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FISCAL POLICY FOR INCLUSIVE GROWTH: AN OVERVIEW

Gemma Estrada, Sang-Hyop Lee, and Donghyun Park

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Fiscal Policy for Inclusive Growth: An Overview

Gemma Estrada, Sang-Hyop Lee,
and Donghyun Park

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ABSTRACT

In recent years, inequality has risen in the region alongside rapid economic growth. The widening income gap strengthens the case for a government response, and fiscal policy is one of the most suitable policy instruments to promote a more equitable society that provides opportunities for all. Developing Asia has trailed other parts of the world in equity-promoting fiscal expenditures, namely education, health care, and social protection, and thus the region needs to do more. Expanding public expenditures without boosting fiscal resources can, however, jeopardize fiscal sustainability. The key challenge is how to use fiscal policy to make growth more inclusive while maintaining fiscal sustainability.

Keywords: fiscal policy, inclusive growth, Asia, economic growth, equity

JEL Classification: D31, H20, H50

I. INTRODUCTION

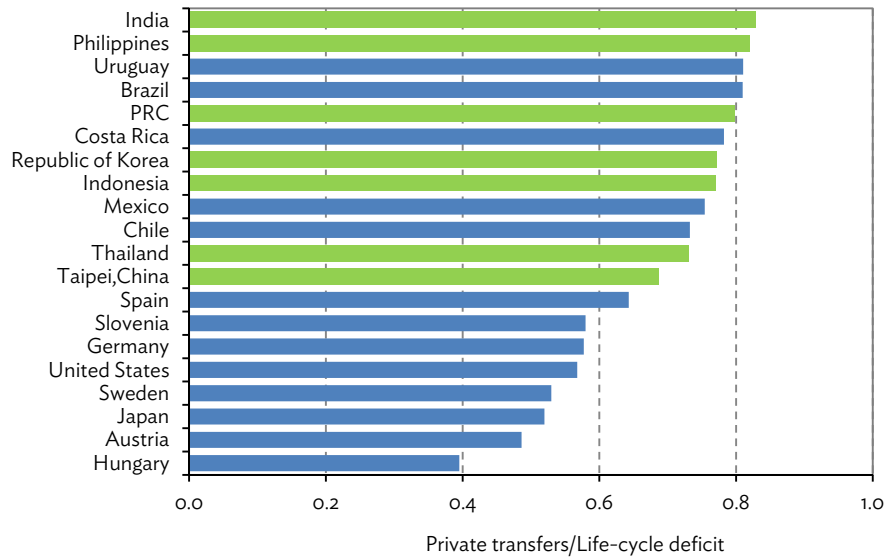
Achieving more inclusive growth is one of the most significant long-term strategic challenges facing developing Asia. Sustained rapid growth during the past few decades has sharply lifted general living standards across Asia and has enabled hundreds of millions of Asians to lead more dignified, humane lives. Asia's record of economic growth and poverty reduction in recent years has been remarkable by any measure. According to the *Asian Development Outlook (ADO) 2012* of the Asian Development Bank (ADB), Asia's annual gross domestic product (GDP) growth rate averaged 7% in purchasing power parity terms from 1990 to 2010. Rapid growth helped reduce poverty—the proportion of Asians living on or below the \$1.25-a-day poverty line—from 52% in 1990 to 21% in 2010.

Notwithstanding such marked progress on poverty reduction, Asia still has a long way to go in achieving fully inclusive growth that benefits the entire population. In particular, the region has seen inequality worsen in recent years, largely in response to the same forces that have caused greater inequality elsewhere. These forces include globalization, technological progress, and market-oriented reform. According to *ADO 2012*, from the early 1990s to the late 2000s, the Gini coefficient, a widely used measure of inequality in per capita expenditure or income, rose in 11 out of 25 Asian economies with comparable data. The 11 include the People's Republic of China (PRC), India, and Indonesia and account for around 82% of Asia's population. If inequality had remained constant, the same level of growth would have lifted an additional 240 million people or 6.5% of their total populations out of poverty.

Asia's widening income gaps strengthen the case for a government response. Governments can, in principle, play a more activist role in bringing about a fairer society that provides opportunities for all and distributes the fruits of growth more widely. Fiscal policy is one of the most suitable policy instruments for direct government intervention to tackle inequality and poverty. In fact, there is now a great deal of interest in leveraging fiscal policy for promoting inclusive growth in Asia; however, in contrast to the advanced economies that have long histories of using fiscal policy for redistribution, as detailed in Heshmati, Kim, and Park (2014), Asia has only limited experience in this area. To some extent, this is due to the huge gap in income levels between the two groups and hence, the difference in the relative importance of growth versus redistribution. When it comes to using fiscal policy for inclusive goals, Asia also visibly trails Latin America, which is comparable in income level.

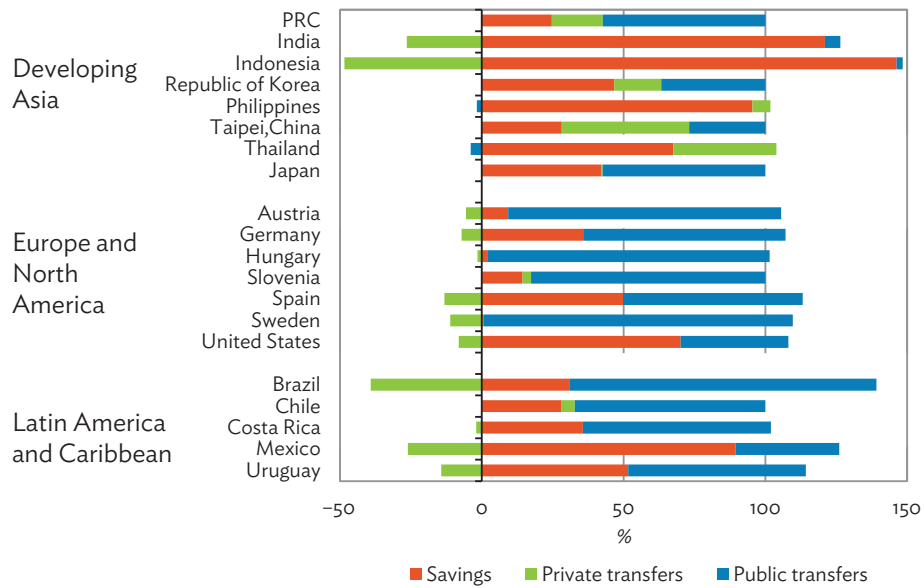
Further strengthening the case for leveraging fiscal policy for inclusive growth in Asia, public transfers from governments to children and the elderly tend to lag private transfers from families (Lee and Mason 2012). During the economic life cycle, individuals consume more than they produce when they are young and old, and do the opposite when they are of working age. A combination of public and private transfers finances the gap between consumption and production in childhood and old age. The relative role of private versus public transfers in financing the consumption-income deficit for children and the elderly differs markedly across Asia, Europe, and Latin America (Figure 1). For children, public transfers play a bigger role in Europe than in Asia and Latin America where private transfers are more important, i.e., the family bears a higher share of the cost of raising children in Asia and Latin America. The percentage of total material needs of children covered by the family stands at 70% in Taipei, China; 82% in the Philippines; and 83% in India. For the elderly, public transfers are noticeably smaller in Asia than in Europe or Latin America implying the smaller role of the government in supporting the elderly (Figure 2).

Figure 1: Private Transfers as a Proportion of the Life-Cycle Deficit for Ages 0–19 in Selected Asian and Non-Asian Economies



PRC = People's Republic of China.
Source: Lee and Mason 2012.

Figure 2: Support System for People Aged 65 and Older in Selected Asian and Non-Asian Economies



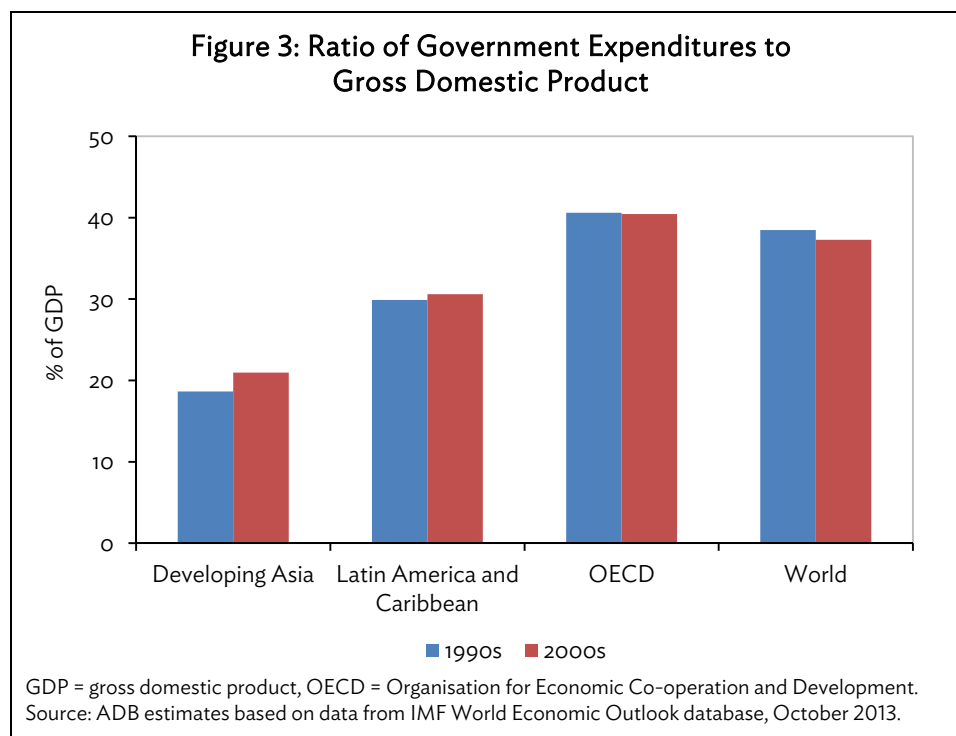
PRC = People's Republic of China.
Source: ADB 2011.

If Asia is to use fiscal policy more actively for inclusive growth, it must do so without compromising two key strategic priorities: economic growth and fiscal sustainability. For all its success, Asia still desperately needs sustained, rapid growth to raise income levels, which remain far below those of advanced economies. In addition, the region remains home to close to two-thirds of the world's poor, and further progress on the poverty front requires sustained growth. Therefore, burdensome taxation that unduly blunts the incentives of firms and workers to engage in productive activities will ultimately hinder inclusive growth. A long tradition of fiscal prudence has given Asia macroeconomic stability as well as adequate fiscal space—a highly valuable resource for fending off severe, negative shocks like the global financial crisis and for addressing medium-term fiscal demands like population aging. Expanding the role of fiscal policy in fighting poverty and inequality should not come at the expense of fiscal sustainability.

Historically, Asian countries used fiscal policy to facilitate economic growth by providing basic infrastructure while safeguarding macroeconomic stability. A tradition of fiscal prudence combined with public investments in growth-promoting physical and human capital played an instrumental role in Asia's past success. While some public spending, such as that on public education, contributes to higher growth and lower inequality, Asian governments were concerned first and foremost with growth. This priority was perfectly understandable in light of Asia's low income levels in the past; however, more recently, new fiscal demands have emerged. Counter-cyclical fiscal stimulus made possible by adequate fiscal space proved invaluable in fending off recession during the global crisis of 2008–2009 (ADB 2010). Going forward, a key fiscal challenge is that of leveraging fiscal policy for more inclusive growth.

II. PUBLIC SPENDING FOR INCLUSIVE GROWTH

Government expenditures in developing Asia are small by international standards. They are substantially less when compared with those in advanced countries or even in Latin America, a region comparable to developing Asia in terms of income and level of development (Figure 3). To some extent, this reflects the region's strong adherence to fiscal prudence which means that the norm among Asian governments has been to avoid spending greatly beyond their fiscal resources. Roy (forthcoming) explores trends among individual Asian economies.



The role of fiscal policy in the region has been to foster economic growth, whereas other parts of the world have more broadly pursued growth-promoting equity. Thus, developing Asia has lagged the Organisation for Economic Co-operation and Development (OECD) and Latin America in three equity-promoting fiscal expenditures: education, health care, and social protection. Public spending on education averages 5.3% of GDP in the advanced economies and 5.5% in Latin America but only 2.9% in Asia (Figure 4). The gap is more pronounced for public spending on health care which stands at only 2.4% of GDP in developing Asia compared with 8.1% in advanced economies and 3.9% in Latin America. On social protection, developing Asia spends about 6.2% of GDP, only half of Latin America's 12%, and less than a third of the 20% in advanced economies. Clearly, Asian governments need to do more to foster inclusive growth by steering fiscal policy toward promoting greater equity.

While fiscal policy can reduce inequality from either the spending or the revenue side, evidence suggests that the impact from public spending is significantly greater (Bastagli, Coady, and Gupta 2012 and Claus, Martinez-Vazquez, and Vulovic 2014). According to Bastagli, Coady, and Gupta (2012), expenditures, especially transfers without means tests, contributed more to income redistribution than did taxes. Significantly, Claus et al. confirmed that the two main lessons from the broader literature for developing Asia are that fiscal expenditures, not taxation, offer the most effective means of reducing inequality and that the public spending best able to reduce inequality is on education and health care. Their analysis of data from 150 economies from 1970 to 2009 shows that despite tax systems tending to be progressive, government expenditures were more effective at redistributing income. Government expenditures on health care and education have been found to reduce income inequality in Asia and the rest of the world as Table 1 shows.

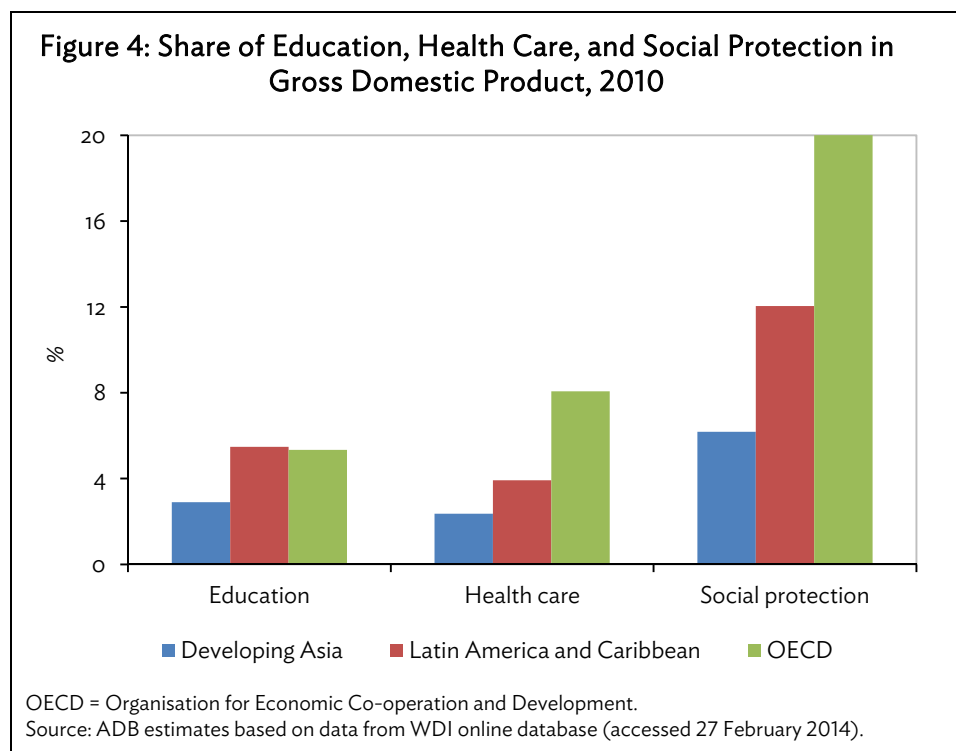


Table 1: Estimated Marginal Impact of Government Spending on Income Inequality (Percentage points)

Spending Type	Asia	Rest of the World
Social protection	0.490	-0.276
Education	-0.486	-0.034
Health	-0.241	-0.330
Housing	2.162	-0.614

Note: Minus sign indicates improved equality.
Source: Claus et al. 2014.

How public spending is utilized and distributed across populations will have deep implications for inclusive growth. In particular, prioritizing programs that benefit the poor, such as education and health care, can help foster inclusiveness. Certain types of spending tend to be more equity-promoting than others. Another crucial issue is the need for better targeting to ensure that benefits from public spending intended to promote equity are captured largely by the poor.

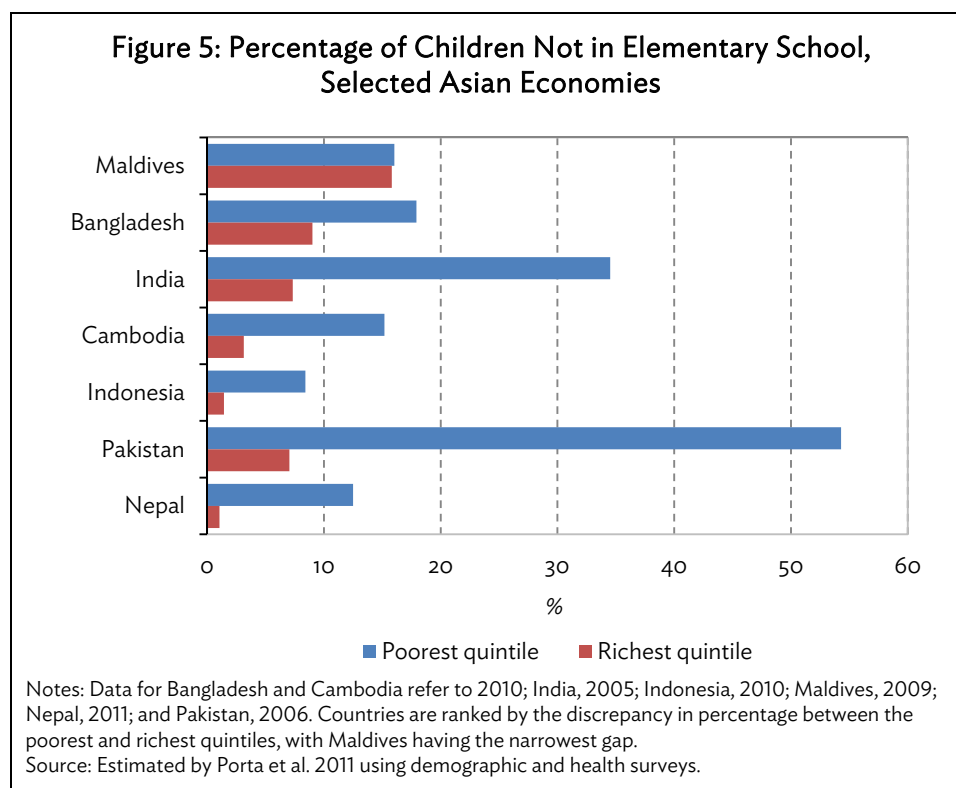
A. Pro-poor Public Spending

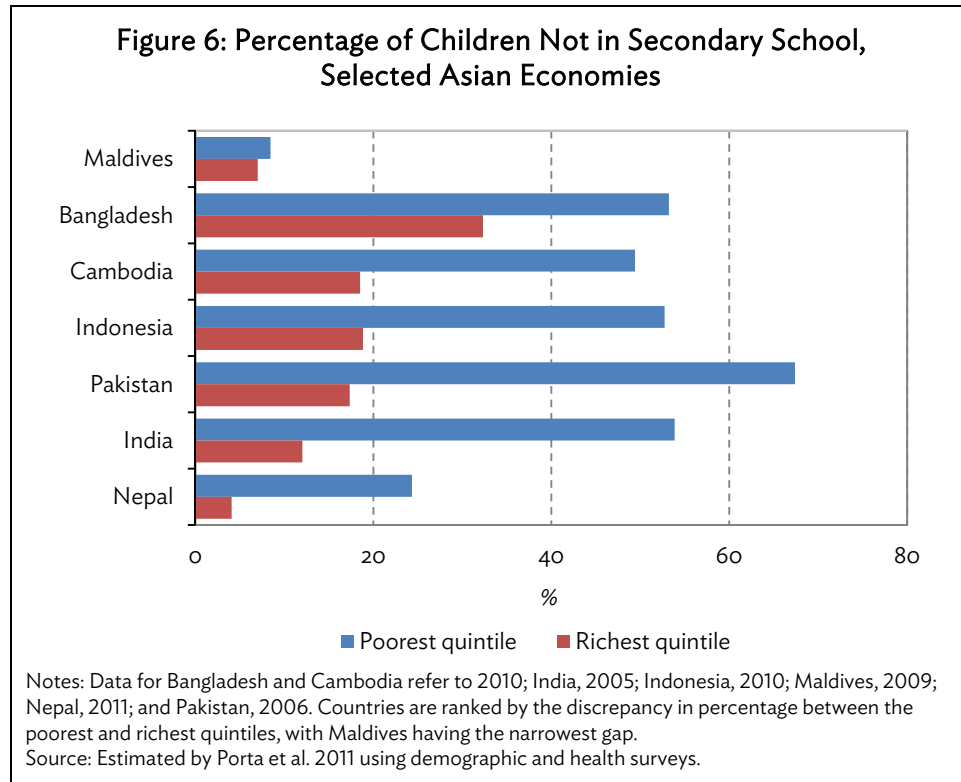
Increasing access to education and health care is important for enhancing human capital, the main asset of the poor. With little or no government support, only those with sufficient incomes can pay for schooling costs or avail of health-care services. Governments, therefore, have a critical role in expanding opportunities for the poor and in enabling them to live more productive, decent lives through spending on education and health care. Public spending on physical infrastructure can also significantly benefit the poor. Better infrastructure improves access to markets, reduces transaction

costs, and stimulates economic activity. Direct transfers are another type of spending that has significant potential to promote equity; however, direct transfers require well-designed targeting mechanisms to largely benefit the poor.

1. Public Spending on Education

Public spending on education can help narrow the gap in access to schooling between the poor and the nonpoor. In several developing Asian economies, differences in access to schooling between the poor and nonpoor are quite evident, especially in South Asia (Porta et al. 2011). Figures 5 and 6 demonstrate the wide gaps in access to primary and secondary schooling between the poorest and richest groups. For example, in Pakistan in 2006, over half of the children of primary school age among the poorest families were out of school compared to just 7% among the richest families. In India in 2005, 35% were out of school in the poorest income group compared to 7% in the richest income group. Similarly, there were wide gaps in secondary schooling between the two groups. Indeed, this points to the need for government support to expand coverage among the poor.

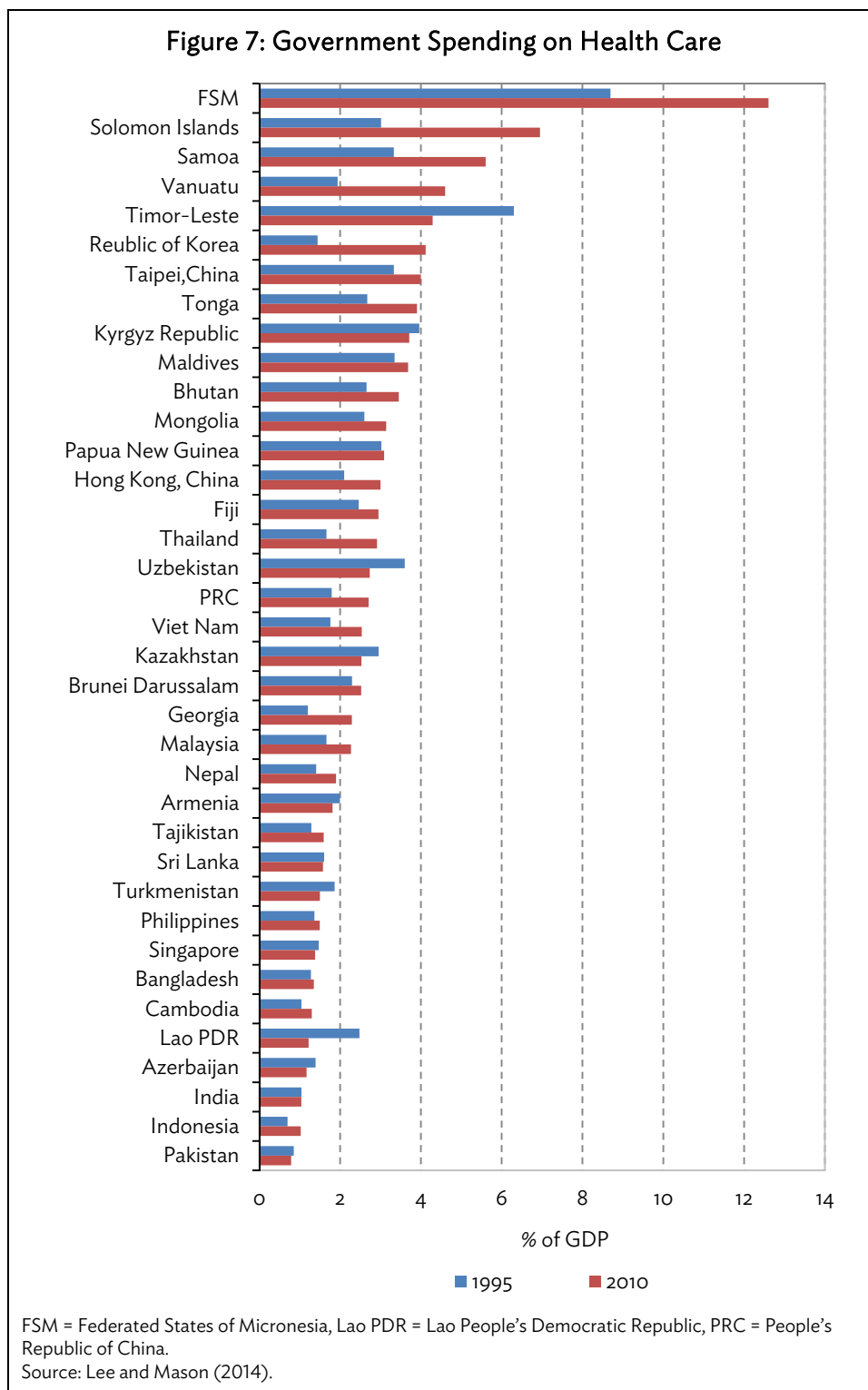




While increasing public financing for education may help raise access of the poor to education, there are demand-side factors that may limit it. These include perceptions of parents on the benefits of schooling, household income, and private costs to households of sending children to school. As children grow older, they are potentially more productive in the household or as child labor, and hence, the opportunity cost of attending school increases. This is a main reason for falling enrollments in higher grades, particularly among the poor. Both the monetary and opportunity costs of sending children to school are higher relative to household income in poor households which accounts for much of the difference in the enrollment rates between the poor and nonpoor. Thus, it is also important to consider complementary government policies that raise returns on schooling to help improve the access of the poor to education (Roberts 2003).

Rising government investment in education has been a region-wide trend across developing Asia (Figure 7). This mirrors the general trend among developing countries to embark on huge education reforms to expand the supply of education, to achieve equity in access, and to significantly improve the quality of education (Tiongson 2005). While rising public spending for education bodes well for improving access to schooling, the type of intervention matters. If public spending for education is to indeed help in reducing inequality and poverty, then the poor should benefit more from it than other income groups.

Benefit incidence analysis has been used to examine whether public expenditure programs have been pro-poor or not. Studies of this type often report the average odds and marginal odds ratios of participation. The average odds for a particular quintile or income group can be defined as the ratio of that quintile's participation rate to the overall participation rate. The marginal odds of participation can be considered as the change in that quintile's participation rate associated with a change in the overall participation rate.



Studies applying benefit incidence analysis show that public spending for primary education tends to be pro-poor, particularly when the marginal odds ratio of participation is considered. Using survey data for rural India in fiscal year 1993–1994, Lanjouw and Ravallion (1999) found that since

average enrollment rates tend to be lowest for the poorest quintile, then the average odds of enrollment indicate that subsidies to primary schooling would tend to favor the nonpoor; however, the marginal odds of participation indicate that expanding primary schooling would be pro-poor. When considering the average odds of participation, the share of the total subsidy going to the poorest quintile is only 14%, but the results from the marginal odds of participation imply that the poorest quintile will obtain about a 22% increase in the total subsidy going to primary education. This suggests that marginal gains from expanding primary schooling in rural India appear to benefit the poor and hence, contribute to lower inequality.

Benefit incidence also shows that public spending for primary schooling is more pro-poor than that for secondary schooling. For example, Lanjouw et al. (2002) found that for Indonesia, public spending on primary education tended to be pro-poor. While gross enrollment rates among the poorest quintiles were not substantially higher than the average, the large number of children in these quintiles led to a higher per capita transfer share in the bottom two quintiles compared with the other three. With regard to secondary schooling, the beneficiaries tended to be the upper-income quintiles; however, after introducing economies of scale in consumption, public spending for primary education became less pro-poor, while spending for secondary schooling became more regressive. Estimates from the marginal incidence of program spending showed that primary education spending was pro-poor, but the evidence was weaker for secondary schooling. The poor would thus benefit a great deal from expanding public spending for primary education in the same way that they would be seriously hurt from reducing it.

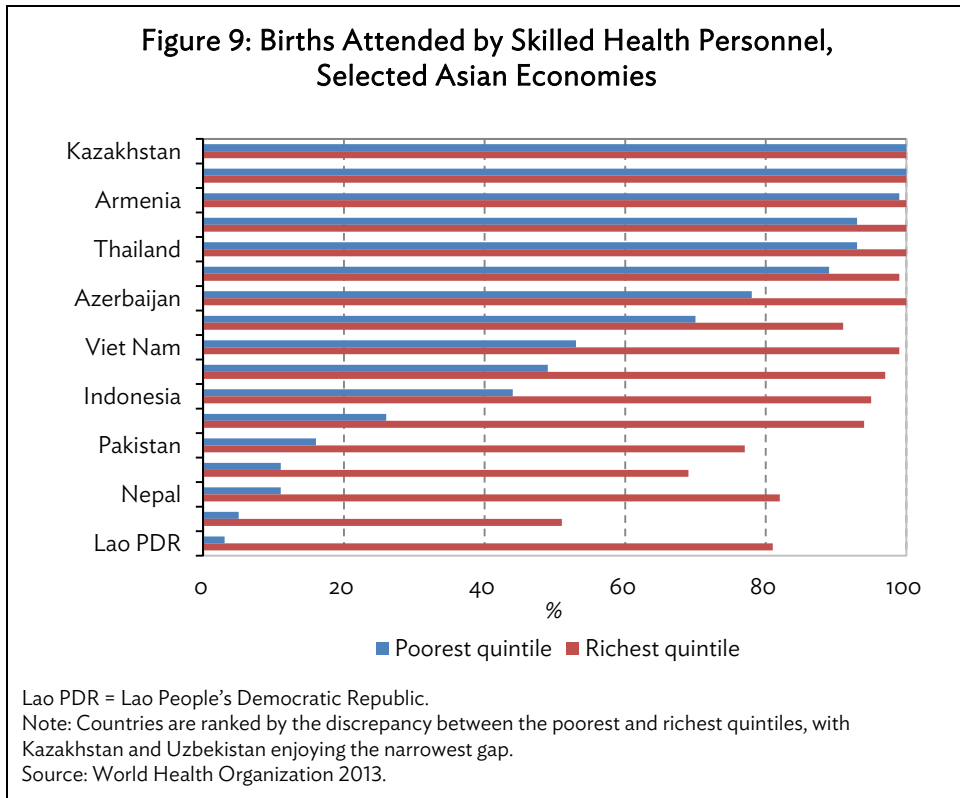
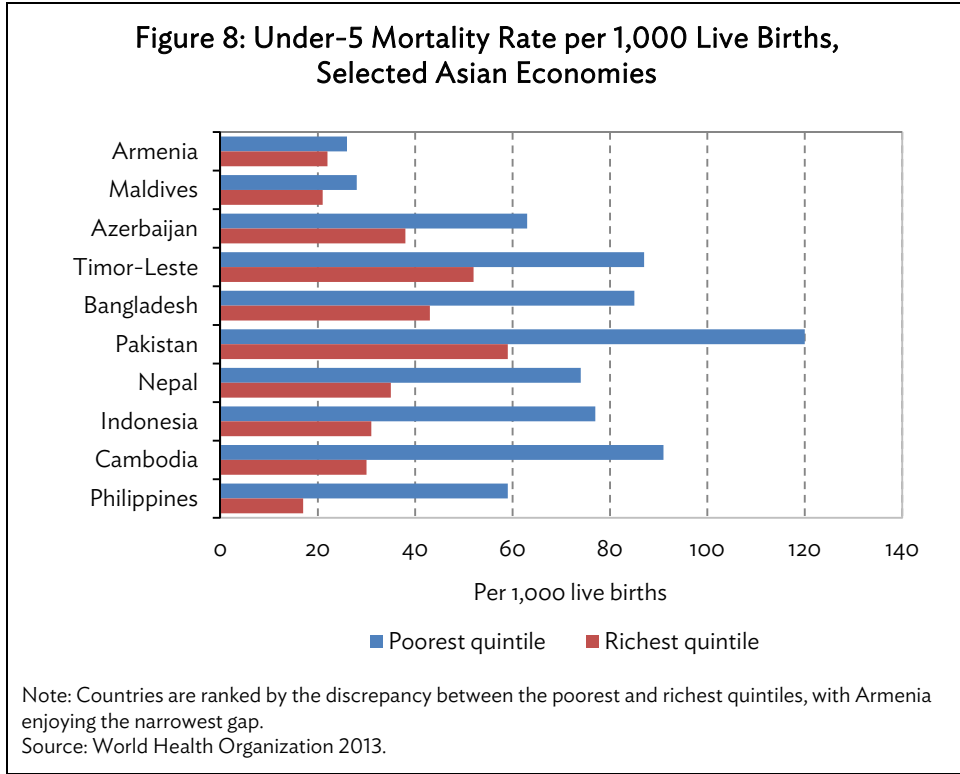
Warr, Menon, and Rasphone (2013) found similar results for the Lao People's Democratic Republic (Lao PDR). In the case of primary education, the average odds indicated that richer households enjoyed a larger share of the total benefits than poorer households, but the marginal odds indicated that the poor benefitted more. For lower secondary school participation, the odds of participation showed a much higher participation rate for richer households, similar to primary schooling. In contrast to primary schooling, however, the marginal odds for secondary schooling did not show the lowest income groups benefitting more; instead, it was the middle-income quintile that was expected to gain more from expanding secondary schooling.

2. Public Spending on Health Care

Studies have shown that the poor are significantly less healthy than the rich, and that they are more likely than the rich to avail of public health-care facilities (Gupta, Verhoeven, and Tiongson 2001 and World Bank 2004). This pattern is particularly evident in developing Asia. In Cambodia, Indonesia, Nepal, and the Philippines, the infant mortality rates of the poorest 20% of the population are more than twice those for infants in the wealthiest 20% (Figure 8). Lack of access to health services also tends to fall disproportionately on the poor in the region. While more than 60% of those in the highest income groups in Lao PDR, Nepal, Pakistan, and Timor-Leste have births attended by skilled health personnel, the corresponding shares of those in the lowest quintile are just under 20% (Figure 9).

Health deficiencies can make the poor more vulnerable, generating a vicious cycle of poor health and poor incomes. Spending for critical illness can push poor households into deeper poverty or move the nonpoor, especially those living at the margins, into poverty. For example, in 1998, health expenses were estimated to have pushed about 3 million people in Viet Nam into poverty. Seldom are the poor enrolled in voluntary insurance schemes or compulsory public programs that provide protection against health expenditure shocks (World Bank 2004). As Bidani and Ravallion (1997) have

highlighted, public spending on health care tends to matter more to the poor. Improved health can enable them to be more productive in school and later in their working lives.



Empirical evidence shows that public spending can substantially improve the health outcomes of the poor and can narrow the gap in health outcomes between the poor and the nonpoor. Examining the impact on the poor with respect to the nonpoor, Gupta, Verhoeven, and Tiongson (2001) found that public spending on health had a greater impact on the poor as a 1% increase reduced their child mortality by twice as many deaths compared with the nonpoor. The relationship between public health spending and the health status of the poor also tends to be stronger in low-income countries; the impact is more apparent when measured in absolute terms, considering the higher levels of child mortality. Indeed, if implemented well, increased public spending for health can be quite beneficial for the poor.

Benefit incidence analysis has been widely used to determine how the benefits of public health spending are distributed across populations. There are studies, such as those by Chakraborty, Singh, and Jacob (2013) for India; and Kruse, Pradhan, and Sparrow (2012) for Indonesia, that examine the distribution of benefits from public health spending, by income groups in general, or from health-care financing reforms. Examining both inpatient and outpatient health services, Chakraborty, Singh, and Jacob (2013) found that India's public health expenditure tends to be inequitable. The poorest quintile captured around 9% of the total net public expenditure in the health sector, while the richest group got around 40%. On the other hand, for Indonesia, Kruse, Pradhan, and Sparrow (2012) found that the health system tends to be pro-poor as increased local public health spending led to net transfers from the richest to the poorest quarter of the population, which increased public health-care utilization by the poor and average health benefits. Given initial utilization shares, however, the bulk of the benefits were still captured by the middle-income groups; thus, it was recommended that increased public health spending be complemented by more directly targeted demand-side interventions for the poor, such as price subsidies or social health insurance.

Other studies such as those by Lanjouw et al. (2002) and Warr, Menon, and Rasphone (2013) compared the distribution of benefits among the types of public health-care interventions. The study by Lanjouw et al. (2002) examined the distribution of benefits between primary health care and hospital services using survey data in Indonesia. In terms of utilization, primary health care was found to be fairly evenly distributed; however, utilization of public hospitals tended to be pro-rich, since the richest quintile was three times more likely to visit a public hospital than the poorest quintile. Estimates from benefit incidence analysis indicated that public spending on health care was indeed pro-poor, while benefits from public hospitals were less frequently captured by the poor. In public health hospitals, per capita transfers going to the richest quintile were about four times greater than those received by the poorest quintile. Even after allowing for economies of scale, public spending for primary health care remained pro-poor, while public transfers for hospital care remained regressive. Marginal benefit incidence analysis indicated that changes in government spending on primary health care would benefit the poor substantially. Warr, Menon, and Rasphone (2013) found similar results for the Lao PDR. Primary health care tended to benefit the lower income quintiles more, but not public hospitals, as benefits from using either outpatient or inpatient public hospitals were captured largely by higher income households.

Applying benefit incidence for the PRC, in Shen and Lee (2014) found that in 2009, benefits from publicly funded health care tended to be fairly equally distributed across income groups until age 60. For those aged 60 and older, public health spending per capita was highly skewed in favor of the top quartile. This inequity at old age reflects the lack of health insurance among the poor as well as low incomes, since the use of health care tends to rise with income. The distance from health centers of

many of the elderly poor also partly explains their limited access. This suggests that in the absence of programs that carefully target the poor, or in this case the elderly poor, inequality may increase.

3. Public Spending on Physical Infrastructure

Developing countries tend to allocate limited fiscal resources to develop the infrastructure that supports economic activities and growth. This is apparent in spending on public gross fixed capital formation which can be viewed as a rough proxy for physical infrastructure: communications, electricity, sanitation, transportation, and water. Since 2000, the average ratio of public gross fixed capital formation to GDP in Asia was 7.7%, which was much higher than the 4.3% average for OECD members (see Hur 2014). Thus, while the region is lagging in terms of public spending for education and health care, it tends to perform better in terms of spending for physical infrastructure.

There are several reasons for the positive growth effect of good infrastructure. A good road network or reliable electricity supply raises productivity across industries and firms, and hence, the economy as a whole. In addition, Winters (forthcoming) points out that there are large potential gains from trade, both within the economy and across borders. The empirical literature broadly supports the view that infrastructure investment boosts growth, especially in developing countries with low infrastructure stocks (e.g., Easterly and Rebelo 1993, and Arslanalp et al. 2010). On the other hand, the relationship between infrastructure and inequality is conceptually more ambiguous. Using data from 1960 to 2005 for over 100 economies, Calderon and Serven (2010) found that both the quantity and quality of roads, telephones, and electricity had a significant beneficial effect on both growth and inequality. For inequality, an additional finding was a highly significant relationship between inequality and the access of the poor to infrastructure.

Hur (2014) explores the link between public spending and inequality by constructing a model that accounts for the links between fiscal spending, income inequality, and economic growth. The analysis does not find a significant link between public gross fixed capital formation and changes in the Gini coefficient, but it does find a strong growth impact. As shown by Kraay (2006), growth is the single key determinant in overcoming poverty.

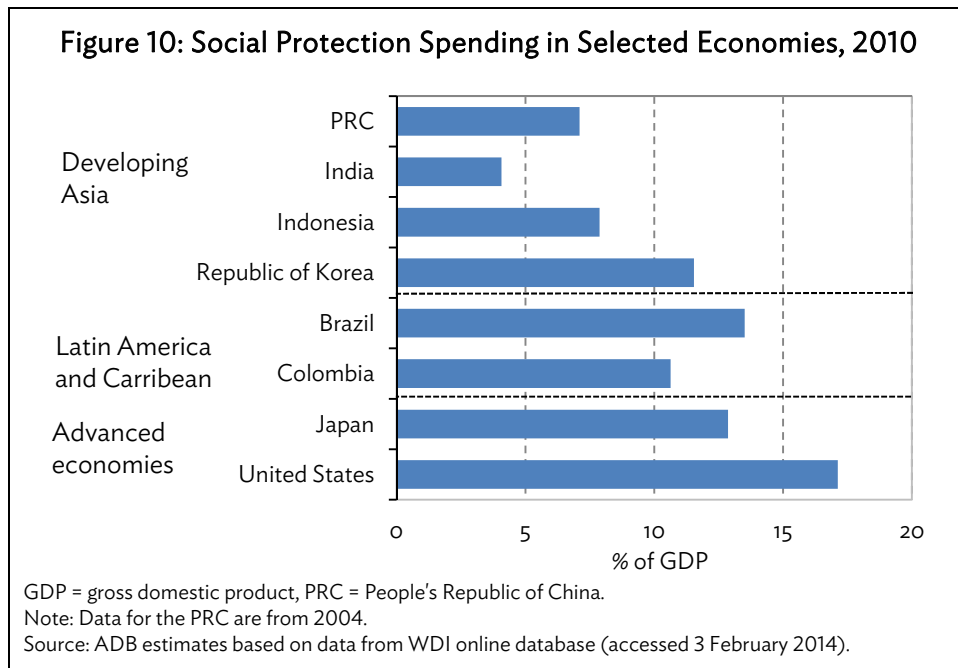
Winters (forthcoming) provides some possible explanations for the failure to find a positive, direct effect from physical infrastructure on inequality. In particular, he points out that infrastructure can exacerbate inequality, in part because of its unfair allocation, but also because the well-off are better positioned to take advantage of the economic opportunities it creates. Similarly, Estache and Fay (2007) showed that access to infrastructure was highly skewed against the poorest. This reflects lack of physical access as well as limited affordability. Therefore, maximizing the inclusive impact of infrastructure requires extending access to the poor and making it affordable for them.

4. Government Direct Transfers

Developing Asia provides fewer direct transfers compared with other parts of the world (Figure 10). According to Bastagli, Coady, and Gupta (2012), direct transfer programs are difficult to establish in Asia because of the presence of large informal economies. Expenditure on social assistance programs for the poor was low and poorly targeted. Heavy spending on regressive general price subsidies, such as fuel subsidies, restricts the space for equity-promoting social transfers. Access to social insurance programs, such as pensions, is often limited to high-income workers in the urban formal sector and public sector. In many developing countries, in-kind public spending on key services, such as

education, is regressive in the aggregate, although it may be progressive for individual components, such as primary education (Davoodi, Tiongson, and Asawnuchit 2010; and Lustig et al. 2011).

In recent years, conditional cash transfers (CCTs) have emerged as a promising option for magnifying the equity impact of public spending in developing countries, especially in Latin America. In essence, such programs provide monetary transfers to low-income households in exchange for their investing in the education and health of family members. In developing Asia, there are CCT programs in Bangladesh, Cambodia, India, Indonesia, Nepal, and the Philippines. Through the *Pantawid Pamilya* CCT program in the Philippines, for example, poor households with children receive education and health grants in exchange for education and health investments.



Lee and Park (2014) find limited and mixed evidence on the effectiveness of CCT programs in Asia. For example, the program has been found to be more successful in Cambodia than in Bangladesh because of the better targeting scheme in Cambodia. As the paper highlights, there is no guarantee that programs that work well in Latin America will also work well in Asia. On one hand, many developing Asian governments lack the complex administrative structure to monitor large-scale programs. On the other, local communities in the region are more organized compared with Latin America, suggesting that the programs could fare better in Asia.

Further, strengthening the impact of public spending on inequality will require careful targeting. As discussed in the next section, the case for improved targeting is crucial in light of the experience in implementing government subsidies.

B. Need for Better Targeting: The Case of Energy Subsidies

In general, government subsidies aim to provide consumers, especially low-income groups, access to essential goods at more affordable and stable prices. Despite these sound intentions, rather than promoting equity, a large part of the subsidies have been found to benefit the well-off, as is the case with energy price subsidies.

Studies have shown that energy subsidies primarily benefit upper-income groups. There is a tendency for fuel consumption to rise substantially with income, so general subsidies will largely benefit non-poor households (Hope and Singh 1995). In low-income and middle-income economies, on average, the richest 20% of households capture 6 times more in total fuel product subsidies than the poorest 20%. The distributional effects of subsidies vary markedly by product, with gasoline being the most regressive (i.e., subsidy benefits increase as incomes rise) and kerosene the most progressive (IMF 2013). In Indonesia, more than 90% of fuel subsidies benefit half of the richest households. In India, the richest 10% of households receive seven times more in benefits than the poorest 10% (Agustina et al. 2008 and Anand et al. 2013).

Energy subsidies entail significant fiscal costs. In 2008, subsidies on coal, refined petroleum products, natural gas, and electricity consumption were equivalent to about 3%–8% of GDP in India, Indonesia, Malaysia, Pakistan, Thailand, and Viet Nam (Burniaux and Chateau 2011). Subsidies have remained substantial despite past efforts to implement energy price reforms.

In theory, removing subsidies is expected to generate economic gains arising from an increase in consumer welfare and from a more efficient reallocation of resources. Burniaux and Chateau (2011) analyzed the impacts of gradually removing oil subsidies globally from 2013 to 2020, based on data from 37 economies that comprise about 95% of global subsidized fossil fuel consumption. The unilateral removal of fossil fuel subsidies would result in welfare gains to most economies or regions ranging from 0.3% to more than 4% in 2050, relative to the baseline of 2008. In a multilateral removal of subsidies, India would benefit from welfare increases by 3% and the PRC by more than 0.5%, relative to the baseline, but other countries such as oil-exporters would no longer obtain welfare gains, as efficiency gains from improved resource allocation would be more than offset by the terms-of-trade losses associated with a sharp cut in world energy prices and demand.

In recent years, escalating international energy prices have put more pressure on governments to phase out energy subsidies. In India, domestic retail prices of petrol were liberalized in 2010, but diesel retail prices continue to be regulated by the government. Subsidies for kerosene and liquefied petroleum gas have often been much greater than for petrol and gasoline. Anand et al. (2013) found that eliminating subsidies in the country would have a substantial negative impact on real incomes of households, ranging from about 4% for the lowest income groups to 5% for higher income groups, but since lower income groups receive a very small share of total fuel subsidies, it should be possible to generate net fiscal savings from subsidizing them. Since the cost of fully compensating the poorest 40% of households was less than 0.2% of GDP, and the gross fiscal savings from a subsidy reform would be 1.9% of GDP, net fiscal gains from a targeted subsidy scheme would equal 1.7% of GDP. This suggests that huge fiscal gains can be reaped from implementing a well-targeted social safety net mechanism.

In Indonesia, estimates by Agustina et al. (2008) indicated that reducing the amount of fuel subsidies in the country by 25% could generate savings of about 0.2% of GDP and lessen the fiscal sector's vulnerability to movements in international energy prices. There was a risk, however, that removing subsidies without any compensation would lead to greater poverty, as fuel spending accounted for about 5% of total spending of the poorest households (Mourougane 2010). In general, the high direct and indirect welfare losses from the removal of subsidies imply that it will be politically challenging to implement such reforms (Table 2); hence, it may be important to introduce compensating measures to support the income of the poorest households once subsidies are removed.

Table 2: Direct and Indirect Welfare Losses from Fuel Price Increases
(% of household consumption)

Region/Country	Direct Impact	Indirect Impact
Africa	2.0	3.8
South and Central America	1.4	2.4
South and Southeast Asia	3.9	2.1
Bangladesh	1.7	1.5
Sri Lanka	2.7	2.6
Cambodia	2.2	na
India	3.6	na
Indonesia	8.8	na
Middle East and Central Asia	5.8	4.2
All regions	2.8	3.3

na = not available.

Notes: Examples of direct impact are higher prices for fuels used for cooking or lighting. Indirect impact occurs as prices for other goods and services rise because of higher production costs associated with more costly fuel.

Source: del Granado, Coady, and Gillingham 2010.

Governments have been wary of removing subsidies, maintaining that it may unduly harm poor households, yet phasing out subsidies could generate savings that could otherwise be used to provide direct transfers to the poor. Making public spending more inclusive requires well-targeted schemes rather than general subsidies. CCTs implemented in Latin American countries are a good example of a government spending program that is well-targeted and has significant equity impacts.

Overall, public spending can promote more inclusive growth by focusing on programs like primary education and basic health care that benefit the poor. Removing costly general subsidies while at the same time putting in place well-targeted schemes can also render public spending more inclusive. In addition to managing public spending well, governments also need to ensure that fiscal resources are sufficient to fund equity-promoting spending. Achieving fiscal sustainability to meet both current and future challenges can have far-reaching implications for inclusive growth.

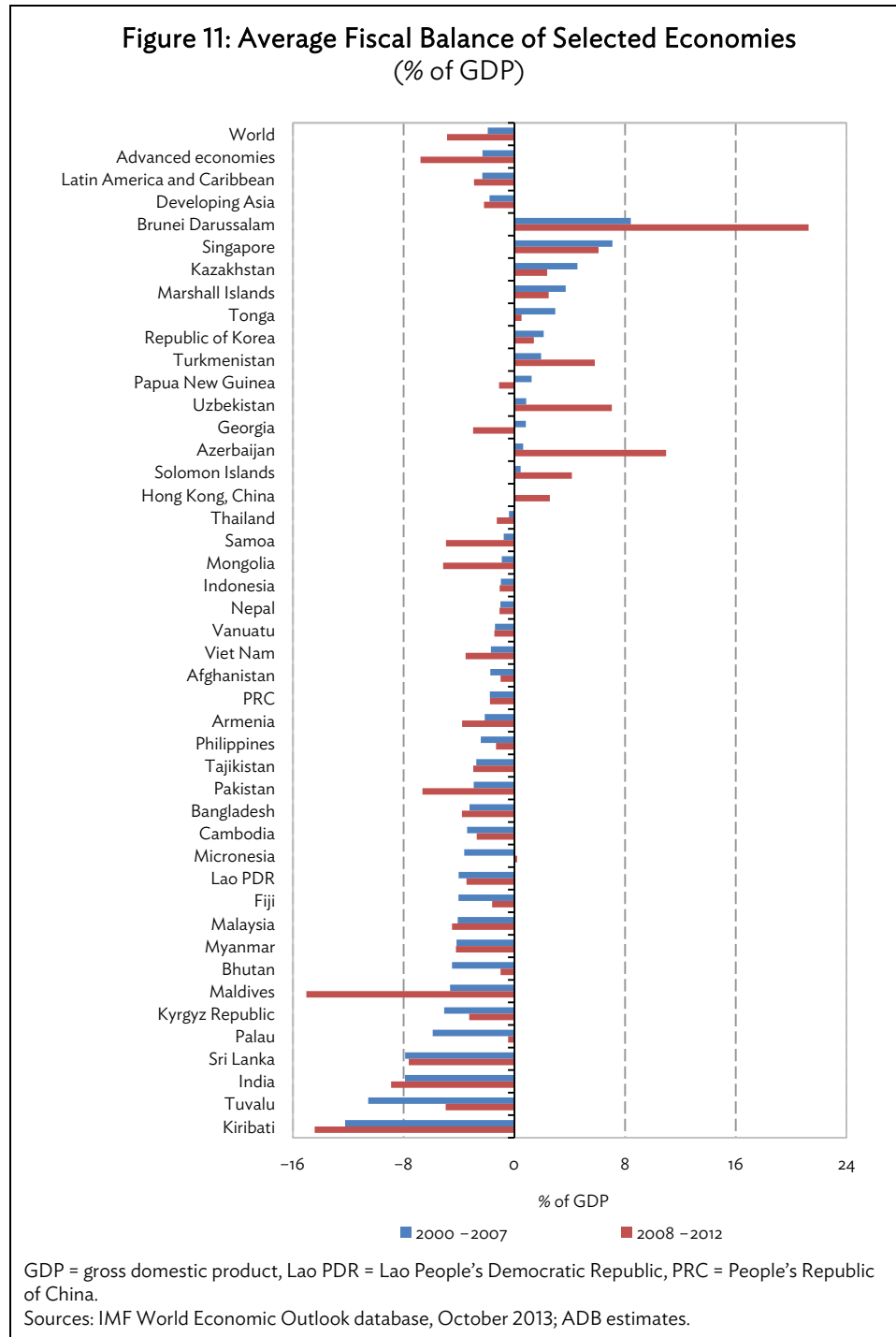
III. FISCAL RESOURCES TO FOSTER INCLUSIVE GROWTH

The previous section discussed how public spending can promote more inclusive growth in developing Asia. Given the considerable amount of public spending required to significantly narrow inequality and reduce poverty, the region needs sufficient fiscal space, as more public spending in the absence of sufficient fiscal space may jeopardize fiscal sustainability and macroeconomic stability, which would adversely affect both economic growth and inclusive growth.

A. Enlarging Fiscal Space

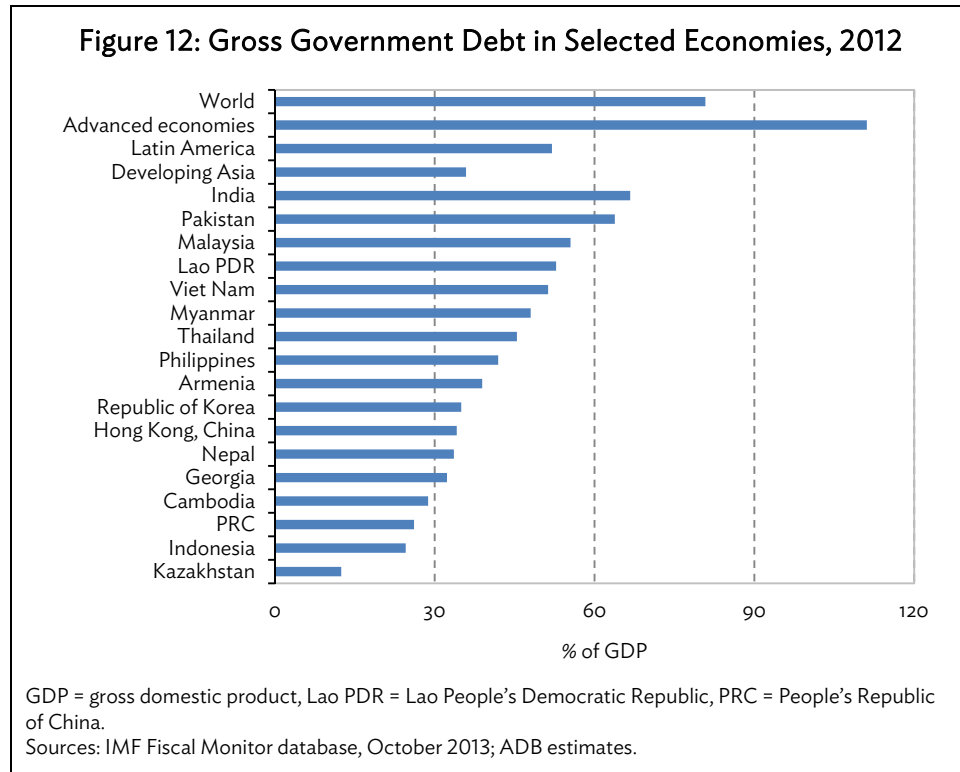
Trends since 2000 indicate that developing Asia, in general, has maintained a prudent fiscal stance despite more aggressive public spending in the post-global financial crisis era. Since the crisis, spending has been ramped up in line with the massive fiscal stimulus implemented to counter declining external demand. Increased spending since the crisis has led to somewhat weakened fiscal positions; countries with sizable fiscal deficits, such as India and Pakistan, have witnessed deteriorating fiscal positions. In contrast, others, such as Kazakhstan, the Republic of Korea, Singapore, and Turkmenistan, have continued to post surpluses, but for many economies in the region, average fiscal balances have yet to reach their pre-crisis levels. While there is an obvious need for fiscal consolidation

in many economies in developing Asia, overall, the region has maintained a healthier fiscal position compared with other parts of the world (Figure 11).



Prudent fiscal behavior has enabled developing Asia to maintain lower government debt compared with that of other regions (Ferrarini, Jha, and Ramayandi 2012). Gross government debt ratios across several Asian economies are comparable to the average for Latin America and are much lower than those of advanced economies (Figure 12). For developing Asia as a whole, the gross

government debt ratio is lower by more than 10 percentage points compared with that of Latin America, and relative to the debt ratio of advanced countries, that of developing Asia is only about a third. Low debt ratios and favorable fiscal balances suggest that the region's overall fiscal stance is within sustainable levels, but there is a great deal of diversity among individual economies. The PRC, Indonesia, and Kazakhstan have the lowest debt ratios at less than 30%, while India, Pakistan, and Malaysia have debt ratios of 50% to 70%. For the latter, there is a need to closely monitor debt levels to ensure that they do not reach alarmingly high levels.



While the region appears to currently have sufficient fiscal space to finance equity-promoting programs, it does not guarantee the future availability of fiscal space, as major structural changes may create additional fiscal demands that will affect it. The single biggest medium- to long-term structural challenge confronting the region is population aging. While there is considerable demographic diversity across subregions and economies, the region as a whole is in the midst of a shift toward markedly older populations. Lee and Mason (2014) explain how expected changes in demographic structures will affect public spending, especially on education, health care, and social protection. Governments need to boost their revenues if they are to adequately meet the demands from these structural changes.

B. Raising Fiscal Revenues

Developing Asia needs to raise more revenues to finance public spending. A comparison of the trends during the 1990s and 2000s indicates that the region has trailed other parts of the world in tax revenues, as they are less than half those of the OECD, as is graphically illustrated in Abdon et al. (2014). The gap between developing Asia and the OECD may be explained in part by the tendency for tax revenues to rise with per capita income, but developing Asia also lags Latin America—a region with comparable income and development—in both tax and non-tax revenues (see Das-Gupta 2014). From 2005 to 2011, Asia's tax revenues as a percent of GDP were only about three-fourths those of

Latin America and barely half of the latter's non-tax revenues. Overall, the trends suggest that there is considerable scope for boosting developing Asia's tax revenues.

Taxes are the primary sources of fiscal revenues. As Das-Gupta (2014) explains, a large part of the region's revenues are accounted for by current revenues that in turn are dominated by taxes. Among the different types, taxes on goods and services, and taxes on income are the two main sources. Across subregions, there are differences on which type of tax plays a more dominant role (Figure 13). The share of goods and services taxes is more pronounced in East Asia, but in Central Asia, South Asia, and Southeast Asia, income taxes account for a larger share.

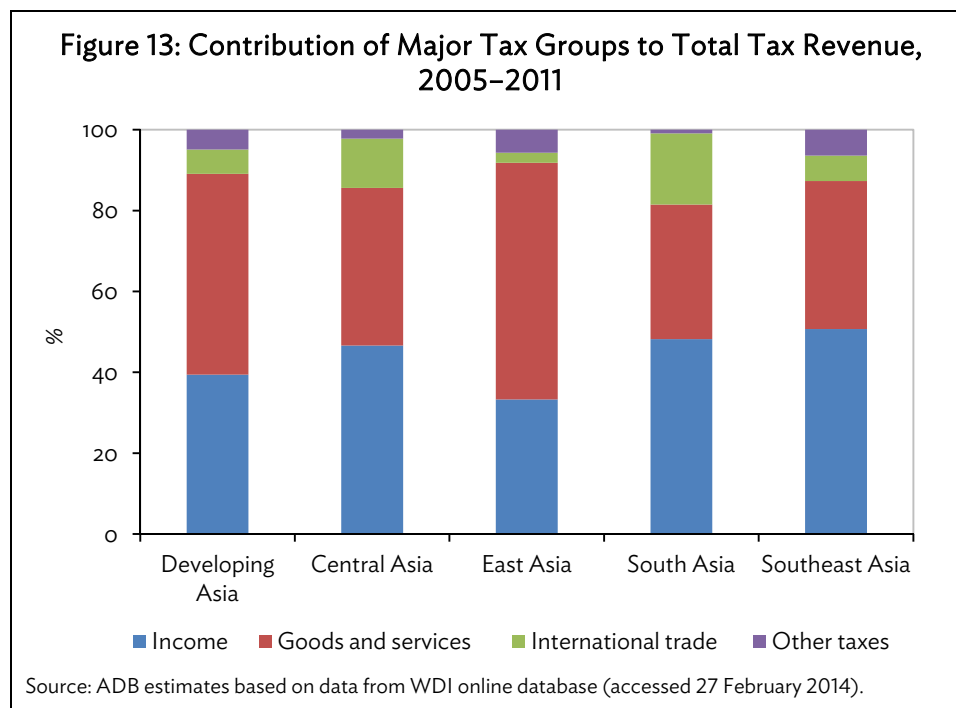
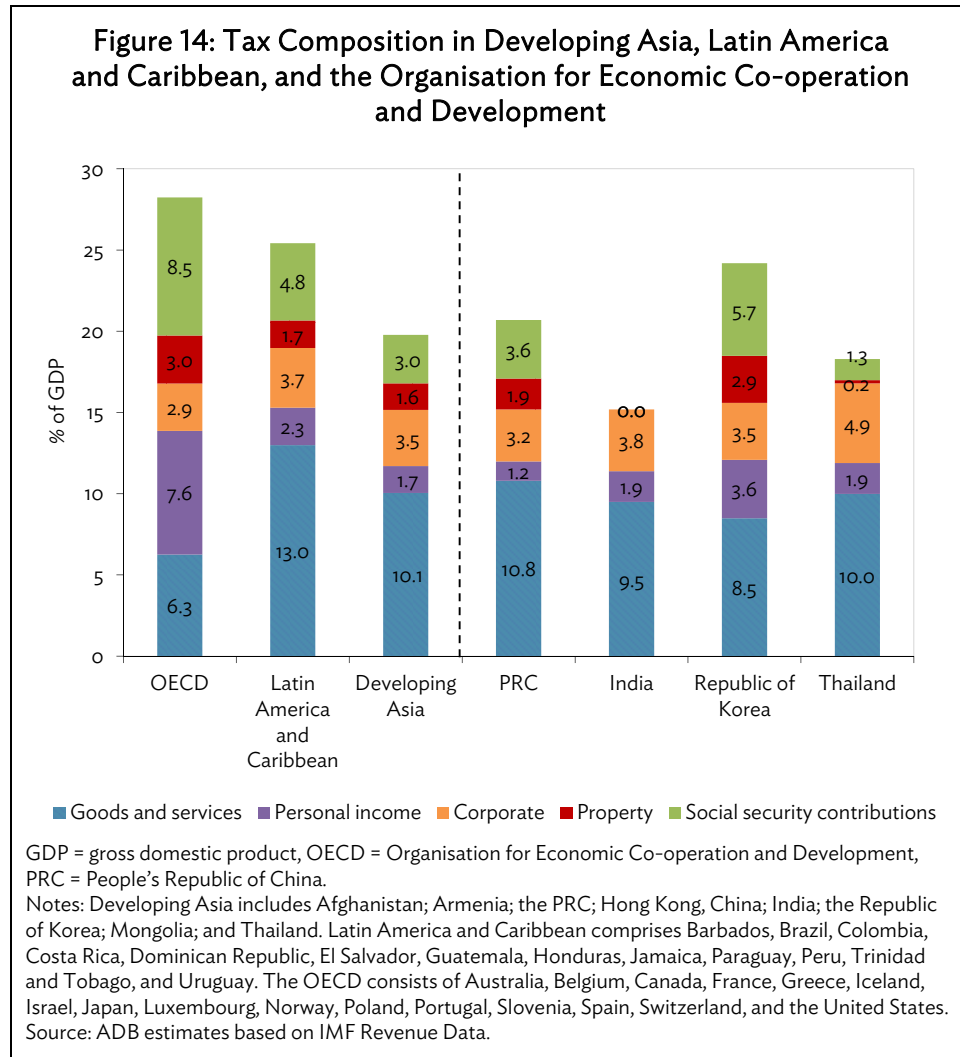


Figure 14 shows a comparison of the GDP share of corporate income tax, personal income tax, goods and services tax, and social security contributions among OECD members, Latin America, and developing Asia. The regional averages are weighted by the GDPs of member economies. The sum of tax composition is lower in developing Asia compared with the other two regions. The shares in GDP of income tax and property tax in developing Asia are less than those in the OECD and Latin America. Goods and services taxes have a greater share in developing Asia compared with the OECD, but compared with Latin America; the share in developing Asia is less. The evidence confirms that indirect taxes are more important than income taxes in developing economies, but that the opposite holds true in advanced economies. Developing Asia also collects less in social security contributions relative to GDP, indicating its social security systems are less developed than those of the OECD and Latin America.

Data on tax composition for the PRC, India, the Republic of Korea, and Thailand indicate some common features and differences. A distinct feature among the four economies is the dominant role of goods and services taxes. Corporate income tax also accounts for a substantial share in all four, with Thailand having the largest share, while personal income tax and property tax are more significant in the Republic of Korea compared with the other three. Among the large Asian economies in Figure 14, only the share of social security contributions in the Republic of Korea is comparable to that of

advanced economies, although the PRC is not too far behind. This signifies that the two East Asian countries have more advanced social security systems.



While taxes in general tend to deter growth, there are certain types of taxes that are considered less detrimental than others. Abdon et al. (2014) simulate the impact on growth of altering the tax composition and find that reducing the reliance on income tax while raising the use of consumption and other taxes can raise GDP growth over the long run. Another finding is that raising property taxes while reducing income tax can be more beneficial to growth. Property taxes are likely to be borne more by the rich since they are expected to own more property holdings than the poor. This implies that raising the property tax can be a sound option in terms of both boosting revenues and promoting equity.

The huge role of taxes in the region's fiscal revenues suggests that stronger revenue mobilization will require reforms in tax systems. Different types of tax have varying effects on growth and income inequality. In addition to revenue and economic growth impacts, tax reforms must therefore consider the expected consequences for income distribution. Beyond tax revenue measures, there is a need for governments in the region to explore other options that will enable them to raise much-needed resources to enlarge their fiscal space and promote inclusive growth.

IV. CONCLUDING OBSERVATIONS

The region has achieved rapid economic growth driven by globalization, technological progress, and market-oriented reforms, but that growth has occurred alongside deterioration in income distribution. Rising inequality strengthens the case for Asian governments to do more to ensure a more equitable distribution of the benefits of growth and for fiscal policy to play a more fundamental role in fostering inclusive growth.

Evidence indicates that public spending on education, health care, and direct transfers can reduce inequality. In fact, some public spending can promote both growth and equity. However, the region has trailed other parts of the world in using fiscal policy as a tool to improve income distribution; however, expanding public expenditure without boosting fiscal resources can jeopardize fiscal sustainability.

The key challenge is how to use fiscal policy to make growth more inclusive while maintaining fiscal sustainability. Developing Asia has traditionally maintained fiscal prudence which has helped the region achieve macroeconomic stability and enabled it to respond well in times of economic crisis, but future structural challenges, such as rapid demographic transition, can significantly narrow the region's fiscal space.

Asian economies need to thoroughly examine their range of options. Evidence shows that government expenditure rather than taxation has a substantial effect on inequality. Economies need to consider that the composition of public expenditures, including their design and implementation, matters greatly. Furthermore, economies face limited resource bases; thus, strengthening fiscal mobilization and exploring more sources of revenues will be crucial.

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Fiscal Policy for Inclusive Growth

An Overview

The paper argues that rising inequality in developing Asia strengthens the case for a government response, and fiscal policy is one of the most suitable policy instruments to promote a more equitable society that provides opportunities for all. The region has trailed other parts of the world in equity-promoting fiscal expenditures, namely education, health care, and social protection, and thus the region needs to do more. Expanding public expenditures without sufficiently raising fiscal resources can, however, jeopardize fiscal sustainability. The key challenge is using fiscal policy to foster equity while maintaining fiscal sustainability.

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ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to approximately two-thirds of the world's poor: 1.6 billion people who live on less than \$2 a day, with 733 million struggling on less than \$1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

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