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# The economic implications and the Indian Pay commission

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## Abstract

The central government spends around 7.29 percent of its revenue expenditure on the pay and allowances of civilian employees. Thus, revised pay structures can put upward pressure on the fiscal deficit, especially when the government has been targeting a lower revenue deficit.

**Key Words:-** Expenditure, Composition, Public, Revenue, Infrastructure.

## Introduction

The strategy adopted by the Indian government after the independence focused on building infrastructure and capital stock to promote growth (Second five year plan). It is the responsibility of the government to take initiative when the private sector fails to do so. Government is also required to ensure allocative efficiency and redistribute resources in an equitable manner to create conditions for growth and stability (Musgrave, 1959). The arguments for these roles are based on normative concerns (Marshall, 1950; Rawls, 1971). Governments however are constrained by their limited budgets. The composition of public expenditure and their source of financing can have effect on the employment levels, inflation and future growth prospects. The cause of the crisis in the 1990s was imprudent behavior of the government. Since then public expenditure management has become an important objective of the Government of India (GOI). The expenditure items can be broadly classified as revenue and capital expenditure. Revenue expenditure does not create assets or reduce liabilities. Capital expenditure on the other hand by creating assets improves the long run potential of the country. In case of India the share of revenue expenditure has comparatively been higher than capital expenditure. This pattern of the government has been constantly criticized on account of the resulting fiscal imbalances and the substitution of expenditure towards less productive purposes instead of capital formation (Bose and Bhanumurthy, 2013; Goyal and Sharma, 2015). It is being argued that current spending might not improve the long run growth prospects of an economy but capital expenditure with focus on human capital, infrastructure; and science and technology can have sizeable effect (Diamond, 1989; Barro;1991, 1997; Barro and Sala-i-Martin, 1995; Romer, 1994). The role of dedicated bureaucracy in providing good leadership and governance in a highly populated country like India is invaluable. Without greasing the wheels of its administrative machinery, the functioning of the government might become highly inefficient. Efficiency wage theory dictates that to get efficient and competent workers, a firm should provide wage which is more than the market-clearing wage in order to increase their productivity or efficiency (Akerlof, 1982; Akerlof and Yellen, 1986). Although, paying high wages to everyone is not possible but wages can be raised to a level which allows the government employees to maintain a decent standard of living (7th Central Pay Commission). The changing global outlook in the 21st century and the evolving consumer driven nature of the economy has led to vast differentials in salaries of skilled workers in private sector as compared to the public sector (Glinskaya and Lokshin,. Regular pay structure revisions are critical to attract better talent to public service. The size of the public wage bill is typically an important issue of economic policy. The government at times has limited resources and might be keen on reducing the wage bill burden. One option could be to allow the inflation to erode the real wages. However, these cut in real salaries do not go unnoticed and leads to discouragement and creation of an inefficient workforce (Chew, 1993). Clearly, governments are caught in a vicious cycle. The provision of higher wages can leave government with too little resources for other activities. And, the strategy to keep low wages might result in a de-skilled and poorly paid workforce (Chew, 1993). The society suffers. Social sector services need to be more professional and delivery oriented. The problem is compounded when the salary increases for skilled personnel in private sector at a faster pace. There is a trade-off between compensation and productivity. The solution could be to implement compensation reforms in a manner that the incentives of the employees are not distorted (IMF, 2016). It is true that there is no market for output of the public sector. It might be difficult to come up with a method to estimate the vales of these services. The solution in this case will be to compensate the public sector employees at a rate which is comparable (if not equal) to that for equivalent skills which are marketed in the private sector (Campo et. al, 1997). To provide the employees sustainable wages and to nudge the competent and talented workers in the government sector, the Government of India has set up various Pay Commissions from time to time.

## Brief history of Pay Commissions in India

In India till now seven Pay Commissions have been set up. The Pay Commissions are assigned the task to make recommendations on the work and pay structure of all the government employees. The first Pay Commission was set up in 1946 and the constitution of 7 th Pay Commission was approved in 2013. The entrustment of pay revision to a permanent Pay Commission which would be drawing its authority from constitution was recommended by the 5th Pay commission report. The financial impact of the 5th Pay Commission was felt over the period 1997-98 to 1999-00. In case of 6th Pay Commission, the government employees received 40 per cent of the pay arrears in 2008-09 and the remaining 60 per cent arrears in 2009-10. For the 7 th Pay Commission, the pay and pension hike recommendations were implemented in 2016-17 and the hike in allowance has been implemented in 2017-18. Therefore, the recommendations have been implemented over a period of two years similar to approach adopted for the 6th Pay Commission. The recommendations of each Pay Commission are based on certain principles. The 1 st Pay Commission was based on the idea of minimum sustenance. The 3 rd Pay Commission added three very important concepts of inclusiveness, comprehensibility, and adequacy for pay structure to be sound in nature. On the basis of the 3 CPC recommendations One Rank, One Pension (OROP) was terminated, the basis of military pensions till then. There was no specific requirement in the terms of reference of the 4th PC to mention the principles of pay determination. Instead of principles the 4th PC mentions a number of factors which have been considered by them such as simple and rational approach, sufficient pay to attract, motivate the employees, coherent salary structure, acknowledgment of erosion due to inflation and promotion to add more weight. In 5th Pay Commission, the principles of equal pay and equal work, demand and supply considerations, fair comparison, model employer and productivity has been used. The focus in 6th Pay Commission was Page | 8 more on comparison of wages with private sector. The 7th Pay Commission focused on human management reforms, fiscal sustainability and intangible benefits.

## Fiscal consolidation

There is a deficit hawk argument which supports the view that increase in deficits of the government could lead to an increase in rates of investment. The validity of these claims need to be justified in case of India since studies in the past have shown that there is no relationship between rising fiscal deficit and interest rate Chakraborty (2002), Goyal (2004) and Chakraborty (2012). However, the pre-occupation of the Indian policymakers with keeping in check the deficits cannot be denied. The FRBM Act was implemented with an aim to reduce fiscal deficit and improve macroeconomic performance. The FRBM could put a break on the spending propensity of the government. However, spending is required on part of the government to run the administration and maintain law and order. The MTFP Statement for 2018 clearly states that expenditure for maintenance of school and hospitals are equally important as capital expenditure in form of construction. They also plan to do away with the significance attached with revenue deficit. Given this scenario, if the government sticks with the pay commission which is treated as a fiscal shock to the economy due to increase in revenue expenditure, the whole fiscal mathematics of the centre and the states would be disturbed. The implications of a salary hike can lead to additional burden on the states which are Page | 10 suffering from fiscal distress as happened in the past (Ray et. al, 2015; Mohan 2008). Given the resource sharing between Centre and States, the states with poor fiscal performance will be expected to suffer more. It has also been observed that to implement this populist policy, the revenue expenditure has been increased by curtailing the capital expenditure which has definitely reduced the productive assets of the economy and pushed it away from the path of its long run growth potential. Also, States might borrow to finance the salary burden which might increase the interest payments in future. Given these facts this study attempts to estimate the burden of the Seventh Pay Commission on the fiscal accounts of the Central Government and State Governments; and the potential salary and pension burden over the next 10 years till the implementation of the next pay commission.

## Theoretical Background

The policymakers are very clear about the goals to be achieved for the economy which are employment, stable prices and growth. There is still no consensus about the compatibility of these goals. And far lesser agreement about which policies can be used effectively (Snowdown and Vane, 2005). The strand of thoughts associated with the Classical economics dominated the mainstream prior to the emergence of the Keynes General Theory in 1939. Although Classical believed that the capitalist system could deviate from equilibrium level of output and employment but they believed in optimizing tendency of the market forces which could help the economy to stabilize. The reasoning behind this optimist conclusion was based on the assumption of flexibility of the prices and a vertical supply curve. In their view the policies of government could only create instability; the system has the ability to revert back to equilibrium on its own. Keynes was concerned about the ability of the system to be restored without government intervention. He emphasized that macroeconomic equilibrium and involuntary unemployment could co-exist. In Keynes earlier work the idea of multiplier could be identified where he stresses for public works programme to increase employment and generate additional demand. However, it was Kahn who had introduced the concept of multiplier in a memorandum in 1930. In that article he had analyzed the impact of loan financed public works expenditure on employment. Page | 11 He had assumed spare capacity for economy, accommodation of monetary policy and stability of money wages. Later on the idea of super-multiplier was publicized which shows an increase in investment arising on account of increase in income from the multiplier effect (Hicks, 1951). The orthodox Keynsians favored fiscal policy as compared to monetary policy as fiscal policy is more direct and takes lesser time to foster effective demand. However, monetary policy does find a role in the Keynesian framework. Clearly, there is no denying the fact that multiplier is a potent tool which operates by increasing disposable income. Critics of Keynesian model, particularly the classical and neo-classical schools argued that private agents (households and firms) will foresee the increase in tax liabilities in future. This will lead to realization of a lower multiplier effect. More formally, this Ricardian equivalence proposition states that the forward looking customers would take into account the actions of the government while making consumption decisions. Similarly, other schools of thoughts such Real Business School and Neo-Keynesian models agree about the positive impact on output of a fiscal expansion. However, there is no agreement about the effect on private consumption.

## International experience

The occurrence of Great financial crisis (GFC) has revived the interest of policymakers in the estimation of fiscal multipliers. There are a number of studies which attempt to estimate the value of the multiplier using different approaches. A wide variation in the values can be observed. It could be due to the different economic environment and policies being followed in the countries (Ilzetzki et al., 2013; Koh, 2017). The phase of the cycle prevailing in the country can also affect the value of the multiplier (Auerbach and Gorodnichenko, 2011; Blanchard and Leigh, 2013). During a downturn the output of the country is low in such case increase in public spending could raise output but the multiplier effect will be lower. There are instances when the effect is found to be higher during downturn (Reira-Crichton et. al, 2015; Qazizada and Stockhammer, 2015; Karras, 2014). Apart from demand side consideration, the supply side is important. A spending program which could tap the unexploited supply side potential can have a large multiplier effect (Hemmings, 2002). Page | 12 The exchange rate regime of the countries also affects the value of the multiplier. Additional factors affecting the estimation of multiplier could be the stance of monetary policy, trade balance and the level of debt (Ilzetzki et al., 2013; Kirchner et. al., 2010; Perroti, 1999; Sutherland, 1997). The responsiveness of the multiplier effect to the level of interest rate and labour market conditions is also a concern (Alumnia et al., 2010; Christiano et al., 2011; Devereux, 2010; Woodford, 2011; Barro and Redlick, 2009). The system of public expenditure management has been observed to be relatively weaker in developing countries and the lag in effectively rolling out a policy is also larger. Therefore, the value of fiscal multiplier could be lower in case of developing countries (Ilzetzki et al, 2013). Question also arises whether the private consumption moves in the same direction as public spending. Linnneman (2006) argues that due to inter temporal optimizing tendencies of the agents it might be difficult to observe the co-movement. The nature of spending by the government can also decide the course of change in private consumption spending. It has been observed that if spending on public goods increases private consumption whereas on merit good could lead to a crowding out effect. Focusing on disaggregation of government expenditure could give important insights. Marattin and Salotti (2015) report that overall government expenditure might not affect private consumption but individual levels do.

## Indian Experience

There has been a proliferation of studies focusing on estimation of multipliers in India after the GFC of 2008. The slowdown has provided the researchers with a fertile field to test their theories and the impact of policies. Indian economy has become more open since the 1990's and has undergone drastic change; therefore the studies focusing on the post liberalization period has been considered. Two influential studies have been located for the pre-liberalization period by Krishnamurty (1985) and Bhattacharya (1984). Krishnamurty (1985) has estimated the effect of public investment on GDP. And, Bhattacharya has used structural macroeconomic model to estimate the impact of discretionary government consumer expenditure on GDP. The significance of the results of these studies might not hold now since the parameters and the environment of the economy have changed which can lead to a bias in estimation of the multiplier (Ilzetzki et al., 2013; Koh, 2017). Page | 13 Yadav et. al. (2012) has estimate the effect of shock to tax and government spending on output. They report a higher impact of shock to tax variable as compared to shocks to private consumption. They have used two different techniques for estimating the multiplier: recursive scheme which is based on cholseky decomposition and an identification scheme in which the ordering is based on what Blanchard and Perrotti has suggested. They find evidence in favor of Keynesian theory in the short run but the response in long run is not very clear. They also show that the private spending is more sensitive to tax variables affects than the government spending variable. Jain and Kumar (2013) estimate a higher value of multiplier for capital expenditure as compared to revenue expenditure. The higher multiplier effect of capital expenditure is confirmed by Bose and Bhanumurthy (2013), Jain and Kumar (2013); and Goyal and Sharma (2015). Also, capital expenditure seems to have a prolonged effect which can last as long as for four years (Jain and Kumar, 2013). In addition, Goyal and Sharma (2015) also report that capital expenditure has the potential to reduce inflation volatility by overcoming the structure side bottlenecks. The increase in revenue expenditure can lead to an increase in the interest rate in short run. All these aforementioned studies recommend that preference should be given to capital outlay. Kumar and Joe (2018) have reported a higher value of multiplier effect for development expenditure which is non-recurring in nature and is expected to improve the long run growth potential of the country by augmenting the human capital formation. Bose and Bhanumurthy (2013) have tried to explain the transmission mechanism in their paper. Their opinion is that increase in capital expenditure leads to an increase in public investment which in turn create conditions favorable for private investment as well. This association between public and private investment is strong and hence a higher accelerator effect is observed. Interest rate increase due to higher fiscal deficit but private investment lost due to this effect is lesser than the initial increase in private investment, hence net effect is positive.

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