

One Rank One Pension: Its Impact on the Defence Budget

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ABSTRACT The One Rank One Pension (OROP) scheme will pay a uniform pension to armed forces personnel, who retire with the same rank after the same length of service, regardless of their date of retirement. It has quickly become one of the most politicised of all military issues in the country today, which may be called odd, given that the political class rarely takes interest in matters related to the military. Indeed, the debate over OROP, ostensibly an employee-benefit programme, has become a leitmotif of all that is wrong with the nation's treatment of the military. Lost in the political din, however, is the key question of affordability. Not being discussed either are questions on long-pending structural reforms in the military, on issues like officer shortages and the need for modernisation. This paper examines the potential impact of OROP on the nation's coffers.

INTRODUCTION

Over the past several months, probably the single biggest 'defence' issue agitating the public mind—and dominating television discussions—has been the implementation of the One Rank One Pension (OROP) principle, a pre-election promise of the BJP. The Modi government has been under immense pressure to immediately implement OROP. An aggressive, high-octane campaign by ex-

servicemen has been ongoing over the details of OROP. Lost in the cacophony, however, is the larger question of affordability and sustainability of OROP, which is likely to exacerbate the already large 'pension problem' that the defence budget is saddled with. Left unaddressed, this can potentially become the single biggest funding constraint in the defence budget in the years to come.

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'DEFINED BENEFIT' PENSION, OROP, AND LONG-TERM FUNDING LIABILITIES

First, the basic principle: military pensions in India fall under the Direct Benefit (DB) model. The DB model means that pension due the retiree is a guaranteed, inflation-indexed number, which is a function of his or her last-drawn pay, to be paid till death. With vastly improving mortality rates globally, DB pension liabilities have grown exponentially and continue to bloat over the years. These liabilities typically tend to leave large funding gaps in governments' coffers—as states tend to service pension liabilities on a 'pay as you go' principle every year, rather than providing for adequate funding for the future. DB pensions have been identified as some of the biggest sources of fiscal stress across many parts of the world, especially in Europe and the United States.

In what can be regarded as a rare instance of farsighted public policy-making, India moved to a Direct Contribution (DC) pension plan for all civil servants beginning in 2003. A DC pension plan caps the liability of the employer to the annual contribution amount made during the period of service, and therefore eliminates funding gaps on unknown liabilities. All new central government (and state government) employees joining the service from that date are part of the DC pension plan. This has meant that government pension liabilities have been capped and future generations will not be asked to pick up the tab for a back-breaking pension burden.

The coverage of the new DC pension model is universal in the government/public sector, except for military pensions that remain in the older DB framework. OROP, when implemented, will add an incremental number to the current pension base, leading to an even higher funding liability in the future.

DB pensions in India are treated in fiscal terms on a 'pay as you go' basis, i.e., the Union Budget provisions for whatever is the expected pension outgo every year. However, DB

pensions, effectively being a perpetual liability on the fiscal system (and the taxpayer), need to be adequately funded. In other words, the right way to look at pension liabilities is to appropriately price every rupee of pension that is paid.

Economist Ajay Shah of the National Institute of Public Finance and Policy (NIPFP), has done some robust calculations to estimate a realistic price for every rupee of DB pension that is paid.¹ Shah has estimated how much money is required to fund a pension of one rupee/day for the rest of the pensioner's life. He has modelled the same using survivorship functions—based on UN mortality data—and annuity discount rates based on assumptions about the country's inflation rates. He then built several scenarios. The big scenario specific to OROP is an assumption of real wage growth, as OROP builds in a guaranteed real growth rate in pensions linked to growth in salaries of working personnel (as opposed to the current system where the pensions are inflation-linked, not wage-growth linked).

The scenarios are fairly exhaustive and cover various alternative possibilities on inflation, wage growth and retirement. A comparison with Life Insurance Corporation's pension annuity products has also been carried out as a frame of reference. All this provides useful raw material to try and estimate the aggregate liability on the Indian fiscal to implement OROP in terms of its real price.

How much then is the current implicit pension debt? Consider three scenarios (See Table 1).

In scenario one, the current actual funding liability on account of defence pensions is estimated. This means the pension is without OROP. (In other words, it is not wage-growth linked, but only linked to inflation). For the sake of simplicity, consider the starting age for pension to be 60. The pension is inflation-indexed, at four-percent inflation rate (in line with the RBI's target inflation level). In this

Table 1

	Scenario 1	Scenario 2	Scenario 3
Pension outlay FY2015-16 (INR Cr)	54,500	68,500	68,500
OROP	N	Y	Y
Inflation index	Y @4%	Y @4%	Y @4%
Wage growth index	N	Y @4%	Y @4%
Pension start age	60 years	60 years	35 years
Price of INR365 pension/year	4,369.79	6,128.46	14,998.25
Cost of pension (INR Cr)	652,475	1,150,136	2,814,740

relatively basic case, the total funding required to generate INR 54.5 thousand crore of pension (the amount budgeted in this year's union budget) is INR 6.5 lakh crore.

Scenario two is broader, and includes the key impact of OROP, i.e., a real wage-growth rate of four percent, over and above the inflation of four percent (in other words, a pension growth of eight percent). Actual pension payout for the current fiscal year has been increased to INR 68.5 thousand crore (going by the numbers of INR 10,000-20,000 crore being projected as the OROP impact in the current fiscal year). The pension start age remains at 60 years. The funding liability in this case nearly doubles to INR 11.5 lakh crore.

Scenario three has a more realistic set of assumptions. It assumes OROP implementation as per the framework in scenario 2, but takes the pension start date at 35 years. After all, the bulk of service personnel are found to retire between 35 and 40, and thus become eligible for pension. In this case, the total funding liability rises to over INR 28 lakh crore. In other words, it amounts to about a third of the total outstanding sovereign debt of India.

MEDIUM-TERM IMPACT ON DEFENCE BUDGET

The Indian military has followed a unique path in the 21st century, being the only major force in the world to have significantly increased

manpower in the new millennium. On the contrary, the global trend is that large militaries have concentrated on manpower rationalisation and greater mechanisation and mobility of forces. In the past five years alone, the Indian Army has raised two new mountain divisions and started raising a new Mountain Strike Corps (an exercise that has been circumscribed by the present NDA government).

In financial year 2015-16, the budgetary allocation to the Ministry of Defence (MoD) is INR 2.46 lakh crore. Defence pensions—budgeted at INR 54.5 thousand crore—are accounted for separately. Adding pensions, the total defence budget stands at approximately INR 3 lakh crore. It is a large amount, accounting for the single largest allocation in the Union Budget. Of this budget, salaries and pensions for the nearly 1.5 million-personnel add up to nearly INR 1.39 lakh crore. Thus a massive 46 percent of the total defence budget is spent on salaries and pensions. What is even more noteworthy is that despite significant increases in the defence budget over the past five or six years, the proportion of salary/pensions has remained stubbornly high at 45-50 percent levels (See Table 2).

When OROP is finally implemented, and retirees begin getting paid their pensions according to the new rules, it will create a significant impact. Depending on which numbers are given more credibility, the first-year impact of OROP is estimated to be anywhere

Table 2 (In INR Crore)

	2015-16	2014-15	2013-14
Defence Budget (1)	246,727	222,370	203,499
Salaries-Army (2)	66,599	61,972	54,657
Salaries-IAF (3)	11,359	9,972	9,464
Salaries-Navy (4)	6,287	5,820	5,084
Defence Pension (5)	54,500	50,000	45,499
Capex (6)	94,588	81,965	79,125
Total Salaries (2+3+4)	84,245	77,764	69,205
Total Defence Expenditure adjusted (1+5)	301,227	272,370	248,998
Salaries+Pensions	138,745	127,764	114,704
Salaries/Pension % of Adj. Defence Budget	46%	47%	46%
Capex % of Adj. Defence Budget	31%	30%	32%

Source: Union Budget documents

between INR 8,000 crore and INR 20,000 crore. Taking a mid-way number of INR 14,000 crore, it pulls up the share of salaries and pensions in the defence budget to nearly 50 percent.

To put the numbers into perspective once again, the total capital expenditure has stagnated at around 30-32 percent of the defence budget. This, despite a large modernisation deficit in all three arms of the military in spite of seven to eight years of unprecedented growth in defence outlays (2003-2009).

The United States military covers only around 17 percent of its personnel under its pension plan. As a result, total salaries and pensions account for less than 30 percent of the defence budget. Despite a relatively 'healthier' number, the US Department of Defense has been engaged in a relentless drive over the past 10 to 12 years to rationalise manpower and make the military more technology-intensive and less-manpower dependent. From China to Russia, this has been a consistent trend across the world's major militaries.

CONCLUSION

The discussions on OROP have recently gone beyond its definition of a mere employee-

benefits programme for service personnel. It has become a leitmotif for everything that is wrong in how the nation treats its servicemen and women. Recently, the noise around implementation of OROP has risen significantly, with high-visibility media campaigns, dharnas at Jantar Mantar and intense political pressure being applied to push the government into immediately implementing the scheme. Despite the obvious fiscal pressures, the government has already announced that the OROP will be implemented.


Lost in the emotional din is the key question of viability, not just of funding an ever-increasing pension liability, but also of the overall preparedness of the country's defence sector. To begin with, the Indian military has a long and severely delayed modernisation backlog. For instance, the original Rafale Medium Multi Role Combat Aircraft deal for 126 fighters fell through because it was deemed to be unaffordable—the cost of the acquisition was estimated to be INR 10,000-12,000 crore per annum for about eight to nine years (taking the defence minister's estimate of INR 90,000 crore, spread across a delivery period of eight to nine years). A conservative estimate of the impact of OROP is a perpetual incremental liability of that amount.

Also forgotten in the process are structural issues plaguing the Indian military, which remains the only large military in the world to be increasing boots on the ground at a rapid pace, contrary to global trends. Whether shortage of junior officers, quality of new officers joining the military, or maintaining the sharp pyramid at the top, OROP does not address any of the key personnel or human-resource challenges that the military is faced with.

With the fiscal situation expected to remain tight in the foreseeable future, OROP could turn out to be a poison pill that will plague the defence budget for years. While discussions may continue around whether or not enough funds are being spent on the military (as a percentage of GDP), the fact is that fiscal head room is limited. The same globally benchmarked

'percentage of GDP' measures are more dismal for health and education sectors, for example, and India continues to face immense challenges in those delivery areas.

The final result could be a case of *déjà vu*: as non-discretionary heads (salaries, pensions) keep rising, fiscal balance would be maintained by curbing discretionary expenditure (typically capital expenditure). Consequently, the cutting edge of the military would end up progressively blunted as funding becomes more scarce for modernisation programmes.

Unless the Indian military embarks on an immediate programme of capping pension liabilities and salary payouts on the exchequer, OROP may end up creating a weaker military, one that cannot adequately support the growing strategic requirements of India. 

ABOUT THE AUTHOR

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ENDNOTES:

1. <http://ajayshahblog.blogspot.in/>



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