

Pension Privatization in Pakistan

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Keynes had famously said, “In the long run, we’re all dead”. If not very pessimistic, we may conclude that in the medium to long run we’re all pensioners (Congdon, 2006).

INTRODUCTION

The history of state pensions is said to be a history of broken promises, Arthur, (2006). That is why one of the main problems in pension policy is to develop an institutional framework that guarantees that public and private pension promises are kept, Besley et al. (2005). The state pension related problems might have taken birth some times back; yet, they were recognized only in the early twentieth centuries. State pensions were being transformed into privately-owned pensions in the early 1980s, especially in Latin America and Eastern Europe. The aims of these pension reforms were, on one hand, to signal that states were becoming vulnerable to the rising pension liabilities and could not support these financial burdens and, on the other hand, to ensure that private sector provision of old-age security be expanded, and the individual responsibility for old-age pensioners is strengthened. These reforms also ensured that the funds are independent financial entities and that each worker chooses his or her own pension fund. This has been called a “worker-choice model” (Lindeman et al. 2000: 34). The idea of reforms in state pension sprang from weak social and cultural values, breaking up of extended family system, increasing old age group and lower fertility rate, and the skeptical view towards the ability of the state to honor its promises.

The early efforts made in pension privatization came from Chilean Government, which adopted a Defined Contribution (DC) pension scheme with privately managed funded program. Other countries also followed suit and switched over from state controlled Defined Benefits (DB) scheme to neoliberal pension model based on privately managed Defined Contribution pension system. Some countries however, introduced some innovative variants in this model depending upon their inherent social and cultural norms, like Mexico entirely privatized its Social Security System, Argentina pursued a mixed public/private pension system, Whereas, Brazil is still struggling with significant pension reforms. Madrid (2004) rightly says, “Never in the history of social security had so much change taken place in such a short period of times.

It would be incorrect to consider that the problems relating to state pension are associated with developing countries only. The ability of the state to meet the pension dues is skeptical in the developed world as well. In Italy, pensioners are reluctant to go along with the state pension system, because they believe that the investment of their pension income in the private sector would ensure more yield than in the public sector. The inflow of information system has also empowered the pensioners in developing countries far better than before and they seem to have a better comprehension of the state monetary system.

Following questionnaire adequately reflects this assertion.

‘Some people speak of a possible crisis in public pension systems, which would mean that, in ten/fifteen years time we would not be able to enjoy public pensions at their actual level. Do you agree with this opinion?’

	France	Germany	Italy	Spain
Don't know / No answer	14%	6%	7%	23%
Of those who answered: Yes	82%	81%	72%	43%

Source: Boeri, Börsch-Supan and Tabellini, 2001

State owned system of pension needs parametric reforms even if government decides to stick to it. These reforms can take place by introducing Defined Contribution system, ensuring pensioner's liabilities without transferring the burden of old generation to new and young generation, and creating a pension fund, investment of which ensures the required growth. The other parametric reforms may include assigning pension responsibilities to an accredited authority like State Bank for credibility purpose, and setting up an intermediary body like National Insurance Company for entrusting the pension system.

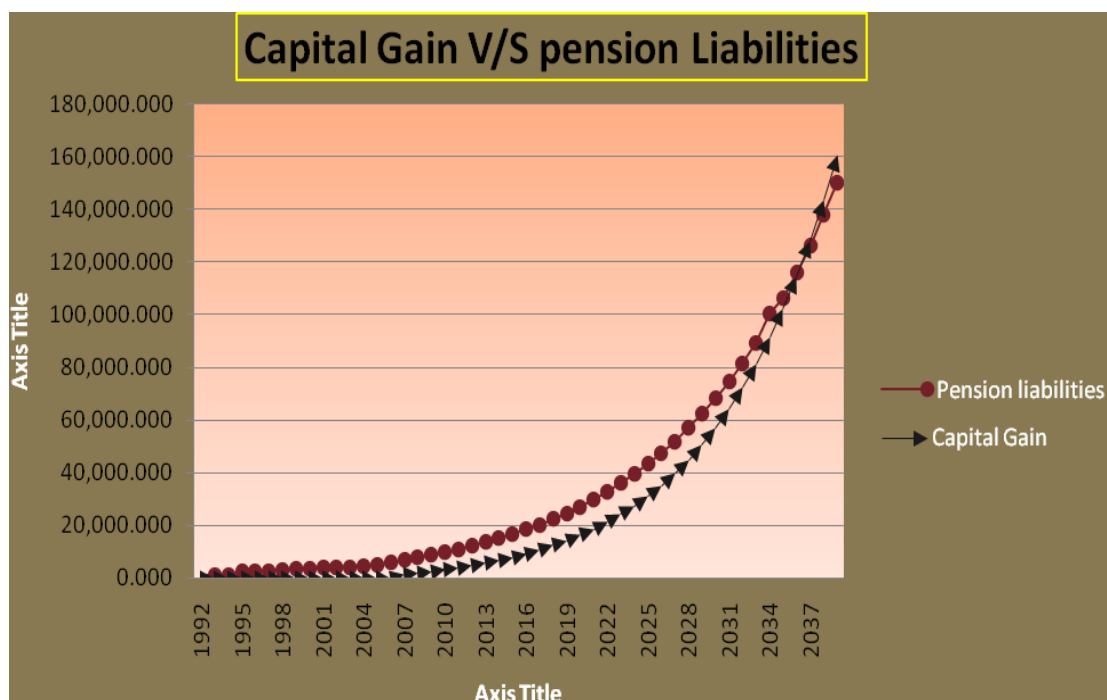
Objective

The main objective of this article, therefore, is to examine Sindh Government's pension system as a test case. The study will examine the Sindh Pension Fund (SPF) created by the Provincial Government in order to off load its rising pension dues. This analysis will discuss fund's capacity to meet the pension liabilities and usher some strategy in the pension reforms, which will, on one hand, alleviate province's worries of internal debt owing to these liabilities, and, on the other hand, provide pensioners with some innovative and profitable rate of return on their pensions through private sector investment modalities.

Sindh Government established Sindh Pension Fund (SPF) in the year 2002, with the seed money of Rs. 1200 million with the aim to enhance it with contribution of Rs. 3.000 Billion each year. SPF stands at Rs12.888 Billion as of today. Simultaneously, the level of pension liabilities has also risen to Rs. 6.782 Billion. An exercise has been done to spread the trends of capital gains and pension dues, to discern whether these two will be able to intersect each other at some point in time in future. The following chart displays 36 years' projected funds flow and the pension liabilities.

The data reflects that consistent contribution of 3.000 Billion each year, in building up the funds up to 2033 and investing the same @ of 12% per annum would result in matching the level of pension liabilities in the year 2037. The same can be witnessed in the following figure.

Capital Gains V/S Est. Pension Liabilities



The above figure clearly marks that it would take almost 30 years for our funds to match our pension liabilities level. The fund volume at that stage would be around Rs.1197 Billion. There are many grey areas in the above hypothesis. The biggest being investing funds @ of 12%. For achieving that goal, our investment strategy needs to be of aggressive nature, which may jeopardize the safety of funds as well. The liabilities of pension dues may well augur far greater than our hypothesized rate of 9% per annum.

This is quite apparent from the above discussion that the idea of establishing pension funds for meeting pension liabilities may not work as well as. There can not be denying the fact that without embarking upon the parametric and systematic reforms in pension system, we can not hope to tackle the problem efficiently. The issue thus calls for privatization of state pension.

The first step toward that direction requires the introduction of Defined Contribution (DC) system replacing Defined Benefit (DB) system. With the introduction of D.C, pensioners can be authorized to switch over to private pension funds where they can be entitled to choose their own portfolios of stocks, bonds, and other privately issued securities that best reflect their individual preferences over risks and returns. The proposed pension system is flexible in terms of contribution, asset allocation choice and above all portability. Upon retirement, the pensioners would be able to use his/her pension assets to buy annuities from life insurance companies and thereby obtain a monthly pension. My emphasis is on transition of public pension system into a vibrant private public mix of the Pension business, where actual business of pension funds should be carried out by the market forces i-e through various Asset Management Companies (ACMs) which offer various Pension Funds duly regulated under Securities Exchange Commission of

Pakistan (SECP). We must also be wary, though, of the apprehensions that we should not let private sector take over public sector in monopolistic form as happened in case of Bolivia, when two mutual funds created by Spanish banks controlled the whole pension funds in 1999 and created a private monopoly of their own choice. (Muller, 2003).

While attempting to create a convincing case for privatization of state pension, we should not forget the role of state in honoring its responsibilities concerning pension schemes. The states typically are responsible for designing and implementation of the pension schemes, regulating and supervising the funded tier, and provisioning of the implementing pension guarantee as of last resort.

Would It Work in Pakistan?

This goes without saying that economic and financial openness in our country has provided immense favorable situation in which state pension system can be exposed to private sector pension system. Various AMCs in Pakistan have already established pension funds and they have all the strength and commitment to absorb the state pension fully or partially. The process of transition of state owned pension system to privately held system can be learned from Chile's experience which carried out its pension reform agenda at a time when its financial system was not so efficient, yet, it produced high and stable returns, and boosted investment, employment and capital market development (Niemietz, (2007). Pakistan has immense opportunities of initiating pension reforms with the following advantages.

Firstly, an efficient and strong capital market and strong institutions including strong legal system are pre-requisite for ensuring privatization pension, and Pakistan has already established an efficient and thriving financial market which will help great deal in introducing pension reforms. However, weakened property rights and fragile legal system are some serious concerns in that direction.

Secondly, fast 'emerging financial market' in Pakistan has already encouraged establishment of effective and independent Pension Funds which have capacity to respond in changing macro economic variables in Pakistan. It is also hoped that pension privatization would enhance saving and investment level which is already very low in our country.

Thirdly, it would promise better rate of return to employee. What is disturbing, however, is the fact that defined contribution factor would affect like a tax addition in the income of the poor workers. The economists however, may find out some solution to this problem of defined contribution and may design a pension policy which works in both employer/ state and employee favour.

Fourthly, long term real growth could be attained from introduction of reforms in pension.

How Much Pension Privatization Do We Need?

It is utmost important to have a demarcation line for the privatization of pension scheme Carmelo Mes-Lago (1996) identifies three major sets of reforms. He is of the view that most of the Latin American Countries like Mexico, Chile and Bolivia etc had converted from state owned pension system to fully liberalized private pension system and drew all future workers to opt for new system. Peru and Colombia adopted parallel system which meant that state owned system of pension remains effective and competes with newly establishing private pension. Another mode

of pension privatization exists in Argentina, Uruguay and Poland etc where workers are allowed to contribute to state and private pension schemes and can benefit from both the system.

It can therefore, be subsumed that it is utmost essential and imperative to have a private pension scheme in which state pensioners should be given equal right and access to either switch over to that pension scheme or contribute in that fund alongside the state control pension system. Since it has already been stressed above that state can not withhold the pressure of mounting liabilities, it would therefore, be appropriate for the government to absolve her from this responsibility and give way for the private pension system to over take its burden. What government however, should not forget, is her responsibility of effective regulation. Definitely, the workers are going to face enormous risk on their investment due to the fact that the guarantee that public pension grants, is scant in private pension scheme. Vulnerable groups like illiterate workers and women folk are an easy prey to the private pension owing to information asymmetry. That is the place where government role matters. The second area, where this scheme will hit, is the elite class which will not fare so well in private pension, i-e if a public pension system benefits certain class like high level bureaucrat etc, it is likely that they might not get undue advantage of their positions and market forces will not be influenced by their class or creed.

Conclusion

Keeping in view the above discussed views, it can safely be concluded that the concept of pension privatization would drastically widen the margins of individual liberty. However, we can not forget the fact that in achieving the objective of pension privatization, not only private sector capacity, but also government capacity matters. As noted by Barr (2000:23): “If government is ineffective, *any* pension scheme will be at risk.” Consequently, countries that opt for structural pension reform should be encouraged to make sizeable ex ante investments in human capital and IT in the public sector. The success of pension privatisation reforms, therefore, depends largely on the stringent regulatory role of SECP, stable performance of stock exchange, rapid expansion of pension funds and strong legal system.

All said, the only answer of long awaited state pension related worries, lies in funded, personalised, privately held and highly redistributive pension system in which market forces should carry out this redistributive function under stringent state regulatory control.