Understanding one-rank-one-pension

It is a dramatic escalation of the implicit pension-debt for the government


AJAY SHAH

IT SEEMS impossible to reverse one-rank-one-pension in India now, and it seems hopeless to fix the military pension. However, it is worth understanding what the issues are, and the mess that we have landed in.

Nominal annuities in a zero-growth environment

Let us start with a country with no GDP growth. So, a worker earns some income all his life. We want him to tuck some money away every year into a pension account that will buy an annuity at the age of retirement. He builds up this pension wealth, and at age 60, he buys an annuity. It is common to target a "50%-benefit rate", i.e., the magnitude of the annuity should be half his last wage.

To fix intuition, let us assume the number A is the price of an annuity which yields a flow of income of Rs.1 per month. In this case, the pension wealth to get to half the last wage is Aw/2.

This is the challenge of the ordinary pensions discussion. If you want an unfunded, i.e., a "defined benefit" pension, then you want the taxpayer to pay Aw/2 for each person. There is no other difference; the basic story is the same.

In India today, A is roughly ₹133. That is, if you buy an annuity at age 60 which pays ₹1 per month until death, the price is ₹133.

So far, we have asked the annuity-provider a simple question. We have asked: I want a fixed cash flow of ₹1 per month until I die. What would you charge for this? The annuity market says: I will charge A for this contract. This is the lowest price of an annuity; this is a simple unindexed nominal annuity.

Now, we can modify the terms of this annuity in many ways.

Real annuities in a zero-growth environment

You could say: Instead of giving me a nominal ₹1 per month, give me an inflation-indexed ₹1 per month. This is an inflation-indexed annuity. This will, of course, cost a lot more than A. To produce a nominal annuity, the annuity-provider invests in nominal bonds which produce a stream of cash. But to produce a real annuity, the annuity-provider has to invest in inflation-indexed bonds, which yield a lower stream of cash. Hence, it needs much more than A to produce an inflation-indexed stream of ₹1 per month. Suppose the price is B, and we know B >> A.

A government that promises an unfunded inflation-indexed annuity is placing an expense on the tax-payer of Bw/2.

The problem of GDP growth

Into this environment, let us inject high GDP growth. Let us go to the higher side by assuming per capita GDP growth of 7%, which means that per capita GDP doubles every decade.

When a person is 60, he was at half the wage of persons who are 59. But when he reaches 70, his pension has stood still, but the persons who are at age 59 have (roughly) got a doubling of their wage. The pensioner has lost ground compared with the worker.

That pensioners lose ground when compared with workers is a fact of life for all pension systems. In the West, where pensions were invented, this was not a big deal, as they have had a slow growth environment. But when there is high GDP growth, this can yield glaring gaps. A pensioner who is at the 90th percentile of the Indian income distribution at age 60 will end up at perhaps the 70th percentile of the Indian income distribution at age 70.

This is just a fact of life and you can't do anything about it. Anyone who builds up wealth in India over the working years 1980 to 2020 will seem prosperous in relative terms in 2021 but will seem less prosperous in relative terms in 2031 and in 2041. That is the inexorable logic of high GDP growth.

Suppose we go to the annuity provider and say: Sell me an annuity which is not just inflation-indexed, but wage-indexed. The payment per month will go up to reflect the average wage growth of the economy. This is a pension which will keep up with the Joneses.

In my knowledge, there is no private insurance company which will produce such an annuity. It is a very expensive annuity to produce. Let's use the symbol C for the price of this annuity. C >> B >> A. A government that promises someone a wage-indexed pension is asking the taxpayer to put up Cw/2 which is much bigger than Bw/2 or Aw/2.

That's one-rank-one-pension

This is the costliest pension imaginable. The Indian government seems to be on the trajectory of offering this for all military personnel. It is a dramatic escalation of the implicit pension debt for the government on account of military personnel.

Once this entitlement is in place, it will be hard for the government to go through with the NPS reform, where the second stage was supposed to be integrating uniformed personnel into the NPS.

It is a disappointment that we did not have adequate thinking on these issues in time. The delays and sloppiness of implementing the NPS have been extremely costly for India.

From the author's blog: ***ajayshah.blogspot.in***

The author is professor, National Institute for Public Finance and Policy, New Delhi