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Deferred Dreams: Building a Sustainable Pension System for Pakistan

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Piecing Together the Puzzle

This is the third and the last part in a three-part series of articles on Pakistan's pension crisis.

In the first part of this series, we delved into the growing crisis of Pakistan's public sector pensions, highlighting the unsustainable trajectory of pension expenses that threaten the country's fiscal stability. The discussion revealed alarming trends: pension liabilities have been ballooning at a rate far outpacing revenue growth, with projections suggesting that the pension burden could double every four years if left unaddressed.

In the second part, we broadened the discussion, seeking inspiration from global experiences with pension reforms. We examined how countries like Chile and India navigated their pension crises, transforming their unsustainable pay-as-you-go (PAYG) systems into financially viable contributory models. These international case studies offered valuable lessons on managing political resistance, building consensus, and ensuring both fiscal sustainability and benefit adequacy.

As we move into the third and final part of this series, our focus shifts from diagnosis and international lessons to actionable solutions tailored for Pakistan. Based on the insights gained from the first two parts, this article outlines a strategic framework for designing a sustainable and equitable pension system in Pakistan. The goal is to propose a pragmatic and politically feasible reform strategy that not only stabilizes the fiscal outlook but also ensures that retirees can enjoy a dignified and secure post-retirement life.

The Building Blocks for a New Pension System

The lessons learned from other countries reveal several essential features that characterize a well-functioning pension system. The best rated pension systems have robust governance and regulatory structures to ensure transparency and credibility. Typically, these systems are based on a multi-pillar approach, incorporating state, occupational, and voluntary pensions, and are backed by consistent policies with broad political support. They generally offer broad coverage, ensuring that all segments of the population have access to retirement savings and benefits, and provide adequate benefits with a reasonable replacement rate of pre-retirement income. Continuous adjustments, driven by evidence rather than political expediency, enable these systems to adapt to changing demographics and economic conditions. Lastly. enhancing financial literacy is often a cornerstone of these systems, equipping the participants with the knowledge and tools necessary for informed retirement planning.

Table: Characterizing Features of Best Rated Pension Systems

No.	Feature	Details
1.	Multi-Pillar System	Distributed financial burden through state, occupational, and personal pension systems
2.	Robust Governance and Regulation	Transparency, accountability, and good governance through strong regulatory frameworks
3.	Policy Consistency	Long-term stability with broad political support and consistent policy direction
4.	Adequacy of Benefits	Adequate replacement rate of pre-retirement income
5.	Comprehensive Coverage	Broad access to retirement savings & benefits across different population segments
6.	Flexibility and Portability	Pension portability across jobs and flexible retirement planning options
7.	Continuous Adjustment	Regular reviews and adjustment to adapt to changing demographics and economics
8.	Financial Literacy	Enhanced understanding of pension systems and retirement planning, especially among pension scheme subscribers, with education and tools
9.	Prudent Investment Strategy	Balanced investment strategy to grow pension funds while reducing risk as retirement nears

Crafting a Hybrid Solution: A Multi-Pillar Pension Strategy

In case of Pakistan, the dual and often competing objectives of sustainability and adequacy must guide the reform process, so that financial sustainability ensures the long-term viability of the pension system, while adequacy guarantees that retirees receive sufficient benefits to maintain a decent standard of living.

However, it is important to understand that no single pension source can provide adequate coverage to all pensioners. Like other well-functioning models in the world, the new pension system in Pakistan must have a multi-pillar structure.How would such a multi-pillar system look like? Potentially, a hybrid pension system, blending defined benefits with defined contributions, could create the fine balance needed between financial sustainability and benefit predictability.

The foundational pillar of such a hybrid system would be a basic pension for all civil servants, a non-contributory scheme funded through budgetary allocation. It could either be an annuity or a minimum return guarantee or both, depending on an individual subscriber's remaining years of service. Its primary objective should be to provide a safety net that ensures a minimum income level for all retirees. This pillar must fully cater to the legacy retirees[1] and partially cater (possibly as a top-up) to those who are not expected to contribute sufficiently to the contributory fund due to lesser number of remaining years in service. For the rest of the retirees, who have reasonable number of years left to sufficiently contribute to their retirement nest, the same pillar could also provide a minimum return guarantee, in case their contributions do not lead to adequate returns due to inadvertent or unforeseen economic circumstances. Such a provision can provide great comfort to and significantly reduce resistance from the participants of the existing defined benefit scheme. The government however must ensure that it provides sufficient funding for this pillar to maintain the solvency because any unaddressed risk in this area could potentially derail the whole system.

Staggering the Contributions

One option is to initially err on the side of adequacy to preempt resistance and gain acceptance while subscribers are gradually weaned off defined benefits. Contribution rates can then be ramped up in staggered increments negotiated among all stakeholders. For instance, in the Indian experience there was a long period of initial consultation to arrive at contribution rate of 10% for employees to be matched by Government, with a provision to revise these rates in future. This revision was carried out following a second round of consultations in 2019, when the rate was increased to 14%. Similarly, Kenya introduced a DCS for civil servants with a contribution rate of 7.5% for employees and 15% from government. But employees would start by paying 2% in the first year, 5% in the second year and 7.5% in the third year of employment. This relates to reform sequencing considerations discussed in a later section.

The second or the main pillar of the proposed pension system should include a mandatory contributory pension scheme, designed to establish a sustainable framework where individuals actively contribute to their own retirement savings. This system should involve contributions from both employees and the government, ideally managed by private pension funds under stringent regulatory oversight.

In addition, there could be a third pillar as well to serve as an additional top-up to encourage voluntary savings as supplementary pension, to enhance financial security for the post-retirement life. This could be incentivized through tax benefits, offering flexible contribution rates and investment options.

[1]The existing pool of retirees

Aligning Stakeholder Interests

A successful reform must create a win for all major stakeholders, otherwise either it won't sail to begin with or will sink early on. The major stakeholders for public sector pension reforms include the politicians on one side and the government servants and retirees on the other. Military is also an important stakeholder, considering that the lion's share of federal pension budget is earmarked for the military retirees. What could be a win-win proposition for all these stakeholders?

For politicians, the implementation of a contributory pension scheme offers a pathway to achieve fiscal sustainability, a critical goal for any government. By alleviating the significant fiscal pressures currently exerted by the pension system, the government can reallocate resources to other priority areas such as infrastructure, poverty alleviation and social services. Moreover, the establishment of a large, well-managed pension fund can act as a substantial economic stimulus. By investing in selected areas, this fund can spur economic growth, create jobs, and enhance national development.

For the military, pension reforms also promise sustainable benefits, ensuring that retired personnel continue to receive adequate and reliable pensions without the fear of an untoward fiscal crisis. This sustainability is crucial for maintaining the morale and welfare of current and future retirees. Furthermore, a shift to a contributory pension scheme can create more fiscal space for the military budget. With a more balanced and sustainable approach to pensions, the government can allocate additional resources to essential areas such as training, equipment, and modernization programs, thereby enhancing overall military effectiveness.

Agnipath – An Experiment in Indian Military Recruitment

In 2022, the Indian government introduced the 'Agnipath' scheme where new recruits into the armed forces would serve a 4-year period at the end of which, three-fourths of their strength would exit with a severance package, while the rest would be absorbed into the mainstream to serve a minimum of 15 more years. This replaces the earlier system of long-term employment with the armed forces where recruits served a minimum of 17 years and then retired with a life-long pension. However, according to media reports, the scheme has not been well-received by the armed forces or other stakeholders across the political spectrum, while it's still not clear whether intended savings in salary and pension have materialized.

Government employees and pensioners also stand to gain significantly from pension reforms if they are structured appropriately. One of the primary benefits will be improved retirement security without the fear of a fiscal blowout. By ensuring the sustainability of pension funds, a new contributory scheme will provide government employees with greater confidence in the adequacy and reliability of their retirement benefits. This security is essential for long-term financial planning and peace of mind. Enhanced transparency will be another key advantage. A well-managed and transparent pension system will offer clear information about retirement benefits, reducing uncertainty and anxiety about the future.

It is however important that all stakeholder groups understand these benefits well and embrace the reforms willingly.

Sequencing the Reform: Paving the Way to Sustainable Pensions

Implementing pension reform would require careful sequencing and a deliberate pace. Before embarking on the actual reform journey, it's crucial to establish a long-term policy that underpins the entire effort. This policy should provide visibility into the government's intentions, define the structure of a multi-pillar pension framework, manage stakeholder expectations, and outline the prioritization and sequencing of reforms. The reform process should begin modestly, starting with the federal government, cascading to provincial governments and state-owned enterprises[2], and finally extending to cover beyond public sector pensions[3].

In the first phase, the new contributory scheme should target new government employees, while existing employees may continue under a modified defined benefit scheme after parametric reforms, such as adjusting benefit formulas and eligibility criteria. As the next step, existing employees should be offered incentives to transition into the new scheme, with a funding mechanism in place to ensure that their years of service are accounted for, preventing any loss of expected pension income.

Implementation of this new system would require addressing various structural, regulatory, and administrative challenges, but protecting the pensioners' interest would be of paramount importance, because they would be putting in their lifelong savings based on the trust in the system. Therefore, establishing a robust regulatory authority to oversee the pension fund will be crucial to ensure transparency and accountability and should take precedence over all other implementation considerations. The regulatory body should enforce stringent guidelines to manage risks effectively and ensure transparency in investment activities. Regular audits and compliance checks will be necessary to maintain the integrity of the pension fund and protect the interests of the contributors.

Enhancing transparency and communication, coupled with fostering financial literacy and planning, would also be essential for building trust and encouraging participation in the pension system. Providing clear, accessible information to all participants about their pension rights, contribution requirements, and benefit calculations, along with regular updates on fund performance and any changes to the system, will ensure transparency.

For the contributory scheme, establishing the funding and investment mechanism will be critical. The primary investment objective would be to ensure long-term viability and stability of the funds while maximizing returns for retirees. This means allocating assets across various financial instruments, including equities, bonds, and other investment vehicles. The balance between high-yield investments and stable, low-risk options is vital for the sustainability of the

[2]Those SOEs that do not have a defined benefit scheme.
[3]Well-functioning pension systems globally offer universal coverage. Although Pakistan's immediate concern is the financial burden of public pensions, any proposed solution should have a broader scope, aiming to scale up to universal coverage in the future. This approach would help integrate disparate systems like the Employees' Old-Age Benefits Institution (EOBI) and the Provincial Employees Social Security Institutions (PESSI) into a cohesive framework, extending pension benefits to formal and informal sector workers, the self-employed, and vulnerable groups such as women and the elderly.

pension funds. The approach should draw from best practices worldwide, emphasizing lifecycle funds management[4].

Modernizing the administration of pensions through technology will also be important to improve efficiency, transparency, and accountability. The implementation of centralized databases and online portals will provide beneficiaries with real-time access to their pension details, facilitating better planning and management of their retirement funds.

By carefully sequencing these reforms, Pakistan can make significant progress in pension reform, effectively managing stakeholder expectations and adjusting the approach as needed.

Realizing the Deferred Dreams

As we conclude this series on pension reform in Pakistan, the challenges are formidable but not insurmountable. Our journey began with an in-depth analysis of the current pension crisis, highlighting the unsustainable trajectory of pension expenses that threaten the fiscal stability of the nation. We also examined international models of pension reform. These case studies demonstrated that while the path to reform is fraught with challenges, it is possible to create a sustainable pension system that balances financial stability with benefit adequacy. We have now outlined a strategic vision for reforming Pakistan's pension system and hope that this blueprint will facilitate the ongoing dialogue around pension reforms and will help Pakistan tread the trajectory towards a state-of-the-art pension system, ensuring that the dreams of its citizens for a secure and dignified retirement are no longer deferred.

[4]Life cycle fund management, also known as target-date fund management or life-cycle investing, is an investment strategy designed to automatically adjust the asset allocation of a portfolio based on the investor's age, time horizon, or target retirement date. The primary goal is to balance risk and return by gradually shifting the investment mix from more aggressive, high-growth assets (such as stocks) to more conservative, stable assets (such as bonds and cash) as the investor approaches a specific date, typically retirement.

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