Don't cut corners on pension reform

Strengthen the New Pension System to head off 'one rank one pension'-like political crises

Renuka Sane and Ajay Shah

EMOTIONAL ARGUMENTS are being made about one rank one pension. The implementation of this would result in a sharp escalation in pension payments for military personnel, which could have implications on a GDP scale. Before any decisions are taken, careful calculations should be made. This episode is a reminder of the importance of building the New Pension System.

When a pension promise is made to a 20-year-old soldier who will draw a pension from the age of 35 to, say, 100, the stream of payments are spread over the coming 80 years. We should work out the present value of these payments, and not look just at the expenditure in 2015-16. A careful calculation shows that for a pension that starts at age 60, shifting to one rank one pension is a hike in the lumpsum value of the pension of 94 per cent. For a pension that starts at age 35, introducing one rank one pension is a hike in the lumpsum value of the pension of 233 per cent. As 80 per cent of military staff start drawing a pension at age 35, the latter number looms large.

These are relative estimates of how much costlier one rank one pension will be. In absolute terms, how big are the magnitudes? We do not know. The government has not released the data, and external experts are not able to make the calculation. But one illustration will help show the magnitude of what is at stake.

In 2002, when the NDA government was evaluating pension reform, Surendra Dave and Gautam Bhardwaj made a calculation for the ministry of finance, which showed that the lumpsum value of all civil servant pensions was roughly 60 per cent of GDP. Even though civil servants are a tiny fraction of the workforce, the promises associated with paying them pensions were almost as large as the total public debt then. This calculation helped spur the government into building the New Pension System, and to place all new recruits from January 1, 2004 on it. Similar calculations are essential before any decision is made on one rank one pension.

The bond market and credit rating agencies see that pension promises are practically like taking on more debt. They increase the indebtedness of the government, reduce its creditworthiness and increase the cost of borrowing. Every Indian suffers from a higher cost of borrowing when the government's creditworthiness goes down. India is barely within the ranks of "investment grade" credit ratings. A decision to bring in one rank one pension could potentially knock India out of this category — and it could take decades of fiscal austerity in order to climb back in.

Emotional arguments are being made that any payment is justified if it will make India "strong". However, the best way to make India strong is to reduce the indebtedness of the government. Or it could be argued that each $10 billion of increased public debt could be used to buy another aircraft carrier. Do we want a few dozen aircraft carriers or do we want one rank one pension?

If one rank one pension is introduced for military personnel, the courts could potentially force its adoption for civil pensioners too. This would substantially increase the overall cost. This scenario also needs to be factored in.

We are faced with the political crisis of one rank one pension today because many years ago, we faltered on pension reform. In 2002 and 2003, when the New Pension System was being implemented for all new recruits into the civil service starting from 2004, the thinking was that once the system stabilises, it would be extended to new uniformed recruits as well. Unfortunately, there was a lack of continuity and institutional memory. This extension was never carried out. In addition, the New Pension System shaped up in a significantly inferior manner to what was originally envisioned.

We must make the New Pension System work better so that it is well-functioning and attractive. We must zealously guard it and ensure that it is not contaminated with guarantees or defined benefits of any kind. New Pension System assets are below 1 per cent of GDP right now. They need to go up to over 100 per cent of GDP in order to take care of today's workforce as it ages.

We must continuously work to enlarge the coverage of the New Pension System, so as to head off the political crises that will continue to erupt as we face problems of old age and pensions in the coming years. Building and continually extending the New Pension System is important but not urgent. It is all too easy to give it low priority. However, cutting corners on this work will generate a succession of wrenching political crises such as the situation with one rank one pension today.

Sane is visiting scientist, Economics and Planning Unit, Indian Statistical Institute, Delhi. Shah is professor, NIPFP, Delhi

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