Deferred Dreams: Navigating Pakistan's Public Sector Pension Crisis

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I started writing about public sector pensions in 2018. At the time, the federal government's pension expense was Rs. 245 billion[1], covering both civil and military pensions[2], growing at 9% over the preceding three years[3]. Since then, the pension bill has risen to Rs. 1+ trillion (2024-25) averaging an increase of 19%[4] per annum. The fiscal burden of pension is now projected to double every four years[5], a trajectory that is clearly unsustainable.

Over the last decade, the federal government's pension expenditures surged nearly 4.4 times[6]. In contrast, the operational expenses of the civil government increased by merely 2.7 times, highlighting a rapidly closing gap. The fiscal year 2021-22 marked a major milestone for pension growth, when for the first time the pension costs exceeded the expense for running the entire civil government by Rs. 10 billion, a disparity that expanded to Rs. 56 billion the following year. This widening gap is expected to keep growing.

Provincial governments and state-owned enterprises (SOEs) face similar challenges. This year, the collective pension expenses for the four provinces are anticipated to exceed PKR 850 billion[7]. SOEs, including Pakistan Railways, are allocating a significant portion of their budgets to pension payments, often surpassing the total payroll expenses.

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[1]The revised pension estimate for 2016-17.

[2]It must be noted that both military and civil pensions are part of the civil budget, and the latter has not been booked under defense budget.

[3]From Rs. 187B in 2013-14 (revised estimates) to Rs. 245B in 2016-17 (revised estimates)

[4]From Rs. 245B in 2016-17 (revised estimates) to Rs. 1,014B in 2024-25 (budgeted estimates)

[5]In nominal terms

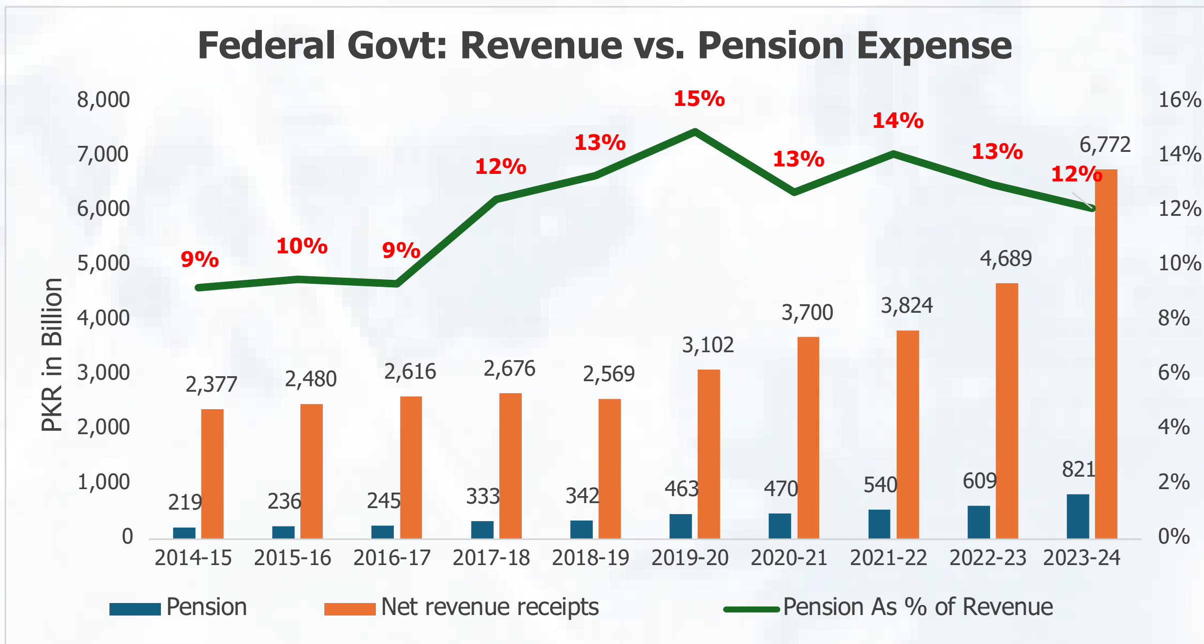
[6]From approximately Rs. 187 billion in the fiscal year 2013-14 to Rs. 821 billion in 2023-24. During the same period, the size of the current expenditure grew from Rs. 2.9 trillion (revised) to Rs. 14.2 trillion (revised) or 4.9 times growth (traditionally this has been less than pension growth, but spike in interest rates in recent years has tremendously increased interest payments. Moreover, over the last decade military pensions grew by four times and civil by five times.

[7]Budgeted 2024-25: Sindh Rs194,400 b, Punjab Rs451,400 b and KP Rs162,402 b. Balochistan Budgeted 2023-24 Rs58,029 b

Approximately one-third of Pakistan Post's budget is now dedicated to pension payments, highlighting a systemic issue across all tiers and organs of the government.

The increase in pension liabilities is also outpacing public revenue growth, consuming 12% of the net revenue receipts of the federal government—up from 8.9% a decade ago[8]. This significant rise underscores a growing challenge in funding these obligations.

Pakistan's pension system is crumbling under its own weight.



Source: Government Budget Documents. (Figures for 2020-21 are budgeted and not revised estimates).

Decoding the Labyrinth: Unpacking Pakistan's Pension Mechanisms

The Government of Pakistan has a pay-as-you-go (PAYG) model funded directly from government revenues without any contribution made by the employees to fund their pension benefits. Employees become eligible for full pension benefits upon reaching the age of 60 or after completing 25 years of service. However, a partial pension is granted after ten years of service.

BOX 1: TYPES OF GOVERNMENT PENSION IN PAKISTAN

Pakistan's pension system incorporates a variety of components designed to provide financial security to government employees both during and after their service years:

- **Retiring Pension:** Granted after 25 years of service, allowing employees to retire with full pension benefits.
- **Invalid Pension:** Offered in cases of permanent disability, ensuring financial support regardless of the length of service.
- **Compensation Pension:** Provided when an employee has to retire before completing 25 years of service due to any reason.
- **Superannuation Pension:** Automatically given upon reaching the retirement age of 60 years, marking the standard transition from active employment to retirement.

[8]Net Revenue Receipts: 2.1 trillion in 2013-14 (revised) and Rs. 6.7 trillion in 2023-24 (revised).

- **Family/Survivor Pension:** Provided to the family members of a deceased employee[9].
- **Group Provident Fund:** A mandatory defined contributory scheme where active employees contribute between 3% to 10% of their pensionable salaries to fund additional retirement benefits.
- **Medical Allowance:** Provided in addition to the regular pension benefits, calculated as a percentage of a pensioner's gross pension based on his/her grade at the time of retirement.

Pension amounts are calculated using a defined-benefit formula, which is based on the employee's final salary and the total years of service. To determine pension benefits, the length of service is multiplied by both an accrual factor and the pensionable salary base. Pension regulations allow for an income replacement rate of 70% of the final basic salary after 30 years of service, corresponding to an accrual rate of 2.33% per year. However, post-retirement allowances effectively raise this rate to 4.09% per year of the basic salary as of 2018[10]. This means that it is fairly common to observe a pensioner drawing a monthly pension greater than the last salary she drew as a serving civil servant i.e. the effective replacement rate is over 100%[11]. The pension system also allows employees to commute up to 35% of their pension into a lump-sum payment upon retirement.

Besides the public sector pension system, various other public and private pension schemes also operate including programs for social insurance, worker benefit.

[9]The survivor pension benefits are differentiated by whether the death occurs pre-retirement or post-retirement.
[10]Pakistan: Assessment of Civil Service Pensions; February 5, 2020; World Bank
[11]Pakistan Federal Civil Servants' Pension Issues; World Bank, 2019. Source: https://documents1.worldbank.org/curated/ar/457631591858011306/pdf/Pakistan-Federal-Civil-Servant-s-Pension-Issues-Paper.pdf

TABLE 1: OTHER PENSION SCHEMES IN PAKISTAN

No	Pension Scheme	Overview	Eligibility	Contributions	Benefits
1.	Employees' Old-Age Benefits Institution (EOBI)	Social insurance for private sector employees	Workers in the organized sector	Employee and employer contributions	Monthly pension, old-age grant, survivors' pension, invalidity pension
2.	Government Pension Funds (Punjab, KP and Sindh)	Funds to partially finance DB scheme and/or recent reforms leading to DC scheme for new employees. (Baluchistan introducing a DC scheme in budget 24-25)	Varies	Government contributions, some employee contributions	Monthly pension based on salary and service, gratuity, family pension
3.	Provincial Employees Social Security Institutions (PESSI)	Provincial schemes for worker benefits	Workers in industrial/ commercial sectors	Employer percentage of payroll	Pensions, survivor benefits, healthcare services
4.	Voluntary Pension System (VPS)	Voluntary pension regulated by SECP	All Pakistani citizens	Flexible, individual choice	Tax benefits, investment options, retirement age flexibility
5.	Private Sector Pension and Provident Funds	Retirement savings by private employers	Employees of private companies	Employee contributions often matched by employers	Lump-sum or annuity

The Hidden Iceberg: Unveiling the True Scale of Pension Debts

Many countries around the world typically report their accrued pension liabilities on an annual basis, similar to how they report public debt. This reporting is generally part of broader governmental financial disclosures and is aimed at providing transparency about the financial obligations of the state, including those related to pensions. But that is not the case in Pakistan. The real-time magnitude of

accrued pension liabilities is therefore not estimated or disclosed regularly. However, actuarial studies conducted in the past do shed some light on the magnitude of these liabilities.

BOX 2: DEFINED BENEFIT vs. DEFINED CONTRIBUTION SCHEMES

A defined benefit (DB) scheme guarantees a fixed benefit for the employee upon retirement. Where it is non-contributory, the employer bears exclusive responsibility both for investing accrued benefits and for paying out emoluments. A defined contribution scheme (DCS) typically only defines the contribution to be made by both the employer and the employee toward the employee's retirement benefits and there are no guarantees of what benefits will eventually be paid out.

According to an actuarial study conducted in 2021[12], the present value of the defined benefit obligation for civil servant employees as of June 30, 2021, stood at PKR 2.9 trillion[13]. A contributory scheme for new employees would need a contribution of 70% of pensionable emoluments. These contributions were estimated to be much higher to pay off the pension liabilities of existing employees, revealing a system teetering on the brink of fiscal calamity.

Fault Lines: The Structural Cracks in Pension Foundations

Why are pensions experiencing such phenomenal growth? The answer lies in a combination of persistent growth in the size of the government, an expanding beneficiary base, structural flaws in the pension scheme and rising life expectancy.

The pension system, for instance, allows for early retirement. Employees who begin working early and retire after 25 years can receive pensions for a duration significantly longer than their service period, often 1.5 times but going as far as 2 to 3 times when family pension is considered. This structure leads to a higher number of entrants into the pension scheme compared to the rate of exits. Moreover, successive ad hoc increases have increased the accrual factor to a level, where at least in some case, the pension can exceed the last drawn salary, thus providing a perverse incentive to retire early.

Commutations pose another challenge, which claim the lion's share in each year's pension expense. Although they remain an essential part of pension scheme to offer pensioners a jumpstart into their retired lives, following a Supreme Court decision in 2015, the full amount of commuted benefit is restored after about 12 years post-retirement, which adds another added layer of financial obligation on the system. The average life expectancy in Pakistan has also risen by about 4 years over the last 25 years, further putting pressure on pension payouts.

For the government, this creates fiscal risk and an inherent moral hazard, where liabilities can be perpetually kicked down the road. It also creates free-rider problems, when individuals benefit from pension payments without contributing to the system.

[12]Actuarial Assessment by SIR Consultants

[13]Present liabilities would be much higher than this amount.

Commissions and Committees: The Broken Journey Towards Reform

Over the years, several pension commissions were established in Pakistan. These bodies sought to address the fiscal pressures exerted by the growing pension liabilities and make the system equitable for future retirees. Unfortunately, the reports of these commissions were never made public by successive governments, let alone get implemented.

The Pay and Pension Committee of 2001 recommended a series of parametric reforms to make incremental improvements in the pension system such as reducing the pension commutation ratio, discontinuing additional benefits for service beyond 30 years, and ceasing the restoration of commuted pensions. The committee also proposed a Contributory Provident Fund for new employees.

The Pension Commission of 2009 recommended a phased increase in existing pensions, enhancing family pensions, and introducing travel concessions for retirees to improve their quality of life. These recommendations were aimed at ensuring adequacy for retirees but not without creating additional fiscal liabilities for the government. The commission also suggested reducing pension commutation, adjusting accrual rates to reflect current fiscal realities, creating disincentives for early retirement and a shift towards DCS.

The 2020 Commission reportedly proposed abolishing the eligibility for more than one pension per government employee and limiting the duration of family pensions to a maximum of ten years. The calculation of pensions was suggested to be based on 70% of the last 36 months of service rather than the final salary, with increases aligned to inflation rates. Furthermore, the commission advocated for a significant reduction in pension commutation and a transition to a contributory pension scheme. The high-powered body also commissioned detailed actuarial work, providing valuable insights into existing pension liabilities as well as the contours for a new defined contribution scheme.

A Delicate Dance: Balancing Politics, Economics, and Fairness in Pension Reform

It's a no-brainer that the present non-contributory defined-benefit pension scheme is not sustainable. The government no more has the fiscal space to keep on giving such generous payouts. A shift to DCS is critical to avert the looming fiscal crisis, stabilize the pension costs in the medium term and distribute the financial risks more equitably between the government and employees. But the devil lies in the details. Moreover, the government does not have the luxury to be content on medium term solutions only. It needs to act fast with much quicker results.

Let's try to unpack such a transition and other reform options:

1) The political economy of pension reforms is intricate. The benefits of existing pensioners cannot be altered because they are beyond the contribution stage, with total reliance on their pension proceeds. But even for present employees, who have several years of service left, a change in their expected pension benefits may be quite challenging. Any such move will be widely unpopular and can lead to excessive litigation. Decades of jurisprudence have established an immutable principle: the terms of service of government employees cannot arbitrarily be varied adversely.

2) Introducing a contributory scheme for the new employees seem like a much easier option without much resistance, to at least put an end to new pension liabilities. This

however has its own set of complications. Introducing such a scheme would mean that while the government would continue to pay for growing pension liabilities for existing pensioners and employees, it would also need to make contributions to the new scheme. This in fact would increase the financial burden of the government for the next several years. In the beginning, such additional contributions may be small but would grow substantially with newer recruitments adding up over the next few years. It will be hard for any political government to accept an additional drag on its own resources, while creating a prospective benefit many years in the distant future, more so in a contentious political environment and a fiscally constrained macro-economic situation. Besides, this solution would not ease out the pension payments and a blowout may happen way before the new scheme starts to give its dividends.

Moreover, it is not essential that any scheme for future employees may not face any significant opposition. There are scores of ad hoc employees especially at the provincial level who manage to get regularized at times. They would resist tooth and nail any such adversely preferential treatment compared to their peers who have been regularized or recruited earlier. The province of KP has witnessed such resistance in the past at the time of regularizing thousands of teachers, after the introduction of a contributory pension scheme for new employees and the issue is still very much alive.

3) Creating a fiscal balance may be an essential and immediate goal, but the government must also ensure adequacy of public sector pension. Relentless pursuits of fiscal affordability may squeeze the pension benefits too much, creating a social crisis.

4) A contributory scheme generally gives some level of control to the employees to manage their pension and choose from a selection of investment options. Given the low financial literacy, such self-control may pose additional risks.

5) Last but not the least, the military pensions constitute the bulk of pension expenditure of the federal government. Only reforming civil pensions would not create a meaningful dent in the growing payouts, but it's also very difficult for any civil government to reform military pensions.

Forging Paths: Strategic Direction for Sustainable Pensions

Navigating through these challenges is difficult but not impossible. There is no single solution to Pakistan's pension woes and instead a combination of multiple solutions is required to adequately address the pension challenge. This may include immediate parametric reforms such as extending the retirement age, disincentivizing early retirement, modifying commutation rules, adjusting the wage base for pension benefit calculation, rationalizing the accrual rate and trimming down family pension benefit structure. But the government also needs a defined-contribution scheme for both civil and military employees, not only for new recruits but also transitioning existing employees onto that scheme. Adequacy of pension benefits should be one of the primary goals in any such transition, without which any reform efforts can miserably fail.

Luckily though, Pakistan is not the first country facing these issues. Many nations with much more complex political economies have transitioned to sustainable pension models and they can teach us some valuable lessons.

What can we learn from these countries? How did they navigate their own set of political economy challenges? And how can we begin

to design a comprehensive pension reform program for Pakistan? I would attempt to answer these questions in the next two articles in this series, drawing insights from pension systems around the world and defining the contours for pension reforms in Pakistan. I sincerely hope that together, these articles will contribute to a deeper understanding of the pension reform landscape and will at least point towards a solution to ensure that Pakistan's pension system remains both financially viable and capable of providing for its aging population. The ultimate goal is to prevent a fiscal crisis while upholding the government's commitment to its retired workers, ensuring they can enjoy a secure and dignified retirement after years of service.

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