Impact of 7th Pay Commission

The Seventh Central Pay Commission has recommended an overall increase of 23.55% in pay, allowances, and pension for government employees. The recommendations are to come into force on January 1, 2016. However, it is believed that there could be some deferral based on the fiscal space allowed in the current year, even if all the recommendations are accepted without any changes.

- The total monetary impact on the central government would be Rs 1.02 lakh crore, of which
  - Rs 73,650 crore would be on the Union Budget
  - Rs 28,450 crore on the Railway Budget
- The total impact of the panel's recommendation would be an increase of expenditure by 0.65% of GDP in FY17

Implicit assumption on GDP

Table 1: GDP Projection for FY17

	FY16	FY17
Nominal GDP (Rs cr)	1,41,08,945	1,57,07,600
Growth (%)	11.5	11.3
Inflation	4.1	3.3-3.8
Real GDP	**7.4$**	**7.5-8.0**

Source: Ministry of Finance, CARE Economics

$: Based on RBI estimate. CARE's is 7.5-7.6%

The GDP for next year is calculated with the information on percentage increase in expenditure after the pay hike is implemented. Based on the pay commission recommendations, the government is expecting the nominal GDP for FY17 to increase by 11.3% above the FY16 number. Assuming, GDP for next year at 7.5-8.0%, inflation, as per the GDP deflator would be 3.3-3.8%.

Fiscal Mathematics

Table 2: Fiscal Deficit Calculation

	FY16	FY17
Fiscal Deficit	5,55,649	6,29,299*
Nominal GDP	1,41,08,945	1,57,07,600
Fiscal Deficit ratio	**3.9**	**4.0**

Source: Ministry of Finance, CARE Economics

**: assuming the fiscal deficit number is frozen at FY16 level and Pay Commission burden added.*

If we assume that the fiscal deficit only increases by the amount of Pay Commission recommendation in FY17, then the fiscal deficit amount stands at Rs 6,29,299 crore which is 4.0% of GDP. The government in its previous budget has targeted fiscal deficit of 3.5% for FY17. Thus, in order to attain the 3.5% deficit ratio; approximately Rs 80,000 crore additional revenue needs to be generated. Alternatively there have to be some cuts in expenditure to ensure that there are savings which can compensate for this additional cost on salary account.

Challenges for the Central Government

- The government needs to facilitate increase in revenues. With the likely reduction in the corporate tax rate, there is going to be pressure on the revenue collections.
    - Service tax rates, which have already been increased, could be hiked further.
- The government needs to maintain its disinvestment levels in order to reduce the fiscal deficit impact. While this would be a challenge for the government which is to raise Rs 70,000 this year for the second successive year, it would be good news for the stock market.
- The government also needs to work on balancing the expenditure, with no compromise on the capital expenditure
    - The cushion of further lower subsidies may not be available, and unless there is further rationalization, the amount would remain high.
    - A question remains however, on whether there will be any impact on capex of the government which was budgeted at Rs 1.3 lkh crore for FY16.

Secondary Government Impact

The state government will experience equivalent amount of additional pay hikes to public sector employees. The finances at the state government would hence also be impacted. The states with fiscal deficits would have to generate additional revenues in order to maintain their deficit targets. The increase in Pay for state governments could be another 0.45% of GSDP, which has to be juxtaposed with their individual fiscal spaces given the 3% norm as per FRBM.

As pay scales of PSUs, PSBs, teachers etc. are also linked with these structures, there would be further secondary effects in terms of higher expenditure on salary account.

Macroeconomic impact

The increase in salaries and pensions will have macroeconomic impact in the form of improved purchasing power in the economy. Based on the FY14 savings rate of 30%, we can assume 70% as the amount spend by the household.

The total increase of Rs 1.02 lakh crore is broken down to; Rs 39,100 crore in salary, Rs 29,300 crore in allowance and Rs 33,700 crore in pensions. Thus, we can assume that 70% of Rs 68,400 crore (salaries + allowance) would be spent by the households. Most of the pension is saved, assuming 80% of this is saved; the total amount circulated in the economy would be Rs 54,620 crore.

Increased expenditure by households would benefit sectors such as

- consumer durables,
- electronic goods including mobile handsets,
- housing, and
- automobiles – the lower income would buy more two wheelers while the higher income groups would end up spending more on four wheelers.

Secondary impact of the same would be seen on steel, electric goods, auto parts etc. Banks would experience increased business in the form of higher home loans.

Concluding remarks

- The Pay Commission's recommendations have the potential to add to the purchasing power of households which should help to prop up demand, though admittedly it would be seen during the course of FY17 when it is implemented. This along with the government's own capex programme would help in accelerating growth.
- The government will have to take a closer look at the fiscal numbers given the pressure of making provisions for the same and moving along the path of fiscal consolidation.

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