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Employment and the Cost of Capital

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Prof. Panda, Prof. Mahendra Dev, faculty and students of the Delhi School of Economics, distinguished members of the Alumni and friends:

Let me begin by saying that I feel greatly honoured and deeply touched at having been invited to speak on this occasion of the 75th anniversary of DSE. My batchmates, some of whom are present here today, and I graduated from our MA class way back in 1971, well over 50 years ago. Barring a few of our own teachers, like Prof. K.L Krishna, we must be among the oldest alumni present here today. Of course I later came back for my Ph.D, as did Biswanath Goldar, and my friend Pulin Nayak spent his whole career teaching here and is a former Director of DSE. But the fact that the School has remembered Alumni who passed out over 50 years ago and has done me the honour of inviting me to speak today bears witness to how much this great institution values the entire DSE family, both young and old, and looks after for its own.

When Prof. Ram Singh invited me to speak today, I wondered what I could talk about on such an occasion. I finally decided that I would share a few thoughts with you on a great paradox of India's growth story which has continued to puzzle me. The paradox is the following. India is perhaps the fastest growing major economy in the world, projected to soon emerge as the third largest economy after the United States and China. It recovered fairly rapidly from the contraction during the Covid 19 pandemic of 2020-21 and has since continued to grow at 7% or more in real terms. Yet, when we look at the growth story through the lens of employment, the picture is quite gloomy. Based on the PLFS survey for 2022-23 and the Health Ministry's Technical Group population projections of 2020, Balwant Mehta of the Institute of Human Development has estimated that we had a workforce of about 466 million persons in 2011-12 employed in one way or another, partly or wholly. That work force grew to about 577 million in 2022-23. This translates to an average annual employment growth of only 1.9%, which is way below the rate of growth of output.

Employment growth need not and should not keep pace with output growth, since a good part of output growth should ideally be attributable to growth in productivity. However, employment growth needs to at least keep pace with the growth of the labour force. Otherwise, the difference will add to the backlog of those who are openly unemployed or underemployed. During the period 2011-12 to 2022-23 the labour force, the number of persons employed or available for work, grew from 477 million to about 595 million by Mehta's estimates. Thus, the number of unemployed grew from about 10 million in 2011-12 to over 19 million in 2022-23, an annual growth rate of over 5.6%. Further, we have to interpret this as a lower bound estimate of unemployment since the PLFS employs a very

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broad definition of employment, wherein all under-employed persons who had any work even for 1 hour a day for just 30 days during the preceding 365 days are counted as employed.

Underlying this imbalance between labour demand and supply, and the growing backlog, is the rising technological complexity and capital intensity of production as has often been pointed out, most recently in the Economic Survey. This tension between the rise in capital intensity and the inadequacy of labour demand is an important policy challenge. As a starting point in addressing this challenge I turn to one of the first things we learn in economics, namely, the power of relative price changes in reallocating resources. If the wage:rental ratio is too high to clear the labour market, should policies be directed at lowering that ratio? However, before getting to the policies, let us first consider how such a lowering of that ratio could play out in the economy.

A decline in the wage: rental ratio, absolute wages remaining the same, would imply a rise in the cost of capital and production costs on that account. However, it does not imply that producers in a capital intensive sector would shift to lower capital intensity technologies. Producers will have to adopt 'best practices' and use technologies that enable them to remain competitive in their sector, even if these are capital-intensive. What it *could* mean is that, other things remaining the same, the relative profitability of products or sectors with more labour intensive technologies will increase relative to sectors with more capital intensive technologies. That in turn could induce a reallocation of resources in favour of those sectors.

Devendra Pratap and Ajaya Sahu of the NCAER have used the Supply Use Tables for 2018-19 published by MOSPI to produce a 64x64 sector input-output table updating the earlier work of the late M.R. Saluja. They have also computed the employment multipliers for these sectors, indicating the extra direct and indirect employment for every Rs 100 crores of additional output in each sector. Apart from agriculture, the other most labour intensive sectors (30-60 persons per Rs 100 crores output) include most services; animal husbandry, production and processing of food products, such as meat, fish, fruits, vegetables, and others; grain mills; textile manufacturing and apparel production; etc. Some of these sectors are already important sources of employment. Sectors like trade, construction and a whole range of other manufacturing and services are moderately labour intensive (20-30 persons per Rs 100 crore output) and also substantial sources of employment. A decline in the wage:rental ratio could lead to a significant re-allocation of resources, including capital, in favour of these sectors.

So what possible policy interventions could help lower the wage:rental ratio? Let us first look at the numerator in the ratio, wage rates. The labour market broadly consists of three segments. Regular employees, casual workers and the self-employed. Regular employment is considered the *best* form of employment, with the highest wages, but real wages of regular employees showed a decline in the 2022-23 PLFS survey. The share of this segment in total employment has also declined to about 28%. Casual wage labour, which accounts for about 22% of total employment, is considered the *worst* form of employment with real wages at less than half that of regular employment, though it has been rising. The largest segment of employment is the self-employed category, which accounted for over 57% of total employment in 2022-23. Real earnings of this group rose moderately in 2022-23. Thus there are signs of some tightening of the labour market, as also signalled by the recent decline in the open unemployment rate.

However, a major share of the recent increase in employment is due to an increase in the number of self-employed women workers, including unpaid workers, in the agricultural sector, reversing a gradual trend of declining share of agriculture in total employment. Besides, the absolute level of wages (or earnings) are depressingly low for most workers. The self-employed, who account for the bulk of the workforce, earned a real wage of just over Rs 7,000/- per month (2011-12 prices) in 2022-23 while casual wage labour earned even less at about Rs 4,500/- per month. Even those in regular employment, who are the best paid, earned only around Rs 10,000/- per month. Clearly, the policy goal here has to be not lowering but raising the absolute level of real wages, based on rising productivity and rising demand. Especially so because a disproportionately large share of the unemployed are educated young men and women who are aspiring to find decent, productive jobs.

So the numerator is no help if we want to lower the wage:rental ratio. What about the denominator? It has long been argued that the cost of capital in India is too low, well below the scarcity value of capital in a capital scarce developing country. Underlying the low cost of capital is a peculiarly distorted, heavily state dominated, financial sector. On the demand side the government, especially the central government, has all along been the largest and dominant borrower of resources. On the supply side, following the nationalisation of banks, government owned financial institutions were the main suppliers of credit in the organised sector, including term lending institutions like IDBI, ICICI, etc. for long term loans. This situation improved somewhat following the licensing of some private banks, the conversion of term lending institutions into commercial banks and the privatisation of some public sector banks. But the sector is still state dominated, with government still the dominant, pre-emptive borrower of funds and government owned financial institutions the dominant providers of finances, both in the debt market as well as in the capital market. With the state dominating the market on both the demand and supply side, the cost of capital is essentially a quasi-administered price which does not reflect the scarcity value of capital.

As we pointed out in the NIPFP Mid-Year Economic Review, the yield on the benchmark 10-Year government security has remained stationary in the range of 7-7.5% for the past couple of years and the short term 180-day Treasury Bill yield has converged with the long term yield for monetary policy and other reasons that I won't go into now (NIPFP Policy Brief May 2024). The yield curve on corporate bonds has also closely tracked the benchmark 10-Year sovereign bond yield with just about a half percent risk premium. Further, as Radhika Pande and Madhur Mehta have indicated in a private communication, the 10-year G.Sec. yield has either been at the present level or lower during most the past two decades and the 180-day short-term Treasury Bill yield has usually been significantly lower. With the headline inflation rate hovering around 5-6% for the last couple of years, and higher in many years during the past two decades, it implies that real the interest cost of capital is around 2% at present and was significantly lower, even negative, in many years during the past two decades. A world awash with capital, thanks to dramatic quantitative easing following the financial crisis of 2007-8 and again following the global pandemic shock in 2022-21, has also been an important factor contributing to this remarkably low real cost of capital.

What policy instruments do we have to raise the real cost of capital and lower the wage rental-ratio to incentivise more labour intensive growth? In a closed economy with a state dominated financial sector, domestic policy rates can be easily raised. However, with international capital flows significantly impacting domestic financial markets, this cannot be done without ring fencing the domestic cost of capital. Depreciation of the exchange rate is an attractive policy option. It would raise the cost of foreign capital inflows along with macroeconomic expenditure switching in favour of exports vis-à-vis imports. However, there are limits to how far this can be done without attracting charges of currency manipulation from our trading partners. Moreover, domestic policy rates cannot be suddenly raised in a disruptive manner at a time when the private investment cycle is just beginning to gather some momentum. Raising domestic real interest rates, supported by exchange rate depreciation, can thus at best be part of a larger menu of policy measures to lower the wage-rental ratio and induce more labour intensive growth.

A second and more promising policy measure that can significantly lower the wage-rental ratio is an Employment Linked Incentive scheme (ELI). The concept of an ELI has in fact just been introduced by the Finance Minister in her recent budget speech, while highlighting a few schemes to subsidise salaries for new entrants to the formal job market, their provident fund contributions and apprenticeship costs in large firms. Though a welcome first step in the right direction, the incentives being offered are very limited and unlikely to have much impact. What could be really effective is a substantial ELI grant scheme linked to additional employment similar to the present PLI grant scheme linked to increases in production. As the Economic Survey points out, the present PLI scheme itself could be adding up to an estimated 12 lakh jobs a year. This is despite the fact that the PLI is available mainly for capital intensive products. This approach can be taken much further. An ELI linked to additional employment, which would in effect lower the net wage cost of additional employment, would tilt the incentive structure in favour of the high employment multiplier sectors I listed earlier, and significantly move the needle towards more labour intensive growth.

I have so far discussed the impact of relative price changes on the employment intensity of growth. However, it is also necessary to consider the impact of non-price factors. An important macroeconomic consideration here is the pattern of aggregate demand. In their recent paper Bharti, Chancel, Picketty and Somanchi have summarized the available literature on wealth & income inequality in India. Their conclusion that inequality was declining till the early 1980s but has since increased, particularly sharply during the past two decades, has generated some controversy. However, there is little disagreement that the level of inequality in India is indeed very high. As the production structure shifts towards more labour intensive sectors, this would also change the composition output. Would these changes be compatible with the composition of demand generated by a high level of wealth-income inequality? As I have mentioned earlier, the labour intensive sectors would mostly consist of food products, textiles and apparel, and traditional services. A rise in the aggregate share of labour because of a rise in the share of value added by these sectors would mainly increase the share of similar items of mass consumption in the composition of demand. Hence changes in composition of output and demand would move in tandem.

Another, possibly more important, non-price factor relates to structural rigidities in the labour market. The discussion of labour market rigidities often focusses on inflexibility arising from the Industrial Disputes Act. However, this Act applies to large enterprises with 100 or more workers, with an even higher floor in a few States. It covers only a small share of the workforce in India, where most workers are employed in smaller enterprises. Moreover, large corporates have found their way around the rigidities of this Act through the device of sub-contracting many functions to smaller companies providing labour services. As such, informal employment in the organised sector is virtually as large as employment in the informal sector. A more binding rigidity relates to the Factories Acts in different states which apply to all factories having 10 or more workers with power or factories with 20 or more employees if without power. Some States have similar provisions for services under their Shops and Establishments Acts.

There is a view that it is not so much the cost of labour but the rigidities and compliance burden of these Acts and a maze of other similar laws or rules of the Central, State and local governments, implemented by a predatory 'inspector raj,' which stands in the way of higher employment. As it happens, there are large variations across States in the laws and rules that apply, some under the States list and others under the Concurrent list in the Seventh Schedule of the Constitution. These variations enable us to look at the actual comparative evidence instead of just speculating about labour market rigidities and their impact on employment. This is an important issue which requires careful analysis by labour economists.

Let me close by saying that in sharing a few thoughts about the paradox of low employment growth alongside high output growth, I have raised several questions but provided only some tentative answers. It is my hope that that some of the very bright, young minds present here today will find these questions interesting enough to undertake the research that can provide us robust answers.

Thank you.