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India Economics

Sixth Pay Commission: Threat to India's Fiscal Consolidation

Major wage hike for central government employees likely: The government-appointed Sixth Pay Commission is due to announce its recommendations on the magnitude of wage and pension hikes for central government employees. Assuming that the Sixth Pay Commission announces a hike in salaries and pension slightly lower than that announced under fifth pay commission, we believe that that the total central government salaries and pension payments could increase by about 0.4% of GDP (Rs300 bn) to 2.5% in F2009.

State government and quasi-government entities could follow: We expect the combined wage and pension costs of the state governments to rise by about Rs900 to Rs1000 billion spread over the next 2-3 years. Other quasi-government entities are also likely to resort to some hike in its employees' wages.

Reversal fiscal deficit trend: The recent farm loan relief spending and the pay hike impact will decidedly reverse the six-year trend of reduction in government deficit. On our estimates, the central and state governments' consolidated deficit including off-budget spending is likely to deteriorate to 8.3-8.5% in F2009 from the trough of 7.0% of GDP in F2008.

Equity market implications: Our Strategist Ridham Desai believes both discretionary and staple consumption is likely to rise with the positive effect on earnings. However, discretionary spending continues to face headwinds from restrictive rates and we stay cautious on the stocks. Valuation and earnings support in consumer staples makes it the largest overweight position in our model portfolio. On the other hand, the pubic sector companies may see downgrade to earnings due to the higher-than-expected increase in wage expense.

Recent Reports

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India Economics: Budget F2009: Jai Kisan (Victory to the Farmer) Chetan Ahya / Tanvee Gupta	Mar 3, 2008

Sixth Pay Commission: Threat to India's Fiscal Consolidation

Central Government Wage Hike Likely in F2009

The government-appointed Sixth Pay Commission is due to announce its recommendations on the magnitude of increase in salary and pension (compensation) for 2.9 million central government employees over the next few days. The compensation increase will be effective from January 1, 2006. Assuming that the Sixth Pay Commission announces a hike in salaries and pension slightly lower than that announced under Fifth Pay Commission, we believe that the total central government salaries and pension payments could increase by 0.4% of GDP to 2.5% in F2009. In other words, total salaries and pension costs for the central government employees could rise by about Rs300 billion (30 % YoY) to Rs1,307 billion (about US$33 billion) in F2009. Fifth Pay Commission recommendations had resulted in a 34% increase in wage costs for central government in the first year (F1998) post implementation.

State Governments Could Resort to Similar Hikes

Although Sixth Pay Commission recommendations are specifically for central government employees, state governments tend follow a similar hike. Some states appoint their own separate commissions. The impact on state budgets tends to be larger as state governments employ 7.2 million people compared with 2.9 million for the central government. Most state governments are likely to announce a major wage hike following the central government. However, not all states are likely to announce a revision in pay immediately. Post the fifth pay commission announcement, state governments' wage hike was spread over three years. We believe that a similar pattern may be followed this time. Some states have already started announcing an increase in salaries. For instance, the Karnataka government announced a revision in pay for its 0.6 million employees in May 2007. Post the fifth pay commission, total salaries and pension costs for state governments increased an average of 24% over three years. Assuming a lower average of 20% growth state governments' salaries and pension costs will rise to Rs2,255 billion (3.4% of GDP) in F2011 from an estimated Rs1,305 billion (2.8% of GDP) in F2008.

The Central Bank has advised the state governments to be careful in announcing the wage hike, reminding them of major deterioration in state fiscal deficit trend post the fifth pay commission. Post the fifth pay commission, the impact on the state finances was far more severe than that on the central finances as salaries and pension costs form a large part of their total expenditure. It accounts for 23% of state government

Exhibit 1

Basic Facts on Pay Commission

Central government appoints Pay Commission, a panel of members for advising the salaries of government employees. Pay Commissions examine various issues such as pay and allowances, retirement benefits, conditions of service, promotion policies, etc. and submit recommendations to the government. Five successive Central Pay Commissions were set up in the past at intervals of 10 to 13 years. In July 2006, the Cabinet approved setting up of the Sixth Pay Commission. This commission has been setup under Justice B.N. Srikrishna with a timeframe of 18 months. Members in sixth pay commission include a retired Supreme Court judge, a professor and other representatives of the government. The government is likely to release sixth pay commission's recommendations over the next two weeks. The pay hike will be effective from January 1, 2006.

Source: Government Documents, Morgan Stanley Research

Exhibit 2

Government Employee Strength (Million)

Type	F1995	F2000	F2005
Central Government	3.4	3.3	2.9
State Governments	7.4	7.5	7.2
Quasi-Governments	6.5	6.3	5.7
--PSU's*	2.1	1.8	1.7**
--Indian Railways	1.6	1.6	1.4
--Others	2.8	3.0	2.6
Local Bodies	2.2	2.3	2.1
Total	**19.5**	**19.3**	**18.0**

*Excludes PSU Banks. **During the year 2004-05, BSNL has been included in the survey
Source: Railway Yearbook, Economic Survey 2007-08

Exhibit 3

Summary of Current Salaries and Pension Costs

Rs Billion	F2008 Salaries and Pension Costs	Comments
Central Government Employees	1005	Most of the impact will come in F2009
State Government Employees	1305	Impact will be spread over the next 3 years
PSU's	575	Magnitude of hike is unclear, impact could be spread over the next 2 years
Railways	248	Impact will come in F2009

Source: Bloomberg, Morgan Stanley Research revenue expenditure and 17.9% of the total expenditure in F2007. In addition, interest payments account for 19.3% of revenue and 15% of total expenditure, respectively. Hence, there will be little room for adjustment in other expenditure items to offset the adverse impact of the wage cost increase. Like in the late nineties, we believe the governments will not be able to offset this cost increase with higher tax to GDP considering that GDP growth is already slowing. We believe that state government fiscal deficit could deteriorate significantly over the next three years due to employees pay hike.

Government Enterprises and Companies Will Follow

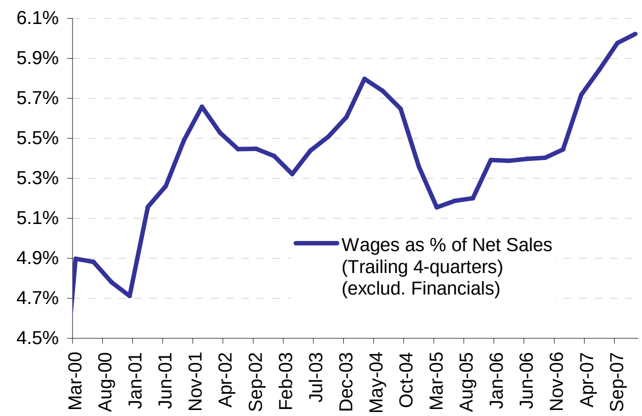
Apart from the Central and State government employees, there are about 5.7 million quasi-government employees working with public sector corporations (PSUs), the Railways and other entities. In addition to that, about 2.1 million people are employed with municipalities and other local government bodies. We believe that many of these entities will also be forced to announce a hike in compensation for their employees. Indian Railways, which employs about 1.4 million people, will follow the Sixth Commission recommendation. The total salaries and pension costs for Railways is estimated to be about Rs250 billion (0.6% of GDP) in F2008. PSUs, excluding banks, employ about 1.6 million and their total salary costs are estimated to be Rs550 billion (1.3% of GDP). The public sector banks are a notable exception. They follow a different cycle. According to Morgan Stanley Banking Sector analyst, Anil Agarwal, their wage negotiations could take another two years to come into effect. However, banks' unions are likely to use the central government employees wage hike as a bargaining tool to seek high growth in their compensation.

Reversal Fiscal Deficit Trend

We believe the combined impact of the all the government and quasi government employees salary and pension hike could be about Rs1.4 trillion to Rs1.5 trillion, spread over the next three years. The central and state government employees alone would result in additional burden of Rs1.1 trillion to 1.2 trillion spread over three years. The combined effect of the pay hike and the recent farm loan relief spending of Rs600 billion (1.2% of GDP) will decidedly reverse the six-year trend of reduction in government deficit. As per our estimate, the government's (centre plus states) consolidated deficit including the impact of off-budget spending was likely to deteriorate in F2009 to 7.7% from trough of 7.0% of GDP in F2008 before accounting for wage cost increases post sixth pay commission recommendations. We now estimate the government's consolidated fiscal deficit could shoot up to 8.3-8.5% in F2009 and potentially to 8.4% to 8.6% of GDP in F2010. This large revenue expenditure increase

Exhibit 4

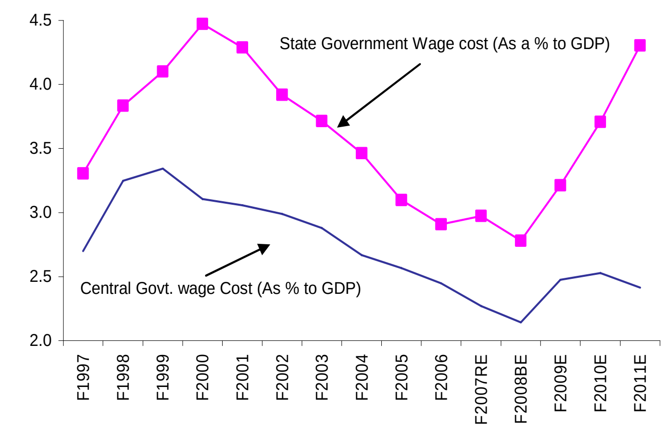
India: Corporate Sector Wage Costs (% of Net Sales)



Source: Company data, Morgan Stanley Research

Exhibit 5

Central and State Government Salaries and Pension Costs (As of GDP)



Source: Government Documents, Morgan Stanley Research, E= Morgan Stanley Estimates

Reducing the Potential for Loosening Monetary Policy

The RBI has been maintaining policy rates at relatively high level due to its concerns on inflation. We believe this expansionary fiscal policy could adversely affect the Central Bank's ability to cut policy rates in the near term. Moreover, we believe that the increased fiscal deficit burden at a time when capital inflows could slow, will potentially result in a rise long bond yields and steepening of the yield curve.

Potential Adverse Impact on Private Companies' Wage Costs?

Increased competition for talent and high wage growth in the recent past has already pushed the trialing four quarter sum of corporate sector (BSE 200 ex-financials) wage costs as a percentage of net sales to a high of 6.0% as of December 2007 would mean the share of development in total spending would fall further over the next three years. (Exhibit 5). We believe this increase in wages for government employees and quasi-government entities could have some pressure on the wages of the private corporate sector as well.

Equity Market Implications

We believe that this wage hike for government employees adds to the consumption boost provided by the budget provisions in February. Our Strategist Ridham Desai believes both discretionary and staple consumption is likely to rise with the positive effect on earnings. However, discretionary spending continues to face headwinds from restrictive rates and he remains cautious on the stocks. On the other hand, the pubic sector companies (ex-banks) may see downgrade to earnings due to the higher-than-expected increase in wage expense. Public sector banks' earnings could also be negatively affected due to the potential rise in long bond yields and consequent loss in Treasury bond portfolio.

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