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At the IMF/NIPFP Conference on Fiscal Policy in India
Taj Mahal Hotel, New Delhi, India
January 16-17, 2004

Comments on Stephen Howes and Rinku Murgai,

Subsidies and Salaries: Issues in the Restructuring of Government Expenditure in India

This paper is premised on the belief that the Government of India needs to substantially increase its expenditure on agriculture, infrastructure and the social sectors, particularly primary schooling and health care. On this assumption, the paper examines new avenues for fiscal savings. The existing literature on the topic focuses on three possible sources for additional funds: tax revenues, expenditure restructuring and the elimination of subsidies. This paper departs from the literature in advocating reductions in public sector salaries as a source of potentially large fiscal savings. The reasons for this are multifold. First, the authors argue that public sector salaries are "too high". Second, they opine that salary reductions need not result in corresponding declines in productivity, if accompanied by complementary reforms. Finally, they suggest that alternative sources of fiscal savings, such as privatization and reduction in subsidies, may be harder to pursue than reductions in government salaries.

I am in full agreement with the authors on the need for reform of the public sector labor market, particularly for changes in how salaries are determined. But, the paper's focus on the possibility of enacting reductions in salaries and using this to increase fiscal savings has little to do with investments in social sectors, the topic of this session. There are several important issues which one might expect to see in a paper on this topic, such as the effect of the low productivity of public social sector investments on the fiscal deficit, and on the relationship between the country's level of human capital and its tax base, and hence its potential to raise revenues in the future. These issues are not discussed here. In that sense, those who look to this paper to learn more about the relationship between social sector investments and the country's fiscal situation will be disappointed: Though there are sections of the paper which speak to this issue, it is not the central focus of the paper. The paper does, however, provide a wealth of evidence on public sector salaries, on the operation of public sector labor markets and on the political economy of subsidy reform. This discussion makes the paper well worth reading for any student of India's economic growth and reform process.

Since the paper is very broad, I pick only a few of the issues raised by the authors, those that are particularly germane to the topic of social sector investments and the role of the public sector in ensuring their productivity. Specifically, I raise three broad concerns: the presumption of the paper that we need an increase in public expenditure on social sectors; the question of whether reductions in public sector salaries can generate the additional funds, if any, required for social sector investments; and some long-term issues relating to the consequences of changes in social sector policy.

The paper starts with the presumption that we need an increase in *public* expenditure on social sectors. Rather than start from this premise, this question first needs to be asked and answered, particularly given the evidence from several studies of the very low productivity of government investments in schooling and health. Given this, should we increase social sector investment if we cannot ensure productivity? Are their policies which can enhance the productivity of public social sector spending? If expenditure increases are necessary, does this have to be an increase in the public sector, or is there a role for the private sector?

The author's argument that significant fiscal savings can be generated by reducing public sector salaries and that such reductions will not reduce productivity are not well substantiated. Claims that achievement levels can be maintained even with substantial reductions in expenditure levels are based largely on the experience of some states, notably Madhya Pradesh, with para-teachers. However, the evidence on the effects of para-teachers is scant; implementing government agencies did not build an evaluation strategy into the design of these programs, with the result that there are no credible evaluation studies on the effect of para-teachers. As noted above, Madhya Pradesh's Education Guarantee Scheme (EGS) is generally cited as an example of the possibility of substantially reducing expenditure on schooling without adversely affecting quality. But, the effect of the EGS schools on schooling achievement has yet to be conclusively established.[1] The one program which has shown substantial benefits is a remedial education program run by a NGO, which provided remedial schooling to those with weaker academic skills.[2] The program, however, required *additional* funds. As yet, we do not know which policy measures can improve social sector productivity, and whether efficiency gains are possible without spending more.

My own feeling is that improvements in social sector productivity need far more difficult labor market reforms than reductions in pay for public sector employees. What may be necessary are changes in pay structure which link salaries to teacher productivity.

A related issue is the need for additional *public* sector expenditure. If expenditure increases are necessary, does this have to be an increase in the public sector, or is there a role for the private sector? In the Introduction, the authors' downplay the possibility of

[1] The most frequently cited studies include Kothari, Chand and Sharma (2000), Leclerq (2003) and Clarke (2003). However, Kothari, Chand and Sharma's evaluation was, as they themselves note, weakened by the high absentee rates at the time of administering the test. Leclerq's study is based on field visits of only a very few villages, and cannot be taken to be indicative of conditions in the state, a point he repeatedly makes. Finally, Clarke examines differences in pass rates for board exams between EGS and other schools, but makes no correction for selectivity bias caused by the decision on whether or not to appear for the exam.

[2] This is the Balwadi Program run by the NGO, Pratham, and evaluated by Banerjee et al (2003).

privatization, citing the limited growth of the private sector in infrastructure development as a justification. Of course, this is not true of the India's social sectors, such as schooling and health, where private sector investments are large and growing. The question we need to ask is: Can we reduce the need for public funds for social sector investments by relying more greatly on the private sector?

Public sector investment is generally favored in cases whether the social returns to the investment in question exceed the private returns, or in the case of market imperfections (such as credit constraints) which inhibit efficient levels of private investment. This theoretical justification of the public sector suggests a policy of selective private-public partnerships, with the public sector concentrating on areas where the social returns are largest or where households' investments are limited by lack of access to credit.

This suggests a schooling policy, for example, in which the public sector is made primarily responsible for the delivery of elementary schooling, since the social returns to elementary schooling are widely believed to exceed those to higher schooling. Substantial improvements in the productivity of public schooling investments may then be possible through a policy of expenditure re-allocation, by which the public sector concentrates its funds on elementary schooling, and encourages greater private investment in higher schooling. Many of the factors the authors see as limiting the size of the private sector, such as the willingness to invest, are less of an issue in higher schooling than in elementary schooling. Concerns of the effect of credit constraints on the ability of the poor to invest in higher schooling would remain, but, again, the financial sector has shown itself to be willing to invest in higher schooling (relative to elementary schooling), suggesting the need for policy attention to this area.

However, the Government of India does not have a well-formulated policy towards private schooling, so that the growth of the private sector has been in a haphazard fashion, with no attempt by the Government to channel private sector investments in appropriate areas. And, in fact, private schools have grown most rapidly in areas where the social returns to schooling are likely to be the greatest and in areas where access to credit is more likely to be a constraint, exactly the areas where theory suggests greater public investments are required. Comparing data from the 42nd and 52nd rounds of the NSS, private sector enrollments in rural India have increased the fastest at the primary level, relative to both the middle level and enrollments in secondary and higher secondary schools. And, looking across India's major states, private schooling has grown at a faster rate in the relatively poor Northern states (Bihar, Madhya Pradesh, Rajasthan, Orissa and Uttar Pradesh).

The second area I would like to address is the possibility of reducing public sector salaries as a means of fiscal savings. The paper provides little quantitative analysis of the magnitude of savings which may be possible through reductions in public sector salaries, and how this compares to the resources necessary for needed investments in schooling. It does note, however, that political factors have inhibited India's ability to enact reductions in subsidies. If so, one would suspect that these same political economy reasons would limit the potential for savings through salary reductions. It may be possible to implement salary reductions only for new staff. Even here, however, the reduced salaries offered to public sector employees such as para-teachers have been difficult to enforce. And, the government remains under constant pressure to increase the salaries of those already on the payroll.

The paper is silent on the third area of concern I wish to raise: the long-term consequences of policy changes. A significant portion of the paper is devoted to the difficulties faced by the government in reforming the public sector and reducing government subsidies. In this, and other discussions of the difficulty of reform, “political economy” factors, such as the political power of rural elites, are frequently taken as exogenous, as being determined by factors outside the system and not conducive to change by policy directives. It needs to be recognized, however, that policies affect the distribution of power and affect the socio-economic structure of the society, contributing in part to the ability to implement reforms in the future and to affect improvements in the delivery of social services. In discussing policies, such as policies which relate to the decentralization of schools (such as through programs like EGS0 or privatization, this long-term perspective must be kept in mind.

One example of the effects of policies on the ability to enact reforms comes from the area of school finance. Because wealthier households are better able to pay for private schools, the growth of the private schooling sector generally increases the heterogeneity of interests in a village community, with village elites, who may have a dominant voice in local governments, having very little direct stake in the quality of public schools. A policy of decentralization which passes control over schools to local governments may, under these circumstances, fail to affect necessary improvements in quality.

Another example comes from the operation of India’s Public Distribution System (PDS), a case studied in Kochar (2003). In June 1997, the Government changed the program to a targeted program, with differential benefits to the poor and the non-poor. Indeed, the subsidy on purchases of foodgrains for non-poor households was removed in April 2000, with the non-poor being charged a price equal to the Government’s economic cost of procuring foodgrains. As in schooling, these policy changes substantially reduced the stake of village elites in the operation of the program. Yet, at the time of changing to a targeted program, the Government made oversight of the program the responsibility of village governments. Not surprisingly, I found that leakages under the targeted program exceeded that under the earlier program which provided universal benefits to both the poor and the non-poor.

In conclusion, I agree with the authors on the need for reform of the public sector. However, rather than focus on means to increase fiscal savings, I feel that a session devoted to social sector policies must focus on the critical issue on how to improve the productivity of social sector expenditures. This topic merits far more research attention than it has currently received. I argue, in this note, that even if productivity increases require additional expenditure (and I expect that they would), reductions in the pay bill may not generate the additional funds required, primarily because these reductions are as difficult to implement as are reductions in subsidies. Additional resources are perhaps possible from the privatization of higher levels of schooling. But, I argue that, in the design of schooling policy and indeed all social sector policies, the government also needs to keep a long-term perspective which evaluates the policy not just in terms of its immediate impact on the outcome of interest, but also in terms of its longer-term effects on the socio-economic fabric of our society.

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