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Research Papers

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PRIVATISATION OF INDIAN PENSION SCHEME

Dr.D.Chennappa
Associate Professor of Commerce, Nizam College, Hyderabad

ABSTRACT

In India, total pension outgo in respect to Central Government employees as proportion of GDP rose to 0.56 per cent in 2003-04 from 0.38 per cent in 1990-91. The pressure of pensions on Central and State finances is becoming increasingly troublesome. To avoid this the New Pension System (NPS) was introduced on January 1, 2004 for Central Government employees recruited on or after this date. The NPS aims to change from the existing Defined Benefit (DB) system to a Defined Contribution (DC) system. And, Pension Fund Development and Regulatory Authority (PFDRA) was established regulate the NPS in 2004. In this paper an attempt is made to study the difference between old and new pension scheme and find that under new schemes the entire investment risk is borne by the employee. There will be no explicit or implicit guarantee from the Government. Finally, Social Security Funds are diverted to the equity market. In this changing circumstances, it is suggested that the success of new pension system mostly depends the overall reforms in the Capital market, Insurance industry and tax regime.

Introduction

In India, retirement benefits, in one form or the other, are currently available to only about 11 per cent of the working population, including Government employees. This leaves 89 per cent of the working population in the unorganised sector uncovered by any formal pension provision. The payment of pensions on Central and State finances is becoming increasingly oppressive. The total pension outgo in respect of Central Government employees as a proportion of GDP, after rising from 0.38 per cent in 1990-91 to 0.74 per cent in 1999-2000, declined to 0.56 per cent in 2003-04. The outgo in absolute terms increased from Rs.2,138 crore in 1990-91 to Rs.15,367 crore in 2003-04[1]. As a proportion of net revenue receipts, expenditure on pensions after increasing from 3.9 per cent in 1990-91 to 7.9 per cent in 1999-00, started declining from 2001-02 to reach 5.8 per cent in 2003-04[2].

In the Budget for 2003-04, Government announced the introduction of a new restructured Defined Contribution Pension System applicable, in the first stage, to new entrants to Government service, except armed forces. Accordingly, the New Pension System (NPS) was introduced on January 1, 2004 for Central Government employees recruited on or after that date. The NPS will be available, on a voluntary basis, to all persons including self-employed professionals and others in the unorganized sector. However, mandatory programmes under the Employees' Provident Fund Organisation (EPFO) and other special provident funds continue to operate as per the existing system under the Employees' Provident Fund and Miscellaneous Provisions Act, 1952 and other special Acts governing these Funds, such as the Coal Mines Provident Fund and Miscellaneous Provisions Act, 1948, the Assam Tea Plantations Provident Fund and Pension Fund Scheme Act, 1955, the Jammu and Kashmir Employees' Provident Funds Act, 1961 and the Seamen's Provident Fund Act, 1966.

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It was announced in Budget 2004-2005 that a suitable legislation providing for a regulatory framework for NPS would be introduced in Parliament. The Union Cabinet subsequently approved a proposal to introduce a legislative framework for the NPS. An ordinance was promulgated on December 29, 2004 for the establishment of a statutory regulatory body called the Pension Fund Regulatory and Development Authority (PFRDA) to undertake promotional, developmental and regulatory functions concerning of the pension sector. The ordinance empowers the PFRDA to regulate the NPS, apart from authorizing and regulating intermediaries and protecting the interests of subscribers. Therefore, in view of high financial burden on account of pension expenditure, reforms of the pension system becomes critical in order to gradually move towards a contribution based Pension System. In accordance with this fifteen States (15) have introduced NPS for their newly recruited employees. Moreover, the saving behavior in India has undergone remarkable changes. In this regard, the present paper critically reviews the New Pension System. Though ample research work was done on old pension system, nonetheless, selected articles were referred to ascertain the difference between old pension scheme and New Pension Schemes, observations of the eminent persons on NPS are presented here under.

Schwarz Anita.M and Demirgue-Kunt (1999)[3] expressed that the real consistency text for the objectives of the pension reforms is whether the reforms can provide workers with a way to maintain adequate living standard in the old age on a sustainable basis or force them to participate in the new system, which provides them a far lower rate of return compared to the rate of return that they would have earned on the money saved in other places. The world Bank opined that the pension sector (Holzmann-1999)[4] has problems to reforms like, Pay- As- You- Go (PAYG). Fox an Palmer (1999)[5] noted that only few countries, including some Latin America countries (Chile) and Kazakhstan in central Asia have introduced legislation to completely phased out the PAYG system. However, Levine Ross and Zervos (1997 and 1998)[6] empirically shown that the development of financial market would result in independent and robust contribution to economic growth and predicted that systematic pension reforms would be conducive to accelerating economic growth. Vittas Dimitri (2000)[7] argued that prevalence of "feasibility pre conditions" might be required for successful implementation of pension reforms. Shashank Saksena (2004)[8] felt that 85 per cent of workers who work in the informal sector have little opportunity to save their old age pension and retirement system of private sector employees is complex. The High level Expert Group of New Pension System, Department of Pension and Pensioners' Welfare (2001)[9] expressed that the pension system has serious implications in the form of potential increase in Government's contingent liability. In a report titled `Pension Reforms in India: Myth, Reality and Policy Choices' the author Ramesh Gupta, a Professor at the Indian Institute of Management, Ahmedabad[10], poses the question as to who should bear the risk. He writes that the changeover from individual (funded defined contribution) accounts or a single collective fund with a defined-benefit formula involves a larger public policy choice issue, which is, who should ultimately bear the risk. The choice, argues Ramesh Gupta, would rest on which group the individual belongs to. Financially successful people may believe in individual ownership and choice, while low-wage earners may want assured returns because they do not have other resources to fall back on. Unfortunately, notes Ramesh Gupta, most Indians, unlike those in many other countries, are in the latter category, which cannot bear any risk, more so in old age.

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Objective of the Study

1. To explain the functioning of PFRDA.
2. To find the differences between old and New Pension System (NPS).
3. To trace the differences between Defined Benefit (DB) system to Defined Contribution (DC) system.
4. To critically evaluate the New Indian Pension System.

Methodology

This paper is prepared based on secondary data, which has been collected from Budget Reports 2000-01 to 2004-05, World Bank Reports, Annual reports of Ministry of Finance, Government of India, Pension Reform Committees and High Power committee report and supported the argument with RBI reports. The period of study is Five (5) years from 2000-01 to 2004-05. The 2000-01 year being chosen because major reforms initiated in this year. However, depending on the necessity tables, charts, figures have been used. This study is confined to envisage the changes in pension sector only. Mostly, this paper focus on evaluating the old and new pension scheme and study the role PFDRA to control NPS. However, to understand the Indian Pension Sector reforms are presented in chronological order in Table 1.

Functioning Of New Pension Scheme (NPS) under PFRDA

The Pension Fund Regulatory and Development Authority Bill, 2005 establishes an authority to develop and regulate the new pension system (NPS) which seeks to provide old age income security for all individuals, including those in the unorganised sector.

1. NPS will be implemented through a combination of retailers, pension funds and record keeper(s).
2. Every subscriber will have an Individual Pension Account (IPA), which will be portable across job changes. The subscriber will choose the fund managers and schemes to manage his pension wealth. He also has the option of switching schemes and funds.
3. The NPS has already been pressed into service for new central government employees through a notification. This is a 'Defined Contribution' (DC) scheme unlike the 'Defined Benefit' (DB) scheme for existing central government employees.
4. The PFRDA provides a structure to the private and unorganised sectors to plan for old age income security. It is not compulsory for these sectors to take part in this system. Those not participating may still have to fall back on public resources in old age.
5. This Bill sets a framework for the development and regulation of pension funds in India in order to promote old age income security. It defines an architecture consisting of retailers, pension funds and record-keeper(s), and

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establishes a statutory body to regulate the sector. The pension scheme for new government employees has been changed from the existing defined benefits (DB) system to a defined contribution (DC) system. That is, the pension payable at the time of retirement is not fixed on the basis of the pay-scale (DB) but will be determined by the funds accumulated through contribution and investment gains during the service of the employee (DC).

Table 1: Milestones of Indian Pension Sector Reforms

January 2000	Government of India (GoI) introduced Old Age Social and Income Security (OASIS) scheme and recommended to open an Individual Retirement Account (IRA) any where in India
Budget 2001-02	Government of India decided to introduce New Pensions Scheme (NPS) for the new entrants in the Government services based on defined contribution.
March 2002	GoI suggested having new hybrid pension scheme that combines contribution from employees and the union government on matching basis.
Budget 2003-04	New Pension System (NPS) is announced based on defined contribution, shared equally in case of Government employees between the Government and the employees.
December 2003	The NPS is made operational, which is applicable only to new recruits in the central government from 1st January 2004.
1st January, 2004	NPS started operating and Pension Fund Regulatory and Development Authority (PFRDA) is also set up and started functioning through ordinance.
29th December 2004	An ordinance is promulgated and 15 State government adopted the NPS for their own employees.
March 2006	The PFDRA bill referred to Standing Committee of Finance of GoI
July 2006	The PFDRA bill is likely to introduce in Parliament in this year only
Source: colluded from different research papers	

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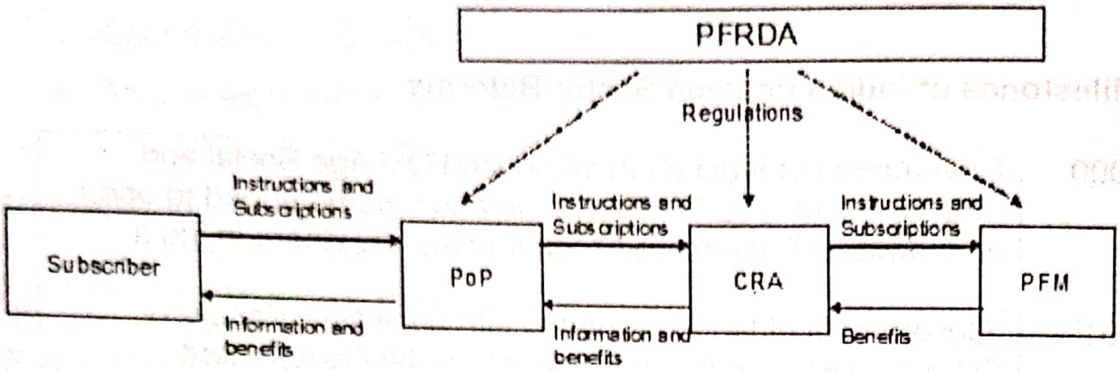
Procedure of Functioning of PFDRA

The procedure of functioning of New Pension Scheme (NPS) under PFRDA is presented in Figure 1.



The NPS architecture

By observing figure 1, the NPS system comprises one (or more) Central Recordkeeping Agency (CRA), a set of Pension Fund Managers (PFMs) and Point-of-Presence Agencies (PoPs). The CRA shall maintain records, accounts and effect all instructions regarding subscription, switching of options and withdrawals by the subscriber. The subscriber may access the CRA directly for information. The PFMs shall provide a set of schemes with varying risk-return profiles (i.e., balance between risk taken and returns expected), and manage the assets of subscribers. The PoPs shall receive instructions and contributions from subscribers, transmit these to the CRA, and pay out benefits to the subscribers. They will be the 'windows' for subscribers to the system. Every subscriber shall have an individual pension account (IPA). He has the option of selecting the PFMs and schemes. He can switch his funds across PFMs and schemes.

The IPA will be portable in case of change of employment. (As in the case of a bank account, the IPA is independent of employment details). The subscriber cannot exit from the system except as specified by notification by the central government. The current notification specifies two options. (a) If the subscriber chooses to exit at the normal age of retirement (60 years), he shall use at least 40% of accumulated pension wealth to purchase an annuity from a life insurance company. This annuity will provide pension for the lifetime of the employee, his dependent parents and spouse. (b) If the subscriber chooses to exit the scheme any time prior to retirement, the minimum amount to be converted as an annuity is 80% of the accumulated pension wealth.

The notification mentions a two-tier structure for government employees. Tier-I will be the core level with the employee and the government each contributing 10% of basic+DA, and there will be no withdrawals till exit. The employee can opt to contribute a further amount into a withdrawable Tier-II account, which will not have any contribution by the government.

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The PFRDA shall regulate the NPS and other pension schemes under its purview. It shall be responsible for protecting the interests of subscribers and establishing a mechanism for redressal of their grievances. It will approve the schemes and norms (including investment guidelines) for management of the investments by PFMs. It shall standardise dissemination of information about performance of pension funds and performance benchmarks. The PFRDA comprising a Chairman and up to five members shall be appointed by the central government for a five year term, and may be removed from office only under specified conditions.

COMPARISION BETWEEN OLD AND NEW PENSION SCHEME

Comparison of old and NPS is presented in Table 1.

Table 1 shows the defined benefit (DB) system, currently applicable to government servants appointed before 2004, and to EPS, promises a fixed amount to be paid per month as pension. This amount is linked to the pay drawn, number of years of service etc., and has no direct linkage to the contribution of the employee or employer towards a pension fund. Thus, the employee faces no direct risk, and the entire investment risk is borne by the pension fund manager and the government. However, the employee is exposed to the risk that the total benefits liable from the pension scheme manager are higher than the funds available, which can lead to delays and defaults. EPS was reportedly under funded to the extent of Rs 22,000 crore as on March 31, 2004. Even in cases where the benefits are paid out by the exchequer, limited resources can lead to delays, as witnessed by pensioners of several state governments.

In the defined contribution (DC) system as proposed in the NPS, each employee (and his employer in the case of government servants appointed since 2004) contributes a proportion of his monthly income to an individual account. This account is invested in one or more schemes offered by pension fund(s). The balance in the account belongs to the employee, which will be accessible at the time of exit. The employee bears the entire investment risk. However, there is no risk of default by the fund as the liability of the fund to its subscriber equals the assets owned by it.

Traditionally, a large proportion of pension funds around the world have been of the DB type. However, many of these have been under funded, and some have collapsed. This has led to a debate in a number of countries regarding the sustainability of their pension and social security systems. Hence, the Defined Benefits V/s Defined Contribution is presented in Table 2.

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Table 1: Comparison of Existing scheme and NPS

	Current system	NPS
Coverage	Organised sector employees through EPS, and government employees	Available to all subscribers, including the unorganized sector
Eligibility Requirement	Minimum term of employment (typically 10 -20 years)	None
Portability across job changes	None for government employees. Limited portability for those covered under EPS.	Portable
Type of account	Pooled	Individual pension account (IPA)
Type of pension	Defined benefit	Defined Contribution
Risks	The employee carries no investment risk. However, he is faced with the risk of default delay in pension payments by the government or EPS.	The employee carries the entire investment risk. There is no risk of default by PFMs.
For government employees	For existing central government employees, the government pays 50% of the average of last 10 months' pay (Basic+DA) if employee has 33 years' service. There is no contribution by the employee or the government into a fund but this is paid out of the Consolidated Fund of India.	Government and the employee will each pay 10% of Basic+DA into a scheme of a PFM. Separate account for each employee will be maintained, and the amount invested. At time of exit, a part (now 40%) of the pension wealth will be used to buy an annuity, and the remaining paid as a lump sum amount.
For those not employed by the government	For those covered by EPS, the employer pays 8.33% of Basic+DA to the EPS (maintained by EPFO), and the government pays 1.16%. EPS will pay pension after retirement at a rate based on years of service and last pay drawn	No contribution from the employer. The employee selects a particular scheme
Disclosure of Performance	None. There is no regular update on performance of the EPS. Government pensions are unfunded.	Each PFM will publish the performance of schemes managed by him at regular intervals. The subscriber can see the balance in his IPA.
Investment strategy	The EPS board decides the strategy, and this strategy and the investment portfolio are not disclosed to the employee.	Each scheme has to follow a specified investment pattern. The subscriber chooses his portfolio of schemes.

Table 2 shows, under the NPS, PFMs will offer an array of schemes (the current notification specifies 3 types) offering differing risk-return profiles. The Standing Committee has recommended that at least one scheme should be fully invested in government securities. The subscriber divides his contribution (as well as existing pension wealth) into these schemes, and has the option of changing this combination at any time.

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Table 2: Defined Benefits versus Defined Contributions

	Defined Benefits	Defined Contribution
Advantages	- Guaranteed retirement income - Employees do not bear investment risk - Flexibility for inflation and wage adjustments - Independent of participant's savings	- Participants have more choice in investing - Participants can benefit from better returns - Plans are more portable across job changes - Option to switch fund managers and schemes - No risk of default by fund managers
Disadvantages	- Not beneficial to employees who leave before minimum eligible service - Less portable in switching employers - Fund manager could default if funds are not invested appropriately	- Returns are subject to market performance -Participants bear investment risk and may make misinformed choices -Difficult to build a fund for those who enter late in life -Shifts administration costs to employees

The final pension wealth will depend on the performance of the schemes chosen by the subscriber. Thus, the subscriber takes the entire investment risk. The premise is that fluctuations in market value would smooth out over the working life of the subscriber. However, the subscriber is exposed to two major risks at the time of exit. If there is a major market shock at the time of retirement (say, an incident such as the attack on Parliament on December 13, 2001), leading to a fall in asset prices, the entire accumulated wealth is at risk. A subscriber with a few years to exit would likely ride over this shock but a subscriber retiring at that time will be affected adversely. Second, the subscriber has to purchase an annuity at the time of exit, and is similarly exposed to any sharp downturn in the annuity market at that time. The PFRDA states that there will not be any explicit or implicit assurance of benefits except market based guarantees to be purchased by the subscriber. This rule is different from the case of bank deposits, where deposits up to Rs 1 lakh are guaranteed by the Deposit Insurance and Credit Guarantee Corporation.

Financial implications for implementing NPS

The NPS is mandatory for government employees appointed since January 1, 2004. Most of these employees will retire about 30-35 years from now.

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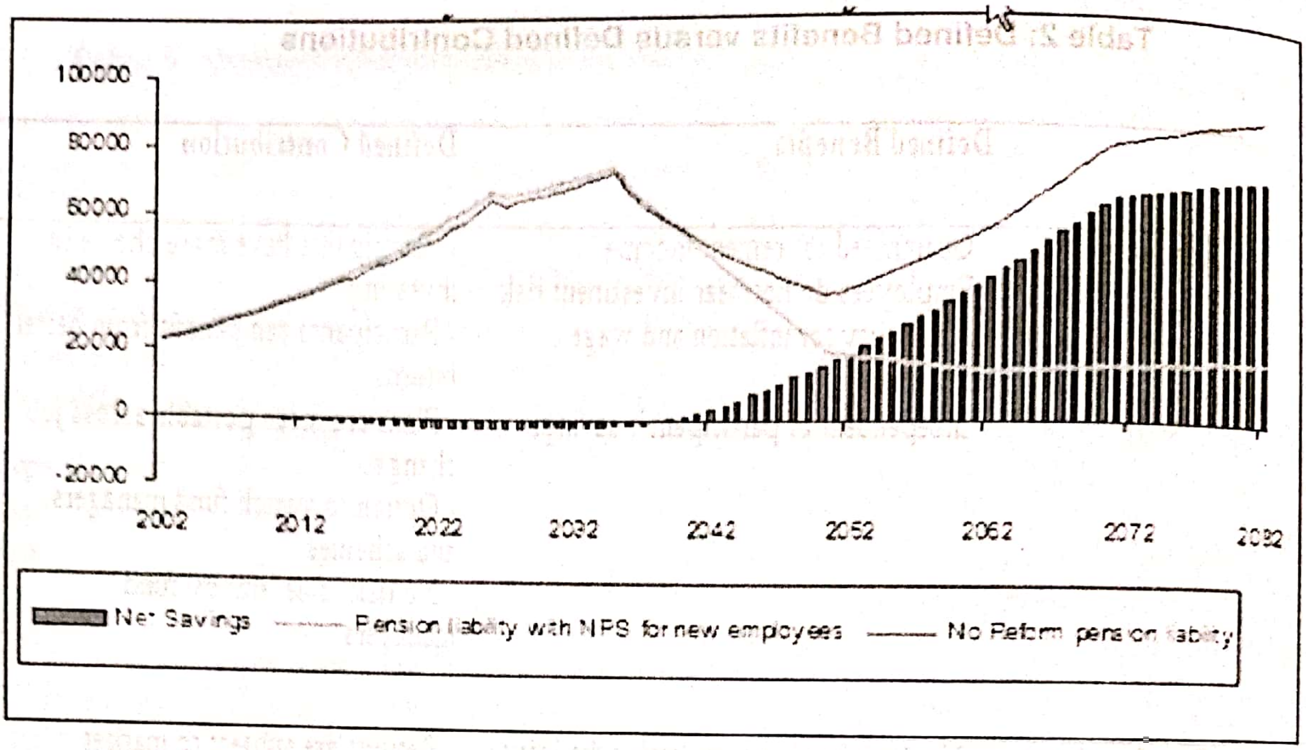

Source: Bhattacharya B.K, "21st Report of Standing Committee on Finance on PFRDA Bill 2005, High Level Expert Group (Chairman: BK Bhattacharya)], Government of India, 2004.

During this period, the government will continue to pay pension to retiring employees under the old regime as a DB plan. The government will also contribute 10% of the Basic+DA of new government employees to the DC plan. Thus, the actual costs to the government will rise. This will reverse as the proportion of new employees among pensioners rises. During this period, the government will continue to pay pension to retiring employees under the old regime as a DB plan. The government will also contribute 10% of the Basic+DA of new government employees to the DC plan. Thus, the actual costs to the government will rise. This will reverse as the proportion of new employees among pensioners rises.

Projected pension cost of central government: Gains under new system will occur from year 2038-39. Computations presented to the Standing Committee suggest that the incremental cost to the government will peak at Rs 2,900 crore in 2021-22, and then decline. Savings will be apparent after 2038-39, and will rise from Rs 1,000 crore in 2039-40 to Rs 37,000 crore in 2059-60 and Rs 72,000 crore in 2081-82[11]. However, these estimates must be viewed with caution as they make several simplifying assumptions owing to lack of detailed data. These include assumptions about age profile of existing pensioners and serving employees, downsizing central government employment, gender profiles etc. Under differing scenarios of return, PRS has estimated the likely annual pension if Rs 1000 is invested in a subscriber's IPA for 35 years. PRS assumes that the entire pension wealth will be converted to an annuity and the annuity rates at that time will be the same as currently available. PRS cautions that the actual annuity could be lower if the average life expectancy increases over the next 35 years, leading to lower annuity rates.

Estimated pension per Rs 1000 : Estimated pension per Rs 1000 invested per month in an IPA is presented in Table 3.

By observing Table 3, it shows, (1) The return has been assumed to be net of inflation, and at a constant rate throughout the period. (2) The entire pension wealth at the time of retirement (age 60 years) is invested in an annuity. (3) Life annuity currently offered by LIC is 8560 per lakh for self and Rs 7770 for self and spouse (in which spouse will get 50% of the amount as annuity after death of self). (4) The monthly investments would typically rise with wage growth.

Table 3. Estimated pension per Rs 1000 invested per month in an IPA for 35 years.

Scenario	I	II	III	IV
Inflation adjusted annual return on pension corpus	1.50 %	2 %	3 %	4 %
Pension wealth (inflation adjusted)	551,540	606,413	737,282	902,862
Annual pension only for self OR	47,212	51,909	63,111	77,285
Annual pension only for self and spouse	42,855	47,118	57,287	70,152

All calculated values

PROBLEMS ON NPS

Criticisms on New Pension System are emerged in the following grounds:

1. It marks a forced transition from Defined Benefit to Defined Contribution concept; the PFRDA Bill categorically provides that 'there shall not be any implicit or explicit assurance of benefit'.

2. It seeks to privatise social security pensions through pension fund managers, which denotes only mutual funds.

3. The contributions of the workers will be diverted, in different proportions, to the speculative share market, which could put them in great jeopardy.

4. It will be followed up, as announced by the government, by allowing 'FDI in pension sector', which will result in foreign operators garnering the contributions of the workers and deploying the funds for speculative purposes in international markets.

5. The PFRDA is intended to flag off retrograde moves towards privatisation, which has three main thrust areas. First, switching over to the "defined contribution" from the "defined benefits" concept; two, shifting to personal and social insurance schemes from social assistance schemes; and three, diverting social security funds from the debt market to equity markets. This is an erroneous and dangerous move, as the private sector seeks to participate in social security only eyeing the huge corpus of private pension funds that could be generated, which could be diverted to the equity market in the country.

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6. This is also accompanied by two other retrograde moves. One, a change in the tax treatment for contributions to the pension scheme, shifting from the EEE formula, where the monies were exempt from taxation at all three stages of contribution, accruals and withdrawal (of terminal benefits), to the EET formula where terminal benefits will be taxed at the applicable rates in the year of receipt.

7. The present fiscal-related problem cited by the government for the unsustainability of the present "Pay As You Go" pension scheme is of its own making.

8. In the system for new government employees, the investment risk is entirely borne by the employee. However, he is no longer exposed to the risk of default by the government.

9. Any unfavourable event affecting market prices at the time of retirement could lower both pension wealth and the annuity rate. Subscribers may have to stay on in the system beyond their retirement date in order to ride over such a shock.

SUGGESTIONS

After careful evaluation of New Pension Scheme, and to protect of old age employees interest the following suggestions have been made and presented as under:

1. The government should set up a separate corpus out of its tax funds to provide social security net to those below the poverty line.

2. The liberalized life insurance industry should build pensions through occupational and personal pensions initiatives.

3. It is suggested that for employers with 5 or more employees and who do not provide any retirement benefit in the form of provident fund or pension it may be made mandatory that they provide their employees an access to the OASIS pension by facilitating deduction of contribution from the salary and its remittance.

4. The pension fund industry once developed would lead to a higher inflow of returns. The privately managed funds if invested prudently over a long period would benefit both the fund starved industry and the employees. In fact most countries including Latin America are able to generate incremental savings of US $8-10 billion per annum, which give a large fillip to the investment position ·

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of those countries. In India too the pension fund industry can help improve returns tremendously.

5. The development of pension funds will also give an access to long term funds. This will really plug the gaping hole in India's fine market where access to India's long term finance is an issue.

6. The success of a Pensions also largely depends upon the overall reform of the capital market, insurance industry and the tax regime. Macro issues like a further deepening of the financial markets, increased liquidity in the financial system and a more efficient redressal system (judicial system) will play a very crucial role in the performance of the Pension Fund industry. Another important factor that will contribute to the success of the Pension Reforms, is the ability of the government and the regulator to take all sections of the community into confidence including the employers, employees and their representative Trade Unions, the NGOs and the media.

7. The working population of the country needs a social security net. In the era characterized by heightened insecurity. Al least, the existing government should do something to protect the interest of retired employees.

CONCLUSION

The New Pension System (NPS) was introduced on January 1, 2004 for Central Government employees recruited on or after this date. The NPS aims to change from the existing Defined Benefit (DB) system to a Defined Contribution (DC) system. And, Pension Fund Development and Regulatory Authority (PFRDA) was established regulate the NPS in 2004. The PFRDA is intended to flag off retrograde moves towards privatisation, which has three main thrust areas. First, switching over to the "defined contribution" from the "defined benefits" concept; two, shifting to personal and social insurance schemes from social assistance schemes; and three, diverting social security funds from the debt market to equity markets. This is an erroneous and dangerous move, as the private sector seeks to participate in social security only eyeing the huge corpus of private pension funds that could be generated, which could be diverted to the equity market in the country. The success of Pensions also largely depends upon the overall reform of the capital market, insurance industry and the tax regime. Macro issues like a further deepening of the financial markets, increased liquidity in the financial system and a more efficient redressal system (judicial system) will play a very crucial role in the performance of the Pension Fund industry. Another important factor that will contribute to the success of the Pension Reforms, is the ability of the government and the regulator to take all sections of the community into confidence including the employers, employees and their representative Trade Unions, the NGOs and the media.

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