General Economic Situation and Financial Resources of the Central Government

Chapter 2.1

Section-I

2.1.1 This Commission is required by its Terms of Reference to make its recommendations keeping in view, inter alia:

i. the economic conditions in the country and the need for fiscal prudence;
ii. the need to ensure that adequate resources are available for development expenditures and welfare measures;
iii. the likely impact of the recommendations on the finances of the State Governments, which usually adopt the recommendations with some modifications.

2.1.2 The Government of India (GoI), Economic Survey 2014-15 is optimistic and bullish about the future: "*a political mandate for reform and a benign external environment have created a historic moment of opportunity to propel India onto a double-digit growth trajectory. Decisive shifts in policies controlled by the Centre combined with a persistent, encompassing, and creative incrementalism in other areas could cumulate to Big Bang reforms....*" The survey also clarifies that "…*macroeconomic fundamentals have dramatically improved for the better, reflected in both temporal and cross-country comparisons....*" This improvement in macroeconomic performance is expected to impact the fortunes of the economy, principally through a sustained higher rate of growth of GDP.

2.1.3 In this context the two implications of the positive future growth and macroeconomic scenario that are of direct interest to this Commission are:

1. The incremental fiscal space that will be secured through such improved macro performance.
2. The constraints imposed by the macro fiscal framework that government will adopt through to 2017-18 which will be underpinned by its FRBM legislation.

2.1.4 The government has two instruments to secure resources for the expenditures that they must undertake:

a. Revenue Mobilisation
b. Borrowing

2.1.5 Government spending (like for all other economic agents) can be divided into consumption (revenue) and investment spending. The fiscal deficit[1] (FD) conceptually measures the difference between total government spending and total non debt receipts thereby indicating the total amount the government needs to borrow to finance its projected

[1] Conceptually, as is the practice in India, fiscal deficit may measure the difference between total expenditure and total revenue plus non debt capital receipts.

expenditure. The revenue deficit (RD) measures the difference between government's total revenues and its consumption (revenue) expenditure. The core focus of this Commission is on Pay, Allowances and Pensions (PAP), which is fully revenue expenditure.

Table 1: Macro Fiscal Position of the Centre

As % of GDP	2013-14	2014-15 BE	2014-15 RE	2015-16 BE	2016-17#	2017-18#
Revenue Deficit	3.1	2.9	2.9	2.8	2.4	2.0
Fiscal Deficit	4.4	4.1	4.1	3.9	3.5	3.0
Revenue Expenditure	12.1	12.2	11.8	10.9		
Capital Expenditure	1.7	1.8	1.5	1.7		

Source: Budget at a glance, Union Budget of Government of India 2014-15 and 2015-16.

 # Rolling Targets presented in Medium Term Fiscal Policy Statement 2015-16.

BE=Budget Estimates, RE=Revised Estimates.

2.1.6 Table 1 expresses these key fiscal aggregates as a percentage of GDP. We can see from this table that the GoI intends to reduce its overall borrowing for both revenue and capital expenditure from 4.1 percent in 2014-15 to 3 percent in 2017-18. Almost the entire reduction in fiscal deficit is to be secured by a corresponding reduction in the revenue deficit. This reduction is sought to be attained largely through containing the growth of revenue expenditure, expressed as a percentage of GDP. Thus, in the current (2015-16) budget, revenue expenditure expressed as a percentage of GDP is expected to fall by 0.9 percent. Such a drop will need to be maintained (if not increased) if the government's medium term revenue and fiscal expenditure targets as expressed in the medium term fiscal policy statement of the Union Budget 2015-16 (Table 1) are to be met. The impact of not meeting or revising these targets will be negative for India's economic growth and it is for this reason that the government has repeatedly stressed its commitment to medium term fiscal prudence with the medium term targets as the basis and backed by the Fiscal Responsibility and Budget Management (FRBM) Legislation.

2.1.7 The macroeconomic aspiration to deliver double digit growth in the medium term is underpinned by a concrete commitment to immediately secure real GDP growth of at least 7.5 percent. In addition the government and the Reserve Bank of India are committed to bringing down inflation to 6 percent by January 2016 and to a formal long term target of 4 percent[2].

The implications of the above are:

2.1.8 The size of the government sector in the total economy, expressed as a proportion of GDP, will stay roughly constant over the medium term. This is because the increase in the size of government (expressed as a percentage of GDP) can only be financed through an increase in the revenue-GDP ratio and/or an increase in the FD-GDP ratio. The latter ought not to happen; indeed the government is committed to reducing the FD-GDP ratio over the medium term as discussed above. If the Revenue-GDP ratio is increased then:

[2]Source: http://finmin.nic.in/reports/MPFAgreement28022015.pdf

a. The additional resources will be used to reduce the RD.
b. Following the recommendations of the Fourteenth Finance Commission (FFC) the Centre will get a lower share in the divisible pool of taxes than in the past i.e., 58 percent in 2015-16 to 2019-20 as compared to 68 percent in the period 2010-11 to 2014-15. This further limits the possibility of a significant increase in net revenue receipts of the Centre.

2.1.9 At the same time the government has emphatically indicated key government spending priorities that will involve substantial financing of both current and capital expenditures over the medium term to fulfil government's core obligation to provide public as we as merit goods and services. Hence, equally it cannot be assumed that there will be a reduction in the size of the government.

2.1.10 Since PAP is entirely revenue expenditure and since revenue-GDP ratio increases will first be deployed to reduce the revenue deficit, it follows that there is no fiscal space available to increase the share of the total spending on PAP other than that afforded by GDP growth. The share of PAP in total revenue expenditure will, at best, stay constant over the medium term.

2.1.11 It therefore follows that any increase in PAP that can be financed without jeopardising the government's macro fiscal parameters can, in the medium term, at most be equal to the growth rate of GDP. Of course, due to the peripatetic, decennial, occurrence of the Pay Commission recommendations this condition cannot be met in the initial year of award, as the award has to adjust for many cumulative factors that have negatively impacted the purchasing power of the PAP over the historical medium term. Even so it is important to ensure that the increase in the PAP-GDP ratio in the initial year of the award is moderate, so that it stabilizes over the medium term (provided growth is secured as planned).

Section-II

2.1.12 With the above framework in place we can now assess the extent to which the Seventh Central Pay Commission's recommendations address macroeconomic conditions, the need for fiscal prudence and availability of adequate resources for development and welfare expenditures. Table 2 presents different categories of PAP expenditures as percentages of GDP over time. It is clear from the table that pay and allowances as a proportion of GDP has remained fairly stable since 2010-11, i.e., in the range of 1.8 percent and 2.0 percent, as has the share of pensions, which has ranged between 0.9 percent and 1 percent of GDP.

2.1.13 The Seventh CPC recommendations can cause macroeconomic stress in two ways:

1. The awards of the previous Pay Commissions, both V as well as the VI, involved payment of arrears. If awards are made with an arrears component then the cumulative impact of arrears would temporarily increase government expenditure on PAP, thereby causing an appreciable shock, albeit for a short time. This shock impacts both fiscal stability and the price level through demand and supply channels. However, **the**

Seventh CPC recommendations entail, at best, payments of marginal arrears and we do not therefore envisage any macroeconomic shock on this score.

2. A pay commission award can cause a significant increase in the ratio of PAP to GDP in the year the award is implemented. This happens for two reasons:
    a. Due to the fact that many allowances are not fully indexed to DA, and some allowances are not indexed at all, there is some increase in expenditure on PAP that happens when basic pay and DA are merged.
    b. Total government spending on PAP increases due to an increase in the real value of PAP as a consequence of a pay commission award.

2.1.14 As we show in Table 2 the cumulative effect of these elements on the award of the VI CPC was of the order of 0.77 percent of GDP in 2009-10. This Commission is of the view that any macroeconomic impact that exceeded this number would not be fiscally prudent and would put undue pressure on the government in terms of discharging its development and welfare spending responsibilities. Table 2 shows the impact of the proposed recommendations of the Seventh CPC. In arriving at an assessment of the impact, three Scenarios have been considered. Scenario I represents a "business as usual" scenario i.e., a situation that we estimate would prevail in the absence of the pay commission award. Scenario II represents the net impact on the PAP-GDP ratio if the Commission were to only merge basic pay and DA. Scenario III represents the full impact of the Seventh CPC's recommended award on the PAP-GDP ratio.

2.1.15 The merger of basic pay with DA would ***need*** to be effected in the sense that this merger is inevitably carried out when Pay Commissions submit their recommendations. The net increase as a consequence of the pay commission recommendations is therefore the difference between the PAP-GDP ratio in Scenario III and Scenario II i.e., 0.56 percent. **The Commission is of the view that this represents an extremely reasonable increase in the PAP-GDP ratio in the initial year of award. In future years this ratio will in fact decline, as GDP growth is expected to be faster than the growth rate of inflation in future years as projected by the government and as explained in Section-I above.**

2.1.16 **The total impact of the Commission's recommended award is also less than that of the VI CPC.** As can be seen from Table 2, the increase in PAP-GDP ratio (excluding arrears) in the case of the VI CPC was 0.77 percent of GDP as compared to 0.65 percent (the difference between the PAP-GDP ratio in the year following the award period) in the case of the Seventh CPC's recommendations.

2.1.17 In assessing the impact on the capacity of the government to maintain its expenditure on welfare and development commitments, it would be incorrect to simply look at the ratio of PAP to total revenue expenditure. This is because the railways are expected to meet their PAP commitments from their own internal resource generation and therefore it is not appropriate to include the railways component of PAP in our calculation. We have therefore calculated the increase in the share of PAP in total revenue expenditure (excluding railways) in the two years following the VI CPC award and compared this with our estimated increase in this ratio in the year following our award, if the Seventh CPC recommendations are accepted.

Table 2: Impact of VI CPC and Seventh CPC Awards on Macro-fiscal Statement

(In percentage)

Ratios	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	Scenario (2016-17)		
									I	II	III
Pay and Allowances/ GDP	2.05	2.47	2.03	1.94	1.92	1.87	1.88	1.86	1.84	1.93	2.28
Pensions/GDP	0.84	1.20	1.00	0.94	0.95	0.92	0.92	0.91	0.91	0.91	1.12
PAP/GDP	2.89	3.67	3.04	2.87	2.86	2.79	2.81	2.77	2.75	2.84	3.40
Increase in PAP/ GDP		**0.77**								**0.09**	**0.65**
PAP/GDP **(Excluding Railways)**	2.03	2.65	2.22	2.10	2.10	2.03	2.04	2.02	1.95	2.02	2.41
Increase in PAP/ GDP		**0.62**								**0.07**	**0.46**
PAP/RE **(Excluding Railways)**	14.12	18.44	16.24	16.17	16.88	16.80	17.20	18.51	18.06	18.61	22.32
Increase in PAP/RE		**4.32**								**0.51**	**4.25**

2.1.18 **We find (Table 2) that the rise in estimated share of PAP in total revenue expenditure (excluding Railways) as a consequence of the Seventh CPC recommended award will be 4.25 percent which is lower than the corresponding figure for the VI CPC award which is 4.32 percent (Table 2).**

2.1.19 The Commission has not made any assumptions regarding efficiency savings, which will no doubt be effected as part of the overall government strategy for enhancing administrative efficiency, and following implementation of the report forthcoming from the Expenditure Management Commission. If these reforms are credible, one would expect efficiency gains to more than pay for these modest increase in the PAP-GDP and PAP (excluding railways)/RE ratios. **Thus, we feel that the macroeconomic impact of the recommendations is in conformance with the need for fiscal prudence and macroeconomic stability**.

Assumptions

Gross Domestic Product

2.1.20 The central statistical organization (CSO), Ministry of Statistics and Programme Implementation (MOSPI) has released the new series of GDP with base year 2011-12 with revisions in methodology of estimating national income[3]. However, at the time the calculations for this chapter were made, the CSO had not released the back series of GDP based on the new base year. The CSO, in its press release (see footnote below), stated, *"...Improvements as noted above, especially incorporation of new datasets, have resulted in a correction in the level of GDP, which is likely to affect a wide range of indicators where it is used as a reference point:*

[3] http://mospi.nic.in/Mospi_New/upload/nad_press_release_30jan15.pdf

for instance, trends in public expenditure, taxes and public sector debt that are conventionally analysed in terms of their ratios to nominal GDP. It may be noted that the level of revision in the present base revision is not large enough to affect any of these ratios significantly…." In the annexure attached to the press release it indicates changes in GDP at the aggregate level.

2.1.21 After consultation with the Chief Statistician of India, MOSPI, we created the back series of GDP with new base year assuming that the gap between the two series at the new base year will remain at least constant for previous years. In addition, we also calculated the impact of Seventh CPC award with the old GDP series for the year 2015-16 and 2016-17 by using the nominal growth rate of the new series for these two years. The impact of pay and allowances on GDP under both series is thereby analysed and the difference between the estimates of two series is minimal.

2.1.22 Further, in case of new series, while projecting the GDP for 2016-17, we assumed that the real growth rate of GDP will be 7.5 percent and inflation will be 4 percent in 2016-17.

Pay and Allowances

2.1.23 The actual data from Finance Accounts of India for pay and allowances and pensions is available till 2013-14. We, therefore, projected the data from 2014-15 onwards with an annual growth rate of 11.07 percent (an average of PAP from 2011-12 to 2013-14).

Pensions

2.1.24 The share of pensions in total PAP has been stable since 2009-10. Thus, we maintained the same share while estimating the projections for pensions for 2016-17 and estimated the total pensions under different scenarios as in the case of pay and allowances.

Expenditure

2.1.25 To assess the impact of Seventh CPC award on Central finances, we considered the total expenditure and revenue expenditure projections made by FFC. We also analysed the impact using the Budget estimates for 2015-16. The budget estimates for 2016-17 were projected, using the projections made by FFC for 2016-17 over 2015-16.

Financial Resources of the State Governments

Chapter 2.2

Impact of Central Pay Commissions on State Finances

2.2.1 To address the question of implications of Seventh Central Pay Commission's recommendations on the States, it was necessary to ascertain the fiscal impact of the previous Commissions' awards on the states. To this end, Indian Institute of Management Calcutta (IIM, Kolkata) was asked to undertake a study on the subject for the Seventh CPC.

2.2.2 The broad conclusions of the study indicated that the states on the whole were able to manage their finances and absorb the fiscal shock caused by the VI CPC (relative to previous Pay Commissions) better, principally because of the implementation of the FRBM Act by the States.

2.2.3 The study finds that the macroeconomic impact on states depended on the speed and the extent to which individual states implemented their pay awards, which varied considerably. The empirical analysis conducted indicates that the macroeconomic impact on States' finances tends to taper off in two years in most cases. In this context, it is encouraging to note that States' finances continue to be reasonably sound at present.

2.2.4 It is clear from the study that a significant number of States follow the recommendations of the Central Pay Commission. Equally, there is significant plurality of States that design their own pay awards based on the recommendations of their own State Pay Commissions, which of course do consider the recommendations the Central Pay Commission and subsequent Government of India award.

2.2.5 The question then is the extent to which these findings continue to hold true at present. RBI (2015)[4] reports that the consolidated revenue deficit of all states (budget estimates) is expected to be (-)0.4 percent for the year 2014-15. Further, the Fourteenth Finance Commission has increased the ratio of States' share in the divisible pool of receipts to 42 percent from the 32 percent that obtained in the Thirteenth Finance Commission. States as a whole are expected to maintain this healthy trend, particularly since the macroeconomic outlook is now expected to be better than in the recent past. Ceterus paribus, one would expect this situation to remain, if not improve, in 2015-16. States' own revenues, as a percentage of Gross State Domestic Product (GSDP), are also stable at 7.7 percent for three years now.

2.2.6 Notwithstanding this commendable fiscal performance, it is important to see how states were able to cope with the award of the VI CPC and the impact of the award on the macro fiscal fortunes of the individual states

[4] State Finances: A Study of Budgets, 2015, Reserve Bank of India.

2.2.7 In the case of Special Category States (SCS) it is generally recognised that these states would, because of their special circumstances, only secure fiscal consolidation if additional resources were made available to them over and above their share of revenues from the divisible pool. Central Governments do not, in normal cases, provide such assistance. Finance Commissions take account of this fact by providing such states with revenue deficit grants. Thus, both the 13th and 14th Finance Commission awarded revenue deficit grants to most of these special category states. In addition, these states also receive special purpose grants that take account their specific cost disabilities and low revenue base. These efforts have been broadly successful. The RBI (2015) clarifies that the special category states as a whole have not been incurring revenue deficit in recent times.

2.2.8 In the case of the General Category States (GCS), in recent times, only a few states have consistently faced revenue deficits. We find (Table 1) that some states that were normally in revenue surplus did incur revenue deficits following the implementation of their Pay Commission awards. However, these states were able to stabilise and return to revenue surplus within a reasonable period of time. Therefore, there is every reason to expect states that are currently structurally fiscally prudent and in compliance with FRBM to be able to cope with the consequences of increases in pay allowance and pension (PAP), as long as the level of fiscal prudence is broadly in line with that of the Seventh CPC recommendations.

Table 1: Revenue Deficit of General Category States (GCS) (as % of GSDP)

States	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15 (RE)	2015-16 (BE)
Andhra Pradesh*	0.0	-0.2	-0.3	-0.4	-0.5	-0.2	-0.04	2.7	1.3
Bihar	-4.1	-3.1	-1.8	-3.1	-1.9	-1.7	-1.8	1.1	2.6
Chhattisgarh	-3.8	-1.9	-0.9	-2.8	-2.3	-1.6	0.4	-1.1	-1.8
Goa	-0.8	-0.4	0.4	-2.0	-0.7	0.5	0.7	-0.1	-0.8
Gujarat	-0.7	0.0	1.6	1.0	-0.5	-0.8	-0.6	-0.7	-0.7
Haryana	-1.5	1.1	1.9	1.1	0.5	1.3	1.0	2.1	1.8
Jharkhand	1.8	-0.7	-2.6	-0.7	-1.1	-0.9	-1.6	-1.9	-2.1
Karnataka	-1.4	-0.5	-0.5	-1.0	-1.0	-0.4	-0.1	0.0	-0.1
Kerala	2.2	1.8	2.2	1.4	2.6	2.7	2.8	2.1	1.4
Madhya Pradesh	-3.2	-2.1	-2.4	-2.6	-3.2	-2.1	-1.4	-1.2	-1.0
Maharashtra	-2.2	-0.7	0.9	0.1	0.2	0.3	-0.3	-0.8	-0.2
Orissa	-3.3	-2.3	-0.7	-2.0	-2.5	-2.3	-1.2	-1.1	-1.5
Punjab	2.5	2.2	2.7	2.3	2.7	2.6	2.1	1.8	1.6
Rajasthan	-0.8	0.4	1.8	-0.3	-0.8	-0.8	0.2	0.7	-0.1
Tamil Nadu	-1.3	-0.4	0.7	0.5	-0.2	-0.2	-0.2	-0.4	-0.4
Uttar Pradesh	-0.9	-0.4	-1.3	-0.6	-1.0	-0.7	-1.1	-3.3	-3.2
West Bengal	2.7	4.3	5.4	3.7	2.8	2.3	2.7	1.3	0.0

Source: State Finances- A Study of Budgets, Reserve Bank of India. The numbers for 2014-15 and 2015-16 are from states budget documents.

Note: "" Andhra Pradesh here refers to erstwhile Andhra Pradesh before Telangana was formed. Data for 2014-15 and 2015-16 is related to the new State of Andhra Pradesh.*

2.2.9 In the case of States that have been in chronic revenue deficit there is no doubt that even the awards with the level of fiscal prudence of Seventh CPC will cause a fiscal strain to these states. These states must "cut their coat according to their cloth." Therefore, just as in the case of all expenditures that states with chronic revenue deficits undertake, they will have to be more restrictive in their pay awards than states which have successfully secured fiscal consolidation.

2.2.10 The FFC has opined as follows, *"….the recommendations of the Seventh Central Pay Commission are likely to be made only by August 2015, and unlike the previous Finance Commissions, we would not have the benefit of having any material to base our assessments and projections and to specifically take the impact into account. We have, therefore, adopted the principle of overall sustainability based on past trends, which should realistically capture the overall fiscal needs of the States…*" Thus, account has been taken of the Commission's recommendations at a macro-fiscal level by the FFC.

2.2.11 In this context, it should be borne in mind that the FFC has also provided revenue deficit grants to states to compensate for cost disabilities and shortfalls in their tax base. Such grants have been awarded to key states with chronic revenue deficits after a rigorous assessment of their revenue base and expenditure needs. Hence, these States have already secured additional resources from the divisible pool on this account and this should further enable them to administer pay awards consistent with fiscal prudence and allow them to persist in their path to fiscal consolidation.

2.2.12 It is also clear from the study by IIM, Kolkata that the pace and impact of implication of pay commission award varies quite substantially across the States. The States have deployed a number of options to deal with impact of their pay awards following the awards made by the Government of India based on the recommendations of the previous Central Pay Commissions. The states used the following options:

- deciding to award lower increases than the Centre,
- deciding on a date of implementation different from that of the Centre,
- staggering the payments of arrears suitably,
- generating additional tax and non-tax revenues, and
- compressing expenditures

2.2.13 On the basis of above analysis, we conclude that States which have successfully maintained fiscal consolidation will be able to absorb the impact of additional expenditure on PAP and the fiscal stress on them in so doing would not exceed that faced by the Government of India. This would require States to calibrate the speed and the extent of their own award. It is to be expected that the existing fiscal arrangements that govern the relation between the Centre and special category States would continue to hold. In the case of general category States undergoing long term fiscal stress, clearly further structural fiscal reforms are immediately and urgently required. In these circumstances calibration of pay awards in such states would need to be more prudent than other States.