

Fiscal Challenges for Asia in the Post-Crisis World



Carlo Cottarelli
Director, Fiscal Affairs Department

Remarks at the conference on "Tax Policy and Administration
Challenges for Restoring Fiscal Sustainability"

Tokyo, January 13, 2011

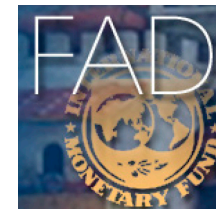
Outline



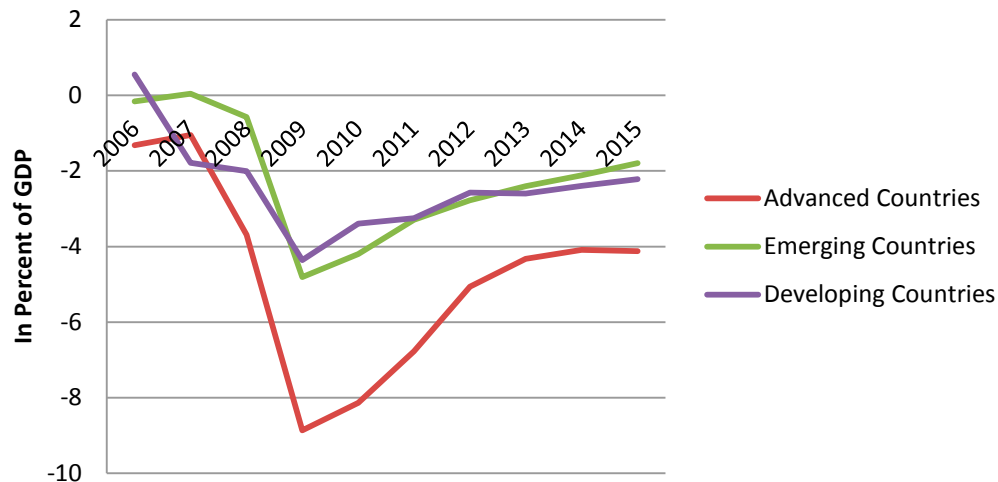
- Impact of the crisis and policy responses to date
- Projected fiscal outlook
- Fiscal risks and medium term challenges
 - Risks: international spillovers, capital inflows.
 - Challenges: population aging, infrastructure, poverty.
- Fiscal policy strategies in the aftermath of the crisis
 - Return to building fiscal buffers.
 - Announce and begin to implement adjustment plans.
- Expenditure and revenues measures
 - Reforming pensions and health, enhancing infrastructure quality and quantity, better targeting welfare spending.
 - Reforming revenue structures

Fiscal Cost of the Crisis

Fiscal balance (as a share of GDP)



Overall Balance, World



The impact of the crisis is slightly smaller in Asia than elsewhere, but is still important, especially for advanced economies in the region

Overall Balance, Asian Countries



Country groupings:

Advanced Asia: Japan, Korea

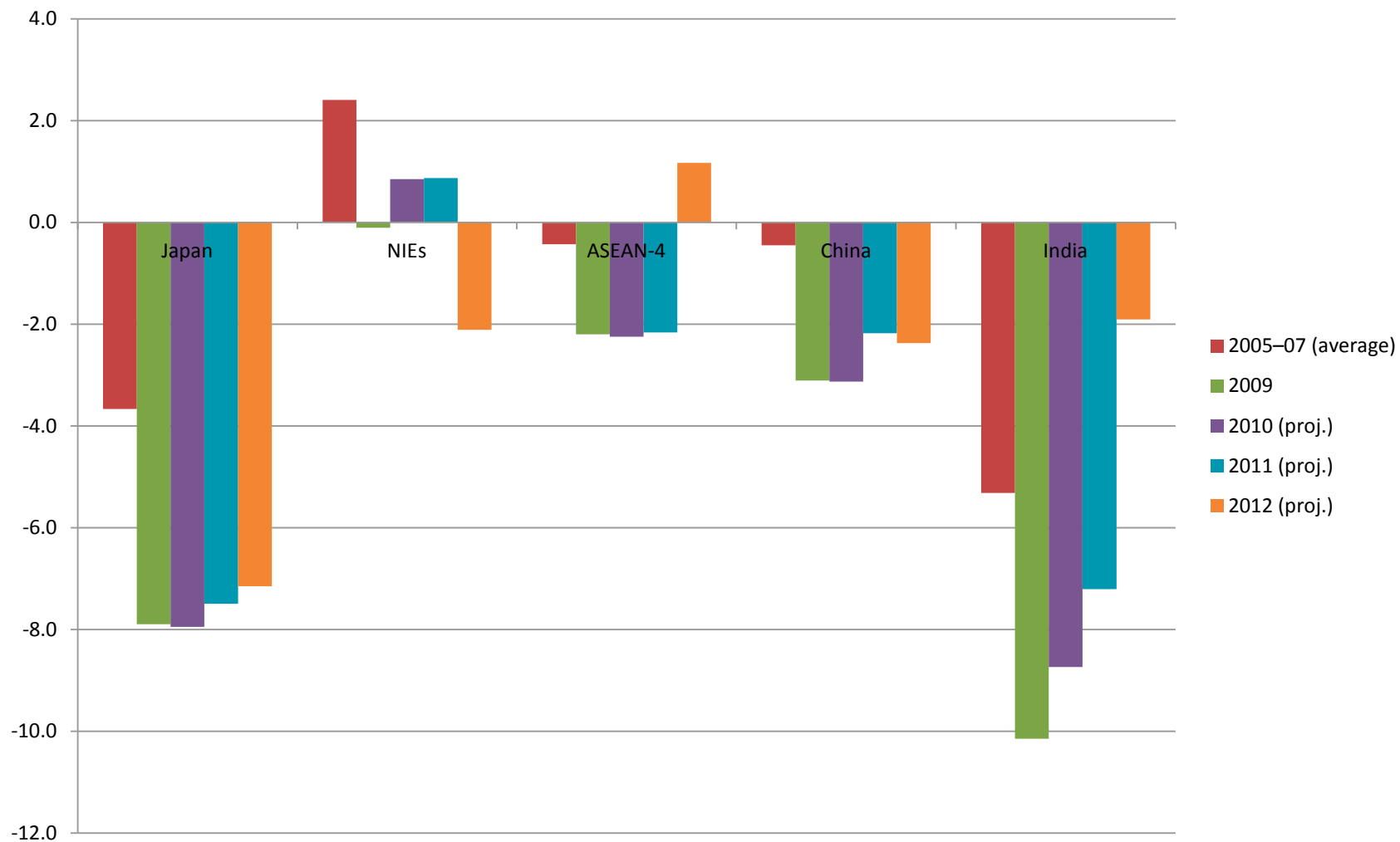
Emerging Asia: NIE (excl. KOR), ASEAN4

Developing: rest of Asia

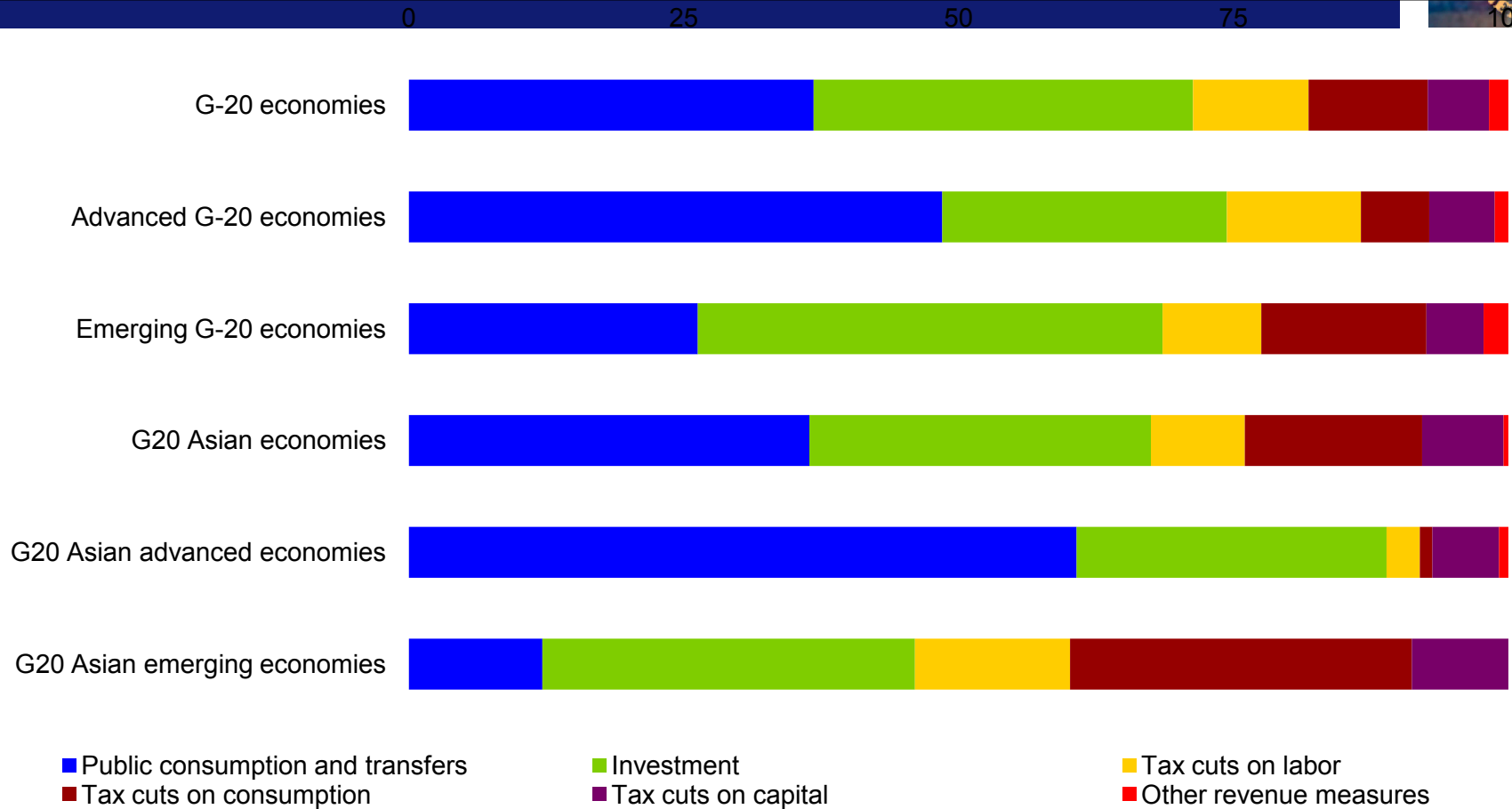
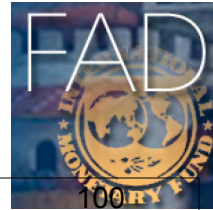
NIE: HKG, KOR, SGP, TWN

ASEAN4: IDN, MYS, PHL, THA

Cyclically adjusted fiscal balances as a share of GDP



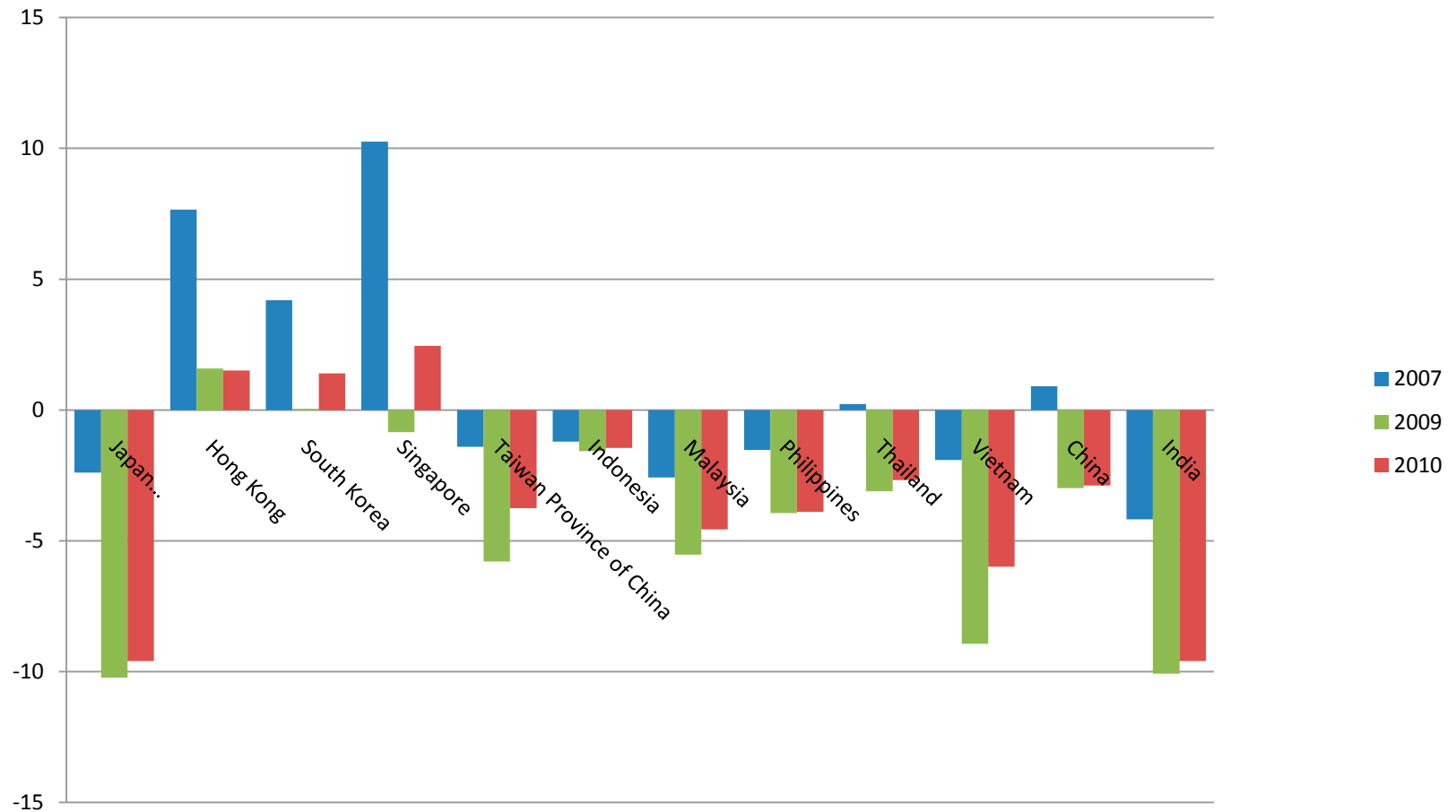
Composition of Discretionary Stimulus



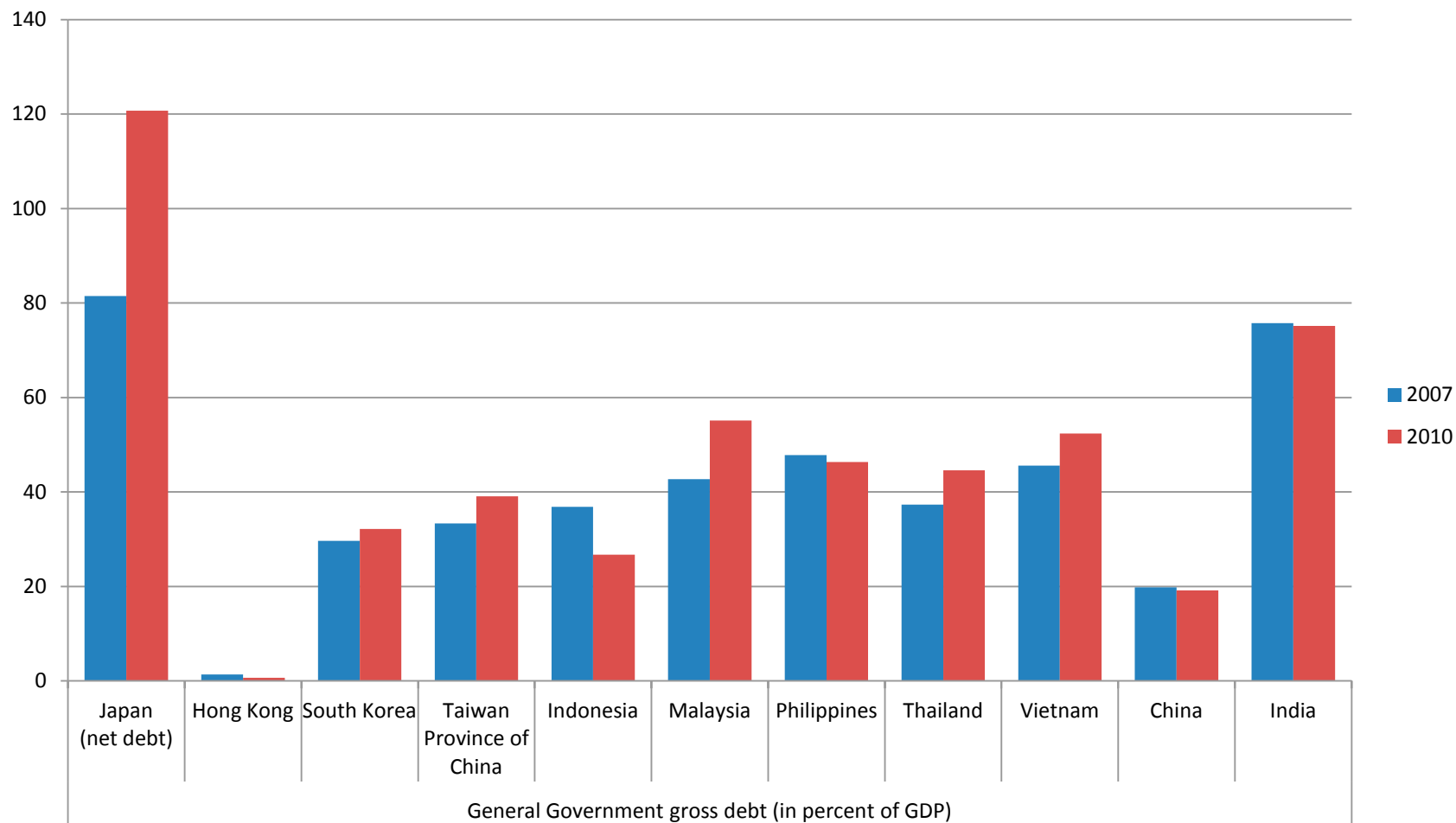
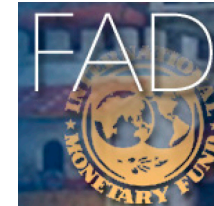
1 / Includes expansionary stimulus measures only.

In Asian G-20 – Advanced: Higher share of Public Consumption & Transfers
Emerging: Tax cuts and infrastructure more common

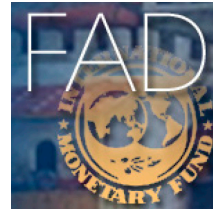
Overall fiscal balance, 2007-2010



Public debt, 2007-2010

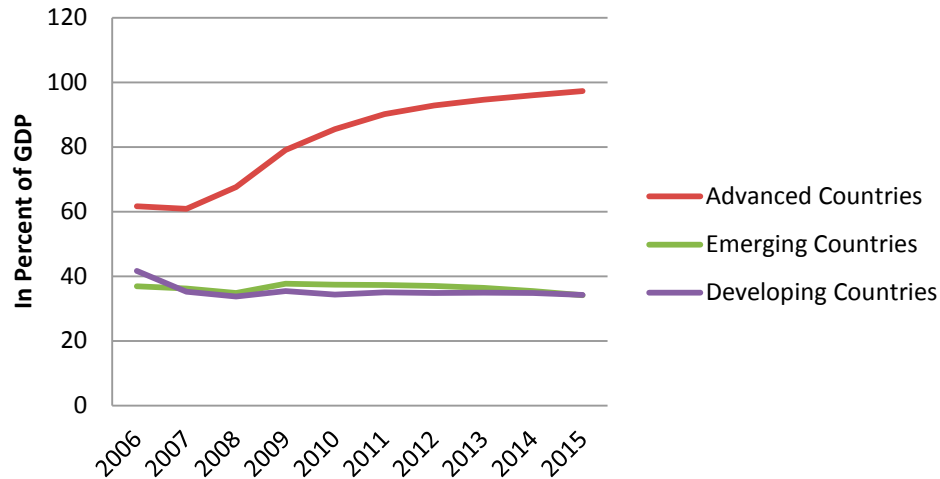


Medium-term outlook for government debt

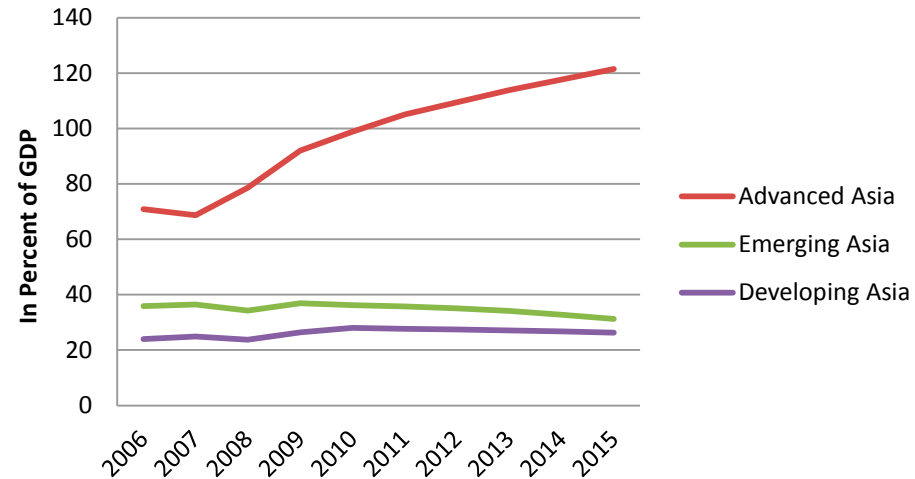


- Large, sharp increase in advanced economies
- More moderate debt pressures in emerging markets

Government Debt, World



Government Debt, Asia



Looking ahead: strong growth in 2011, but downside risks remain

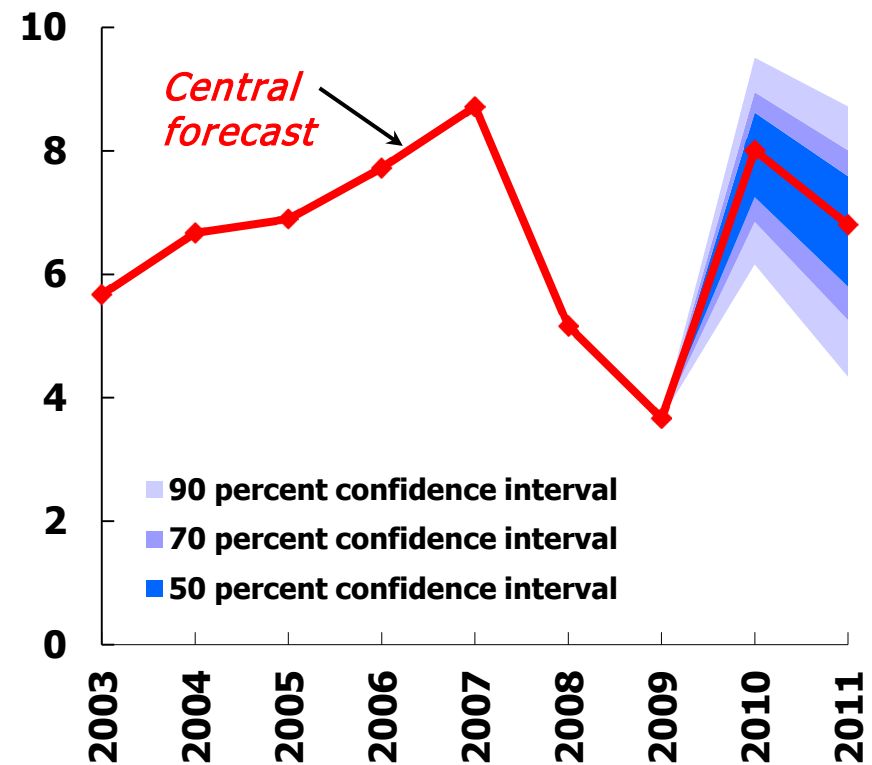


**Asia: Real GDP Growth
(Year-on-year; in percent)**

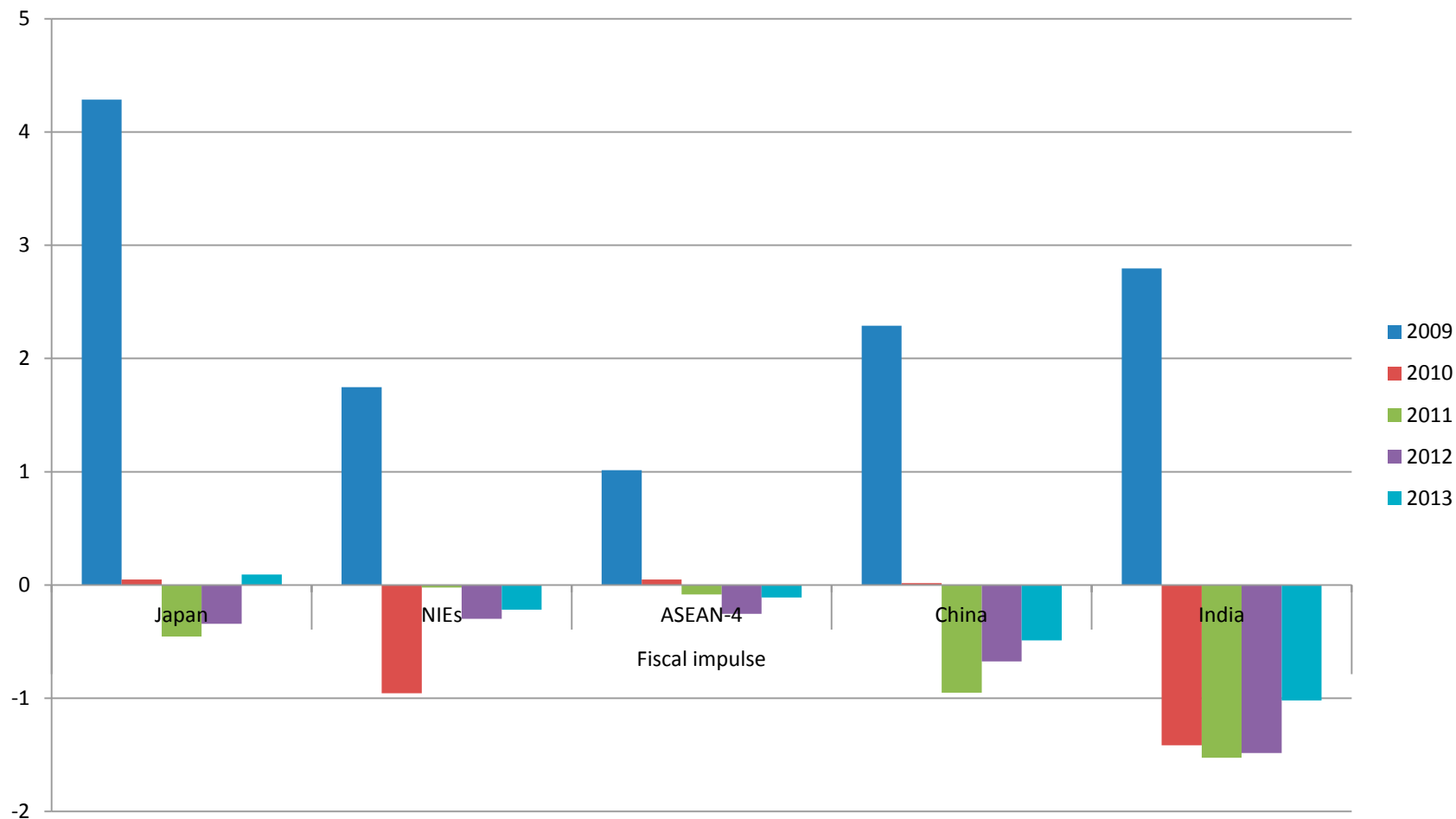
	2009	2010	2011	2012
Asia	3.7	8	6.8	6.9
Advanced Asia	-3.9	3.6	2.3	2.6
Emerging Asia	6.3	9.7	8.4	8.3
Developing Asia	2.6	4.3	4.7	4.8
NIE	1.3	6.6	5.3	5.4
ASEAN4	-0.9	7.8	4.5	4.4
Japan	-5.2	2.8	1.5	2.0
China	9.1	10.5	9.6	9.5
India	5.7	9.7	8.4	8.0

Asia: Real GDP Growth

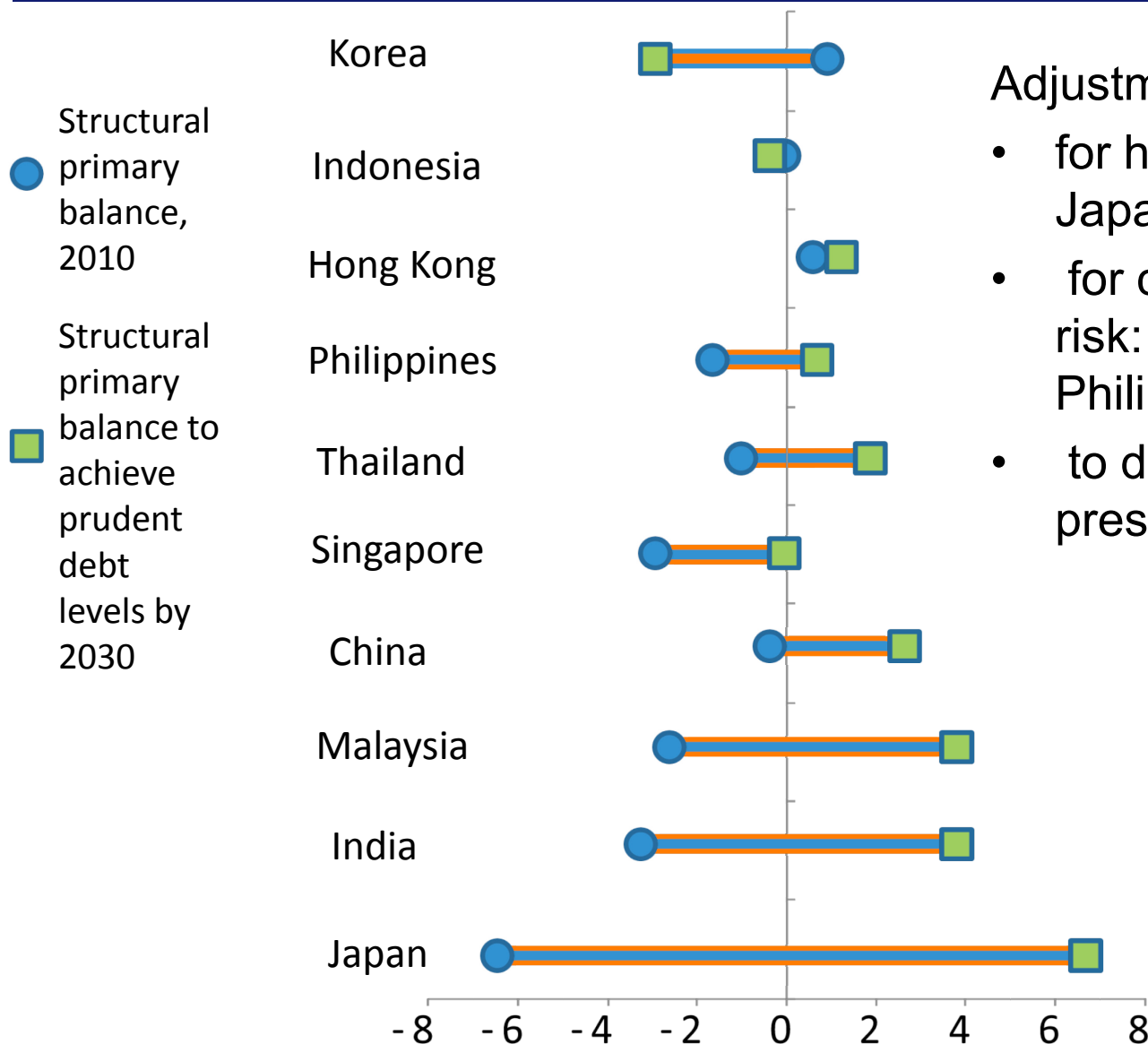
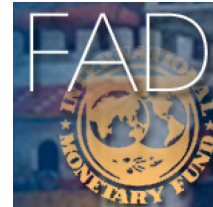
(Central forecast and confidence intervals; in percent)



Fiscal impulse during and after the crisis: change in cyclically adjusted primary balance



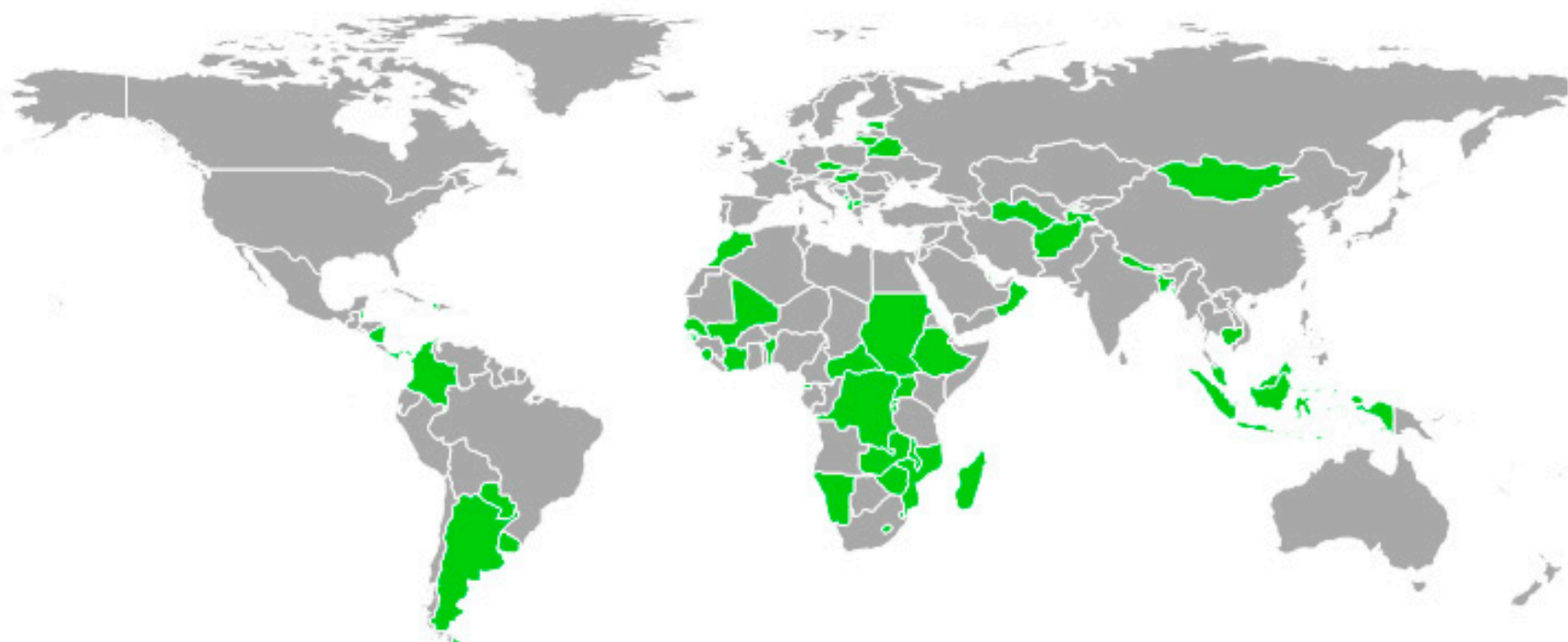
Required Fiscal Adjustment in Structural Primary Balance Between 2010 and 2020



Adjustment needed:

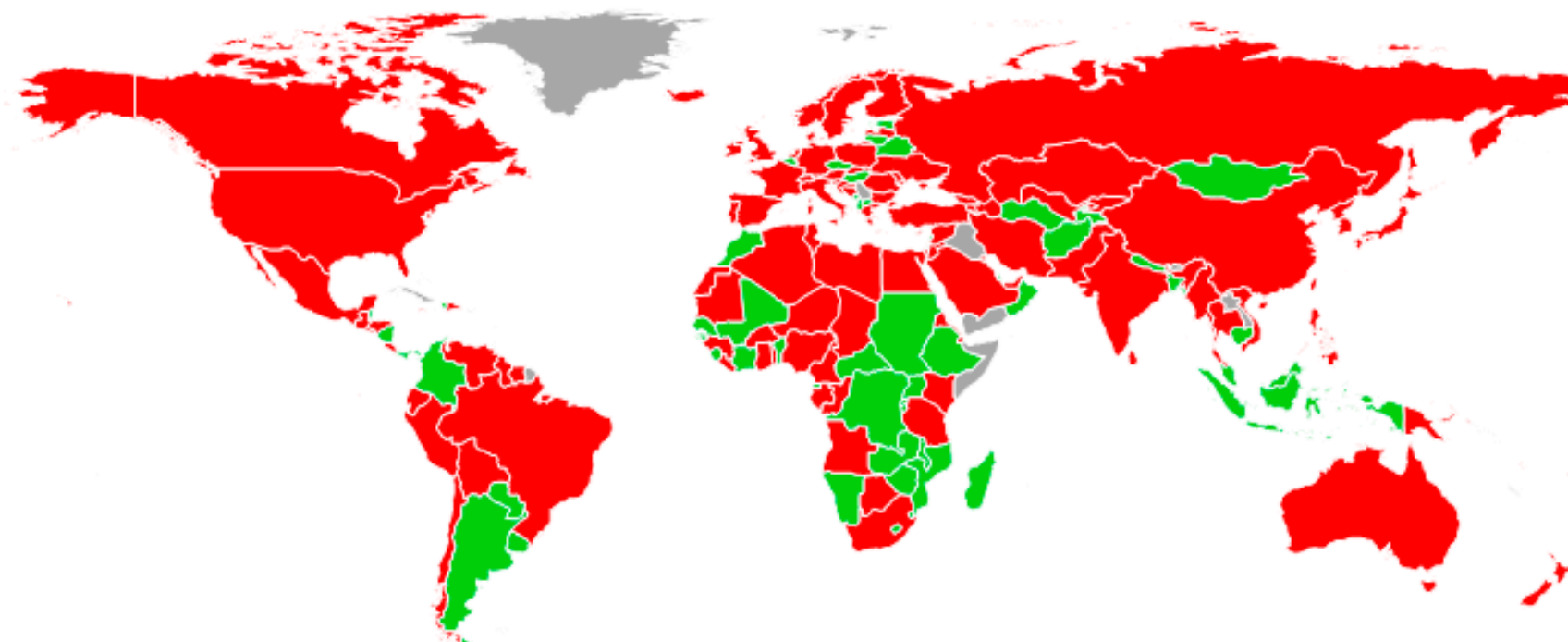
- for high debt countries: Japan, India
- for countries exposed to risk: Indonesia, Philippines, Vietnam
- to deal with inflows / pressures

Change in the Overall Balance in 2011



■ Loosening

Change in the Overall Balance in 2011



- Loosening
- Tightening

Fiscal risks and challenges looking ahead



Risks for the fiscal accounts:

1. Debt dynamics and spreads
2. Developments in world demand
3. Capital inflows, overheating, bubbles

Long term challenges with fiscal impact:

1. Population aging
2. Improve infrastructure to accompany growth
3. Reducing poverty and improving welfare

Risk 1: Debt dynamics and possible contagion in sovereign spreads



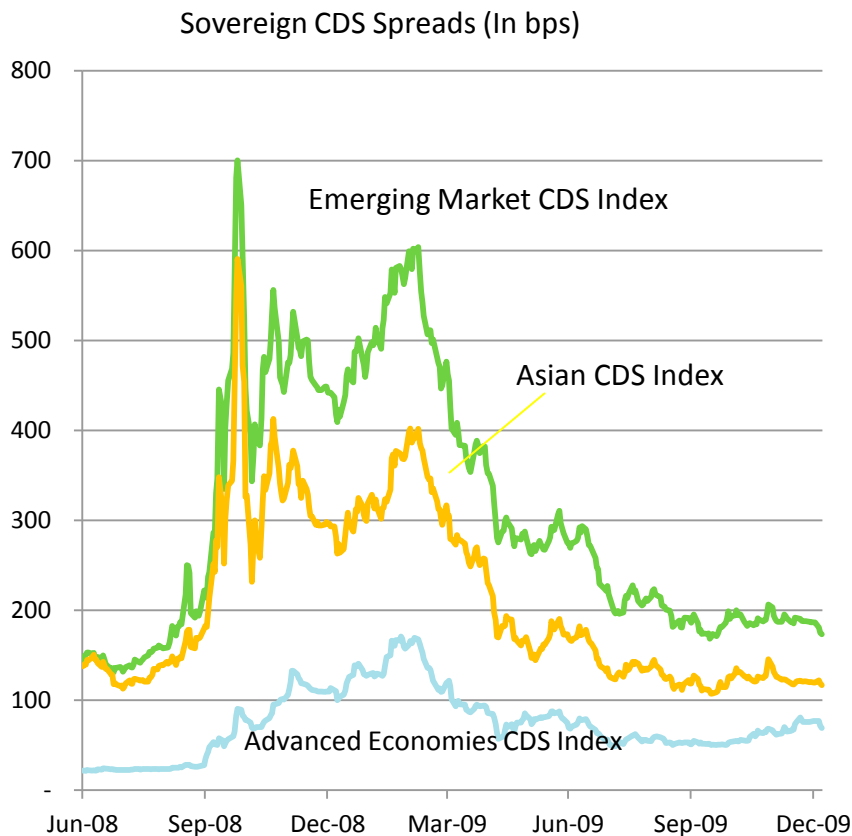
- In general, lower debt levels than most advanced countries, but lower tolerance
- Japan stands out
- Spreads normalizing from initial spike—now better differentiation
- Potentially still exposed to changes in global risk aversion, spillovers.

Risk 1: Credit Risk Spreads

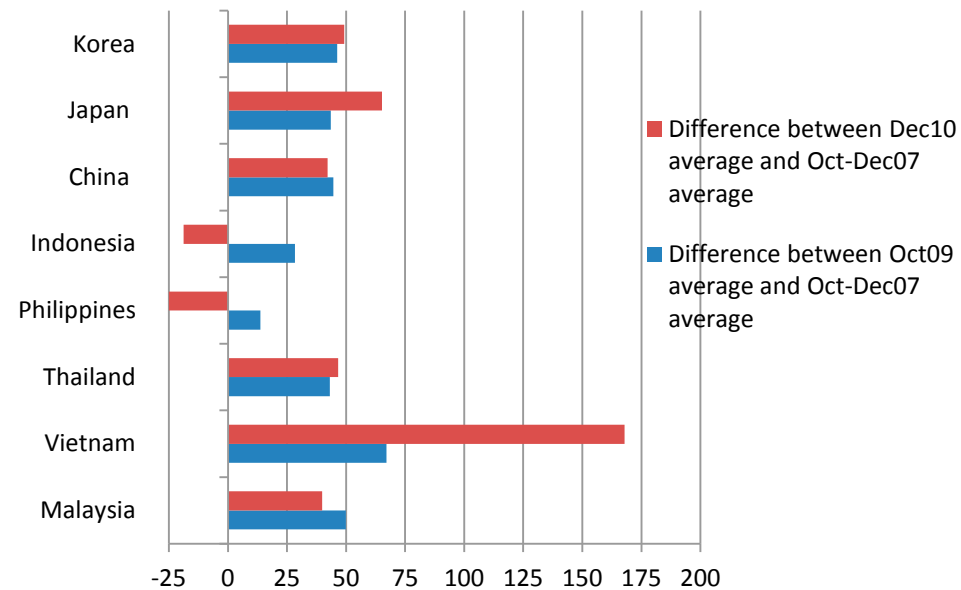


■ Normalization from crisis peaks

■ But recent risk differentiation



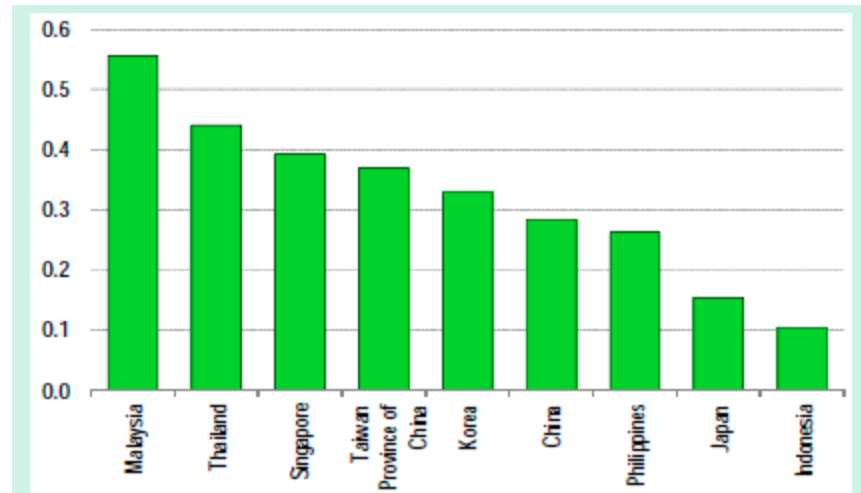
Change in Sovereign CDS Spreads since 2007



Risk 2: A fall in world demand?



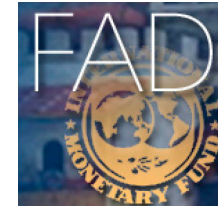
Impact of 1 percentage point decline in G-2 final demand on GDP growth



Beyond direct effects on output, the fiscal impact would depend on revenue structure of individual countries:

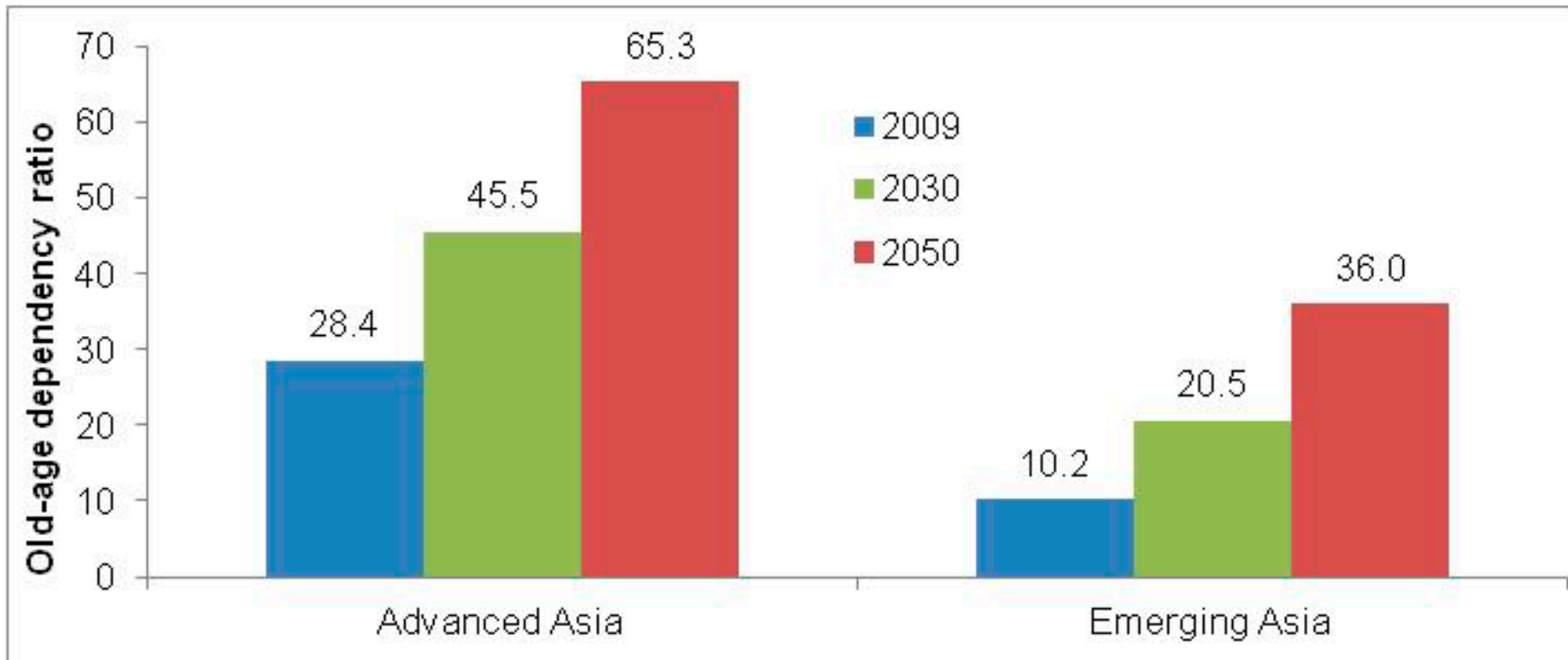
In particular, smaller economies and developing countries more reliant on tariff and commodity revenues; narrower export and production base and few productive sectors
➔ Impact of lower external demand likely to be stronger

Risk 3: Capital inflows, overheating?



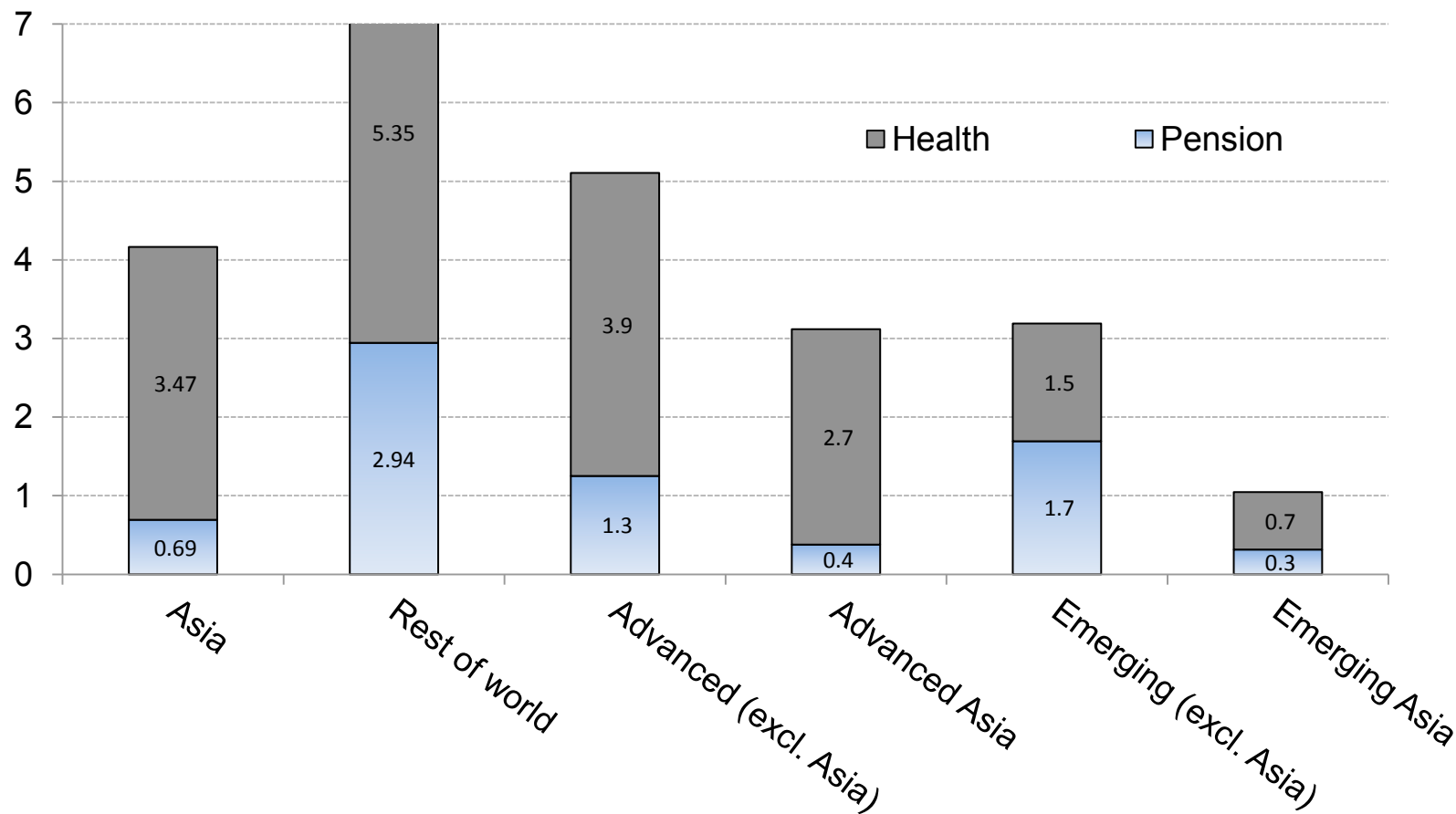
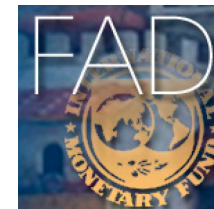
- Another argument in favor of a return to “building buffers in good times.”
- Loose policies may inflate bubbles, particularly in NIE.
- Strong procyclicality of revenues related to “bubble prone” assets and activities.
- Macroprudential regulations are in place
- While price increased in housing market, no evidence of bubble burst.

Challenge 1: Population aging

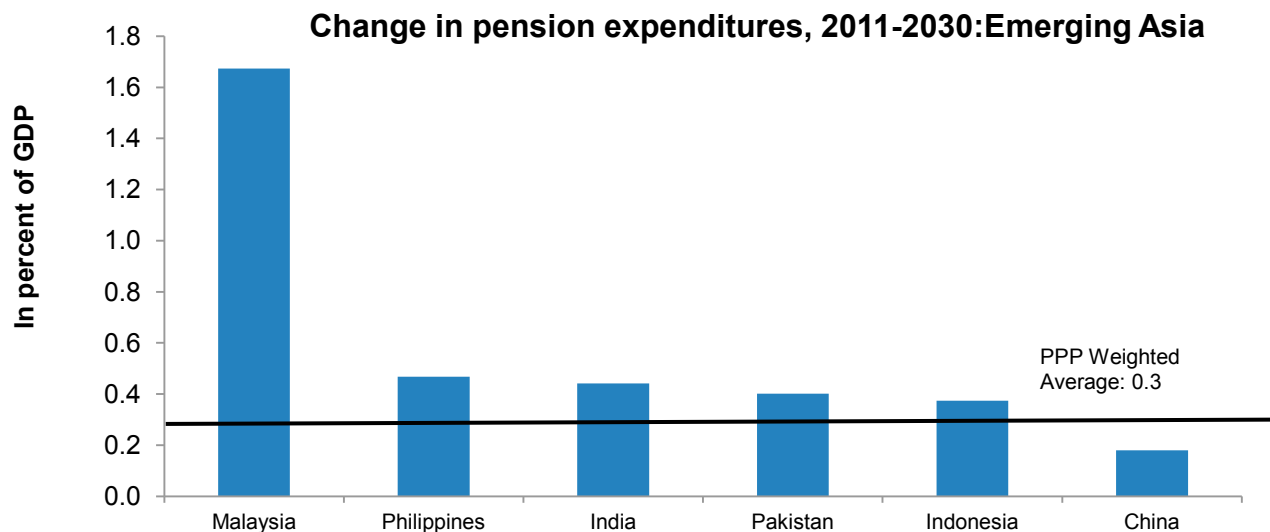
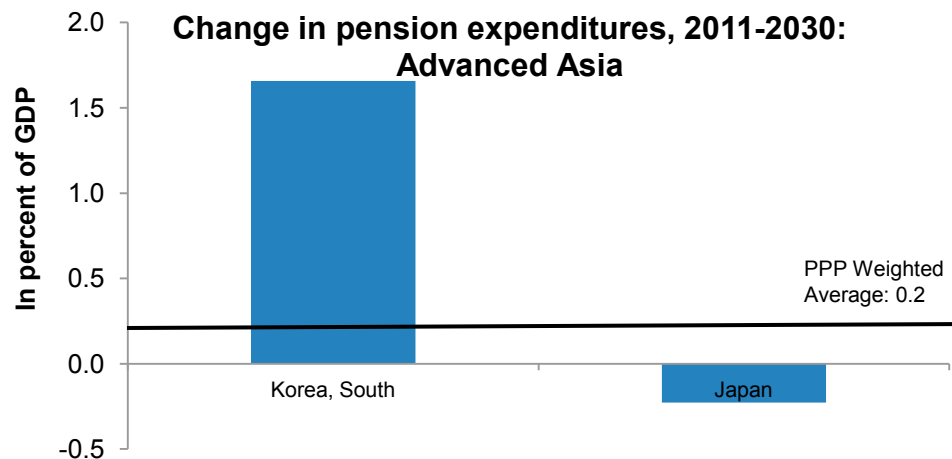


- Need for pension reform and improved efficiency of health-related expenditure
- Challenge is to ensure that all new entitlements are fiscally sustainable

Projected increases in pension and health care spending, 2011-30



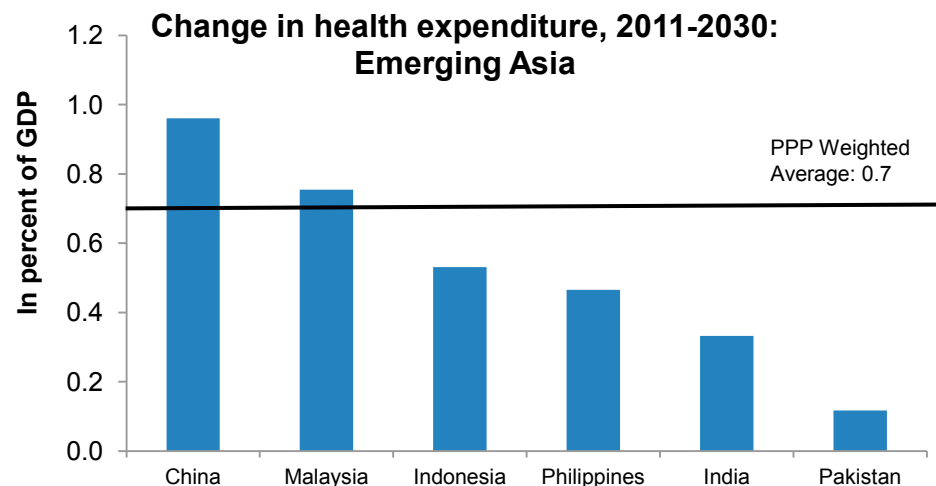
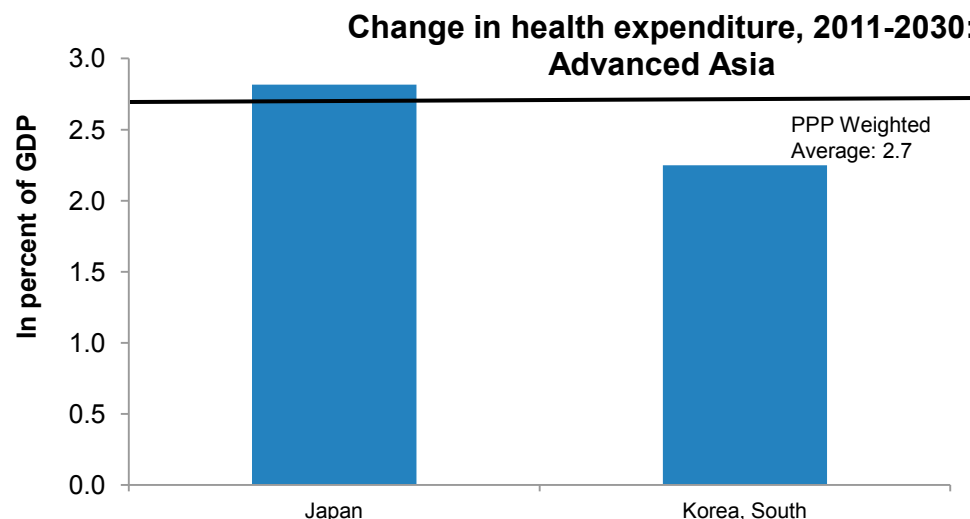
Challenge is particularly acute in some countries



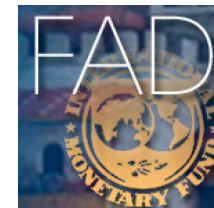
Health care spending: more daunting challenges



- Advanced economies should stabilize finances over the long term
- Emerging Asia should expand coverage in a fiscally sustainable manner
- Must ensure: an adequate rate of return on pension contributions; and adequate benefits to prevent old-age poverty and protect against illness



Challenge 2: the infrastructure gap



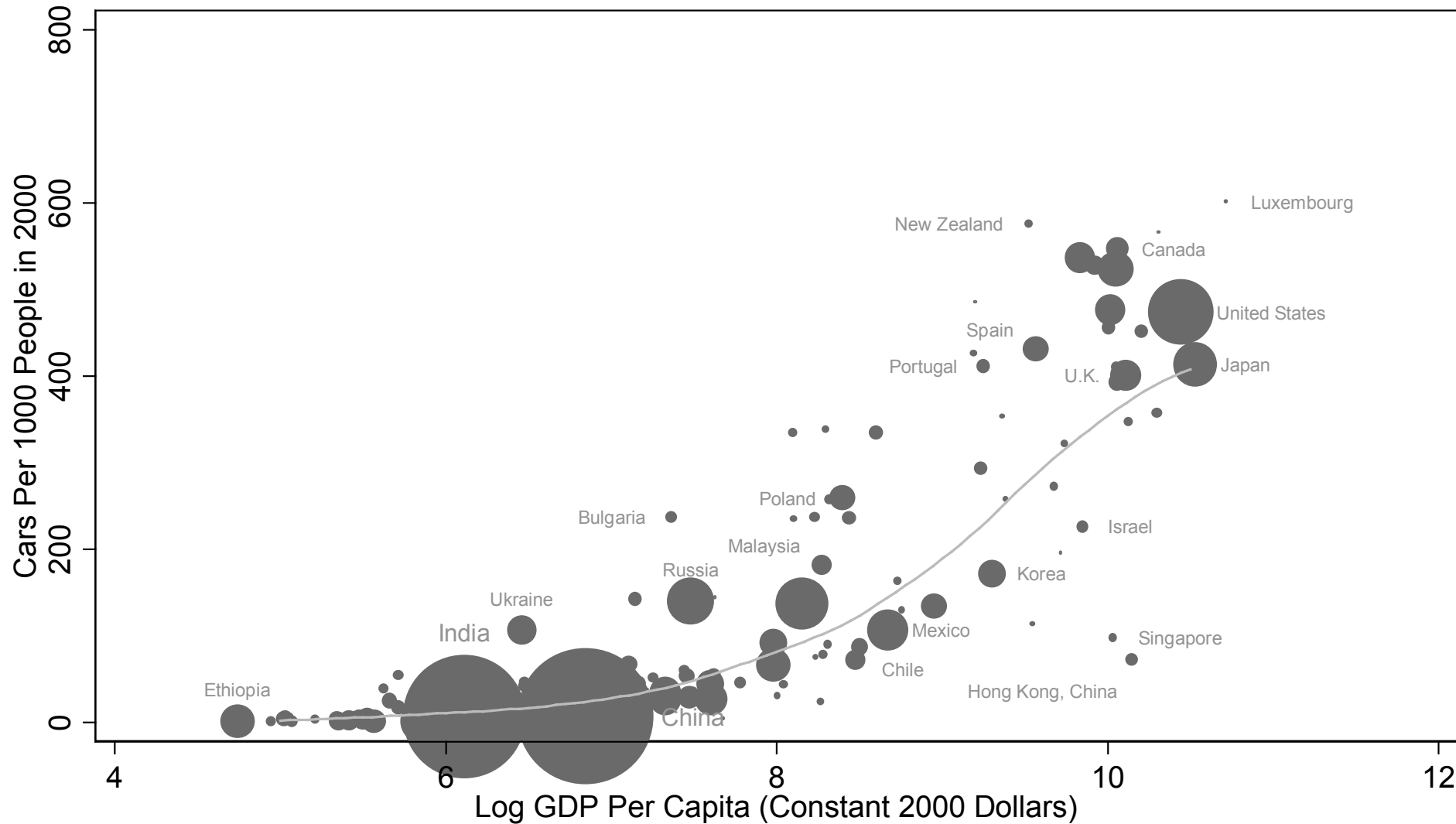
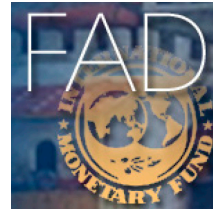
- Perception that infrastructure quality and quantity is a brake on growth for many countries in the region
- Investment spending has remained flat in last 10 years
- Challenge to raise investment to levels in comparable countries and improve investment quality
- Some of the largest countries in the region are at a level of development where a major increase in infrastructure is needed.

World Ranking of Asia Pacific countries on basic infrastructure performance

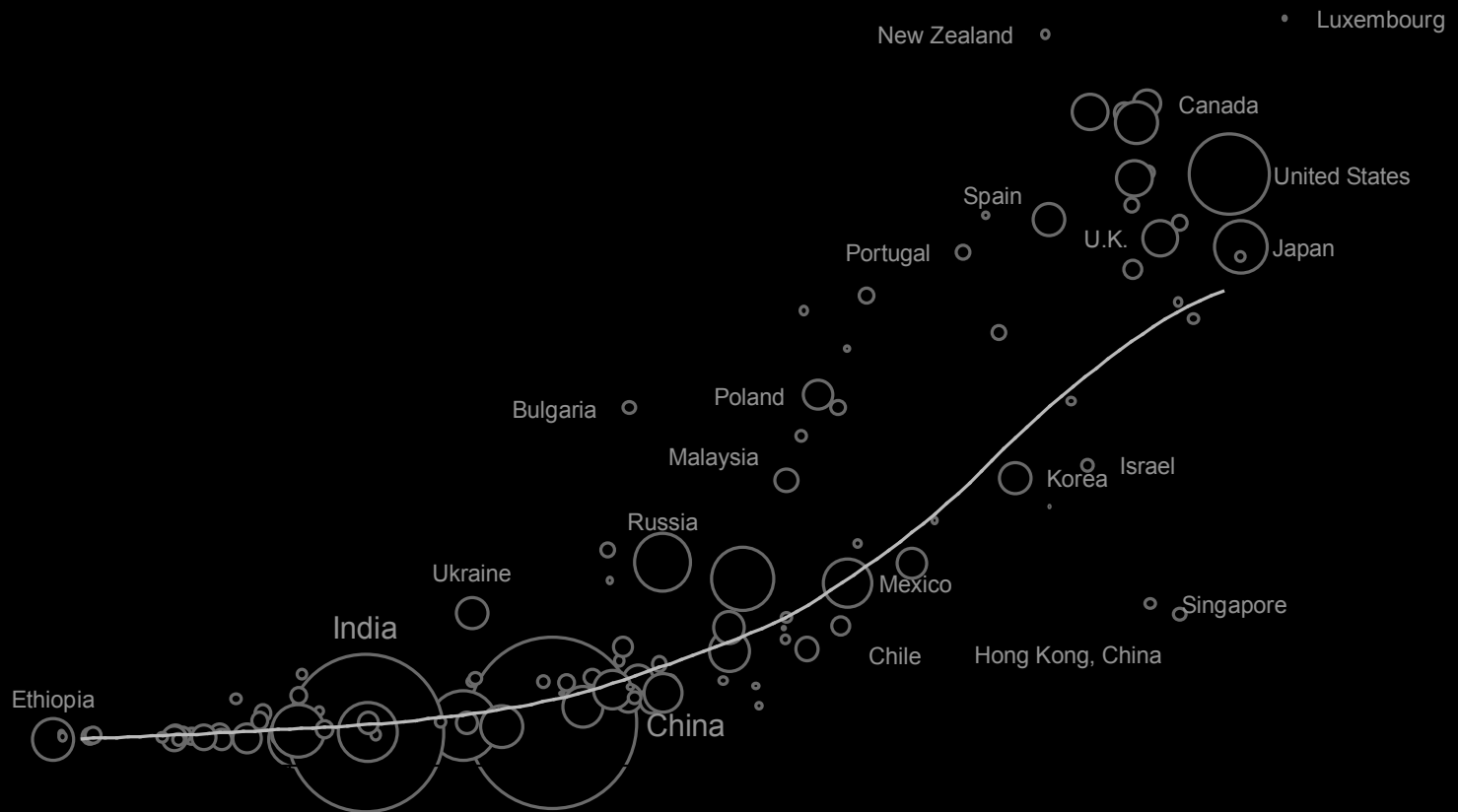
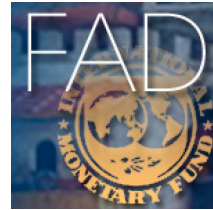
Ranks	1999	2009
Singapore	8	2
Hong Kong SAR	19	5
Australia	1	12
Japan	20	15
China	13	16
New Zealand	15	21
Malaysia	26	22
Korea	41	23
Taiwan Province of China	23	27
Thailand	33	29
India	38	37
Indonesia	39	48
Philippines	47	57

Source: IMD, *World Competitiveness Yearbook*, 2009.

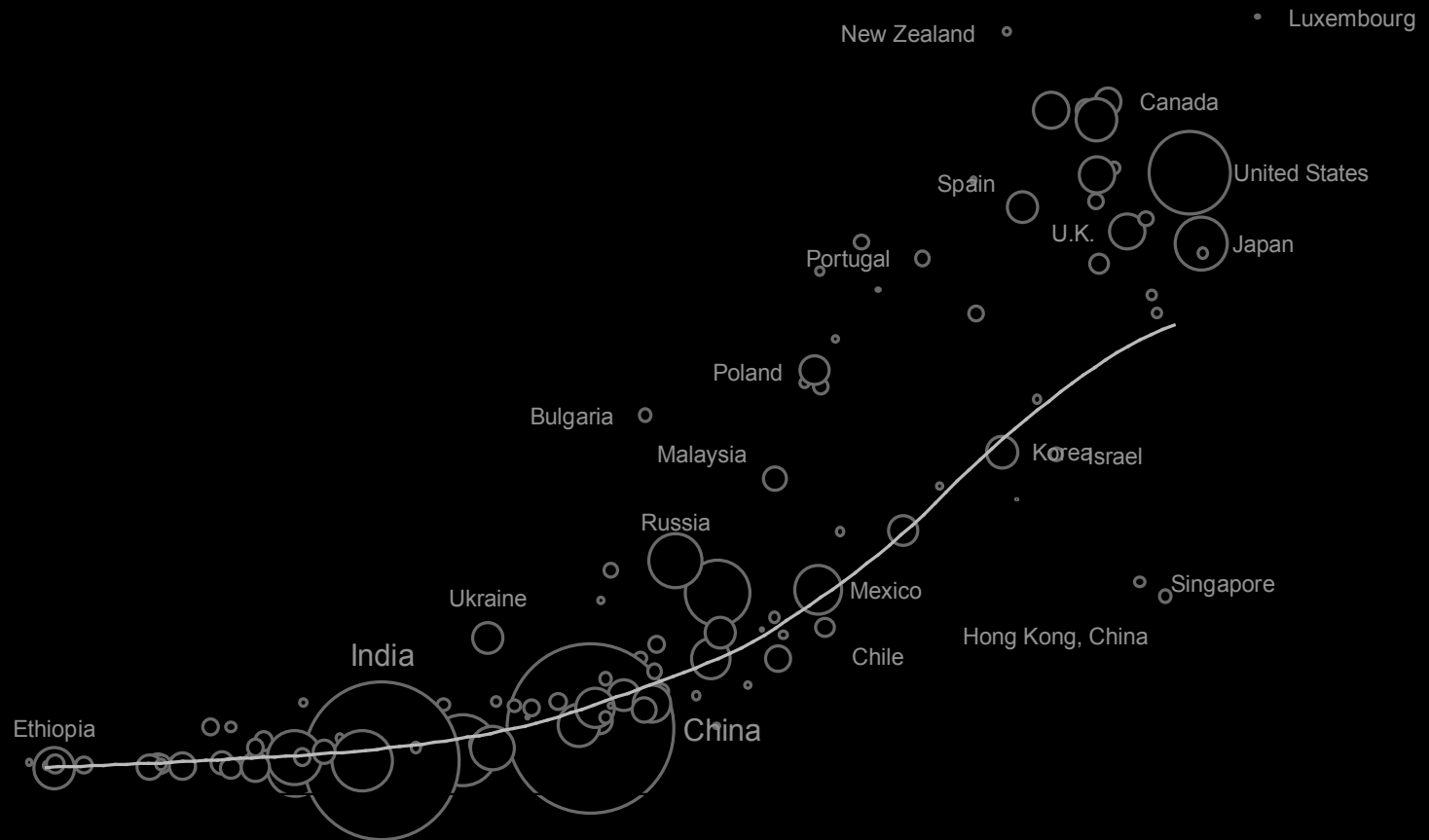
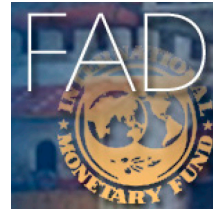
Rising demand for infrastructure: automobiles as an illustration



Rising demand for infrastructure: automobiles as an illustration

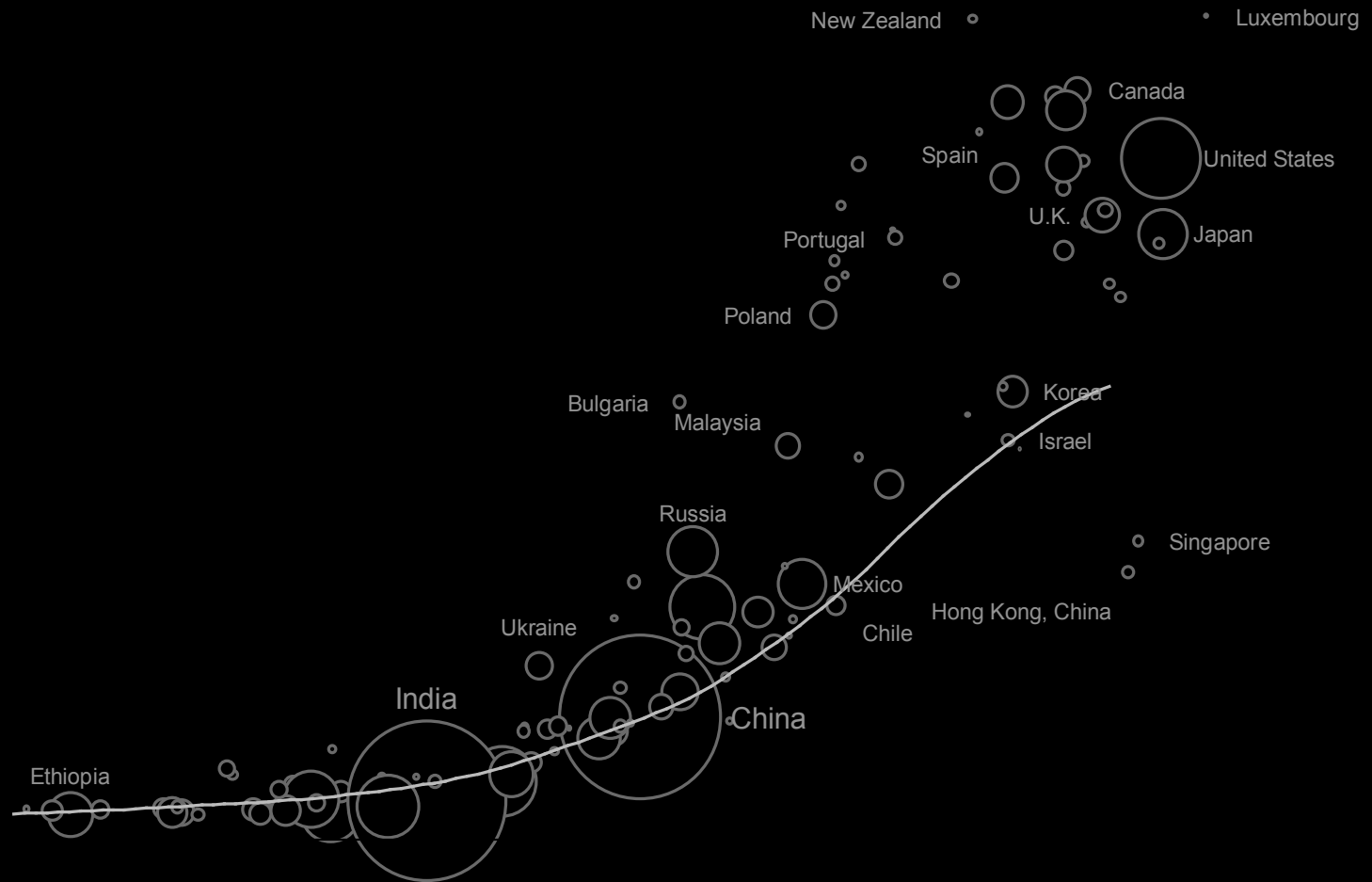
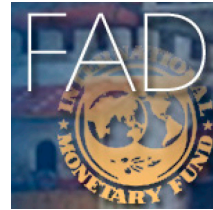


Rising demand for infrastructure: automobiles as an illustration

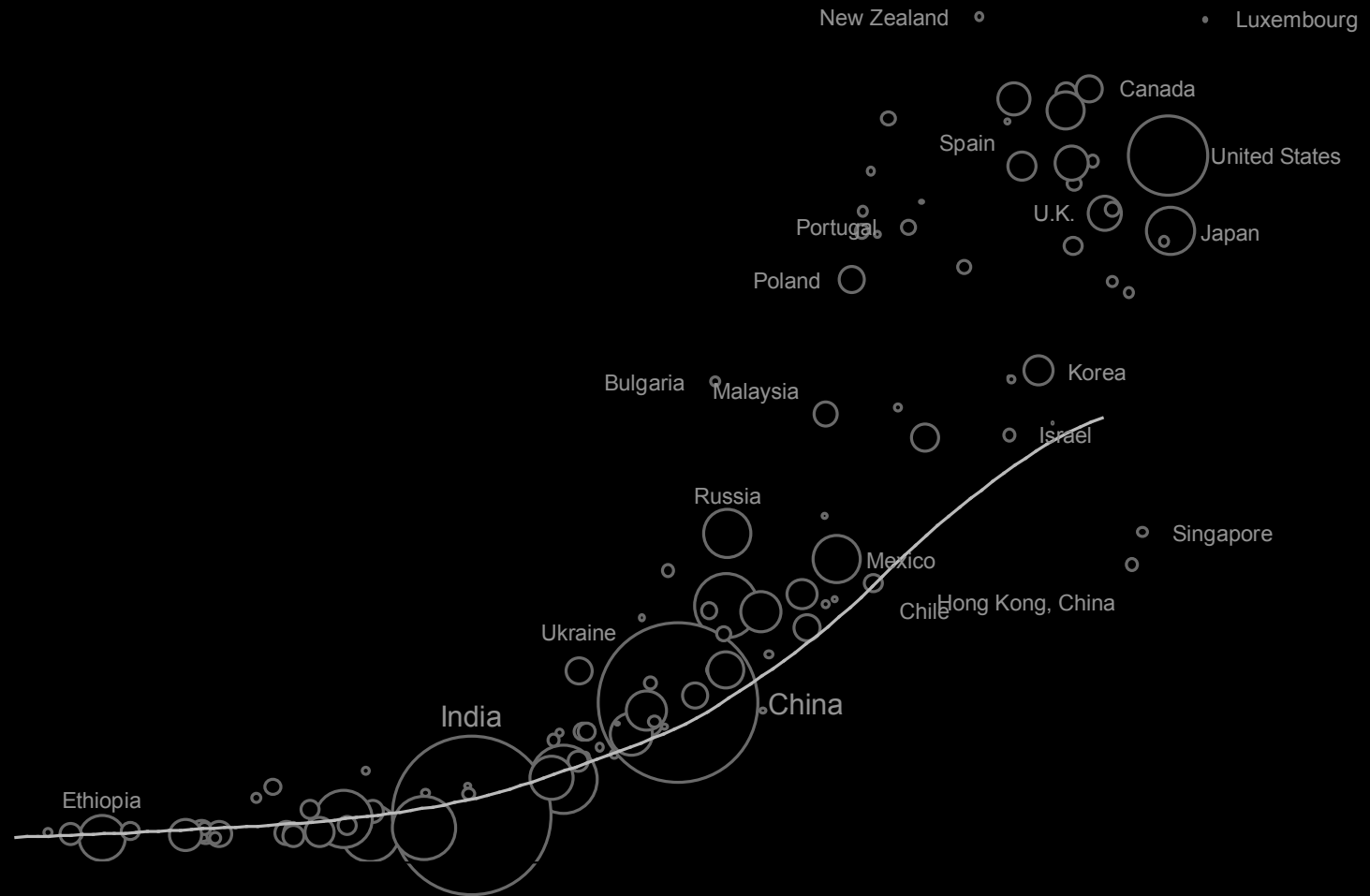
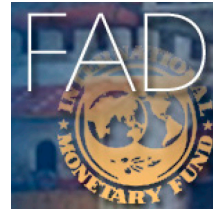




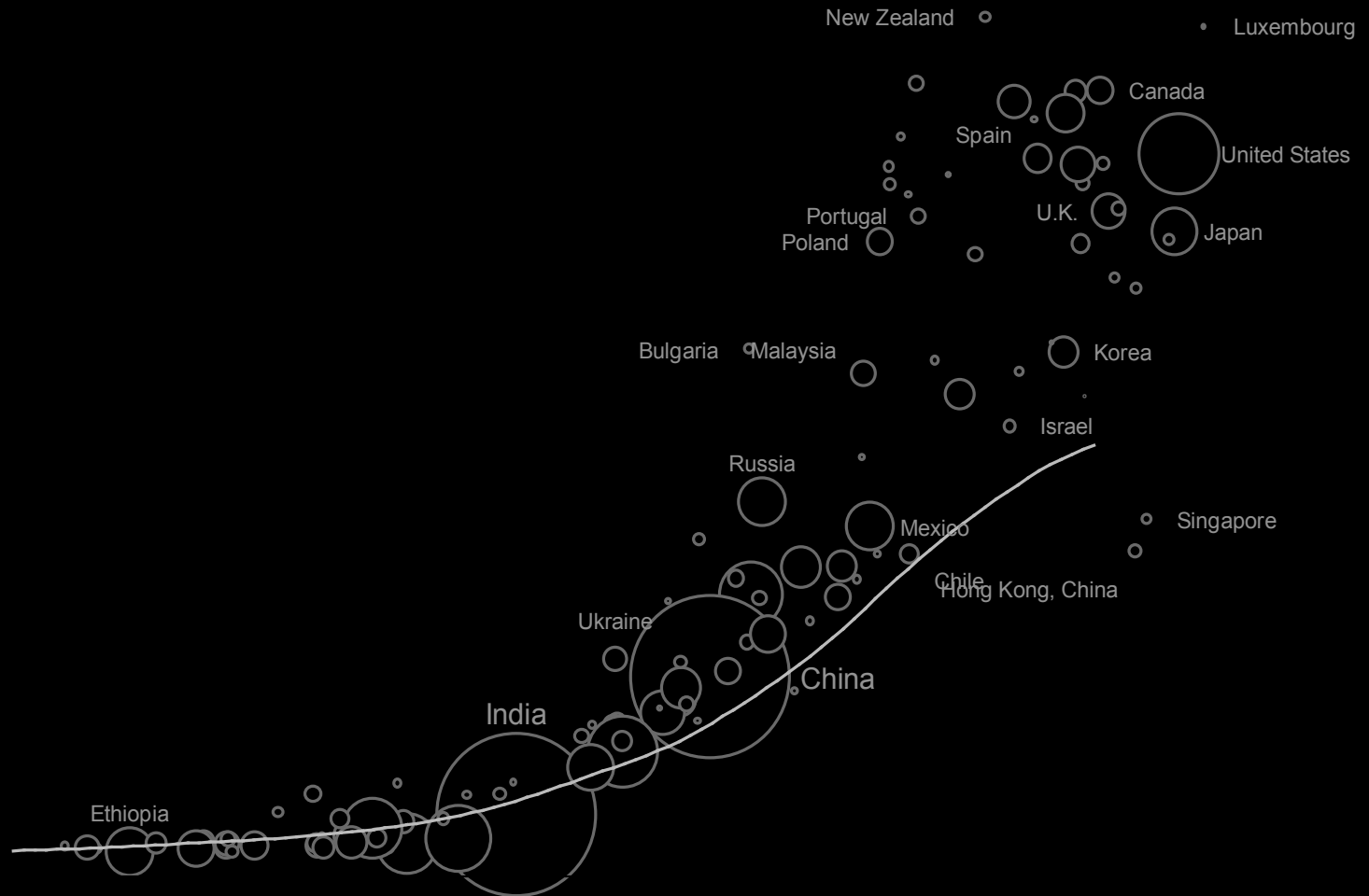
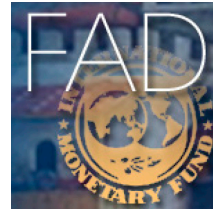
Rising demand for infrastructure: automobiles as an illustration



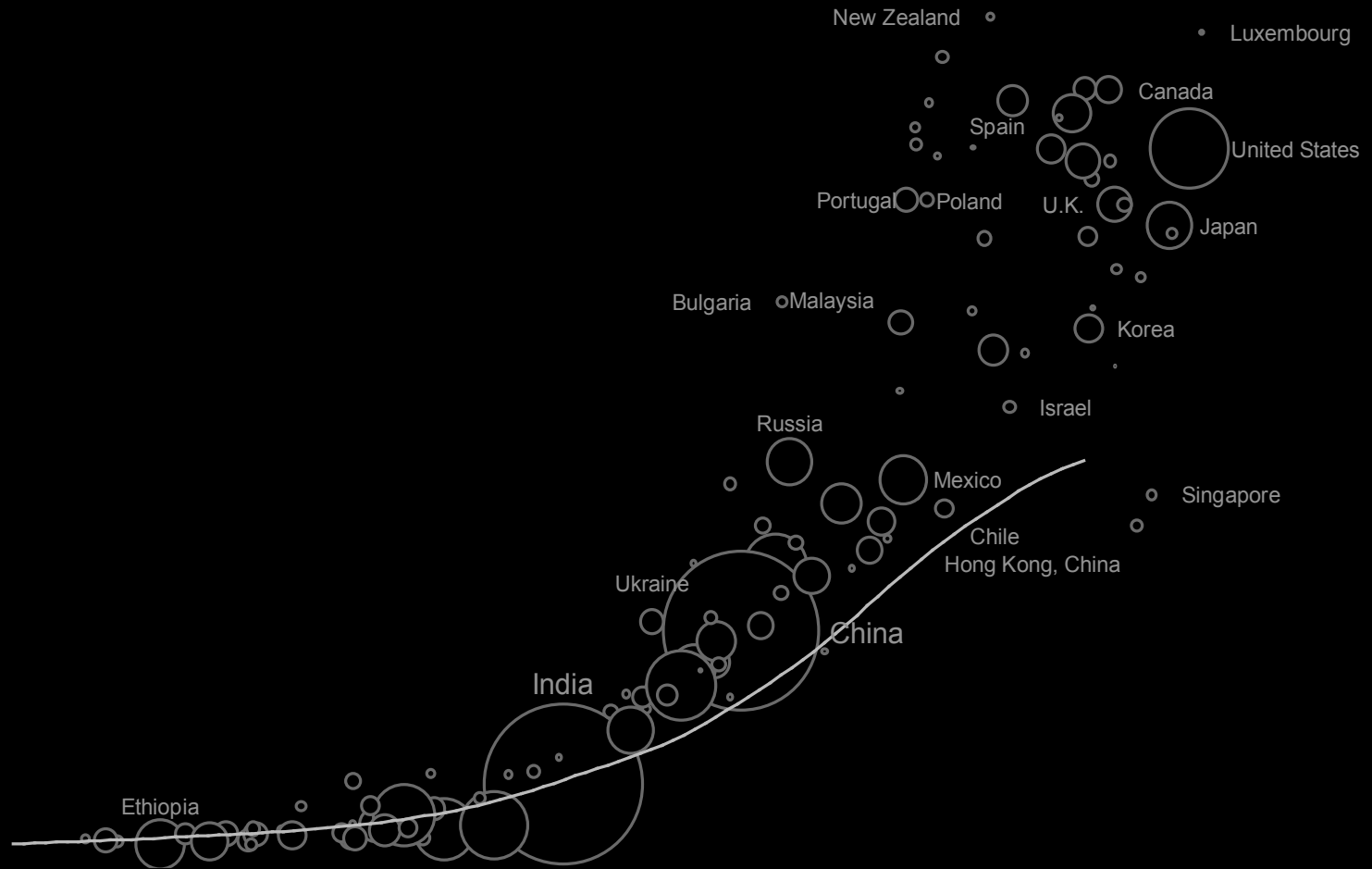
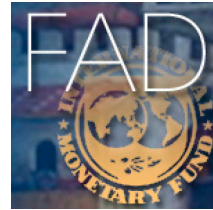
Rising demand for infrastructure: automobiles as an illustration



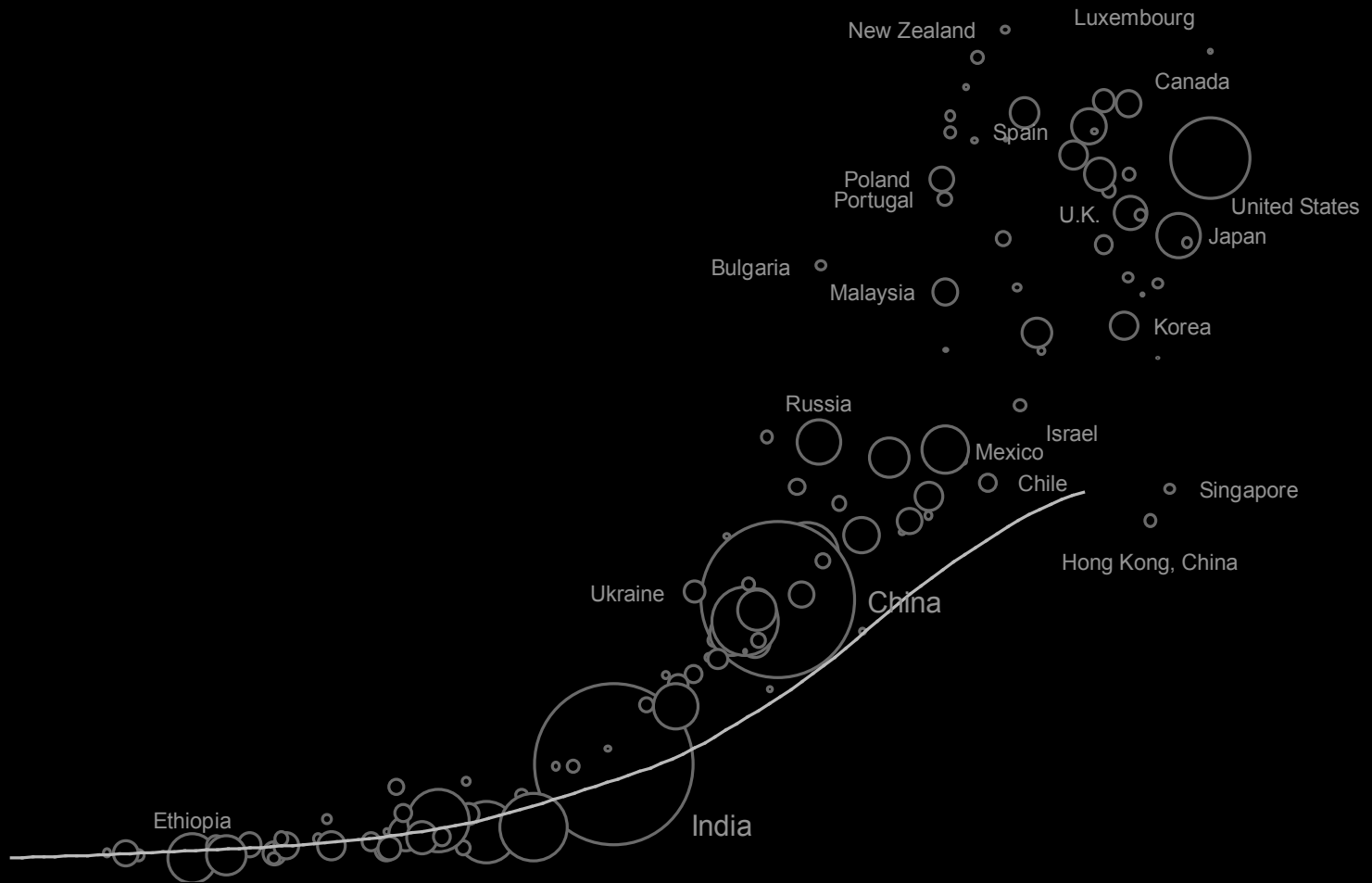
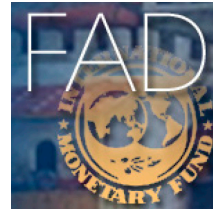
Rising demand for infrastructure: automobiles as an illustration



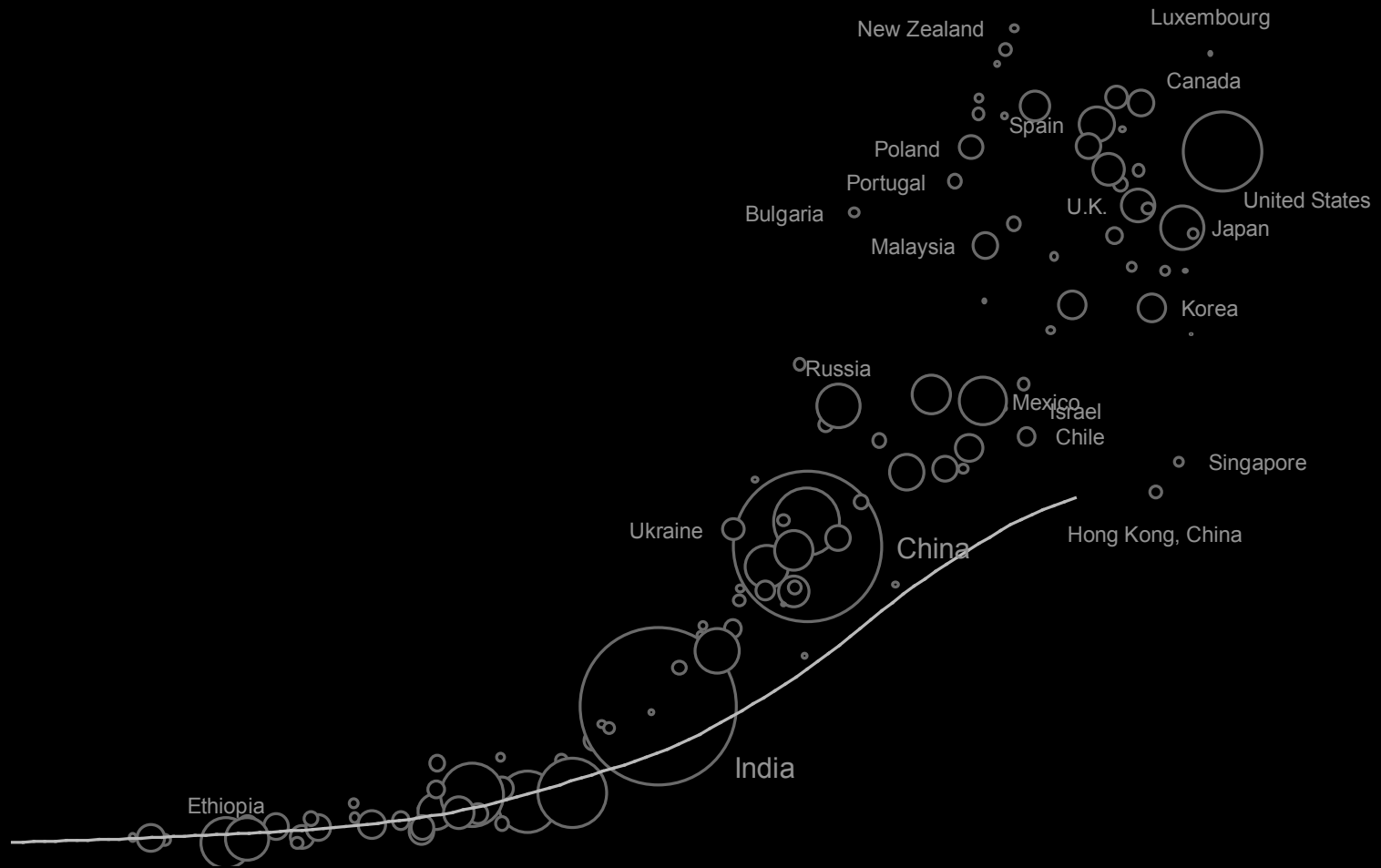
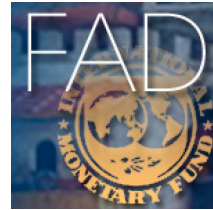
Rising demand for infrastructure: automobiles as an illustration



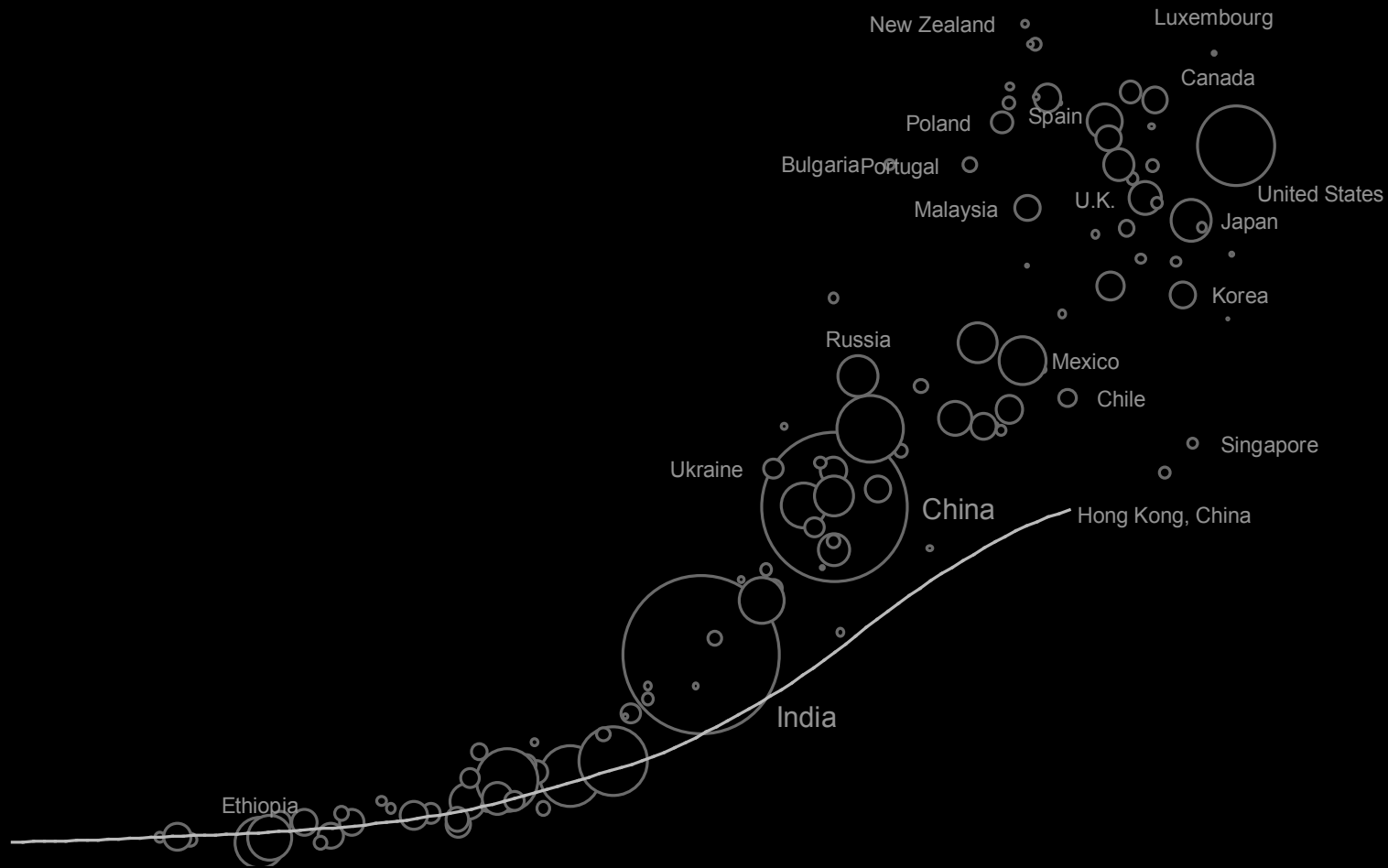
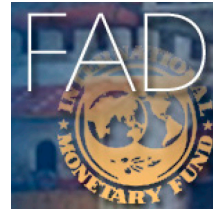
Rising demand for infrastructure: automobiles as an illustration



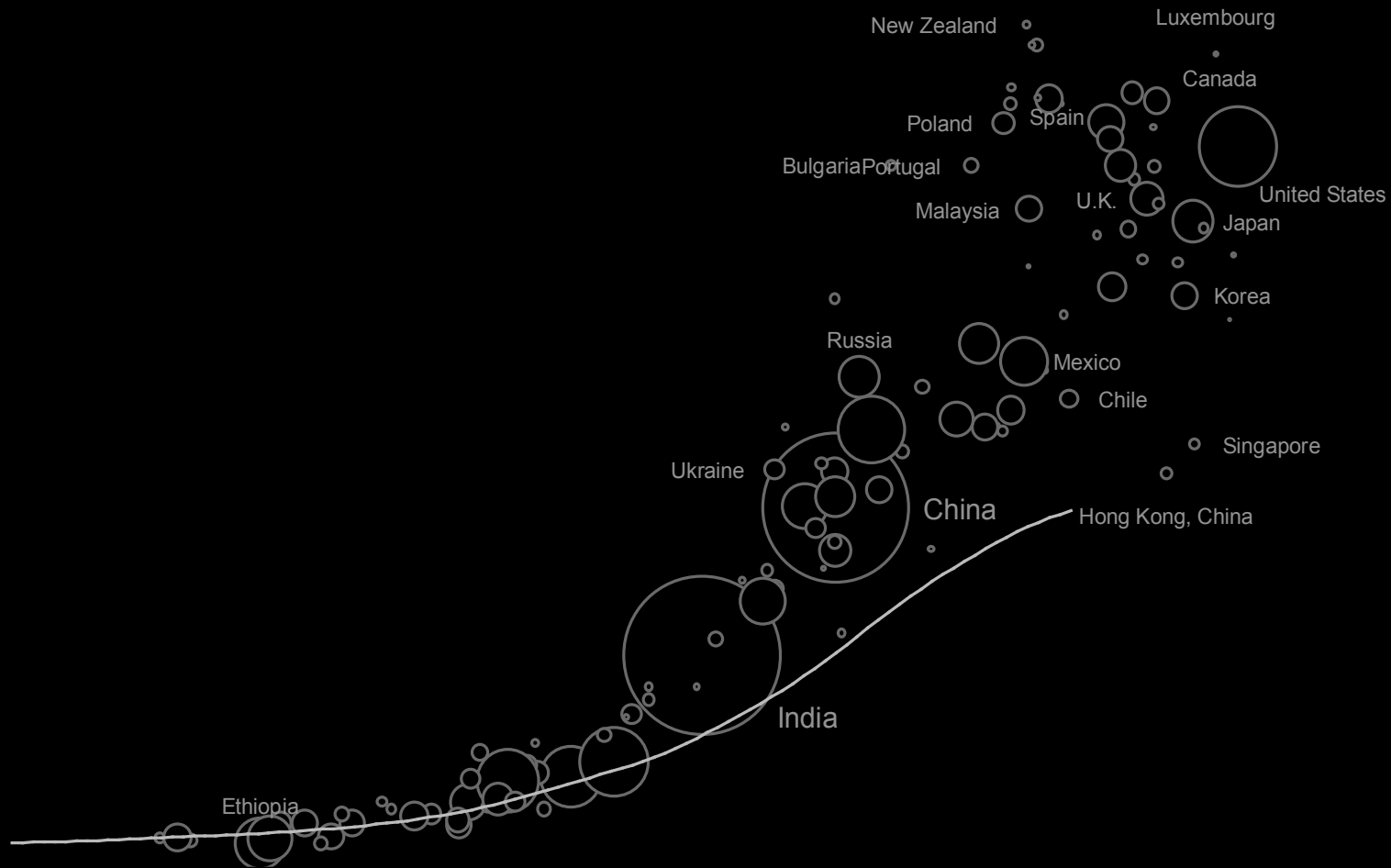
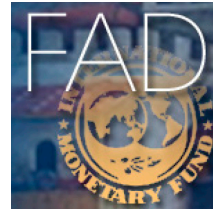
Rising demand for infrastructure: automobiles as an illustration



Rising demand for infrastructure: automobiles as an illustration



Rising demand for infrastructure: automobiles as an illustration



Challenge 3: Reducing poverty and improving welfare



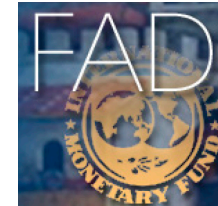
- Given fiscal constraints, not much room to increase envelope of total poverty and social spending
- Poverty spending must be targeted and effective to recoup “lost biennium”

Poverty and inequality indicators in
selected Asian countries

	Population Living Below \$2 a Day 1990–2005	Income Share of Highest Decile 2004–05	Income Share of Lowest Decile
Indonesia	52.4	32.3	3.0
Malaysia	9.3	...	...
Philippines	43.0	34.2	2.2
Singapore	...	32.8	1.9
Thailand	25.2	33.4	2.7
China	34.9	34.9	1.6
India	80.4	31.1	3.6
Asia-12	54.6	30.4	2.8
OECD	...	24.2	3.1

Source: OECD (2009).

Post crisis fiscal policies

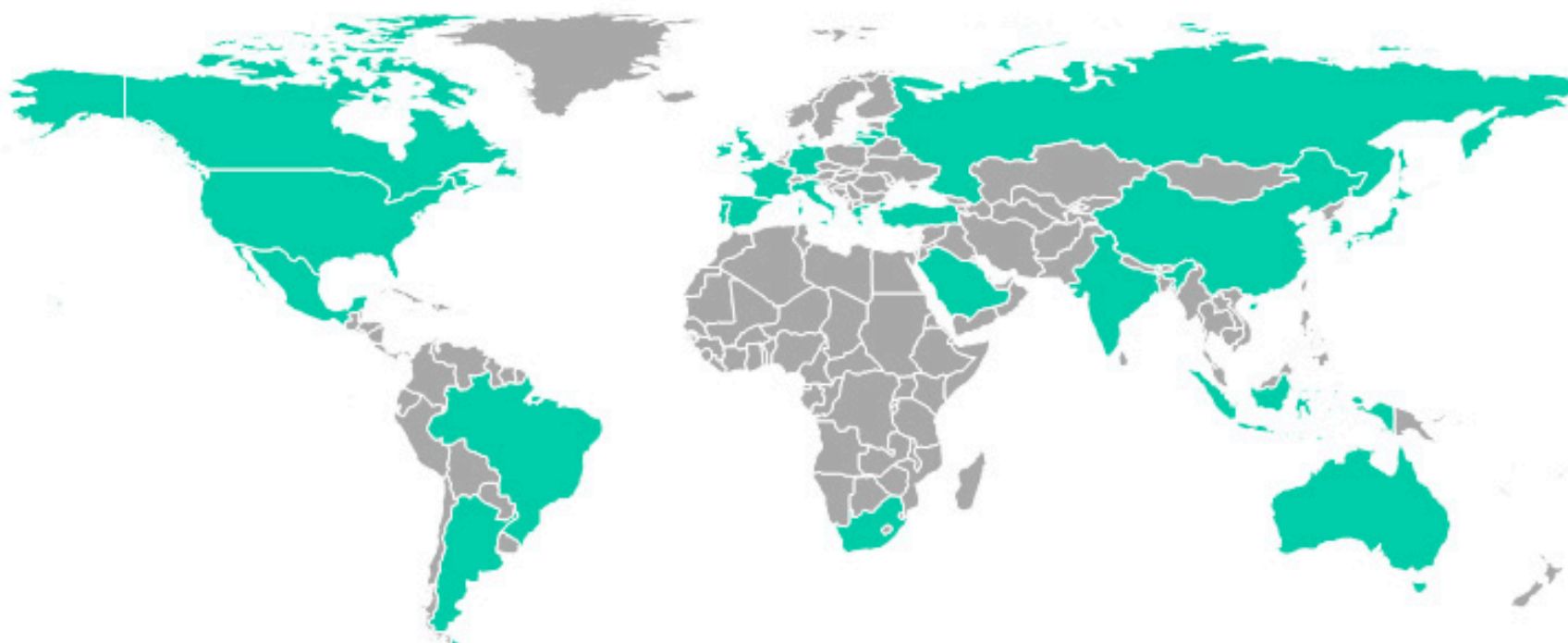


- Many countries are appropriately exiting from fiscal stimulus and moving back to rebuilding fiscal buffers in good times
- Several countries have announced medium-term fiscal adjustment plans; this helps reassure market participants and the public at large.
- Adopt sustainable measures to deal with ageing and reform health entitlements early on
- Transparent disclosure and management of fiscal risks (from e.g., guarantees, SOEs) helps credibility.

Fiscal Consolidation Over the Medium-Term: G-20

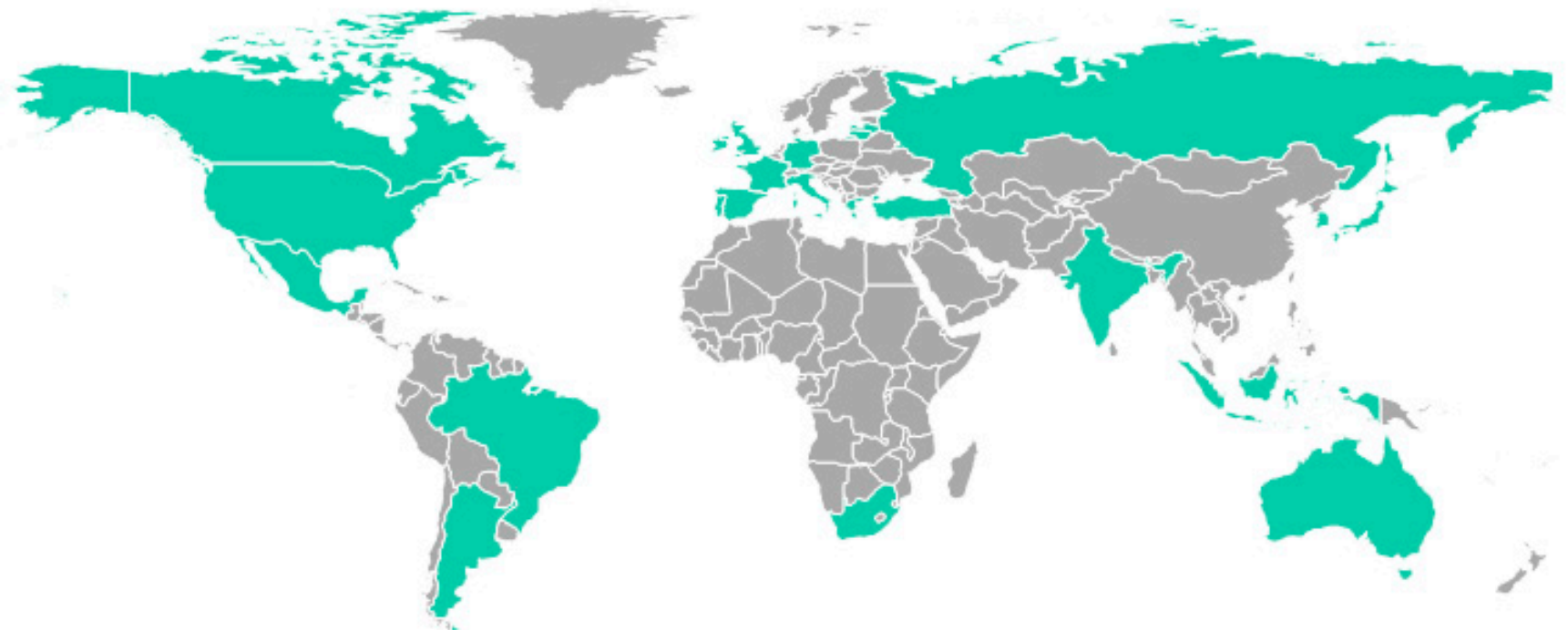


G-20 and Selected Economies with an Adjustment Plan



 Country sample

G-20 and Selected Economies with an Adjustment Plan

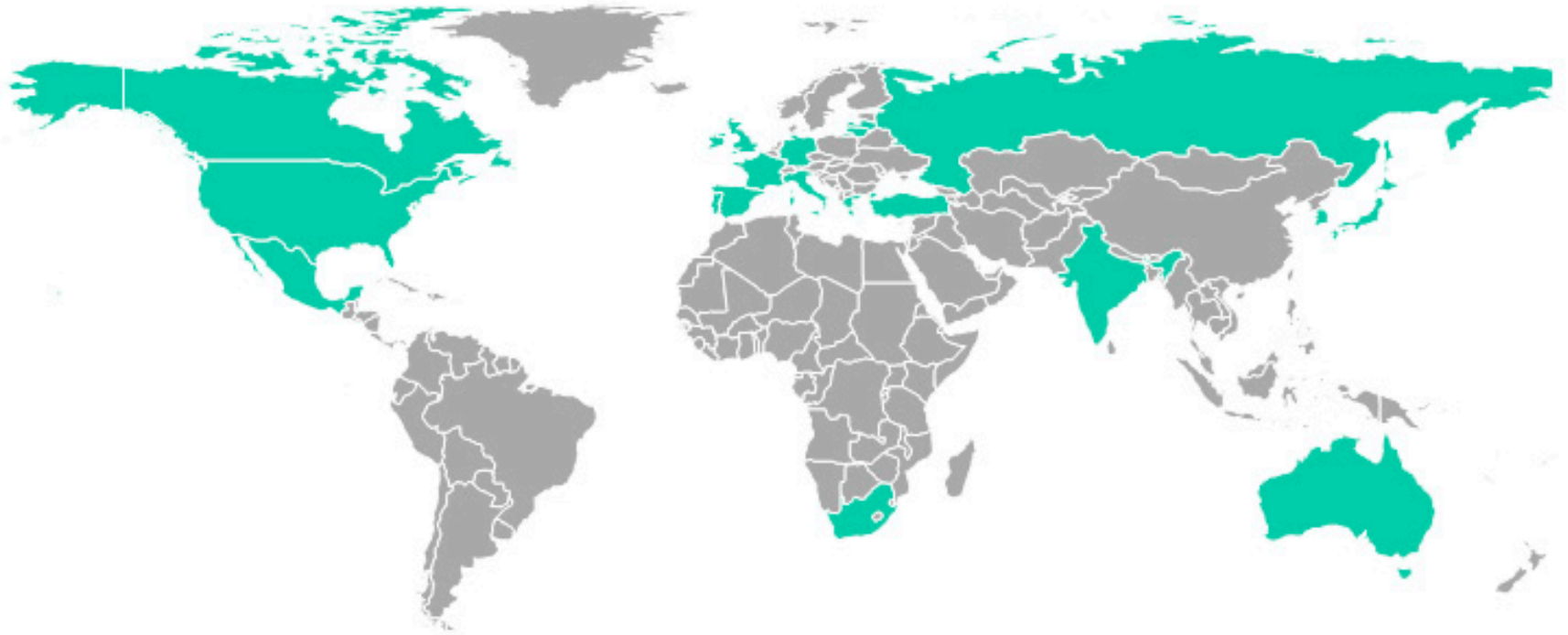


■ Economies with published plans

Fiscal Consolidation Over the Medium-Term: G-20



G-20 and Selected Economies with an Adjustment Plan

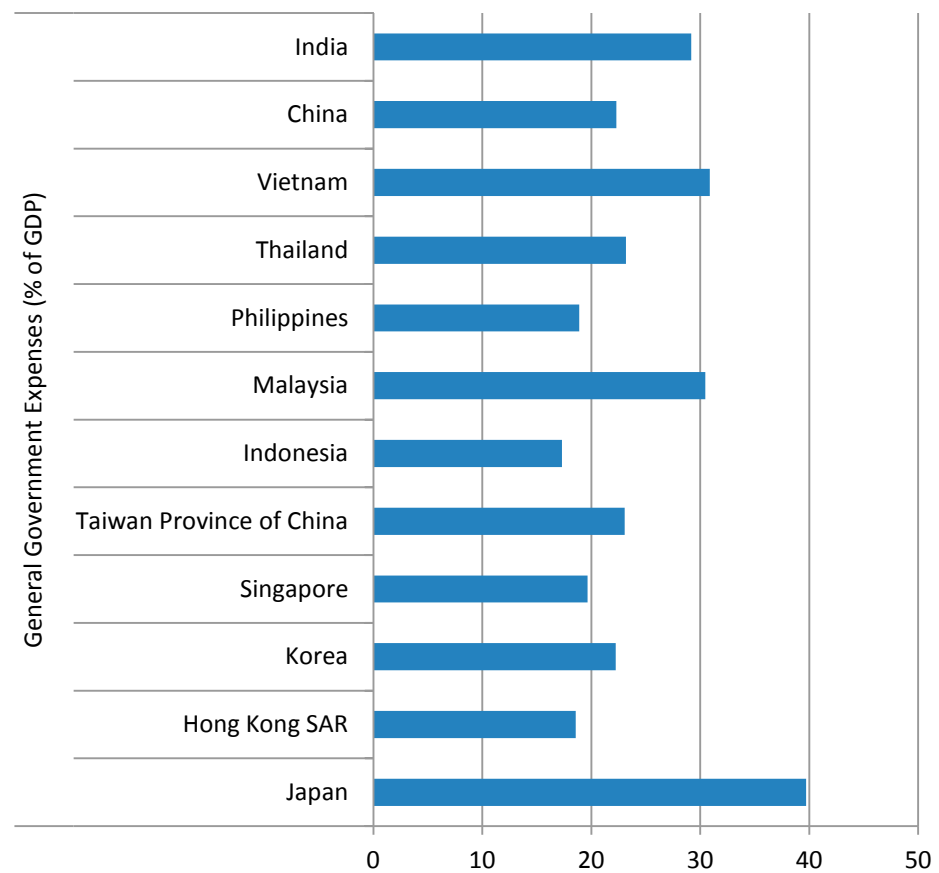
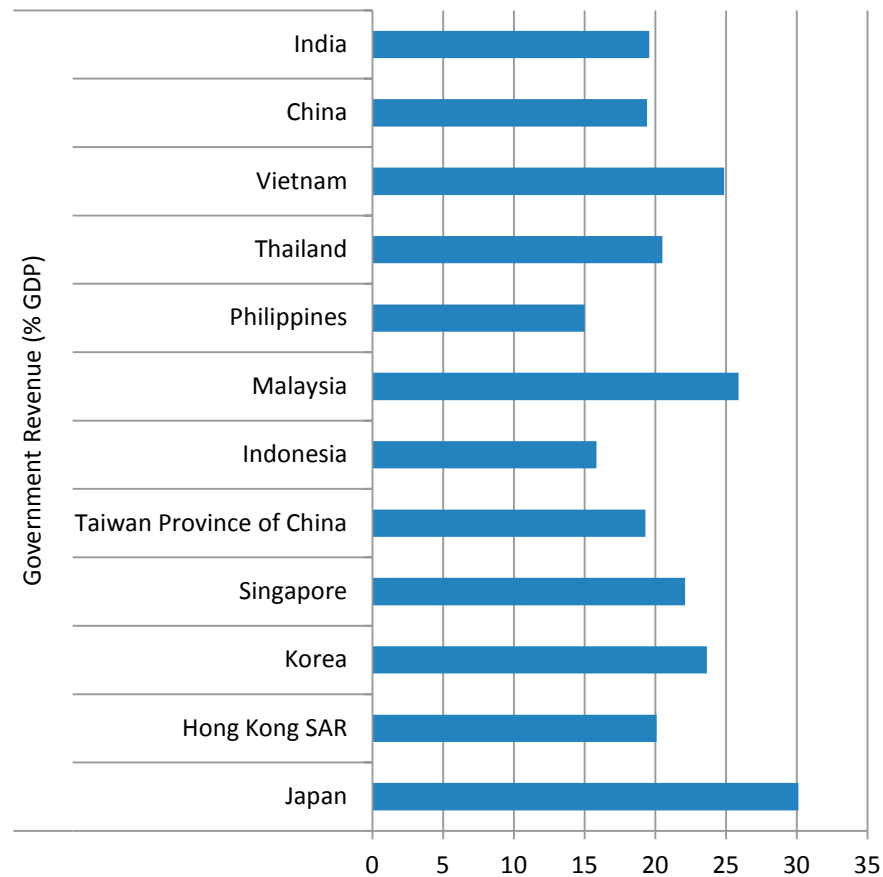


■ Economies with published plans involving fiscal adjustment

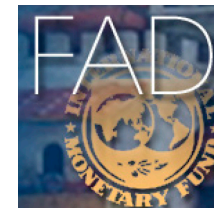
How to exit? Composition of fiscal adjustment will depend on current “size of the state”.



Government revenues and expenditure as a share of GDP, 2010



Expenditure structure of selected Asian economies, 2008



	Primary Expenditure	Compensation of Employees	Social Benefits 1/	Capital Spending	Compensation of Employees	Social Benefits 1/	Capital Spending
	(In percent of GDP)				(In percent of primary expenditure)		
Indonesia 2/ 3/	18.6	4.6	0.8	5.7	24.9	4.3	30.6
Malaysia 2/	27.5	...	6.5	3.0	...	23.6	10.9
Philippines 2/ 3/	13.1	5.0	3.1	2.4	38.1	23.6	18.3
Singapore 2/	17.8	...	...	1.7	...	...	9.6
Thailand 2/	20.4	7.6	3.3	2.6	37.3	16.2	12.7
China 2/	20.5	...	6.0	...	...	29.2	...
India 2/	23.6	...	4.1	...	...	17.4	...
Vietnam 2/	28.6	...	4.9	8.9	...	17.1	31.1
Korea 4/ 5/	29.1	7.3	5.9	6.0	25.1	20.1	20.7
Average (unweighted)	22.1	6.1	4.3	4.3	31.3	19.0	19.1

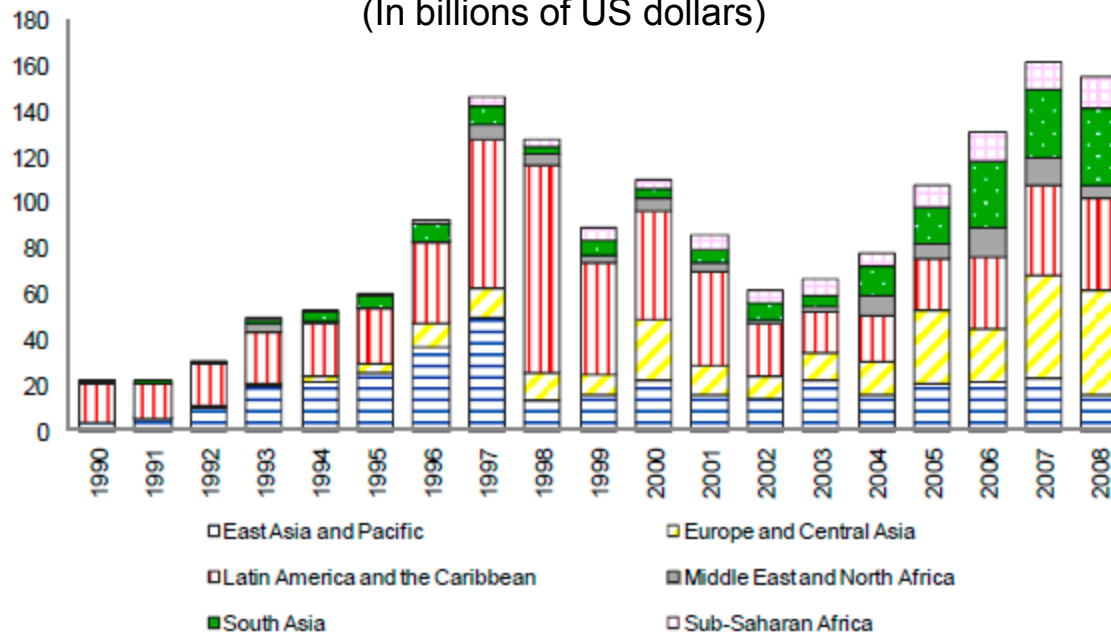
- Wide variation in primary spending as share of GDP
- In most Asian countries, social benefits are small
- Low capital spending in ASEAN and LICs
- Past success stories: reduce current, increase investment spending

Improving infrastructure investment efficiency: a greater role for the private sector?

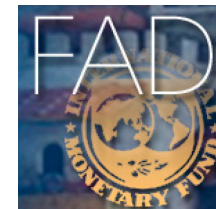


- PPPs may improve efficiency
- However, need to transparently disclose firm and contingent government obligations

Investment Commitments to Infrastructure Projects with Private Participation in Developing Countries, by Region, 1990-2008
(In billions of US dollars)



Poverty and social spending



Social spending in percent of GDP

	Pension 2010 1/	Health 2010 1/	Education 2007 1/
ASEAN-5			
Indonesia	0.9	1.3	3.5
Malaysia	2.9	2.9	4.5
Philippines	1.1	1.4	2.6
Singapore	0.6	1.0	3.2
Thailand	0.8	1.6	4.9
Other Asian Economies			
China	2.2	2.2	1.9
India	1.7	0.9	3.2
Vietnam	1.6	1.5	5.3
Regional average			
ASEAN-5	1.3	1.6	3.7
Advanced	7.4	7.0	...
Emerging	4.2	2.7	...

Sources: IMF, OECD, and UNESCO.

- Avoid perverse incentives, make sure the money goes to the real poor
- Phase out generalized subsidies
- Make use of conditional cash transfers
- Review credit guarantee schemes to limit distortions

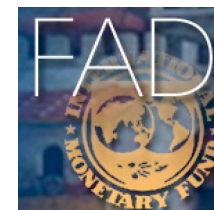
Revenue structure of Asian economies, 2008



	As a share of GDP						As a share of tax revenues		
	Total revenue		Tax revenue						
	Tax Revenue	Other revenue (incl. soc. Sec. and property)	Taxes on income, profits and capital gains	Taxes on goods and services	Taxes on international trade	Other taxes	Taxes on income, profits and capital gains	Taxes on goods and services	Taxes on international trade
China	17.3	2.4	4.7	9.0	1.0	2.5	27.5	52.0	6.1
India	16.6	3.4	6.9	6.7	1.8	1.2	41.4	40.4	11.1
Indonesia	13.3	7.1	6.6	5.3	0.7	0.7	49.7	39.6	5.5
Malaysia	15.2	6.4	7.8	3.4	0.4	3.6	51.3	22.4	2.6
Philippines	14.2	1.7	6.5	5.6	1.2	0.9	46.0	39.5	8.4
Thailand	17.5	4.0	7.9	8.2	1.1	0.3	44.9	47.1	6.1
Vietnam	24.8	1.9	10.3	9.4	4.0	1.1	41.5	37.8	16.3
Korea (2007)	17.5	7.5	8.4	7.5	0.8	0.8	48.2	42.9	4.5
Japan (2007)	15.5	15.6	10.3	4.9	0.2	0.1	66.5	31.7	1.2

- Revenue based fiscal consolidation is important for creating fiscal space in countries with low or declining revenue to GDP ratios.
- Need to reverse permanent tax cuts adopted during crisis.
- More tax competition on CIT: move to broad based taxes on immobile bases and improve compliance.

Tax efficiency and compliance



	Philippines 1/ 2007	Indonesia 2/ 2008	Thailand 3/ 2007	Malaysia 2/ 2008	Singapore 2007	East Asia and Pacific 2008 or latest available	Low- Mid-Income 2008 or latest available	World
Total tax revenues to GDP	14	13	17	17	14	20	21	20
VAT								
Rate	12	10	7	...	7	11	16	16
Revenue share of GDP	2	4	4	2	...	5	7	6
Tax efficiency 4/	18	42	54	...	...	48	47	40
Corporate income tax								
Rate (maximum)	30	30	30	27	18	28	26	26
Revenue share of GDP	4	1	5	8	...	6	3	3
Tax efficiency	12	3	17	30	...	20	13	13
Personal income tax								
Rate (maximum)	32	30	37	28	20	29	27	30
Revenue share of GDP	2	4	2	3	...	4	3	4
Tax efficiency	7	14	6	9	...	14	10	12

- VAT rates are lower in Asia than elsewhere → scope for rate increases
- For CIT and PIT, rates are similar to rest of world, but significant drops in some LICs and ASEAN countries, where tax efficiency is also particularly low
- Solution: increase scope of revenue agencies, encourage formalization by helping new entrepreneurs, reduce exemptions, strengthen legal framework and enforcement

Fiscal reform has started in Asia



Planned and ongoing fiscal reform in selected Asian countries

	Bangladesh	Cambodia	Lao PDR	Nepal	Sri Lanka	Vietnam
Revenue Side						
VAT introduction or reform	X	X	X		X	
Income tax reform	X				X	
Excises reform		X				
Investment tax reform					X	
Trade tax reform					X	
Tax administration reform		X	X	X	X	X
Expenditure Side						
Review wage bills/allowances		X				
Reprioritize development projects			X			X
Reduce/eliminate subsidies				X	X	
Reduce recurrent expenditure					X	
Public Financial Management	X	X	X	X		X

Source: National authorities.

- Several Asian countries have or are pursuing revenue reforms (especially VAT and tax administration). Recent notable reforms include Vietnam and Nepal.
- On the expenditure side, reforms focus on PFM (budget integration, fiscal monitoring and reporting, procurement and payroll control).
- Medium term fiscal frameworks and fiscal responsibility laws have been introduced and had especially beneficial effects for commodity exporting countries in the region.

Conclusions



- The challenges of these post crisis times are many and difficult to dealt with
- The good news is that a start has been made in fiscal adjustment and significant reforms in the fiscal area.
- Seminars such as this one today are an opportunity to discuss ways of making further progress in this direction.