Giving up on NPS a tragedy for state govts. DB pensions are ad hoc, delay fiscal stress

Several of the problems of the National Pensions Scheme can be easily remedied. The solution to fiscal stress isn't going back two decades ago.

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Currently, India provides pensions for the elderly on the basis of the National Pensions Scheme | Representative Image | Wikimedia Commons

everal state governments in India have made the decision to exit the National Pension Scheme for their employees and go back to the Old Pension Scheme. They hail this as a move to protect the old-age income security of their employees. However, the reality is that they are postponing the current fiscal stress on finances to the future, thereby increasing the employees' pension risk.

The two pension schemes

Till 2004, government employees enjoyed a 'defined benefit (DB) pension', which meant that upon retirement, they would get a pension roughly equal to 50 per cent of their last salary for the rest of their lives. And who paid for this? Ultimately, the taxpayer.

By the early 2000s, the fiscal deficit of the Union and state governments began to balloon. Policymakers began to worry that this kind of pension was not sustainable and states would run out of money. The Atal Bihari Vajpayee government at that time came up with a 'defined contribution (DC) scheme' — the NPS. Under this scheme, contributions by the Union government and the employee are taken, and at retirement, the employee can take one part of the accumulation as a lump sum, and another as an annuity (pension). By contributing upfront, the government would reduce its unfunded pension liability in the future.

The Union government implemented the NPS only for those joining service from January 2004. State governments adopted the same system for their employees. But this year, many state governments want to revert to the old DB scheme.

The double payment problem

A contributory system such as the NPS is a check against future liabilities of governments. However, at present, the state government(s) is paying for both sets of employees — it has a pension bill for retirees and a contribution bill for employees. The benefits of the NPS from a fiscal perspective will only be seen once current employees begin to retire. That is still two decades away.

As the fiscal position of states weakens, reversing the NPS appears attractive. States assume they can save money by discarding the NPS and deal with the pension problem when it happens. Indian states are not unique in getting cold feet as the transition from DB to DC gets underway. Several countries in Eastern Europe have also undergone reform reversals precisely because they could not escape the 'double payment problem'. But by postponing the problem to the future, state governments are increasing the risks of DB pensions for their employees.

The risks of DB pensions

A DB scheme that guarantees a pension equal to 50 per cent of the last salary and is indexed to inflation is an attractive proposition. But there are two chinks in the armour that government employees need to think more carefully about.

A DB scheme makes promises for 50 years later. A lot can happen in this time — people may live longer than expected or macroeconomic conditions can change, such that those payouts become no longer viable. Across the world, DB plans are struggling to hold their promises and require additional funding. As employees advance into old age, state fiscal finances may deteriorate and governments may find it difficult to keep promises. Delayed pension payments are not unusual in India. And while the Supreme Court

has ruled that interest should be paid in case of delay, fighting for one's rights during old age may become difficult.

Second, governments can and do renege on their promises in invidious ways. Croatia and Belgium stopped uprating the past earnings that entered the benefit formula in line with average wage growth. Austria and Greece reduced the accrual rate, thereby lowering the initial pension. Italy, Sweden, Latvia, Poland and Norway have shifted their public employment-related schemes to an actuarial method of benefit calculation and eliminating all internal redistribution.

There has been a steady increase in the retirement age in almost all OECD (Organisation for Economic and Co-operation Development) countries. In fact, future life expectancy has gotten incorporated into the benefit formula of pension in all Nordic countries. Other such adjustments to the benefit formula, or pay increases, are a core element of pension policy across the world. In India, the increase in the DB pensions for armed forces, owing to the One Rank One Pension (OROP) policy, has been an important driver of the Agnipath scheme. It would be short-sighted to expect that Indian civil servants will somehow be insulated from the pressures that come with continuing with DB pensions.

Govt guarantee isn't permanent

Most employees seem to think in binaries — that which is market-linked is risky, and that which is government-guaranteed is safe. There is a strong conviction that the government will never run out of money, and even if it does go through a period of fiscal stress, it will cut down expenditure on other things but continue to pay pensions on time. Past experience shows us that the guarantee is not as certain as it seems. There are risks with DB pensions as well, and these are more opaque than the risks the market poses.

The NPS does pose market risks. But as we have argued, several of the problems of the NPS can be easily remedied. It is possible that the NPS annuity will be less than 50 per cent of the last pay that the DB scheme promises. But there is no risk that the benefit formula will change, or a fiscally stressed government will not disburse pensions on time.

Giving up on the NPS would be a tragedy. States have already come halfway to reducing pension liabilities. In another 20 years, the NPS cohorts will start retiring and the benefits of the reform will begin to show.

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