FISCAL POLICY SPACE
in INDIA and other BRIICSAM COUNTRIES

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Executive Summary

This policy brief attempts to present a rudimentary framework for Fiscal Policy Space so that it can be used to compare India with other developing economies namely Brazil, Russia, Indonesia, China, South Africa and Mexico (BRICSAM). It looks at a few fiscal indicators like public spending and taxation to show the difference between India and other BRICSAM countries over the last decade. It compares the human development deficits and the government resources used to address those deficits.
1 A Framework for Fiscal Space

The term ‘Fiscal Policy Space’ is constantly evolving. There is no standardised definition for fiscal policy space.

Fiscal space has been most often used to represent the fiscal sustainability of economies i.e. whether countries are able to spend and raise revenues without compromising on the ability to repay debt.

Over the last decade, multilateral institutions like the International Monetary Fund (IMF), World Bank and United Nations Development Programme (UNDP) have defined it according to different aspects of a government's ability to finance its functions. The IMF and World Bank are concerned about the sustainability and short and medium term macroeconomic stability of the economy. According to Peter Heller, fiscal space is defined as “room in a government's budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy” (Heller, 2005) while for the World Bank, fiscal space exists when a “government can increase expenditure without impairing its ability to service debt”. (Perotti, 2007)

The UNDP on the other hand is more concerned with the state boosting its finances to allocate resources better i.e. “Fiscal space is the financing that is available to government as a result of concrete policy actions for enhancing resource mobilization, and the reforms necessary to secure the enabling governance, institutional and economic environment for these policy actions to be effective, for a specified set of development objectives.” (Roy, Heuty, and Letouze; 2007)

Due to the ambiguous nature of the term fiscal space, we have to re-define it for our cause. Government can increase fiscal space by raising taxes, reducing expenditure or through borrowing. Analytical frameworks developed over the years have promoted the concept of fiscal space from the point of view of ‘financial sustainability’ of governments. The obsession with efficiency in expenditures has led to cutting down expenditures rather than augmenting domestic resources has resulted in the withdrawal of the state from its welfare functions. While there are no empirical studies which show that lack of public spending causes inequality, the government will have less flexibility in providing
public goods for excluded sections of the population (Khan and Das, 2014). In this rudimentary framework, we try to compare India with developing countries like Brazil, Russia, Indonesia, China, South Africa and Mexico (BRICSAM) \footnote{BRICSAM usually includes India and not Indonesia, for convenience, here India and other BRICSAM countries refer to Brazil, Russia, Indonesia, China, South Africa and Mexico} by using two guidelines:

(a) Raising the Public Spending to GDP ratio especially expenditure commitment towards human development (health and education)

(b) Raising revenues from tax sources especially direct taxes

While this framework is useful in assessing fiscal space, it may be noted that BRICSAM countries are at different levels of human and economic development. So, there is no one-size-fits-all solution for enhancing fiscal space and strategies will have to be country-specific.
2 Public Spending to GDP Ratio

In an economy, if the Gross Domestic Product (GDP) – which is the total value of all goods and services produced within the country – is measured using the expenditure method, it is estimated to be the sum of consumption expenditure by households, government expenditure on provision of goods and essential services, investment and net exports (exports minus imports). If the household's ability to spend on essential services is low, the extent of the government's involvement in providing those services to disadvantaged households shows the effectiveness of the welfare state. In developing countries like India and other BRICSAM, where incomes are low or medium, a measure of the state's willingness to improve conditions is public spending to GDP ratio or the size of government spending relative to the size of the economy.

Figure 2.1 shows that in 2004, India had a government spending to GDP ratio of 27.2 percent which was third among the BRICSAM countries. Only Brazil and Russia had higher government spending to India. A decade later in 2014, India's government spending marginally declined to 26.6 while South Africa, China and Mexico climbed above India. India is also the only country among BRICSAM that has seen a decline in government spending from 2004 levels while South Africa, Mexico and China have seen impressive increases.

A further examination of the composition of expenditure, especially on critical social sectors like health and education will reveal more about human development deficits plaguing India compared to other BRICSAM countries. Figure 2.2 gives the public spending on health by BRICSAM countries at two different points in the last decade, namely, 2004 and 2014.

2 Though human development encompasses social expenditure by the state on several essential services like health, education, drinking water and sanitation, for the purposes of this framework and due to data limitations, expenditure on education and health are used as proxies for human development.
As is evident from the above figure, India's public health expenditure has been stagnant in and around 1 percent for over a decade while all other BRICSAM countries have raised their public spending on health as a percentage of GDP. China, Mexico, South Africa and Brazil have significantly stepped up public spending on health.

Figure 2.3 shows that except for Indonesia and India, other countries have stepped up public spending on education as a percentage of their respective GDPs. Estimates of Indonesia's and India's public spending shows a stagnation in the last decade. South Africa has shown half a percentage point increase in government spending on education while China, Brazil and Mexico have significantly stepped up the same. China has doubled its government spending on education during the same time.
Figures 2.2 and 2.3 have shown that India and Indonesia have struggled to step up spending in education and health relative to the growth in size of their economies. Lack of public spending on health and education by India Indonesia is also commensurate with generally low levels of public spending. When the government doesn't spend enough on critical social sectors like education and healthcare, out of pocket expenditure increase. The 68th round of the National Sample Survey Organisation data clearly shows that 80 percent of the non-hospitalization medical expenditure was on medicines in urban areas while in rural India, it was 75 percent for 2011-12. Mitra (2014) shows that India has one of the worst health indicators among BRICSAM countries. Even though infant mortality rate has reduced from 83 per 1000 live births in 1990 to 42 per 1000 in 2011 and maternal mortality rate has reduced from 570 per 100,000 live births in 1990 to 178 in 2010-12, except for South Africa, India fares worst on most health indicators among BRICSAM countries. Kundu (2014) shows that while Russia has achieved universal adult literacy, the literacy gap between India and other BRICS countries is 30 percentage points or higher.

India's dismal performance in these indicators coupled with low levels of public spending provides sufficient reason to enquire into the resources available for the government compared to other countries.
3 Raising Revenues: Tax-GDP ratio

When representatives from 191 countries gathered at the UN General Assembly in 2000 to agree on eight commitments called the Millennium Declaration Goals (MDGs) to be achieved by 2015, it was clear that realising those commitments would be impossible without raising significant amount of resources to enhance fiscal space. Roy et al's framework which has been adapted in its rudimentary form here, allows for evaluating fiscal policy space according to its development implications rather than a strictly fiscal approach by Bretton Woods institutions.

Resource mobilisation can be enhanced by raising funds from tax and non-tax sources in a progressive manner. According to Di McIntyre and Filip Meheus, “The emphasis should be on increasing revenues through the most progressive means possible…the purpose of raising government spending on social services to meet human rights obligations would be defeated if that spending were funded by increasing the relative tax burden of those who are meant to benefit.”

Various studies have also highlighted that most often, rationalising expenditures results in the axe falling on pro-poor budgetary items (e.g. Cornia et al. 1987, Hicks 1991, ILO 2014, Ortiz and Cummins 2013, Ravallion 2002, 2004 and 2006).

Figure 3.1 indicates that Indonesia and India have two of the lowest tax-GDP ratios among BRICSAM countries. They also register the lowest public spending to GDP ratios as shown earlier. South Africa and Brazil have relatively higher tax-GDP ratios which are commensurate with their higher public spending over the last decade. China has raised tax revenues at an impressive rate in the past decade while Mexico has kept pace in terms of public spending with a sizeable increase in tax-GDP ratio. Russia is an outlier as tax-GDP ratio has fallen, but it has managed to raise public spending. There are several reports that show that Russia has ‘unspecified expenditure’ in the federal budget has increased in recent years which has been classified as secret for national security reasons (IMF, 2014).
A progressive tax structure would entail citizens to pay taxes according to their ability to pay that is a higher portion of tax revenues must be derived from direct sources like taxes on income, profit, capital gains, property, goods and services, etc. In recent history, increasing progressive taxation from the richest income groups to finance social and pro-poor investments has been uncommon. (Ortiz et al, 2015)

According to Figure 3.2, Mexico, South Africa and Brazil have the highest share of direct tax revenues as a percentage of total tax revenues. While India and China have managed to significantly raise the share of direct tax revenues, they still have the most regressive tax structures among BRICSAM countries.

Since the 80s and 90s, there has been a substantial decline in tax revenues of the Union government in India as a proportion of GDP. Once the Union government decided to liberalise trade and customs duties, it could no longer impose relatively higher taxation on production in the domestic economy, and hence union excise duties also had to fall. As regard to direct taxes, through the contributions of corporation tax and personal
income tax to the total tax revenue of the Centre increased over the 1990s, these increases were from adequate to offset the fall in indirect taxes as a proportion of GDP (Patnaik, 2003). Poor countries rely excessively on indirect taxes such as those on trade and goods for basic consumption. Also, tax revenues in the two countries are far below any country in the West that have developed proper infrastructure in education and health. Progressive taxation is one of the least distortionary policy tools available that controls the rise in inequality by redistributing the gains from growth (Piketty and Qian, 2009).

Brazil, China and Mexico obtain a higher proportion of their revenues from goods and services. A flat tax rate means the poor and vulnerable pay a higher proportion of their incomes as taxes. This combined with low public provisioning causes widespread human development deficits.
4 Concluding Observations

• Total Government Expenditure-GDP Ratio

Between 2008 and 2013, except for India and Indonesia, all other BRIICSAM countries have stepped up public spending. Mexico increased it marginally by 1.5 percentage points while Brazil, South Africa and Russia have increased it by 2.5-3.5 percentage points. China saw the highest increase, in the last five years, by 8.6 percentage points.

• Government Expenditure on Health and Education

Brazil and China have significantly stepped up spending on education and health in the last decade relative to the size of the economy (as a percentage of GDP). China almost doubled its spending on education. Mexico and South Africa have also seen marginal and reasonable increases respectively in education and health spending as a percentage of their GDPs.

Between 2000 and 2011, Mexico and South Africa have seen declines in their public spending on education as a percentage of total government expenditures, but it has climbed up in the last few years and they accord the highest priority to health and education in their total public expenditures among BRIICSAM countries. India and Indonesia are the lowest public spenders on education and health as a percentage of their respective GDPs. But as a proportion of total public spending, Indonesia has managed to prioritise health in their budget in spite of low tax revenues and they're third after Mexico and South Africa. India, on the other hand, has seen a stagnation in public spending on health.

• Total Government Revenue-GDP Ratio

Except for China, no other country has significantly improved their Revenue-GDP ratios in the last five years. While Indonesia's Revenue-GDP ratio is steadily decreasing, Russia, Mexico, South Africa and India have shown marginal increases in the last 2-3 years following a blip. Brazil had a peak of 38.1 percentage points in 2012 which is the highest among BRIICSAM countries.

• Tax-GDP Ratio

Brazil and China have dramatically increased their tax-GDP ratios between 2002 and 2012 by 4.8 and 7.6 percentage points respectively while Mexico and India have seen moderate increases by 2.8 and 2.9 percentage points respectively. South Africa has seen a marginal increase by 0.8 while Indonesia's tax-GDP ratio has declined by 0.9 percentage points during the same time period. China, Brazil and South Africa have been able to raise public spending especially on critical social sectors like health and education due to increases in their tax-GDP ratios. Among BRIICASM countries, Russia is the only country that has raised its public spending in spite of falling tax-GDP ratio.
Indonesia has seen a fall in both public spending and revenues while India has cut public spending in spite of rising revenues. China, Brazil, South Africa and Mexico have raised their public spending along with rising tax-GDP ratios.

- **Direct Tax Revenues as a Proportion of Total Tax Revenues**

  China, India and Mexico have seen the highest increases in share of direct tax revenues as a proportion of total tax revenues by 10, 11 and 5.2 percentage points respectively between 2002 and 2012. In spite of the gains made by China and India, they still occupy the last two positions among BRIICSAM nations in terms of the progressive structure of taxation. South Africa, on the other hand, is the second highest in terms of proportion of direct tax revenues in spite of a fall in its share by 2.3 percentage points during the same time period. Russia and Indonesia have seen the big falls in their shares of direct tax revenues by 8.8 and 8.1 percentage points respectively.

- **Wealth Shares of the Top Percentile**

  In the short run, comparison of wealth inequality across countries is sensitive to exchange rate movements and prices of asset holdings (Global Wealth Data book, 2014). The top wealth percentile of China has almost doubled its share while those in India, Indonesia and Russia have seen their wealth shares increase by 11-13 percentage points in the last fourteen years. Brazil too has seen a rise in wealth share of its top percentile by 6.1 percentage points. There is a marginal decline in top percentile wealth share for South Africa while for Mexico; it is a decrease by 6.7 percent. Mexico has seen declining top percentile wealth share along with relatively higher priority to education and health.

- **Greater Tax-GDP Ratios correspond to greater Public Expenditure on Education and Health**

  Highest tax revenues in Brazil, Russia, South Africa and China compare favourably with highest public expenditures in the same three countries. India and Indonesia which have the lowest tax-GDP ratios also are the lowest public spenders on health and education.
5 Recommendations

While the elementary framework developed for Fiscal Policy Space in this briefing paper is useful in assessing its state in India and other BRICSAM countries, recommendations for enhancing it should ideally be country specific. But these guidelines will prove effective in a progressive fiscal policy regime.

• Raise Government Spending

Developing country governments need to raise public expenditure to dampen the effects of high out-of-pocket expenditures on essential services like education and health which can have adverse effects on the poor and the marginalized sections. Emerging market economies like India and other BRICSAM countries that are in transition require high volumes of public spending to take care of the needs of the poor and the marginalized. But, due to the pressures of Bretton Woods institutions, they are forced to rein in public debt and focus on sustainability of economies.

• Raise Tax-GDP Ratio

In the absence of a fiscal policy that is able to raise revenues, developing countries have to resort to spending cuts to rein in public debt. China, Brazil and South Africa have been able to raise public spending especially on critical social sectors like health and education due to increases in their tax-GDP ratios. Among BRICASM countries, Russia is the only country that has raised its public spending in spite of falling tax-GDP ratio. But public spending on education and health as a percentage of GDP has declined in Russia between 2002 and 2012 and it has also seen a rising defence budget. So, Russia is an outlier in this analysis.

- Efforts should be made to raise the tax base and to curb tax avoidance by individuals and corporations

- Tax rates should be considered net of exemptions to see if there is potential to raise the peak rates to augment higher per unit revenues. Among G20 countries, Russia, Mexico, Brazil, Indonesia and India have some of the lowest income tax rates (KPMG, 2014).

- Government revenues from natural resources can be maximized through state-owned entities or royalty payments, if extracted by private entities. (McIntyre and Meheus, 2014)

• Increase the Share of Direct Taxes In Total Tax Revenues

A progressive structure of taxation should be ensured so that the tax burden is paid off according to the ability to pay. If a higher portion of taxes is from indirect sources, then it accentuates both wealth and income inequality. India, China, Indonesia and Russia

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which have the lowest shares of direct tax revenues as a proportion of total tax revenues also have the highest or rapidly increasing wealth shares for the top percentile.

China and India have raised their share of direct tax revenues in recent years, but it is still quite low compared to that of Mexico, South Africa and Brazil.

- **Taxes on Accumulated Wealth, Property, and Inheritance**

  At present, among BRIICSAM countries, India has a flat rate of 1 percent for net wealth exceeding Rs. 30 lakh while Indonesia has an inheritance tax rate at 2.5 percent. With the rising wealth shares of top percentiles, it is worthwhile to consider progressive taxes like those on property, wealth and inheritance for effective redistribution of income and wealth as well as for raising funds for crucial social sector expenditures.

- **Taxes on Capital Gains**

  Capital gains can be treated as regular income and taxed as it is income earned without any productive activity, and is a significant source of income for the highest wealth percentiles in the world.
6 Explanatory Notes on Data

The analysis in this policy brief has drawn on a mix of Government Finance Statistics and World Economic Outlook Database by IMF, Factbook by OECD, Human Development Reports of various years by IMF, Global Health Statistics Report (known as World Health Statistics Report till 2009) by World Health Organisation, Education for All: Global Monitoring Report by UNESCO and other data since 1999. The need to access multiple databases is due to limitations in availability of comparable revenue and expenditure data across countries. IMF and OECD provide two of the most comprehensive databases on government revenue and expenditure data for cross country comparisons. OECD provides government finance data for advanced countries in its OECD Factbook Series which also covers Brazil, China, Russia, India, Indonesia and South Africa for certain variables.

Public Spending as a Percentage of GDP and Public Spending on Health and Education as a Percentage of GDP

IMF’s World Economic Outlook Database consists of data on public expenditure in BRICSAM countries. Total expenditure consists of total expense and the net acquisition of nonfinancial assets. Data on government expenditure on health and education as a percentage of GDP is available from Human Development Reports of various years published by UNDP. UNESCO’s ‘Education for All’ Reports of various years provide the data for Public Expenditure on Health as a Percentage of Total Government Expenditure. World Health Organisation’s ‘Global Health Statistics’ published annually consists of government expenditure on health, private expenditure on health, including externally funded expenditure on health. Government expenditure on health includes ‘social security expenditure’ and private expenditure includes ‘out-of-pocket expenditure’ and ‘private prepaid plans’. Hence, to understand the government’s contribution to total expenditure on health, General government ‘expenditure on health as a percentage of total government expenditure’ has been used.

Tax-GDP Ratio

IMF’s Government Finance Statistics is a standard reference for revenue and expenditure data for all levels of government (national, state and local) for IMF member countries. It has undergone some major changes in 1986, 2001 and 2014 which makes it difficult to compare across databases and time. World Economic Outlook database collects data directly from the country’s fiscal files (IMF, 2011) while OECD covers the data points more frequently, it covers the same for advanced and emerging market economies.

Here, the tax-GDP Ratio data extracted from IMF Data warehouse for the Government Finance Statistics Yearbook is not comparable to that of the figures from OECD Fact book. OECD reports social contributions as a component of tax revenues, but IMF only recently upgraded its guidelines to include social contributions as a component of tax.
revenues as they are also unrequited payments to the government. So social security contributions have been added to obtain the respective data for Total Tax-GDP Ratios in Figure 3.1. Addition of Other Revenues and Grants to these Total Tax-GDP Ratios may not yield the same data as the World Economic Outlook Database data used in Figure 2.2 as these components are aggregated for facilitating comparison.

Figures for Mexico and Brazil are for 2000 and 2013 respectively and calculated from Revenue Statistics in Latin America and Caribbean 2015 published by OECD. Figures for India are from 2001-02 and 2012-13 respectively obtained from Indian Public Finance Statistics 2014-15 published by the Ministry of Finance of India. Figure for China for 2002 was calculated from the China Statistical Yearbook 2003 published by the National Bureau of Statistics of China. Figures for Indonesia, South Africa and Russia were obtained from Government Finance Statistical Yearbook 2003 published by IMF. Figures for Indonesia, Russia and South Africa for 2012 and China for 2011 were extracted from the IMF Data warehouse, Government Finance Statistics Yearbook. Figures are for general government except for Indonesia; Indonesia figures are for its central government's budgetary transactions.
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