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NPS REFORMS VIS-À-VIS OLD PENSION SCHEME (PAYG): WHY GOOD ECONOMICS CAN ALSO BE GOOD POLITICS

Recently, state governments of Rajasthan & Chhattisgarh have reverted back to the old pension scheme commonly known as PAYG scheme. PAYG scheme is commonly defined as an unfunded pension scheme where current revenues fund pension benefits.

India had a PAYG scheme prior to 2004. Under such a PAYG scheme, the contributions of the current generation of workers was explicitly used to pay the pensions of current pensioners. Hence a PAYG scheme involved a direct transfer of resources from the current generation of tax payers to fund the pensioners. The PAYG scheme was in vogue in most countries prior to 1990's , but was discontinued given the problem of pension debt sustainability, an ageing population, explicit burden on future generation and the incentive for early retirement (as the pension is fixed at the last drawn salary). The PAYG scheme thus had no accumulated funds and or stock of savings for pension obligations and hence was a clear fiscal burden. Interestingly, the PAYG scheme is always an attractive dispensation for political parties as the current aged people can benefit from PAYG even though they may not have contributed to the pension kitty.

Is the PAYG scheme fiscally viable? **First, the trends in the pension liability of the state governments over the long run shows a very sharp increase**. The CAGR in pension liabilities for the 12 year period ended FY22 was at 34% for all the state governments. As on FY21, the pension outgo as percent of revenue receipts is around 13.2% for all states combined and 29.7% of own tax revenue. In fact 56% of expenditure of the states that is committed (interest payments, salary and pension payments) is met out of state revenue receipts. In FY21, the total committed expenditures of states as a percentage of state own revenue receipts was at a staggering 125%. For larger states like Punjab, the committed expenditure is as high at 80%, followed by Kerala (73.9%) West Bengal (73.7%) and Andhra Pradesh (72.2%) as a % of state revenue receipts. If we take the committed expenditure as a percentage of state own tax revenue, these numbers are higher by 149% -191% for these 4 states.

Second, PAYG financing often masks the long-run cost of promised pension obligations. **One way to estimate it is to quantify the present value of this future stream of expected benefits known as the "implicit public pension debt**." This implicit debt is a complicated function of the number of workers and retirees, entry age of workers, the expected life spans, the size of the average benefit, the retirement age & the discount rate used to calculate the present value.

We endeavoured to quantify the implicit pension debt in the Indian context through the following methodology. In respect of National Pension Scheme (NPS), data on the state-level participants is not available. Consolidated data given by NPS Trust informs us that there are 55.44 lakh contributing state-level employees as of Feb 2022. **If we assume that all states migrate to the old scheme,** and assuming an entry level age of 28 years, with a 5% inflation indexation, **the current present value of the implicit pension liabilities is around 13% of GDP, discounted by the current G-sec yield on 40 years. This is the implicit pension debt that will be unfunded as per the PAYG scheme.**

The above fact clearly underlies World Bank's warning that PAYG schemes are illusory. Specifically, when the population is young it induces the government to offer generous benefits as the costs are low. But the implicit pension debt will explode rapidly as population ages.

Third, India's demographic profile is currently undergoing a structural change with declining fertility, increasing longevity and an ageing Southern States coupled with young Northern States. As per India's demographic profile, the Ageing Index (adapted from Rakesh Mohan, 2004) for India defined as the number of persons 60 years old or over per hundred persons under age of 15 years is likely to reach 76 by 2036 from the current value of 40. The old-age dependency ratio defined as the number of persons 60 years and over per one hundred persons 15 to 59 years is to touch 23% by 2036 from current 16%. By 2050, India's population will be 164 crores, out of which 32 crore will be of age 60 years and above. An increase in the old-age dependency ratio imposes significant demands on the working-age population to maintain the intergenerational flow of benefits to the pensioners and to that extent PAYG scheme is unfair to the younger generation.

Taking all these factors into account, the Government had moved to a system of defined contributory pension benefit scheme, NPS in 2004. **All states have migrated to NPS, with the exception of West Bengal and Tamil Nadu**.

The current government has taken many steps to make the NPS scheme attractive. The Government now makes a 14% matching contribution against the 10% monthly contribution of employees. Secondly, the Government has also notified that subscriber would be adequately compensated for any non-deposit or delayed deposit of contributions during 2004-12. Thirdly, the employee has now the exclusive right to choose the fund manager and his investment pie. There is an additional yearly tax rebate of Rs 50,000, 60% of the corpus is tax free and the entry age has now been raised to 70 years. Going forward, the NPS scheme can be made further attractive, by incentivizing SME/MSME sector covering its employees to be covered under NPS. Secondly, it is mandatory for any company with more than 20 employees to file EPFO employee contributions. This can be made more flexible by introducing NPS and allowing the corporates to select between EPF & NPS. Thirdly, the Govt. may increase tax benefit on Employer's Contribution for Tier- I account holders from existing 10% of Basic + DA to 14% of Basic + DA (at par with Central Govt. Employees). Finally, the Govt. may further extend the benefit of Tier- II Tax Saving Schemes to all citizens of India.

We should not commit fiscal hara-kiri in the quest for populism. Otherwise it will be disastrous for the country's growth potential and at the same time place higher burden on our younger generation!

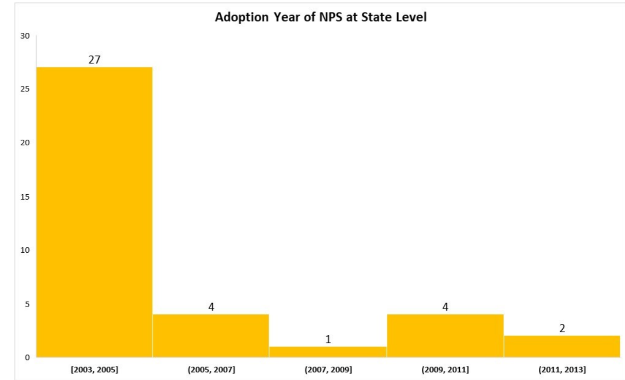
STATE PENSION REFORMS IN HINDSIGHT

- Recent announcement by Rajasthan government to revert to old pension scheme has attracted considerable attention. Demand for similar move is now gathering support in other states as well and Chhattisgarh has also approved a similar decision.
- Pension sector reforms in India started with the OASIS report in 1999 as part of the financial sector reforms. The basic aim of these reforms was to transform the financial markets on free market principles.
- The major step in this respect was taken when in 2003 the Central Government in budget announced the winding up of the pay-as-you-go PAYG pension for central government employees and migrate all new employees to the then new pension scheme (NPS) which was a defined contribution scheme (DC).
- For the states the participation in new pension scheme was on voluntary basis. However, many states beginning 1-Jan-2004 decided to join NPS on the template adopted by NPS. The only state that has so far not joined NPS is West Bengal and Tamil Nadu. 27 states have joined between 2003-05.

PENSION LIABILITY AND FISCAL POSITION

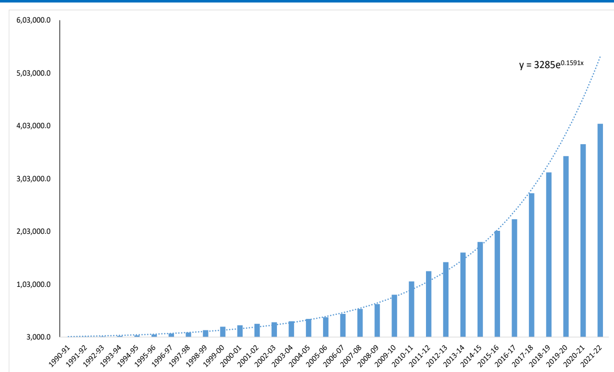
- One of the major concerns during the formative years of the pension policy was the sustainability of the pension liability at the state level. The concerns stem from the recommendation of the 5th Pay Commission and have not subsided if we account for rise in subsequent pay commission. The trends in the pension liability of the state governments over the long run shows very sharp increase. The CAGR in pension liabilities for the 12 year period ended FY22 was at 34%.
- In terms of standard fiscal monitoring ratios the pension liability/outgo of the state government is also increasing. The pension outgo as percent of revenue receipts is around 13.2% for all the states combined and 29.7% of own tax revenue. In fact 56% of expenditure of the states that is committed (interest payments, salary and pension payments) is met out of state revenue receipts. The pension outlay of the state government as a percent of the GDP stands at 1.9%.
- In terms of state level burden in FY21, the total committed expenditures of all states as a percentage of state own revenue receipts was at a staggering 125%. For larger states like Punjab, the committed expenditure is as high at 80%, followed by Kerala (73.9%) West Bengal (73.7%) and Andhra Pradesh (72.2%) as a % of state revenue receipts. If we take the committed expenditure as a percentage of state own tax revenue, these numbers are higher by 149% -191% for these 4 states!

Adoption Year of NPS



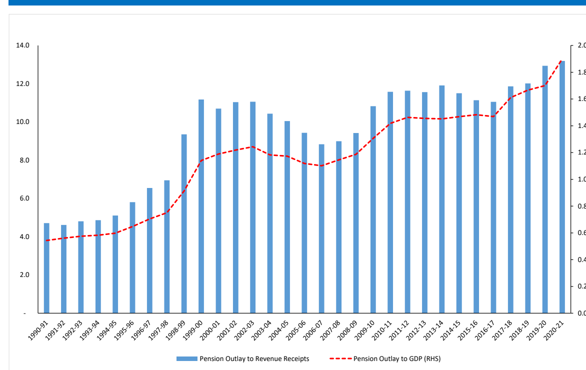
Source: NPS Trust, SBI Research

Trends in Nominal Pension Outlay of States



Source: RBI, SBI Research

Trends in State Finance in Respect of Pension Outlay



Source: RBI, SBI Research

Committed Expenditures of Major States in FY 21				
States/UT	Pension as % of RR	Pension as % of States own tax revenue	Committed Expenditures* as % of RR	Internal Debt as % of GSDP
Andhra Pradesh	12.3	25.3	72.2	26.0
Bihar	11.7	58.9	35.2	25.8
Chhattisgarh	9.8	29.7	54.7	20.2
Gujarat	13.4	21.2	56.5	18.2
Haryana	13.0	21.3	65.7	26.0
Jharkhand	9.8	31.5	41.6	23.1
Karnataka	13.9	23.4	59.2	16.2
Kerala	20.8	42.9	73.9	25.2
Madhya Pradesh	10.8	27.9	53.5	20.7
Maharashtra	11.0	17.3	60.7	15.5
Odisha	13.0	42.9	48.0	12.8
Punjab	18.0	42.8	80.4	38.8
Rajasthan	15.5	33.4	69.1	29.7
Tamil Nadu	15.3	25.2	69.5	22.6
Telangana	8.5	13.2	42.5	23.2
Uttar Pradesh	17.1	42.0	47.6	29.3
Uttarakhand	17.0	58.3	72.2	23.8
West Bengal	13.4	32.8	73.7	31.1
North East	11.2	72.5	54.5	20.4

Source: RBI, SBI Research;*Committed Expenditures is defined as, wages, pensions and interest payments.

MEASURES TO AUGMENT NPS

The CAG had made recommendations in 2018 to make the NPS more effective. These were as follows

- A foolproof system needs to be put in place to ensure that all nodal offices and eligible employees are registered under NPS.
- Delays need to be penalised and compensation effected to avoid loss to the subscriber.
- Government to ensure that rules on the service matters are in place for the government NPS subscribers.
- Government must identify all cases of legacy contributions, not remitted to Trustee Bank and ensure its remittance with due interest and compensation to prevent loss to the subscriber.
- In line with PFRDA Act, immediate steps to be taken to provide Minimum Assured Return to the subscriber, ensuring timely social security post retirement.

Government of India in January 2019 has taken the following initiatives for the benefit of Government sector NPS subscribers, which addresses some of the long pending issues:

- GoI has notified that Government subscribers would be compensated for non-deposit or delayed deposit of contributions during 2004-12 at GPF rates.
- Government sector NPS subscribers were allowed choice of schemes and Fund/ Asset Managers with effect from 1 April 2019.

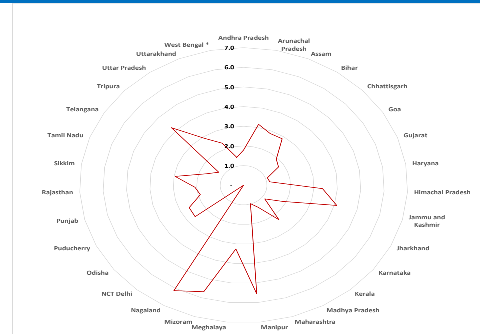
STATE OF FUND MANAGEMENT

- Currently there are around 55 lakh state government employees who have enrolled in the NPS.
- The yearly contribution of the state government employees is in excess of Rs 2.5 lakh crore for this financial year.
- The AUM under management is around Rs 3.5 lakh crore which approximately 50% of the total AUM under the NPS trust that is taking central government employees, state government employees, corporate sector and others.
- The asset growth has been affected by Ukraine-Russia conflict and may fall short of the Rs 7.5 lakh crore declared target by March 2022 this year.

IMPLICATIONS OF THE REVERT TO OLD SCHEME

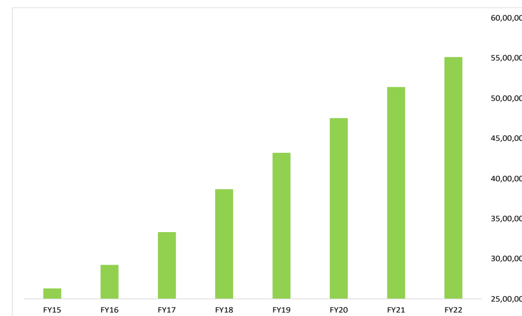
- The sudden reversion to old pension scheme that too with retrospective effect is bound to increase the current expenditure of the state governments.
- The actual affect of the decision will be felt from 2035, although this may differ for different states when actual retirements will happen.

Share of Pension Outlay in GSDP for FY20



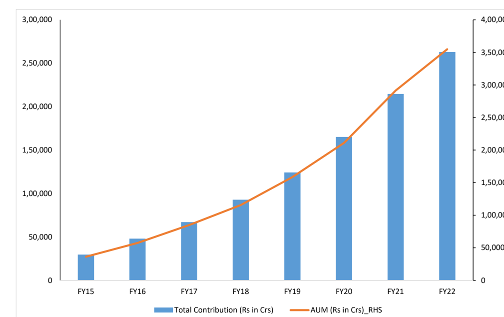
Source: RBI, MOSPI, SBI Research

State Government Subscribers to NPS



Source: NPS Trust, SBI Research

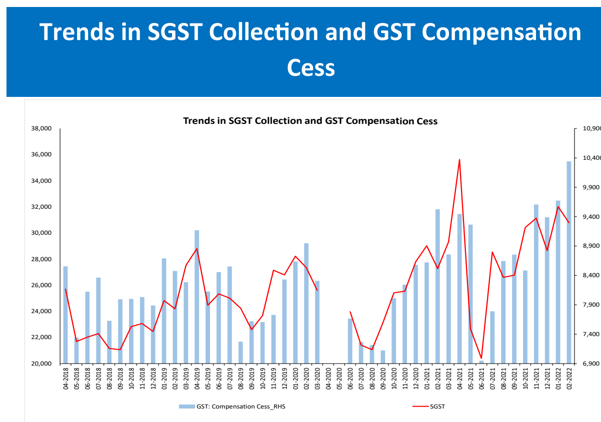
Contribution and AUM of State Government Employees



Source: NPS Trust, SBI Research

- Thus in the short run there may be some savings on current expenditure but given the rate of inflation and regional impact of COVID-19 slowdown this gain will be nullified leaving virtually no gains in terms of finances.
- However, as of now no state has made a formal request to withdraw from scheme and entire matter remains in wait and watch mode.
- We endeavoured to quantify the implicit pension debt in the Indian context through the following methodology. In respect of National Pension Scheme (NPS), data on the state-level participants is not available. Consolidated data given by NPS Trust informs us that there are 55.44 lakh contributing state-level employees as of Feb 2022. If we assume that all states migrate to the old scheme, and assuming an entry level age of 28 years, with a 5% inflation indexation, the current present value of the implicit pension liabilities is around 13% of GDP, discounted by the current G-sec yield on 40 years. This is the implicit pension debt that will be unfunded as per the PAYG scheme.
- The above fact clearly underlies World Bank's warning that PAYG schemes are illusory. Specifically, when the population is young it induces the government to offer generous benefits as the costs are low. But the costs will increase when population is ageing. The implicit pension debt will explode rapidly.
- As per India's demographic profile, the Ageing Index (adapted from Rakesh Mohan, 2004) for India defined as the number of persons 60 years old or over per hundred persons under age of 15 years is likely to reach 76 by 2036 from the current value of 40. The old-age dependency ratio defined as the number of persons 60 years and over per one hundred persons 15 to 59 years is to touch 23% by 2036 from current 16%. By 2050, India's population will be 164 crores, out of which 32 crore will be of age 60 years and above. An increase in the old-age dependency ratio imposes heavier demands on the working-age population to maintain the intergenerational flow of benefits to the older people and to that extent PAYG scheme is unfair to the current generation.
- Lastly, when the pension reforms were instituted there was no GST. The SGST levels after the accounting for phasing out of compensation cess should be able to cover both development and non-development expenses.

Trends in SGST Collection and GST Compensation Cess



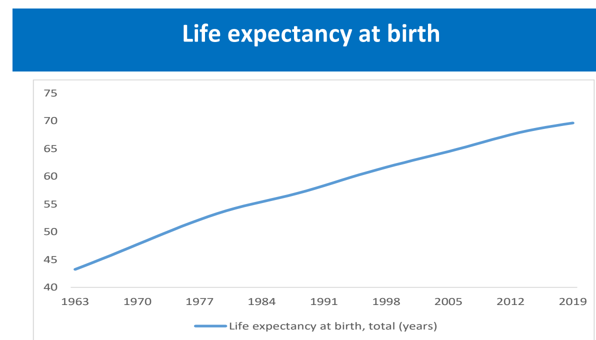
Source: FINMIN, SBI Research

Ageing Population Profile

	2011	2016	2021	2026	2031	2036
Old age dependancy Ratio(60 +)	14%	15%	16%	18%	20%	23%
Ageing index	27%	33%	40%	49%	61%	76%
Young-Age Dependency Ratio	51%	44%	40%	36%	33%	30%
Total Dependancy Ratio	65%	59%	55%	54%	53%	54%
Trends in Proportion of Older People (60+)	8.4%	9.2%	10.1%	11.5%	13.1%	15.0%
Trends in Proportion of Working Age Population (15-59)	60.7%	62.9%	64.4%	65.0%	65.2%	65.1%
Trends in Proportion of Young People (0-14)	30.9%	27.9%	25.5%	23.5%	21.7%	19.8%

Source: NHP, SBI Research,The old-age dependency ratio is the number of persons 60 years and over per one hundred persons 15 to 59 years,The ageing index is calculated as the number of persons 60 years old or over per hundred persons under age of 15 years

Life expectancy at birth



Source: World Bank, SBI Research

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