



Forum on

## Inclusive Growth and Poverty Reduction in the New Asia and Pacific

8-9 October 2007 • ADB, Manila, Philippines



Session 2: Challenges to an Inclusive Growth in the Asia and Pacific Region

### **SUPPORTING INCLUSIVE GROWTH: FINANCIAL REQUIREMENTS AND FISCAL SPACE**

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1. Sharp acceleration in economic growth following market oriented economic reforms in middle income countries such as India has captured the attention because it has raised the hopes of improving the wellbeing of the majority of the world's poor. Globalization and expanding trade in the emerging economies have provided opportunities for the millions to participate in the market, increase global trade and improve living conditions. According to the Asian Development Outlook (2007), backed by strong growth performances in China and India, the 43 developing countries in the Asia-Pacific region are estimated to grow at 8.13 per cent in 2007 and 8.2 per cent in 2008. Indeed, besides China and Vietnam, the South Asian countries are expected to show a strong growth performance in 2007 which is likely to continue in 2008 as well. This has raised the hopes of the poor and disadvantaged sections of population and provided them opportunities to increase capabilities to earn freedoms – freedom from deprivation and hunger, freedom to choose their avocations and freedom to meaningfully participate in economic activities.

2. In India, the first three and a half decades of public sector dominated, heavy industry based, import-substituting industrialization strategy generated an annual growth of just 3.5 per cent per year. The economic liberalization in the latter half of 1980s and systematic market oriented reforms since 1991, have taken the economy to a higher growth trajectory. In fact, the real GDP growth during the 10<sup>th</sup> Plan period (2002-07) is estimated at 8 per cent and the 11<sup>th</sup> Plan (2007-12), the last four years has averaged 8.6 per cent. Both manufacturing and service sectors have shown robust growth performances in recent years, though the growth in agricultural sector has averaged less than 2 per cent per year during the 10<sup>th</sup> Plan.

3. However, although high economic growth is necessary, by itself it is not sufficient to improve the wellbeing of the poor. The quality of growth is equally important. Almost 65 per cent of the population lives in the villages, but agricultural sector contributes less than 20 per cent of GDP. The stagnancy in the sector - it grew at just 2.3 per cent during the 10<sup>th</sup> Plan – put even greater pressure on the rural employment situation. The acceleration in growth has been mainly in the service and to a lesser extent in the manufacturing sectors. The states where these sectors have a smaller presence and where agriculture predominates continue to stagnate. Capital formation in the agricultural sector both from private and public sectors, has been virtually stagnant and there has been no growth in productivity. In fact, the overcrowding in the agricultural sector has led to stagnancy in productivity. Thus, even as the economic growth in the country has accelerated following economic reforms, it has not brought much cheer to the poor and particularly so for the socially and economically disadvantaged sections of society.

4. The market oriented reforms since 1991 have resulted in the Indian states with better infrastructure and more developed market institutions to grow faster than others. The large central northern states of Bihar, Madhya Pradesh, Rajasthan and Uttar Pradesh where there is hardly any appreciable presence of manufacturing and service sectors and where the majority depend on the subsistence agriculture, the situation of significant proportion of population is appalling. As the

reforms impacted on the manufacturing and even more, the service sectors, agricultural sector which accommodates a majority of population, lagged behind and stagnancy in the agricultural sector, bypassed the benefits of growth to the majority of population. Even the manufacturing growth acceleration came about through significant upgradation of technology because, as the economy was opened up, the sector had to prepare itself to meet international competition. Furthermore, the manufacturing sector preferred to adopt capital intensive technology due to inhospitable labour laws enacted supposedly to protect the interest of labour. As the expansion of manufacturing and service sectors did not increase the employment opportunities to the desired extent, the surplus labour in the rural areas could not be easily absorbed in productive employment. The lack of skills among the unemployed and underemployed population did not help the matters either.

5. From the above, it would be inappropriate to conclude that there is a policy choice between growth and distribution. It is also inappropriate to focus on distribution at the cost of economic growth. Undue focus on distribution could lead to adoption of policies to reduce the incomes of the rich, which have not succeeded in the past and in any case, will not increase the incomes of the poor. The attempt should be to have continued acceleration in growth while making the poor and disadvantaged sections to participate in the growth process. This requires changing the growth process to make it participatory and imparting education and employable skills to the people to participate productively in the expanding economy in a more meaningful manner and at higher wage rates. The 11<sup>th</sup> Plan with its emphasis on “grass roots planning” and focus on agricultural growth is expected to increase the opportunities for the excluded sections.

6. As argued by Amartya Sen, “....poverty must be seen as the deprivation of basic capabilities rather than merely as lowness of incomes” (Sen, 1999; p.86). Capabilities provide freedom from hunger and poverty. The human development indicators too show that there is a long way to go to reach the Millennium Development Goals (MDGs)

- Almost 250 million people in India live in abject poverty. According to the recent report of the National Commission for Enterprises in the Unorganized Sector, at the end of 2004-05, about 77 per cent of the population was living on less than 0.50 cents a day in exchange rate terms and \$ 2 in PPP terms.
- Almost 92 per cent of the people are in the unorganized sector. The country has about 370 million illiterate people.
- The infant and maternal mortality rates in the country are very high in relation to not only developed countries but also some of the developing countries as well.

7. It is also seen that government’s commitment in improving the education and health status of population has not been impressive. Public spending on education relative to GDP in 2000-02 was just about 3 per cent and spending on basic education was only about 1.5 per cent. This is less than the spending by most sub-Saharan countries in Africa. Similarly public expenditure on healthcare including water supply and sanitation was just about 1.2 per cent of GDP in 2005-06. In fact, the households spend more than four times the public spending from their own budgets on healthcare. In fact, public health service is characterized by poor quality and even this is not adequately accessible to the poorer and disadvantaged sections of population. Surely, significant additional resources will have to be allocated to education and health sectors in the coming years and the delivery systems will have to be reformed to involve the stakeholders. Increased spending and improved service delivery will have to be done

particularly in lagging regions in human development. The National Common Minimum Programme states that education and health expenditures will be increased respectively to 6 per cent and 3 per cent of GDP. The government has taken up significant initiative in universalizing primary education through a special scheme called *Sarva Shiksha Abhiyan*. The "National Rural Health Mission" attempts to expand access to healthcare facilities in rural areas. Despite this, much remains to be done.

8. The major development challenge is to make the growth inclusive. This calls for significant efforts at not merely accelerating the growth rate of GDP but also changing the quality of growth itself. Increase in the growth rate has to come about by not only enhancing the investment rate but also through productivity gains. There has been significant improving in Gross Domestic Capital Formation in India to 33.8 per cent of GDP in 2005-06 and is expected to improve further in 2006-07 mainly due to improvements in capital formation in the government and corporate sectors. The recent trends also show improvements in productivity in the manufacturing sector. However agricultural sector continues to be devilled by low and stagnant productivity and as a majority of population depends on the agricultural sector, benefit of growth has excluded a large proportion of population.

9. A concern in the past has been that the acceleration in the growth has not brought about commensurate improvements in the employment situation although the recent estimates that the employment growth since the beginning of the decade has accelerated. Nevertheless, to make the growth inclusive, significant acceleration in the employment situation is imperative. The 11<sup>th</sup> Plan intends to shift the focus to the agricultural sector, but to what extent this will actually be done remains to be seen. The Common Minimum Programme of the United Progressive Alliance (UPA) government has included a number of measures both to accelerate growth and make it more inclusive. The enactment of National Employment Guarantee Act, increase in outlay on education and health sectors, measures to improve agricultural productivity, strengthening of infrastructure are some of the intended measures. Initiatives have been taken to implement some of the measures such as Employment Guarantee Act, universalization of education, National Rural Health Mission, a program on rural roads and a mission for urban renewal.

10. Creation of employment opportunities requires a variety of policy and institutional changes. The labour laws in the country, while protecting the interest of the organised labour has put a dampener on expansion of employment opportunities. A variety of fiscal and financial incentives to small scale enterprises which are supposedly employment intensive, have prevented the growth of these firms into medium and large enterprises. The Factories Act and various other regulations have only helped to perpetuate the problem. More importantly, India can secure demographic dividend and accelerate its growth due to the large proportion of working population if only they can be made employable. Skill development and vocational education for the rural youth can extricate them from the curse of unemployment and poverty and release overcrowding in agriculture. In this initiative, special attention must be given to specially and economically disadvantaged sections of society.

11. Major risk to acceleration in economic growth comes from the poor state of infrastructure. Easing the constraint would require massive investments in the power sector, railways, roads, ports, airports, irrigation and urban development. The attempt to contain fiscal deficits in the wake of sharp increase in wages and salaries following the implementation of Sixth Pay Commission recommendation in 1997-98 and decline in tax revenue relative to GDP by almost two percentage points has sharply reduced

capital expenditures during the decade of 1990s. Sharp compression of capital expenditures at both Central and State government levels has led to significant infrastructure deficit which has posed a binding constraint on economic growth. It is therefore, necessary to significantly enhance outlay on infrastructure sectors and create an enabling environment for the private participation in allocating resources to augment infrastructure. At the same time, significant increase in spending will have to be made in education, healthcare, anti-poverty programs, housing, water supply and sanitation and rural roads. Although since 2001-02, the revenue productivity of the tax system has shown significant improvements and the tax-GDP ratio in the country has increased by four percentage points, equal amount of the increase has gone into reducing fiscal deficits as required by the Fiscal Responsibility Act and to finance increased expenditures for the programmes under the Common Minimum Program with very little additional resources to finance infrastructure.

12. The problem of finding adequate fiscal space to finance infrastructure facilities is common to most middle and low income countries. These countries are typically confronted with large fiscal deficits. Fiscal restructuring programs undertaken by different countries, some even with legislated restructuring programs, have envisaged significant compression of expenditures. In many countries, given the sociology of fiscal politics, attempt to bring down the deficits by compressing expenditure has invariably resulted in reducing allocations to productive sectors such as education and healthcare or physical infrastructures. Pressures to spend large amounts on politically populist schemes and directly visible employment generation programs have crowded out spending on infrastructure projects. The reform to bring down the tariffs and inability to substitute the revenue loss through domestic trade taxes has added to their fiscal pressures. The continued increase in oil prices and inability to increase the consumer prices has added to the subsidy bill significantly. Under these circumstances, private sector participation in the provision of infrastructure becomes imperative and an appropriate framework for the participation is necessary. While the private sector should be involved in financing infrastructure, many of the countries still do not have a workable model and political and administrative preparedness for private public partnerships to be put in place.

13. Significant augmentation of infrastructure financing is necessary to maintain the high growth rates. Similarly significant increase in spending on education including skill development and healthcare is imperative to increase capabilities of the poor and disadvantaged sections to make the growth inclusive. Even as the private sector participation is necessary to maintain high growth rates of emerging economies, governments will have to create fiscal space to finance services with a very high degree of externalities and to provide viability gap funding for major infrastructure projects. The experience of countries like India shows that it is possible to increase revenue productivity of the tax system and create additional fiscal space by improving the tax administration particularly, by inducting technology and building the information system. Since 2002-03, the tax administration reform in income tax has caused the revenues to increase relative to GDP by 3.5 percentage points during the last 5 years. Indeed, in developing countries, tax reform should focus on broadening the base, reducing rates, minimising rate differences to design a simple tax system is important. But the most important reform in developing countries is in tax administration and as stated by Milka Casanegra "...tax administration is tax policy".

15. Even creation of additional fiscal space can not solve the problem of providing large amount of funds required to finance infrastructure. Infrastructure finance for power, railways, ports, airports, roads, irrigation, water supply and urban renewal is large and

has to be financed through private finance. Given the competing claims on the budget, fiscal support to these activities will be confined to meeting the viability gap funding. Even the private domestic financing of infrastructure will reduce the resources available for investments. Financing the infrastructure through external commercial borrowing is possible but that would add to the cost of borrowing. Thus, the emerging developing countries will have to depend increasingly on multilateral lending for financing their infrastructures. The coming years will see the emerging middle income countries seeking significant foreign development loans from multilateral development institutions to financing their infrastructure and other priority sectors.

16. There is a real danger that the poor and disadvantaged sections of society in the emerging economies are left behind and this could add to serious disharmony in development and in the society itself. Immediate measures have to be taken to make the growth participatory and this requires significant initiatives to build capabilities in the excluded sections of society. Given the constraints on raising additional resources and competing demands on budgetary resources, external financing to support these initiatives is imperative. Thus, the emerging middle income countries will have to seek the support of multilateral development institutions like the Asian Development Bank in their quest to improve capabilities and freedoms of the people in their countries. Easing the constraints on fiscal space for making additional allocation to build capabilities of the poor and disadvantaged sections in emerging economies is possible only when the institutions like the Asian Development Bank play a proactive role in supporting and assisting important development initiatives.