit varies amongst employers but usually is above Rs 200,000 (approximately US$4,000) for each employee. Some companies maintain a buffer amount for discretionary coverage if an employee exhausts the limit. Most health policies also impose various benefit limits and privileges in room types, depending on the employees' occupational level. (Currently, no antidiscrimination rules apply.)

Indian tax laws provide for annual tax-free cash reimbursement of personal expenses, certain hospitalizations, drugs, and outpatient treatments up to Rs 15,000 (approximately US$300). Once employees submit bills for services to their employers, the taxable income of the employee is reduced by the total value of bills or Rs 15,000, whichever is less.

With rising medical inflation, improved access to healthcare, and rich coverage in benefits, claim costs have been steadily increasing.

Other benefits in india

Employers in India offer various other benefits that are offered to employees:

- **Paid time off/leave encashment programs** – After health benefits, the most common employee benefit program is paid time off/leave encashment programs. All employers in India have a leave policy that either allows employees to carry forward their untaken leave to the next financial year or cash out the value at the end of the year.

- **Food coupons** – Traditionally, large Indian companies provide lunch on site for their workers. More recently, they instead have been providing employee food coupons, which up to Rs 50 (US$1) per meal is untaxed to the worker and claimed as a business expense by the employer.

- **Flextime** – Allowing employees to work flexible schedules is a relatively recent development and a benefit most appreciated by employees but underutilized by employers. It is primarily provided by large employers specializing in information technology and related industries. Flextime is offered only to employees who have spent a certain amount of time with the organization, under strict, mutually acceptable policies. However, as flextime grows in popularity, companies are realizing that informal schedule changes can create communication problems and hostility among some employees. To combat this problem, more organizations are implementing formal policies that require workers to present solid business cases for flextime, including how it will benefit their clients and how they plan to manage workflows with team members and supervisors.

- **Transportation benefits** – Employers may provide a company car lease for senior management (which would have tax implications to the employee) and cab/shuttle service/carpooling to and from work paid for by the employer.

- **Financial education** – As people near their retirement age, they understandably desire help to overcome the financial anxiety of retirement. Unfortunately, by that time it is usually too late. To ease employees' anxiety, a few companies in India have started to conduct financial education seminars to help employees manage money more responsibly.

Premiums remain competitive and have been driven more by last year's premiums than by claims experience, resulting in employers passing the risk to insurance companies. Insurers have tried to control costs by applying sub-limits, restricting networks or enhancing fraud checks and investigations. Increasingly, there is a growing realization that a broader focus on managed indemnity care is the need of the hour for insurers to be able to manage the healthcare delivery system. Faced with the projected, unavoidable rise in premiums, employers are exploring alternate strategies. These include high deductibles, stop-loss arrangements or waiting periods for pre-existing diseases. However, due to employers' inability to communicate these health benefits clearly, employees perceive these strategies in a negative light. Consequently, many employers either simply bear the cost of increased premiums year after year, or face the risk of diminished employee satisfaction. There is an urgent need to develop long-term measures and means to appraise them to contain costs and ensure effective management of health benefits.

Wellness programs in India take a holistic approach: as companies understand the impact of chronic diseases on their employees and consequently on their businesses, they acknowledge the need to keep employees healthy. Increasingly, employers are moving from *disease management* to *health management*. They may offer preventive health checkups, health risk assessments and gym memberships, as well as additional benefits that in India are not normally covered under health insurance plans: curative services (e.g., vaccinations, yoga and meditation classes) and rehabilitative healthcare services (e.g., physiotherapy, pre- and post-natal care).

Funding of these wellness programs usually take one of the following three routes:

- Full funding by the employer.
- Partial funding by the employer and the remainder by the employee.
- Employees pay all, but they benefit from lower rates from group discounts negotiated by employers in contracts with various providers.

The quality of services in wellness initiatives is, unfortunately, poorly evaluated when employers use either internal staff to assess providers or insurance brokers to identify the service providers. The lack of the specialized skills necessary to understand the medical services or to measure the quality of services may lead to the acceptance of substandard or inappropriate services.

Future trends for workplace-based benefits

As companies in India look to the future, there are several key issues under consideration in the context of benefit offerings:

Retirement benefits – A significant change taking place is the introduction of the National Pension Scheme (NPS). This is a defined contribution retirement scheme, funded by employee contributions only. However, NPS regulations allow for a *payroll deduction*, which permits the employer to make contributions up to a certain limit and deduct the amounts as a business expense. Meanwhile, the employee also may claim a personal tax exemption for the amount contributed as payroll deduction.

Retirement education – Currently, there are few employer-sponsored private retirement plans. Hence, employees are left on their own for planning for their financial needs in retirement. Offering retirement education would be extremely beneficial to all employees, from a new graduate who can learn the benefit of saving early, to a 40+-year-old mid-career manager who can plan for his or her retirement, to the employee who is nearing retirement and needs to start making immediate plans.

Health benefits – The future of group health benefits lies squarely on the ability to control costs, in terms of premiums for insured employers and claims for those few employers that self-insure. India, like other modern economies, appears to be moving towards a defined contribution healthcare system with individual accounts. The current laws and regulations are not yet sufficiently accommodating, but the insurance companies are lobbying for it. There is already a shift towards copayments (particularly to reduce the number of relatively small claim amounts) and coinsurance. Meanwhile, the healthcare providers and insurance companies are developing their internal practices to meet global norms. By enforcing utilization management and clinical review processes, providers are trying to control costs for themselves, as well as for patients. Similarly, insurance companies are developing their underwriting rules so that they can manage the covered population better.

India in the global marketplace

This article examined the most common benefits that are currently being offered, explored, and developed in India. As the search and retention of talent becomes more prominent, companies can be expected to follow the lead of their global counterparts and implement tools and strategies that are tried and tested. However, India is a unique puzzle with its own peculiarities; there is a huge variation in its population demographics, its understanding of the surrounding world and its expectation levels. In the major urban areas where global influences increase awareness, more individuals are starting to understand the responsibility associated with defined contribution plans schemes, both for retirement and healthcare. However, there are still employees who adhere to the concept of lifelong employment and employers that have developed benefit strategies catering to them.

Companies and their decision makers need to understand that there is no single solution; the concept of one size fits all cannot work. Employers need to be flexible enough to adapt their policies to address the specific needs of their employees. Hence, strategic reviews and analyses of benefits will help to confirm the appropriateness of a particular initiative or to avoid an expensive mistake.

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