The Road Ahead

Catastrophic Decisions and Concealed Costs

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In these columns, on a few occasions we explored the state of our public finances. The question we need to address is how to address the mounting fiscal challenges. In order to answer this question, we should distinguish between individual short-term welfare measures (ISW) and old, unfunded pension system (OPS). Though ISW and OPS impose a burden on our tax money, their impact and ways of addressing them are different.

ISW measures, by definition are meant to give short-term relief to those in need so that they can overcome hunger and deprivation for the time being. ISW cannot increase earning capacity and incomes, and do not lift people above poverty. But they are necessary in country with many people living in poverty. However, only the measures to enhance skills and productivity, encourage investments, promote growth, create jobs and increase incomes will reduce poverty and improve lives and livelihoods. Therefore the emphasis and priority should be on economic growth, job creation and income generation.

Growth and welfare go together. Higher growth increases government revenues; and increased revenues allow governments to spend more on short-term welfare as well as on long-term investments for further growth. Rapid economic growth creates a virtuous cycle lifting society out of poverty and enhancing prosperity.

ISW are not as damaging to the economy as OPS: short-term relief of ISW reaches most of the poor and lower middle class families; ISW can be withdrawn or restructured by future governments; ISW expenditure is fully funded in the current budgets, and does not impose a burden on future taxpayers except in the form of interest payments on public debt.

However a far greater danger is posed by switching over to the OPS for government employees. As explained in this column (Dec 18, 2022), in OPS there are no contributions to pension fund by the employee and the government during the working life of the employee. The pension offered is generous, and it is index-linked, increasing sharply with pay revisions and dearness allowances. As the pension is unfunded and rising every year, a huge, unsustainable burden falls on the next generation. Between 2005 and 2022, the pension expenditure increased eleven times! Even more alarmingly, pension burden is rising much faster than states' revenues. In 1990-91, pension expenditure was 7.9% of States' own resources (SOR); in 2020-21, it was 27.4% of SOR. If you take the States' total revenues (STR) (including Union transfers), pensions rose from 4.7% in 1990-91 to 14.3% of STR in 2020-21.

It is clear that the States that continue OPS are going to face catastrophic financial crisis which cannot be resolved. That is why a contributory pension system, NPS was introduced in 2004, and the Union and all States except West Bengal implemented it. The employee and government contribute to a pension fund every month, and the fund is managed professionally to increase income with minimal risks. There are several schemes available for employees to choose from, depending on their

willingness to take risk. After retirement, the pension is drawn from the accumulated pension fund, and not from the tax money. Therefore there is no burden on the next generation, and tax money would be available to discharge government functions efficiently.

But several states are now embracing OPS in order to attract the votes of government employees who constitute 3% of the workforce. The organised, vocal government employees are feared by parties much more than the silent, unorganized 97% of the rest of the workers who are largely unaware of what is happening. World over, 15% of government revenues go towards pension payments, and 95-100% of all the workers – government, private or self-employed – derive pension, with average pension being 25% of per capita income. And the pension money is funded by contributions. In India, 15% of government revenues are spent for only 3% of government employees with an average pension of 250-300% of per-capita income! And the pension is not funded by prior contributions. This situation is alarming, and simply cannot continue.

If parties and governments fail to build a reasonable consensus and act recklessly reverting to OPS, does it mean the future of the state is doomed beyond repair? There are still mechanisms available to contain the damage and protect the future. The constitution-makers recognised that the Union is the ultimate guarantor of financial stability and credit of India. While States may borrow and spend as per their requirements and judgment, they cannot borrow recklessly or spend lavishly for unproductive purposes. Article 293 gives the Union the responsibility to consent to States' raising any loan if there is any outstanding debt to the Union. And any such

consent may be granted with conditions. In extreme situations, Article 360 provides for financial emergency, during which the Union has the power to reduce salaries and allowances in a State, and to approve any Money Bills involving taxation and expenditure.

If some States unwisely persist with the ruinous OPS, then the Union should invoke powers Art 293 to protect the financial stability and credit of the rest of India and the Union. States should simply be required to ensure that revenue deficit is brought to zero - that means current expenditure will be met from revenues and not borrowings, and all borrowed money should be spent on investments to enhance productivity and growth. And in respect of pensions, the State should be required to allocate in the current budgets pension fund equivalent to the current value of the entire future pension outflow calculated on discounted cash flow basis. In other words, the money deposited now with accrual of income with fund management should be adequate to pay future pensions. In such a case, there will be contraction of public expenditure for other public purposes and services. The cost of conversion to OPS is borne now, and not transferred to the next generation. There will be transparency regarding public policy and expenditure, instead of concealing the cost and kicking the can down the road. Once the people and politicians understand the consequences of decisions and choices made, there will be better public policy. Catastrophic policy decisions whose costs are concealed and transferred to the future spell a disaster to the nation.

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