Taxation of retirement schemes

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Pakistan's present retirement schemes due to structural issues are far from achieving their desired objectives resulting in low/limited coverage and retirement asset far behind in terms of percentage to GDP. Nobody can afford to ignore the role of contractual savings of which retirement saving assets are the most important components in enhancing the country's saving to GDP ratio. The OECD countries weighted average retirement asset to GDP Ratio is over 70%. In the absence of authentic data, the low coverage and largely unfunded nature of the existing system reflects Pakistan's low retirement assets size to GDP ratio.

The public sector in Pakistan pays pension to its retired employees and spouse in the event of the death of the employee on 'pay as you go' (PAYG) basis. The pension schemes are not funded. The ballooning of pension liability and increasing outlay in the budget under PAYG is a matter of concern. It currently takes up over 5% of the budget outlay that works out to over Rs. 300 billion. Outside the public sector, pension coverage is low.

The provision of financial security in retirement is critical for both individuals and societies. It is also critical that each generation should create assets to pay for its retirement pension and not pass the burden to the next generation. There are three ingredients that constitute a pension index, adequacy, sustainability and integrity.

The 'Adequacy' of pension system covers benefits, savings, and tax support and growth assets. The challenge that are common to many countries include the need to increase the pension/retirement age to reflect life expectancy, promote higher labor force or self-employed participation, encourage or require higher level of private savings, reduce the leakage from the retirement system prior to retirement by permitting withdrawal or entitlement to full withdrawal on resignation and to improve the governance. The net investment return over the long term represents a critical factor in determining whether an adequate retirement will be provided. While investment or administrative cost is important the long term return is affected by diversity of investment held in the pension fund. The mix of the investment varies and is dependent on the number of years of services left before retirement.

The 'Sustainability' of pension system covers pension coverage, total assets, contributions, and demography and Government debts.

The 'Integrity' of pension system covers regulation, governance, protection, communication and cost. It is critical that the participants have the confidence in pension providers, whether employers or Pension Fund Managers, to deliver the pension benefits over a longer period. In this respect the role of regulation, independent custodian, protection provided to participants from a range of risk and the level of communication are of fundamental importance.

During last decade, the Government of Pakistan took some initiative by examining the pension liability and decided to raise the funding level of then existing liabilities. The GOP also considered funded based system for new entrants to the Government services. The Government of India took similar initiative and successfully adopted "National Pension System" in 2004 based on defined contribution in respect of all new entrants to Government Services, excepting the Armed Forces.

The Securities and Exchange Commission of Pakistan (SECP) finalized rules for Voluntary Pension System in 2005, giving birth to a new system in the country, under which the individual pension accounts are managed by professional fund managers, and participants receive annuities/pension at retirement. Individual account balances are invested by licensed pension fund managers according to prescribed investment and allocation policy by the SECP. Both asset management companies and life insurance companies are eligible to apply to the SECP for licensing as managers.

In 2007 SECP approved application of four Pension Fund Managers in the private sector to launch Voluntary Pension Schemes (VPS) to be regulated by SECP. The objectives of the VPS are as under:

* A model of regulated pension scheme;
* Encourage private sector companies to adopt VPS or alternately employees joining for additional savings;
* Participation by self-employed;
* Portability to stop leakages arising due to pre-retirement withdrawals as a result of change of employment;
* Optimization of investment return through asset allocation schemes;
* Option to participants to change Pension Fund Manager;
* Better communication/ disclosures to participants;
* Pension based on globally established and preferred defined contribution system;

In 2008,the SECP Act 1997 was amended to give powers to SECP to promote and regulate retirement schemes managed in private sector and Government Corporations. It was envisaged that existing occupational system now unregulated and managed under different laws will be regulated by SECP. It was also expected that existing structural deficiencies in the occupational savings will be removed.

Provident fund (PF) is the only employers' managed defined contribution thrift scheme that is not designed as a retirement structure and thus cannot provide a retirement income. It has following structural deficiencies.

* The scheme is not portable and allows leakages due to features in the scheme that allows permanent withdrawals during contribution period and encashment on every employment change.
* Being one fund, it does not allow asset allocation and higher return during contribution period, where the investment horizon is 30 to 40 years (i.e., the universally-recognized life cycle asset allocation structure). A 25-year-old employee with long investment horizon and a 55 year old employee with a totally different risk/ return profile have to accept the same asset allocation.
* Carry market risk at the point of retirement. Recent Economist Article described defined contribution schemes such as PF "as lottery for employees. A worker who retired in 2000 when markets were buoyant would have ended up with much bigger pension than who retired in late 2008, after the collapse of Lehman Brothers."

Interestingly the Article speaks favorably for VPS like structure managed by specialists. The Article concludes that "it is a historical oddity that pensions have been delivered by individual businesses, which are otherwise devoted to serving customers and making widgets. Pension provision needs to be left to specialists."

Pension and gratuity schemes are employers' managed and defined benefit schemes. It provides those employees who ultimately join the scheme an assured benefit. The system has disadvantage that there are lot of drop outs. Besides British experience suggest that "defined benefit plans are too expensive."

The pension reforms envisaged in early 2000 have not made any progress since 2008.

* The funding of pension liabilities by increasing funding level has not made any headway.
* Funding of pension liability for new entrants to Government service has not been initiated.
* No progress made by SECP on regulating the occupational retirement schemes

The structural deficiencies of occupational retirement schemes have continued.

Taxation of retirement schemes:

Stages	Voluntary Pension Schemes (VPS) – Regulated by SECP	Occupational Defined Benefit Schemes (Pension & Gratuity)	Occupational Defined Contribution Schemes (Provident Fund)
Contribution	Exempt – 20% of taxable income	Exempt – No limit	Exempt – upto Rs. 100,000
Investment	Exempt from Income Tax;but subject to Sales Tax and FED on Management Fee and WWF (these levies add to the cost of management);	Exempt	Exempt
Pre –Retirement withdrawal	Taxed	Not Applicable	Exempt – both contribution and accumulated income
Retirement	Exempt	Exempt	Exempt

In 2011/12 and 2012/13 budgets, the Income Tax Ordinance was amended to bring VPS at par with Defined Benefit Schemes. The Mutual Funds Association of Pakistan had advocated (and supported by SECP) that there should be level playing field between these two retirement schemes, i.e., VPS and occupational defined benefit schemes. In 2012/13 the Income Tax Ordinance was amended to allow transfer of balance from Provident Fund (PF) to VPS. This has been allowed to safeguard PF Account Holders from market risks in PF as mentioned above.

There is no doubt that there should be level playing field in so far the taxation is concerned among all the retirement schemes. However, the structural deficiencies in the schemes need to be removed first. In order to ensure that level playing field, all regulations such as borrowing against the schemes, encumbering the scheme assets to borrow from elsewhere etc., must be same for all schemes. It is proposed that SECP, having responsibility as regulator of retirement schemes, may take a lead to ensure a vibrant retirement saving sector, where the occupational schemes and VPS will be competing with each other on a level playing field. It is also proposed that the Government should continue with the reforms process initiated in 2008. It is critical that retirement schemes are promoted to increase the saving to GDP ratio and to participate in national development.