



GOVERNMENT PENSION & FISCAL SUSTAINABILITY





GOVERNMENT PENSION & FISCAL SUSTAINABILITY IN KHYBER PAKHTUNKHWA

ABOUT THE WORK

This work has been completed for Foreign Commonwealth and Development Office (FCDO)'s Sustainable Energy and Economic Development (SEED) Programme in collaboration with Sustainable Development Policy Institute (SDPI).

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Sustainable Energy and Economic Development (SEED) is a six-year programme, funded by the United Kingdom Foreign, Commonwealth and Development Office (FCDO). This project aims to improve economic and urban planning in Khyber Pakhtunkhwa. Sustainable Development Policy Institute (SDPI) is a national think-tank that has been conducting research on the economy and environment for almost three decades to support government policies at the national and subnational levels.

SDPI is collaborating with SEED to conduct a series of consultations on public sector pension reform in Pakistan. There is an intent to bring together government officials and independent experts to highlight fiscal policy challenges presented by the growth in unfunded public sector pension and to evolve reform options based on evidence from national and international experiences. The federal and provincial governments are currently exploring solutions to manage their pension liabilities, and our consultations and engagements with federal and Khyber Pakhtunkhwa governments under the SEED programme are intended to inform this process.

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List of Abbreviations

DCS	Defined Contribution Scheme
FCDO	Foreign, Commonwealth and Development Office
GoKP	Government of Khyber Pakhtunkhwa
KP	Khyber Pakhtunkhwa
SBP	State Bank of Pakistan
SDPI	Sustainable Development Policy Institute
SEED	Sustainable Energy and Economic Development
SPSS	Special Professional Pay Scales

Foreword



Photo Credit: Almani

Message from Mr. Taimur Saleem Khan Jhagra, Finance Minister, Government of Khyber Pakhtunkhwa

I congratulate UK Aid funded SEED programme for initiating a broad-based outreach and policy engagement effort on this subject. I am happy to note that in this process our local think tanks such as SDPI are also active. Within the Government of Khyber Pakhtunkhwa, we have already initiated some steps in the direction advocated in this report. Most importantly, we are considering a transition toward a defined contribution scheme.

At the same time, we are also studying changes that could be brought in the Pension Rules. Any modification made will not affect the pension of any single person who is currently drawing it. To prudently manage pensions, we also need an administrative will and improved capacities.

The federal Pay and Pension Commission can also help the provinces in providing a model that can be contextualized and adopted according to the unique fiscal position of each province. Our pay and contractual structures need to be flexible to attract and retain the best talent in today's labor market while remaining within the bounds of fiscal responsibility.

The media has an important role to play in support of our pension reform agenda. We need factual, progressive reporting and commentary to shape public opinion and help raise 'pension-literacy' at the provincial and national levels. The link between pension rationalization and the government's ability to spend on citizens' welfare must be made clear. This effort by SEED is an important step in this direction.



Message from Mr. Hasaan Khawar, Team Leader, SEED

One of the core outcomes sought by the SEED is higher levels of public and private investment in Khyber Pakhtunkhwa. Public investment is needed now more than ever, to offset job losses caused by COVID-19, and create new employment opportunities in the low-income and low-skilled segments of the provincial economy.

However, the fiscal space available to the Government of Khyber Pakhtunkhwa for financing such investment is shrinking. The Government must recalibrate fiscal priorities and rationalize expenditure, especially on the recurrent side. Pension is high on the list of recurrent liabilities that are large and unsustainable.

The Government of Khyber Pakhtunkhwa fully recognizes the nature and significance of the problem and has already taken a number of steps toward addressing it. The Government of Khyber Pakhtunkhwa has completed preliminary diagnostics for parametric reforms, introduced legislative changes, and commissioned an actuarial study. Most recently, the Government of Khyber Pakhtunkhwa has constituted a Cabinet Committee to consider the option of a contributory system for civil service pension in Khyber Pakhtunkhwa.

In parallel, the federal Government and other provincial Governments are also considering appropriate policy responses to what is now a truly national policy challenge. It is in this context that SEED has organized this series of Webinars to unpack the various dimensions of the problem, draw on relevant national and international experiences and expertise and assist the Government of Khyber Pakhtunkhwa in making sound policy choices in designing its pension reform program.

This paper distils the major points of discussion from the first Webinar. This discussion attempted to define the problem in terms of fiscal risks and challenges, while also outlining the reforms needed to both relieve fiscal pressure in the short-term as well as minimize future liabilities in the medium-to-long term so that development expenditure remains intact.



Executive Summary



SA Khan Photography

Pension liabilities are a large and growing drag on the provincial budget for the Government of Khyber-Pakhtunkhwa (GoKP). The pension bill had grown from 3% of the provincial budget in 2009-10 to 10% in 2019-20 – a tenfold increase within a decade, in absolute terms. This amount will grow to 18% of current expenditures by 2022-23, making it difficult for the GoKP to finance development. Other provincial governments and the federal government are facing the same problem in Pakistan.

The legal and regulatory framework in KP provides multiple layers of retirement benefits to civil servants. Civil servants may avail pensions upon superannuation and early retirement, while also opting for commutation of up to 35% of their awardable pensions amounts. These benefits are transferred to eligible family members upon their death. Civil servants do not contribute toward these benefits.

In addition, the balances of both the General Provident Investment Fund and a Benevolent Fund are also available as retirement grants, though these Funds include contributions from employee salaries. Finally, the Retirement Benefits and Death Compensation Act sets up another contributory fund for civil servants.

The Government of Khyber Pakhtunkhwa is spending Rs. 60,241 million in terms of retirement benefits which will grow by 57% until 2022-23 to Rs. 94,657 million. Globally, both private and public sector entities are moving away from such multi-layered retirement benefit systems for employees.

The GoKP has already introduced a range of policy measures to counter these challenges. Recent Cabinet decisions have provided in-principle approval for limiting eligibility for pensions and survivorship benefits, extending the minimum cut-off age or service period for early retirement and excluding dual pensioners and active employees from the system. The Cabinet has also decided to use Pension Fund profits to finance the current pension liabilities. Most importantly, a Cabinet Committee has been constituted to consider a structural transition to a contributory pension scheme where pensions will be funded through payroll deductions from fresh entrants to the civil service, in addition to the Government's contribution.

Pension reforms need to be accompanied by efforts to relieve fiscal pressure in the short to medium terms. While pension reforms may typically undergo longer term gestation cycles before roll-out, the immediate fiscal pressure exerted by growing annual pension payouts must be addressed. A range of measures may be considered as part of an overall pension funding strategy for GoKP, including ring-fencing revenue sources for meeting annual pension payments, pegging government contributions to the Pension Fund to annual revenue growth, freezing basic pay to reduce the knock-on effects on pension expenditure, divesting Government assets to finance pensions, minimizing administrative leakages in pension payment system, further simplifying the eligibility structure and offering cash buyouts to active pensioners in lieu of full pensions payments in future.

1. Introduction



Photo Credit: CreativeWork99

This report explores how expenditure on public sector pension is endangering fiscal sustainability for the Government of Khyber-Pakhtunkhwa, a problem that is common among national and subnational governments within and outside of Pakistan.

Ageing populations, higher dependency ratios and low fertility rates have increased the pension expenditures even in developed countries. In the context of structural problems and limited fiscal space, rising pension expenditures are all the more unsustainable for developing economies. The public sector pension to GDP ratio in Pakistan is estimated to be 2.2% in fiscal year 2020-21 whereas the proportion of the population which is provided old-age contributory pensions, health and social security insurance is only 5.9% (SBP, 2020).

Pension-related spending in Pakistan is increasing at a rapid pace. A number of factors are fueling this phenomenon: ad hoc and retrospective increments in pensions and wages from the government, early retirements, high replacement rate, commutation and restoration facilities to pensioners, and substantial survivorship benefits¹. With the increase in average life expectancy, medical expenditures, and the recent hike in inflation, nominal pensions

are bound to increase further, given demand-side pressures. Recently, the All Pakistan Pensioners Association staged a demonstration demanding an increase in their pensions or inflation-indexing provisions².

Khyber Pakhtunkhwa's pension bill had grown from 3% of the provincial budget in 2009-10 to nearly 10% in 2019-20. In absolute terms, this reflects growth by a factor of 10, from Rs. 7.2 billion to Rs. 74 billion over the same period. These trends are not nationally exceptional. The current expenditures of the federal government on superannuation allowances and pension increased from Rs. 421 billion in FY 2019-20 to Rs. 470 billion in FY 2020-21³. And these figures do not include the pension expenditure of provincial governments and some state-owned enterprises. For example, Pakistan Railway needed around Rs. 6 billion in March 2021 to clear the outstanding pensions payable to its retired workers⁴.

Both nominal and real pension burden have seen an increasing trend. The amount of federal pension has increased around 18% annually in real terms (Economic Survey of Pakistan, 2020). Over the past 5 years, all provinces have seen growth in annual pension bill ranging from 78-113%(Table1).

Table 1: Provincial pension expenditures (Rs. Billion)

Province	2016-17	2017-18	2018-19	2019-20	2020-21 (BE)*	Growth (%)
Punjab	141	173.8	210	244.9	250.7	78%
Sindh	70	92.7	118.2	130.7	145.1	107%
Khyber Pahtunkhwa	47.4	54.3	69.4	74.0	86.0	82%
Balochistan	17.9	23.2	29.8	33.6	38.2	113%
Federal	245	333.4	342	463.4	470.0	92%
Total (% of GDP)	1.6%	2.0%	2.0%	2.3%	2.2%	--

Source: Annual Budget Statements. *BE = Budget Estimate.

¹18.7% of total tax revenue goes to pensioners: Study' ProPakistani, 6 January 2021, <https://propakistani.pk/2021/01/06/18-7-of-total-tax-revenue-goes-to-pensioners-study/>

²'Pensioners staged demonstration' The News International, 17 February 2021, <https://www.thenews.com.pk/print/791126-pensioners-stage-demonstration>

³Federal Budget, 2020-21, Finance Division, Government of Pakistan

⁴'Pakistan Railway require around Rs. 6 billion to clear pension payments' Daily Times, 3 March 2021, <https://dailytimes.com.pk/730003/railways-require-around-rs-6-billion-to-clear-pension-payments/>

The Pay and Pension Commission, 2020 will evaluate the sustainability of the existing system and propose a new system and its implementation methodology, institutional framework and timelines for implementation.

Nargis Sethi, Chairperson, Pay & Pension Commission 2020

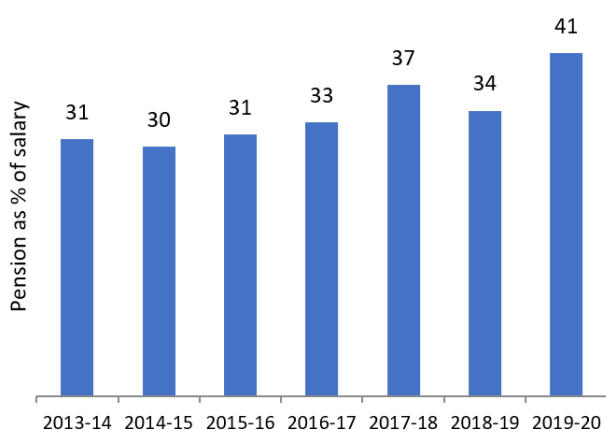
Pension expenditure as a percentage of salary expenditures has also increased over the last few years (Table 1). Studies such as Howse (2004), Grech (2013) and Schneider (2009) explain how growing pension expense could exert pressures on the allocation of tax revenues. The allocation towards pension is fiscally unsustainable as it is being financed by current revenue. Adequate funds are not being set aside to meet future liabilities as they accrue i.e. a Pay-As-You-Go model of financing pension schemes is the prevailing policy approach by GoKP, other provincial governments and the federal government in Pakistan⁵.

Pension expense as a proportion of salary expense has grown from 31% in 2013-14 to 41% in 2019-20, according to official budget documents, as shown in

Figure 1. According to one independent estimate, at the current growth rate in pension expenditures, 56% of the federal budget will be consumed in pension by 2050 (Khalid et al. 2020).

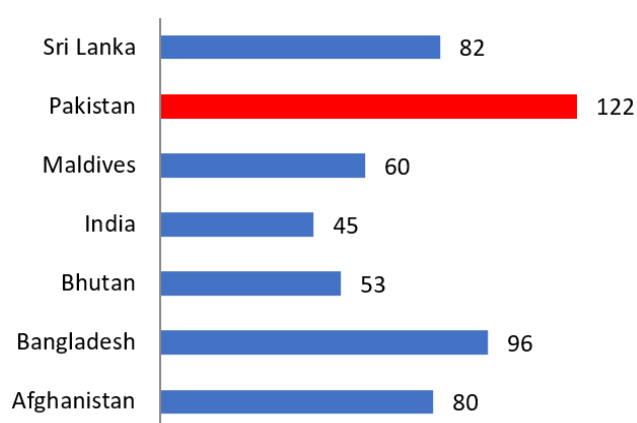
Already, the federal government in Pakistan has the highest gross pension replacement rate for public sector employees across South Asia (State Bank of Pakistan, 2020)⁶. Pensioners in Pakistan are entitled to receive 70% of their last drawn salary. However, once medical and other allowances are priced in, the replacement rate in the public sector is highest for Pakistan as compared to other South Asian countries (Figure 2). Also, the increments from successive governments increase the federal pension from 70% of last drawn salary to around 140% in some cases (Haque et al. 2021).

Figure 1:
Pension as a percentage of salary expenditure



Source: Budget documents

Figure 2:
Gross pension replacement rate



Source: World Bank (2020)

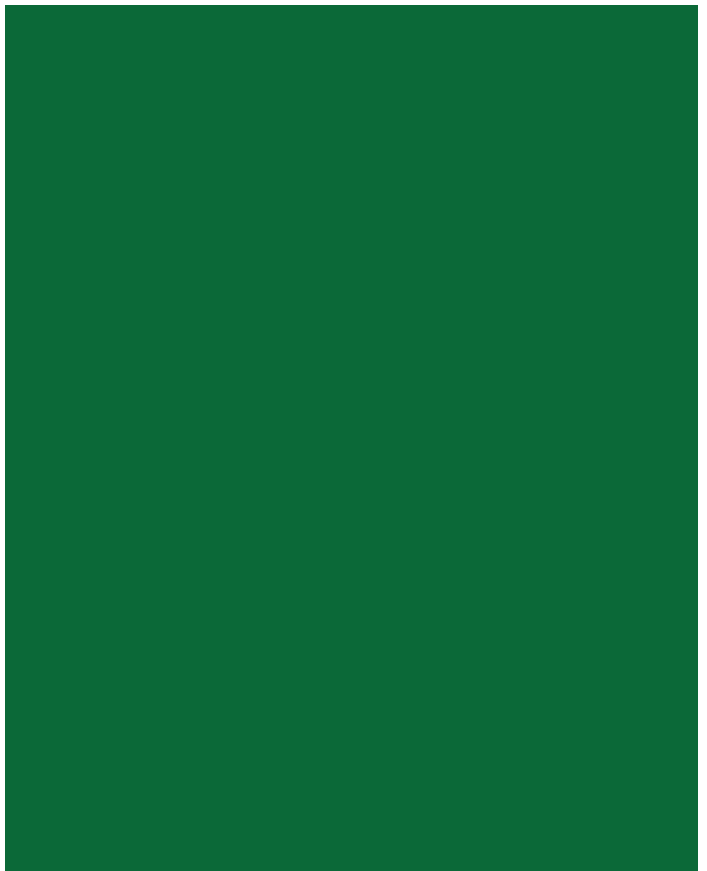
⁵ This model may be contrasted with a fully funded pension scheme where regular contributions are made into a pension pot out of which payments can be made to future retirees.

⁶ According to the OECD: "The gross replacement rate is defined as gross pension entitlement divided by gross pre-retirement earnings." In simple terms, the statistic measures how far pensions payouts substitute the gross salary an employee was drawing before her retirement.

⁷ Gross pension entitlement divided by gross pre-retirement earnings.

The federal government has recently constituted a new Pay and Pension Commission in 2020 to tackle these fiscal challenges⁸. While formulating its proposals, the commission will take into consideration the financial resources of the Government. Ms. Nargis Sethi, Chairperson of the Commission, explained that the commission will evaluate the sustainability of the existing system and propose a new system and its implementation methodology, institutional framework and timelines for implementation⁹.

The GoKP has also taken multiple steps to address growing pension liabilities. The KP Civil Servants (Amendment) Act, 2019 extended the minimum age for superannuation and early retirement. An actuarial assessment has been commissioned to quantify current and future liabilities. Automation of pension records and disbursement is ongoing. Revisions in Pension Rules have recently been approved (in-principle) to rationalize eligibility for pension benefits, while the move to a contributory scheme is under consideration.



⁸ The Government of Pakistan has constituted a Pay and Pension Commission, with effect from 14-04-2020, http://www.finance.gov.pk/circulars/circular_16042020.pdf
⁹ Complete recording of this meeting can be viewed at SDPI's Sustainable Development TV YouTube channel, link: <https://www.youtube.com/watch?v=N51POLHtfOM>

2. Overview of Pensions and Retirement Benefits in Khyber Pakhtunkhwa



Photo Credit: Abdullah Hussain

Pension eligibility and determination

Pensions for civil servants in Khyber Pakhtunkhwa are governed by two key policy instruments¹⁰:

1. Civil Servants Act 1973 (amended up to 2021)
2. Civil Servants Pension Rules & Orders (Corrected and Compiled up to 2006)

Under the prevailing policy framework, the following beneficiaries are eligible to receive pensions:

- Civil servants reaching 60 years of age qualify for superannuation pensions;
- Civil servants completing 25 years of service received retiring pensions;
- Civil servants suffering permanent mental or physical disability received invalid pensions;
- Civil servants made redundant because of abolition of post receive compensation pensions;
- Family members of civil servants who die following 10 years of service or retire.

Government servants who have completed at least 5 years – but less than 10 years – are also eligible for receiving a gratuity amounting to one-month's pay for each year of service. This is payable to the employee upon retirement.

In 1997-98, the Government of Khyber Pakhtunkhwa (GoKP) established a Pension Fund with an initial allocation of Rs. 150 million, under the Pension Fund Act, 1999 (amended up to 2014). At the end of 2019-20, the closing balance of the Fund was as estimated 55.2 billion¹¹. The GoKP's estimated pension expenditure for FY 2020 was Rs. 86 billion. The Fund, therefore, does not have adequate resources to meet even the current pension liabilities of the Government of Khyber Pakhtunkhwa.

Other retirement benefits

Besides pensions and gratuities, public officials are also entitled to other benefits. The provident fund established under the Khyber Pakhtunkhwa General Provident Investment Fund Act 1999, provides a second layer of benefits to civil servants. Government employees contribute toward this fund on a mandatory basis. Fund balances are collateralizable against loans to ease access to credit for beneficiaries. Government servants are also eligible to receive benefits accrued in another contributory fund, i.e., the Benevolent Fund established under the Government Servants Benevolent Fund Ordinance 1972. Under Benevolent Fund, two major grants, i.e., lump sum grant and retirement grants are available to provide financial assistance to government employees at retirement. The Fund is based on compulsory contributions from the employees on a monthly basis, which are deducted at source.

Table 2: Major grants to government employees at retirement

Category of Subscriber	Retirement grant	Lump sum grant
Basic Pay Scale-01 to BS-04	Rs.230,000/-	Rs.250,000/-
Basic Pay Scale-05 to BS-15	Rs.330,000/-	Rs.350,000/-
Basic Pay Scale-16 & Above	Rs.500,000/-	Rs.500,000/-

Source: Provincial Benevolent Fund, Khyber Pakhtunkhwa

¹⁰The relevant provisions of the Civil Servants Act 1973 have been amended in 2013, 2019 and again in 2021. Civil Service Rules have also been amended in 2021. More details are provided in the Section on GoKP's policy responses.

¹¹<https://www.pakp.gov.pk/wp-content/uploads/c-2White-Paper-FY-2019-20.pdf>

The Mainstream global practice has moved away from multilayered retirement benefits and both public and private sector organizations mostly do not provide such retirement benefits anymore.

Shabbar Zaidi, Former Chairman, Federal Board of Revenue

Finally, the Government introduced a fourth layer of social protection for civil servants under the Khyber Pakhtunkhwa Civil Servants Retirement Benefits and Death Compensation Act 2014, which covers all civil servants of the province, and employees of the Provincial Assembly and Peshawar High Court. The Act creates a Fund credited with scheduled employee contributions. Benefits for civil servants dismissed or removed from service are limited to contributions till date. The family receives the full amount in case of the beneficiary's death as per their grade of service.

The Government of Khyber Pakhtunkhwa is spending Rs. 60,241 million in terms of retirement benefits which will grow by 57% until 2022-23 to Rs. 94,657 million.

According to experts, the mainstream global practice has moved away from multilayered retirement benefits and both public and private sector organizations mostly do not provide such multilayered retirement benefits anymore.

Currently, pension increments are not regulated by a predictable, policy-based mechanism. According to global best practice, pensions are pegged to consumer prices, workers' wages or both. Canada, France, Italy, UK are linking (and adjusting) pensions with consumer price indices while countries such as Australia, Brazil, Turkey adjust pension amounts with changes in wage levels. This not only helps in protecting pensioners against loss of purchasing power and real value for money, but also provides a sense of predictability to the government.

3. Fiscal Policy Challenges for Khyber Pakhtunkhwa



Photo Credit: SA Khan Photography

The Government of Khyber Pakhtunkhwa's budgetary position was stressed even before the onset of COVID-19 pandemic (Table 3). During 2019-20, federal transfers to the province accounted for 90% of total provincial receipts. Despite recent gains in revenue growth – especially from Sales Tax on Services – provincial own-source revenue mobilization has not significantly reduced the Government of Khyber Pakhtunkhwa's reliance on federal transfers¹².

The onset of COVID-19 has constricted fiscal space even further, and this is part of a global trend. The pandemic has also affected the financial position of

defined benefit pension schemes around the world (IMF, 2020).

Federal transfers to GoKP stood at Rs. 670.9 billion in 2019-20 but had shrunk to Rs. 609 billion in 2020-21. Provincial taxes cannot be expected to fill the gap created by this shortfall in federal transfers, as shown in Table 3. The introduction of new levies or upward revision in existing tax rates will be counterproductive during the pandemic, while expanding the tax base through administrative reforms will only potentially bear results in the medium to long term.

Table 3: Budgetary position of Khyber Pakhtunkhwa (Rs. Billion)

Description	2019-20	2020-21 (Budget)	2021-22 (Projected)	2022-23 (Projected)
Total revenues	749.0	749.4	694.6	757.4
Federal transfers	670.9	609.1	608.6	658.4
Provincial tax receipts	33.0	28.2	32.4	37.6
Provincial non-tax receipts	20.4	21.1	19.2	20.2
Total expenditures	693.0	739.1	754.3	808.3
Current expenditure	447.3	505.1	532.1	576.8
Pension	69.9	86.0	94.6	104.1
Pension (as % of current expenditure)	15.63	17.03	17.78	18.04
Development expenditure	236.0	221.9	209.0	217.0
Surplus/deficit	56.0	10.3	-59.7	-50.9

Source: Finance Department, Government of Khyber Pakhtunkhwa

Pension expenditures are increasing each year (Table 3). From 2019-20 till 2022-23, these expenditures are projected to grow by 48.8%. Pension expenditures as a percentage of current expenditures are also increasing, from 15.63% of current expenditures in 2019-20 to 18.04% in 2022-

23. The high wage and pension bill will continue to reduce the fiscal space available for Khyber Pakhtunkhwa's health, education, and other welfare-related priorities. This will have serious knock-on effects on a vulnerable provincial economy.

¹²Nazir et al. (2019).

Pressures resulting from pension liabilities

Since 2009-10, annual public pension expenditure in Khyber Pakhtunkhwa has climbed from 3% of the provincial budget to nearly 10% in 2019-20. The pension bill has grown nearly 10 times larger, from Rs. 7.2 billion in 2009-10 to Rs. 74 billion in 2020-21, outpacing the growth of the salaries' bill, federal transfers and even the overall budget size over the same period.

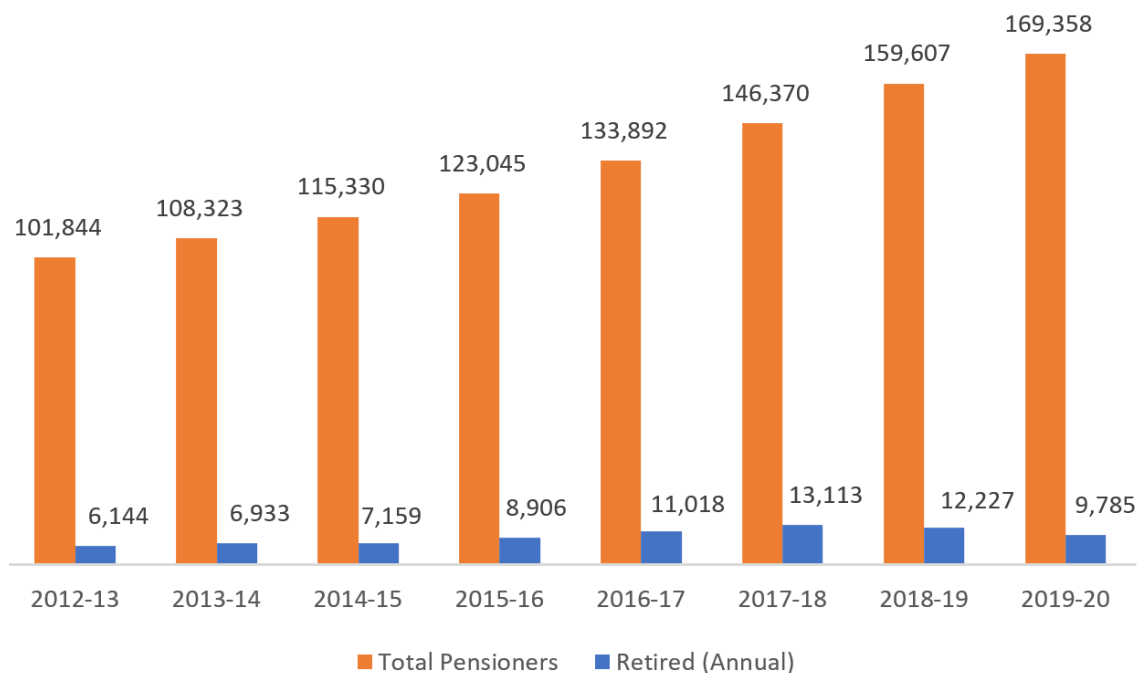
Financing such a rapid increase in pension expense will now pose challenges. If pension expenditures are financed by debt, then a shortfall in government's accounting statements will generate issue of the high cost of refinancing the liability (Wahab et al. 2017). Besides the usual pension expense, the Government is also likely to spend more on family pensions and medical allowances to pensioners in response to COVID-19.

The number of retired civil servants in Khyber Pakhtunkhwa's public sector has also risen at an

annual average growth rate of 7% since 2008-09 (Figure 3). This has pushed the total number of pensioners to 169,358 at the end of the fiscal year 2019-20, which translates to a sharp rise in the government's fiscal liability over the same period. And as per SBP (2020), retrospective increments, restoration facilities and substantial commutation are also driving early retirements of civil servants.

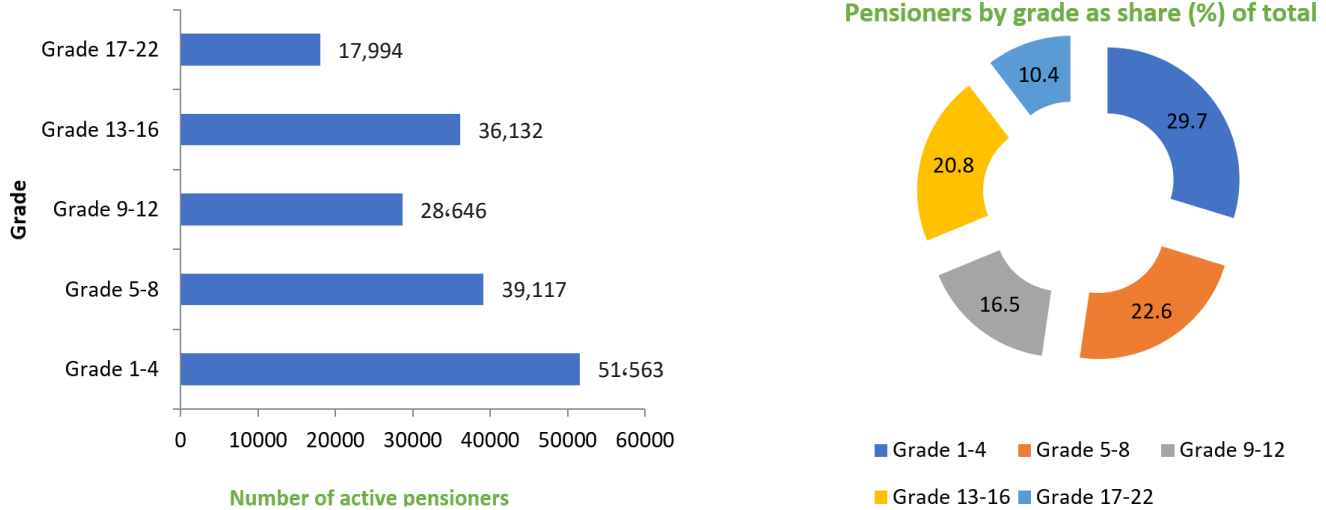
Evidence from Herbertsson & Orszag (2003) and Herbertsson & Thor (2001) explains how early retirements act as endogenous shocks to pension systems. Active pensioners belong predominantly to lower ranks (grade 1-4), as shown in Figure 4. The grades 15-17 are the top three in terms of receiving the highest pension amount. In both cases, there is often popular pressure on the government to regularize adhoc or part-time employees (in equivalent scales) which would only add to mounting post-retirement liabilities.

Figure 3: Number of (Public Sector) Pensioners in Khyber Pakhtunkhwa



Source: Finance Department, Government of Khyber Pakhtunkhwa

Figure 4: Number of Active Pensioners by Grade



Source: Finance Department, Government of Khyber Pakhtunkhwa

The single most important challenge continues to be the multi-level hierarchy of eligible family members which spans across three generations. This raises the administrative burden of scrutiny in terms of time, cost and effort in tracking, documenting and verifying the multiple relationships, which branch out from the retiree to family members and from one family member to another. The documentation includes marriage certificates, medical certificates, affidavits, etc. Despite introducing digital checks, this structure exposes pensions to an increased risk of misuse and fraudulent practices, which are difficult to detect.

Second, as depicted in figure 5, the thirteen layers excessively protract the life of the pension itself. Over 1,300 pension cases initiated over 50 years ago are still active in the system. Even this figure is an underestimation because pensions may be reopened even after cessation, when eligibility conditions change for family members. Figure 6 explains ‘who is receiving the pension’ and it shows that aside from pensioners themselves, a large portion (34%) is being collected by family members, including spouse, children, parents/guardian and siblings. Higher life expectancy has already pushed up pension tenure, and this trend is expected to continue.

The Cabinet has recently approved (in-principle) amendments to the Rules which has limited the

scope of family pensions eligibility and rationalized the structure presented in Figure 5 (to be applied prospectively). More detail is provided in the following section.

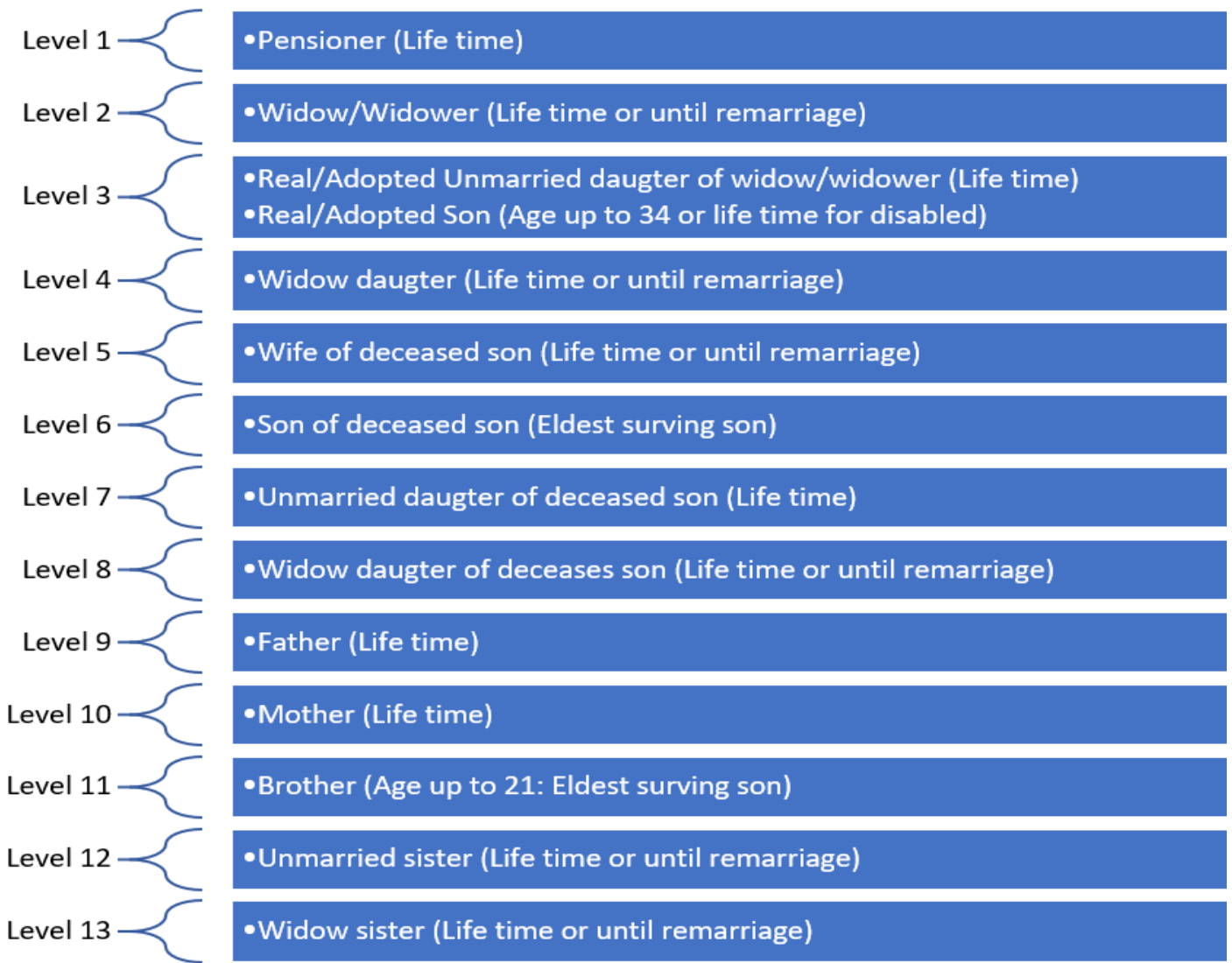
Third, multiple layers create a situation where the rate of new pensioners – retirees and eligible family members – added to the system is much higher than the rate at which existing pensions are ceased. Taking a three-year average over 2015-16 to 2017-18, roughly 11,000 employees retired and became eligible for pensions per year. But over the same period, only roughly 100 pensions were ceased annually on average. This translates to an entry-exit ratio of 110:1. The number of retirees added to the system is growing at 8.1% per annum during 2015-16 to 2019-20 while the pension bill is growing at 18.7% per annum, during the same time period¹³.

Figure 7 shows the number of years since the pensioners are drawing their pensions. It can be observed that 21,736 people are taking pensions for the last 10-15 years while government is bearing pension expenditure of 1,377 people for the last more than fifty years.

Again, this aligns neatly with the national picture. It is expected that due to higher life expectancy and demographic transition, the pension expenditure may increase up to 3.5% of national GDP in the medium-term (Siddique, 2020).

¹³Average annual growth rate computed. Figures sourced from Finance Department, GoKP.

Figure 5: Family members eligible for pensions



Source: Finance Department, Government of Khyber Pakhtunkhwa

Figure 6: Who is receiving public sector pensions in Khyber Pakhtunkhwa?

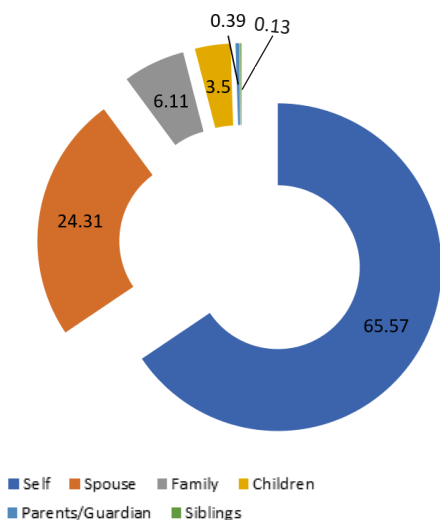
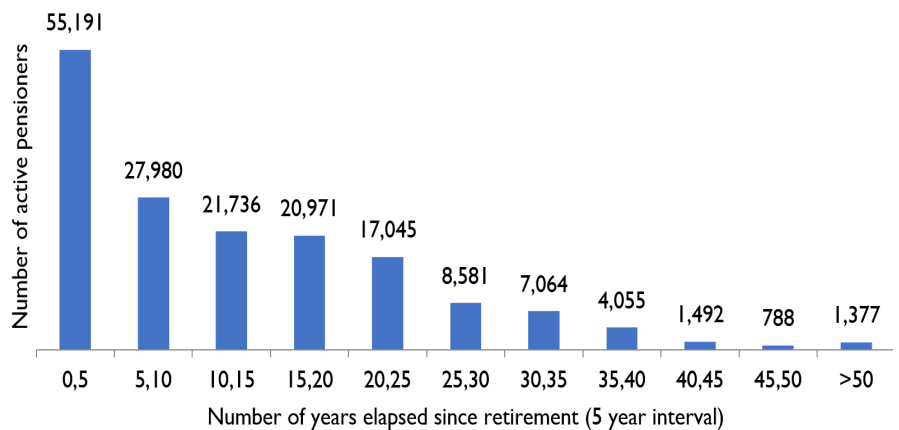


Figure 7: Pensions Age Curve



Source: Finance Department, Government of Khyber Pakhtunkhwa

4. GoKP Policy Responses



Photo Credit: Doulat Khan

In 2019, GoKP increased the superannuation age from 60 to 63 years, but the decision was challenged by the Peshawar High Court, and while the GoKP has reverted the superannuation age to 60 years, it has increased the minimum voluntary retirement age to 55 years¹⁴.

To explore additional pension funding sources, the Khyber Pakhtunkhwa Cabinet has formed a cabinet committee comprising Minister of Finance, Minister of Elementary & Secondary Education, Minister for Local Government, and Minister for Labour & Culture to bring forth recommendations for a contributory pension scheme.

The provincial cabinet has also approved (in-principle) amendments in the Khyber Pakhtunkhwa Civil Servants Pension Rules & Orders 2006, to rationalize pension beneficiaries to direct dependents and parents. This reduces the hierarchy of family

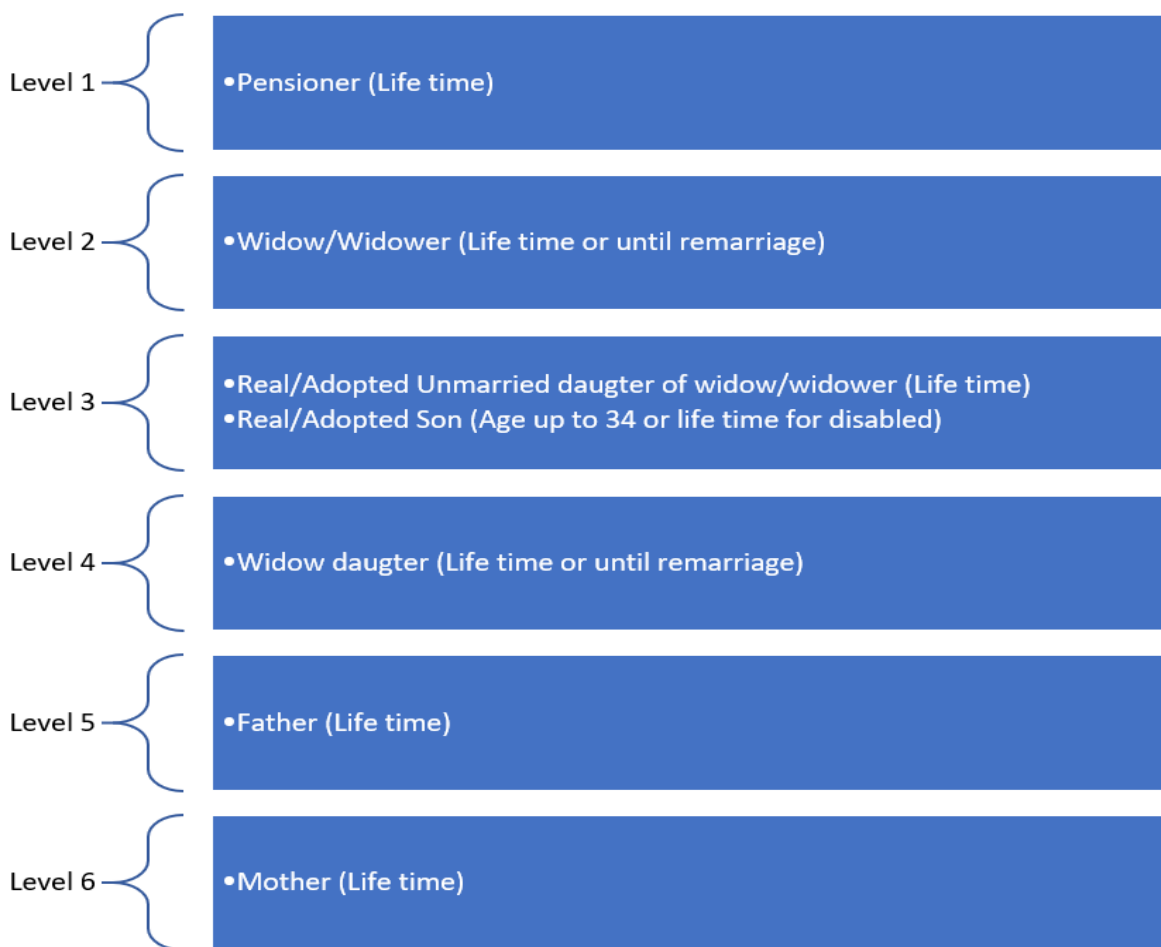
pensions to 6 levels (from 13), as shown in Figure 8 below.

This means that pensions will have shorter durations and cease sooner while costing less. However, these changes will only be introduced prospectively.

Amended rules will also exclude dual pensioners i.e. retirees who are receiving both their own pensions, as well as those of a retired family member. The Finance Department, Government of Khyber Pakhtunkhwa, identified a total of 1,935 dual pensioners in the pensions system.

In addition, active employees will also no longer be eligible to draw family pension. There were 738 active employees drawing pensions of retirees in 2021. All of these amendments, once made effective, will save a total of Rs. 12 billion over the next 10 years.

Figure 8: New proposed eligibility structure for family pensions



¹⁴ Minutes of the 52nd Provincial Cabinet Meeting, Pension Reforms, Government of Khyber Pakhtunkhwa Establishment & Administration Department, 16/03/2021

5. Relieving Fiscal Pressure



Photo Credit: Shahid Khan

The public sector pension system requires comprehensive, structural reform, including changes in laws, rules and administrative structures. All provincial governments – including Khyber Pakhtunkhwa – as well as the Government of Pakistan, are currently considering pension reforms options, including the introduction of contributory systems that would share the fiscal burden of pension with serving employees.

Similarly, there is a range of parametric reforms that could be introduced in the legacy pension system to rationalize survivorship benefits, recalibrate commutation and early retirement provisions, among other reform levers¹⁵. Structural changes would require legislative reform. Certain experts have advised that a comprehensive law, independent of the provincial Civil Servants Acts, to govern all aspects of the pension system would be a workable solution.

However, such reforms often undergo long gestation cycles prior to full-blown implementation. For instance, India first introduced a Defined Contribution Scheme (DCS) for government employees in 2004 with a limited scope, taking a decade to grow into a national system.

While taking on structural reforms, therefore, it is important at the same time, to put in place fiscal measures that create fiscal space for the Government of Khyber Pakhtunkhwa in the short to medium terms.

Freeze basic pay revision

Salary elasticity of defined benefit obligations is likely to be high for the Government of Khyber Pakhtunkhwa. The latest actuarial assessment commissioned by the Government of Punjab revealed that pensions are highly sensitive to pay increases – 1 per cent increase in salary growth rate leads to a 14 per cent increase in Current Service Cost or the amount that should be set aside by the Government to meet benefits accrued over the current period. GoKP's case is likely to be similar. In any case, periodic pay revisions are usually car-

ried out to internalize emoluments such as ad-hoc allowances when they grow to excessive proportions, usually 50-100 per cent of basic pay and begin to cause overlaps between basic pay scales. The government may explore other avenues for pay increase, not impacting the basic pay and hence the pension liabilities.

Targeted divestment

The Government of Khyber Pakhtunkhwa can earmark assets with matching duration and transfer them to the Pension Fund to meet targeted milestones in pension liabilities. For instance, assuming by the end of FY 2023, the Government of Khyber Pakhtunkhwa's pension liabilities should be at least 10 per cent funded, Government of Khyber Pakhtunkhwa will need to identify unused land and property that may be leased, rented or sold so that cash flows match the goal for pension liabilities. The French Pension Reserve Fund set up in 2001 received a significant portion of its seed equity from the privatization of government assets – most notably, the sale of the Autoroute company.

Earmarking revenue sources for pensions contribution

If the Government of Khyber Pakhtunkhwa pension contributions are indexed to revenue growth, this will obligate the Government to prioritize pension servicing and set aside funds for this purpose above and beyond the current Pay-As-You-Go level. This was also recommended by the last actuarial valuation (2015) commissioned by the Government of Punjab. Specific details may be worked out in light of the actuarial study currently being conducted for Khyber Pakhtunkhwa.

In addition, certain tax heads may be earmarked to ring-fence generated revenue for pension contributions. The Professional Tax, among other tax heads may be considered. Developing countries often fund retirement benefits by drawing on a varied mix of direct and indirect taxes. For instance, in Costa Rica, pension expenditure was financed through mixed proportions of the revenue gener-

15' Several counties in European Union (EU) have introduced parametric reforms which include changes in retirement age, contribution rate, contribution requirement, benefit indexation and pension formula (Zaidi, 2006).

ated from the sales tax, alcohol and tobacco tax, and other sources¹⁶. However, the introduction of new taxes or rate changes is not recommended because it is difficult to determine the actual tax burden, assess progressivity and quantify distributional impacts.

Financial innovation options

Raising debt through traditional banking channels or riskier financial markets is a fairly obvious policy option. This could be used to initiate a buyout program. Under this program, government employees could be offered an option to accept immediate partial payments in lieu of full future benefits. This model was adopted in Illinois, USA, where payments typically amounted to 60-70 per cent of the current market value of employee pensions. The specific parameters of such a plan would have to be carefully worked out to avoid excessively front-loading pension liabilities.

Simplify pension structure

As already explained, the family pension structure prevailing in Pakistan is complicated. While the revision in Rules already put in place will address some of these problems, further reforms are necessary to simplify the structure to reduce administrative costs associated with calculating, running and regulating the pension scheme. Calculation of pensioner benefits is so time-consuming that the law provides for an entirely different category of pensions – anticipatory pensions – which may be granted while the determination of actual pension benefits is made. This needs to be addressed.

Minimize administrative costs and avoid leakages

Centralizing and digitizing pension data has already addressed the problem of ‘ghost pensioners’ to a considerable extent. Further adoption of IT-based solutions could help plug and prevent leakages and opportunities for misuse. These savings could ultimately be directed toward government contribution of unfunded pension liabilities.

¹⁶ Financing Pensions in Low and Middle Income Countries, Pensions Watch

6. Conclusion



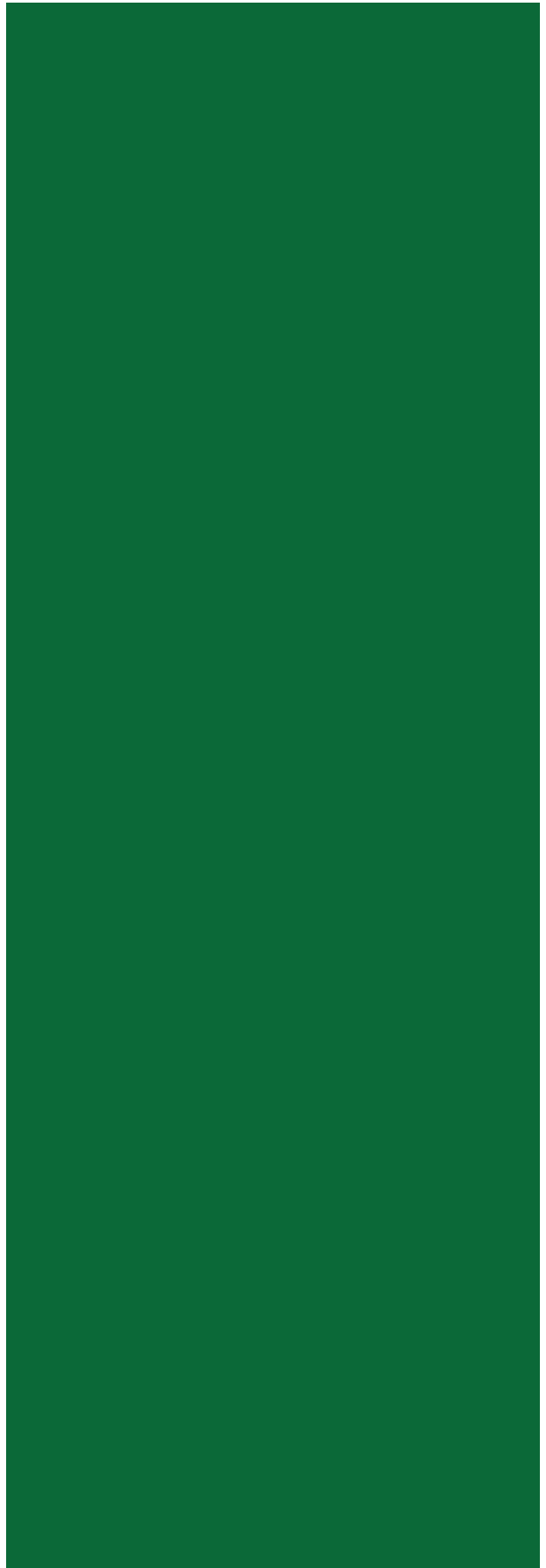
Photo Credit: Abuzar Sheikh

The Government of Khyber Pakhtunkhwa's budgetary position was already less-than-ideal before the onset of COVID-19. The pandemic has constricted fiscal space even further. Pension liabilities represent a long-standing drag on the provincial balance sheet and the annual budget. Pension reforms have now become a fiscal necessity for the government to sustain growth-sensitive fiscal consolidation and respond adequately to the economic impact of COVID-19.

The Government of Khyber Pakhtunkhwa has already introduced a range of policy measures to limit eligibility for pensions and survivorship benefits, while also extending the minimum cut-off age or service period for early retirement which exacerbated the size and unpredictability of current and future pension liabilities. The Cabinet is also considering a structural transition to a contributory pension scheme where pensions will be funded through payroll deductions from service civil servants in addition to the Government's contribution.

While the Government of Khyber Pakhtunkhwa persists in the analytical work, policy deliberations and change management efforts required to design and implement further reforms, it is equally important in the short to medium terms to relieve the growing fiscal pressure exerted by annual pension payouts. This may be done by ring-fencing revenue sources, freezing basic pay to reduce the knock-on effects on pension expenditure, divesting Government assets to finance pensions, minimizing administrative leakages, simplifying the eligibility structure and offering cash buyouts to active pensioners, among others.

Pension reforms are not easy. The Government has made significant headway toward a more fiscally sustainable pension system, despite the attendant technical and legal difficulties of introducing such reforms, as well as the adverse political economy factors that will likely impede their implementation. But this steep learning curve can help the Government make fiscally and politically sound policy choices, while also drawing on the experiences and lessons of other policy-makers who are attempting to solve similar problems across Pakistan.



7. References



Photo Credit: PSO to CS KP

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