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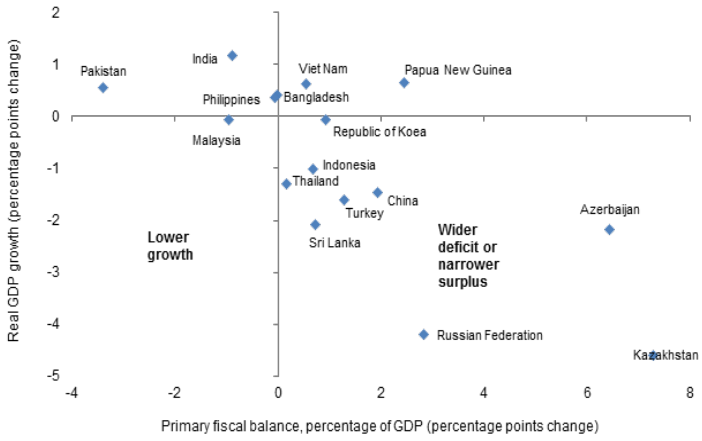
Fiscal stance and fiscal sustainability in Asia and the Pacific

Countercyclical fiscal policy has continued to play an active role in stabilizing the economy in the Asia-Pacific region. Nevertheless, ensuring fiscal sustainability is important and would require comprehensive tax reforms and effective debt management.

Overall fiscal stance and spending mix

In Asia and the Pacific, the prevalent fiscal stance during recent years has been countercyclical and expansionary, which bolstered the region's resilience against the backdrop of the slowdown in growth. Most countries, including China, Indonesia, the Republic of Korea and the Russian Federation, had wider fiscal deficits or narrower surpluses and slower economic growth in the period 2014-2016 compared with the period 2011-2013, while India and Pakistan had higher economic growth and smaller fiscal deficits (figure 1).

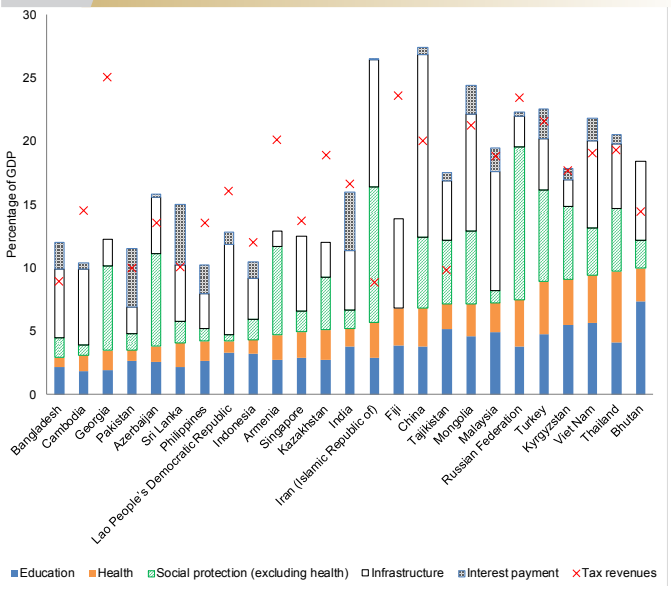
Figure 1. Real GDP growth and primary fiscal balance, 2014-2016 compared to 2011-2013



Source: ESCAP, based on national sources, International Monetary Fund, Fiscal Monitor database. Available from www.imf.org/external/pubs/ft/fm/2011/02/app/FiscalMonitoring.html (accessed 20 February 2017)
Note: Primary fiscal balance = General government net borrowing or net lending, excluding interest payments on consolidated government liabilities. Three-year average for 2014-2016 is based on estimates.

There have also been efforts to enhance the quality of public expenditures to increase spending efficiency and to reallocate expenditures in line with national development priorities. Several countries such as India, Indonesia and Malaysia, for instance, have phased out fuel subsidies in order to increase social or infrastructure spending. Despite such progress, Figure 2 shows that combined education and health expenditures as a share of GDP remains very low in countries such as Bangladesh and Cambodia, both least developed countries, while infrastructure spending as a share of GDP remains low in a number of smaller economies in North and Central Asia. Oftentimes, weak tax collection and/or higher interest payments on debt are the constraining factors.

Figure 2. General government spending and revenues



Source: ESCAP, based on national sources, International Monetary Fund, Fiscal Monitor database. Available from www.imf.org/external/pubs/ft/fm/2011/02/app/FiscalMonitoring.html (accessed 1 February 2017); World Economic Outlook database. Available from www.imf.org/external/pubs/ft/weo/2016/02/weodata/index.aspx (accessed 1 February 2017); and Investment and Capital Stock Dataset. Available from www.imf.org/external/np/fad/publicinvestment/data/data.xlsx (accessed 1 February 2017); United Nations Educational, Scientific and Cultural Organization, UNESCO Institute for Statistics (UIS) database. Available from http://uis.unesco.org/ (accessed 1 February 2017); International Labour Organization, Social Protection Platform. Available from www.social-protection.org/gimi/gess/ShowTheme.action?id=10 (accessed 1 February 2017); and World Bank, World Development Indicators database. Available from http://data.worldbank.org/ (accessed 1 February 2017).

Note: The year 2015 or latest available year for social spending (on education, health and social protection) and tax revenues. Latest three-year average (2012-2015) for public investment and interest payments. Public investment covers social infrastructure (e.g. schools and hospital buildings) as well as economic infrastructure (e.g. roads and railways), thus overlapping somewhat with social spending. Countries are sorted by the sum of education and health spending only. Social protection, excluding health, is considered separately, given that in many countries it consists mostly of social insurance, such as pensions for public sector employees, and offers only limited coverage. While only tax revenues are indicated, some countries have significant non-tax revenues, including from the resources sector. Also in the case of public investment, State-owned enterprises play an important role such that funding is not entirely reliant on government revenues. Tax revenues include social security contributions, which are fairly small in most countries, except in transition economies. Interest payment is on total general government liabilities.

Recent fiscal policy developments

Among major economies in the region, China has pushed ahead with large infrastructure projects while providing tax breaks and other relief measures for firms and consumers, which resulted in a wider fiscal deficit of about 3 per cent of GDP in 2016. Although the country's general government debt is relatively low, there are concerns about off-balance sheet quasi-fiscal support provided to local governments and contingent liability risks from the banking system and state-owned enterprise (SOE) debt some of which are being addressed under the revised budget law. The overall fiscal stance is expected to remain expansionary in the near term to stabilize the economy and to invest in social and infrastructure sectors. A special fund has also been set up to compensate for layoffs in sectors undergoing capacity reduction such as coal and steel.

India has made remarkable strides in boosting social spending, despite constraints posed by relatively high public debt and low tax revenues. As a remarkable step towards universal health coverage, a health insurance scheme was introduced to cover hospitalization expenditures for one third of the population, and a universal basic income scheme is under consideration.[1] To accommodate such ambitious programmes, the Government is reprioritizing expenditures, notably by phasing out fuel subsidies, while enhancing expenditure efficiency by reducing leakages through direct benefit transfers. This is further supported by measures to curb tax evasion and boost tax revenues, including the demonetization initiative. The tax system is also expected to gain greater efficiency through a nationwide goods and services tax and become more progressive through an additional surcharge on top incomes.

Net commodity exporters, such as Indonesia and the Russian Federation, have taken a more cautious approach in view of unfavourable changes in their terms of trade in recent years. Those changes have adversely affected public finances and fiscal sustainability. Indonesia has successfully phased out its fuel subsidies and reallocated the savings to infrastructure and social spending. Amid persistent revenue shortfalls however, the budget was revised to meet the legal deficit ceiling of 3 per cent of GDP. The 2016 ESCAP Survey argued that some flexibility may be warranted given the relatively low levels of public debt and the need for large public investments – through a cyclically adjusted deficit rule for example, or the exclusion of priority outlays from the perimeter of the rule.[2] While views may differ on this point, it is clear that weak tax revenue has become a key fiscal risk. Efforts to boost revenues, such as the recent tax amnesty programme, have had limited success. In the Russian Federation, the impact of lower oil prices on the national budget was mitigated as the Government drew on past windfall savings. Nevertheless, the budget for 2017 and the medium-term expenditure framework for the period 2017-2019 target consolidation through a mix of expenditure cuts and revenue mobilization efforts.

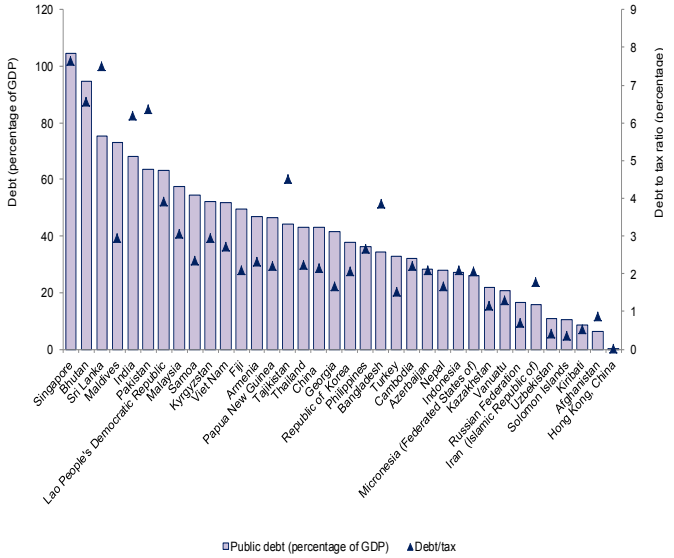
Net commodity importers, which have benefited from lower oil prices, have generally pursued an expansionary fiscal policy. For example, Thailand implemented tax incentives aimed at stimulating private investment and quasi-fiscal measures, such as subsidized loans for farmers and small and medium-sized enterprises. One fifth of the 2017 budget is earmarked for capital expenditures to support a multi-year infrastructure development plan. The budget of the Philippines has increased rapidly in recent years on the back of strong economic growth and tax revenues. The 2017 budget contains large increases for police, education and infrastructure. In Bangladesh, the budget contains large increases for education and health, although much of it is driven by increased compensation for government employees. In the Survey for 2016 it was suggested that, in addition to such indicators as the cost of living, Governments could also compare the wage bill with the size of selected non-compensation expenditures administered by employees.[2]

Fiscal sustainability

Given the proactive use of fiscal policy in many countries, fiscal sustainability issues have become important. One key issue for fiscal sustainability is the differential between the interest rate to service government debt and the nominal GDP growth rate. For highly indebted countries, a small but sustained change in this differential can mean the difference between an explosive or a declining path for the debt-to-GDP ratio. Other factors include the primary fiscal balance , which in turn depends on factors such as expenditure efficiency and tax collection.

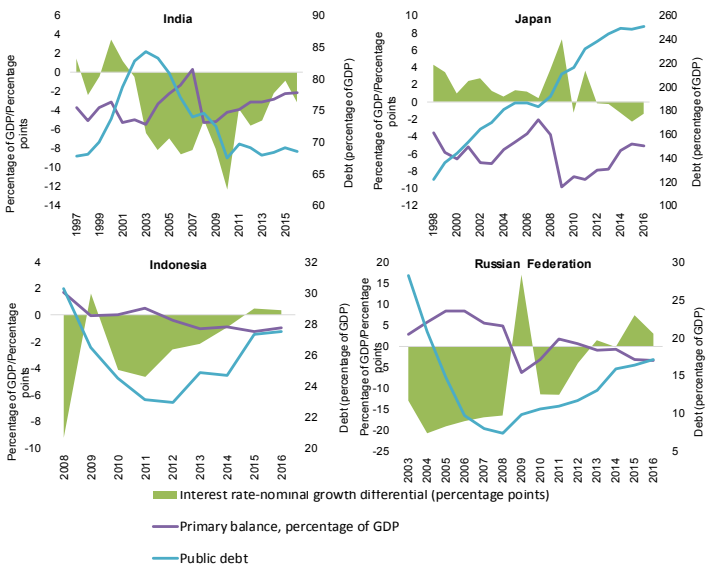
While conventional approaches to estimating the "sustainable" debt threshold, such as taking the mean or median debt to GDP ratio of a defined peer group, could be a useful, albeit illustrative, reference. In assessing fiscal sustainability or fiscal space, Governments employ various measures,[3] for instance, the ability-to-pay model estimates the level of debt for which the primary balance adjustment would be insufficient to offset growing debt service.[4] Another model compares public debt levels to the number of tax years a Government needs to repay its debt.[5] Applying this measure finds that the Maldives may have more fiscal space than Pakistan despite having a higher debt to GDP ratio (see figure 3).

Figure 3. General government debt, compared with GDP and tax revenues



Source: ESCAP, based on IMF Fiscal Monitor Database. Available from www.imf.org/external/pubs/ft/fm/2016/02/fmindex.htm (accessed 1 February 2017).

Figure 4. General government debt



Source: ESCAP, based on CEIC, IMF and Government of India Economic Survey 2016-17.
Note: Primary balance is the overall budget balance, excluding interest payments on consolidated government liabilities. The differential is expressed in reverse, that is, r-g rather than g-r, for easier comparison with primary deficit. Data for 2016 are estimates.

Ensuring fiscal sustainability typically requires tax reforms and effective debt management, keeping in mind the potential positive spillovers of social and infrastructure investments on the economy. Tax collection remains relatively low in the Asia-Pacific region and the scope for boosting revenues through improved compliance and base-broadening is particularly large.[6,2] In countries where domestic demand is depressed, and under certain conditions, higher tax revenues could be partly offset by debt finance, taking advantage of the relatively low government bond yields in recent years – although the window of opportunity may be narrowing.

While running primary deficits could be desirable from a stabilization or development viewpoint, it does make Governments dependent on economic growth and favourable interest rates to contain the debt ratio. This situation has been a concern in some countries, as economic growth slowed and disinflation occurred in recent years. In India, the debt to GDP ratio stopped declining in the wake of the global financial crisis of 2008 as the differential narrowed and the primary deficit widened; in Japan, it has continued to rise to very high levels (see figure 4). In contrast, Indonesia and the Russian Federation have fairly low debt levels, but the debt trajectory has made a clear turn following large terms of trade losses – which explains why the authorities are pursuing conservative budgets.

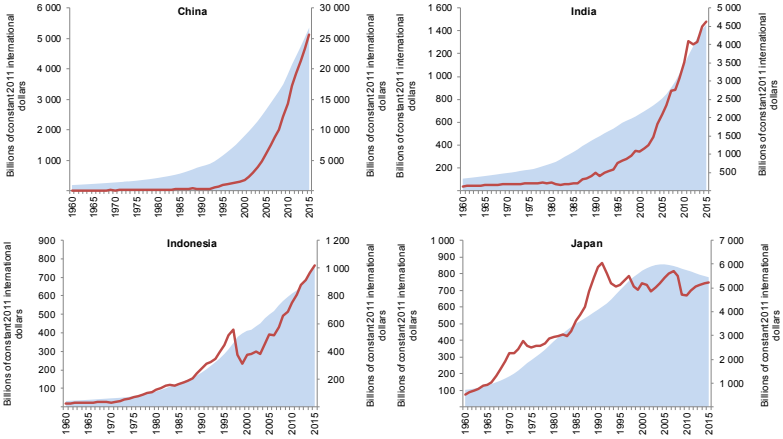
Another consideration in assessing fiscal sustainability is the concept of fiscal multipliers, which measure the short-term impact of discretionary fiscal policy on output. As illustrated above, the debt trajectory depends critically on the nominal GDP growth rate, and so countries could consider the potential positive spillovers of social and infrastructure investments on the economy. If the spillovers are sufficiently large, for instance due to the "crowding in" of private investment, the public debt to GDP ratio could be stable over the long term. It has been argued that the current environment of weak external demand, weak private investment, low borrowing costs and benign inflationary pressures supports the case for greater public investment, including in infrastructure.[7]

However, this is an area where more research is needed given the mixed empirical evidence. There is little consensus in the literature on the size and persistence of multipliers. For instance, Ricardian equivalence and possible "crowding out" effects would suggest negligible or even negative multipliers. In recent papers, however, it has generally been found that multipliers tend to be higher during recessions, especially if monetary policy is constrained.[8] With limited empirical evidence for developing economies, it is also unclear whether multipliers should be expected to be higher or lower than in the developed economies.[9] While lower capital stocks would imply higher returns, developing economies also tend to suffer from inefficiencies in public expenditure management and revenue administration. Another possible explanation for low multipliers is the prominence of policy objectives other than output stability. Indeed, fiscal policy in developing economies could be more concerned about supporting development priorities than just

stabilizing output – in which case, fiscal performance would be better assessed through such indicators as public expenditure efficiency instead of multipliers. It could also be the case that some of the dynamic, long-term effects of fiscal policy on output are not captured in the short-term multiplier. For instance, if ambitious social and infrastructure spending results in large positive spillovers into the economy, the debt to GDP ratio could eventually fall below the baseline case.[10] Existing multiplier estimates for countries in the Asia-Pacific region are in fact closer to zero than 1. On average, the multiplier is above 1 only in China, about 0.5 in the Republic of Korea and the Philippines, about zero in Indonesia and Thailand, and negative in Singapore.[11,12]

The literature points to higher multipliers for capital expenditures compared with current expenditures. A key question is whether public investment does in fact "crowd in" private investment and if so, to what extent. This would also depend on how the public outlays are financed – through additional revenue collection, borrowing or a mix of these. Another consideration is the pace of investment (front-loading or gradual), with some empirical studies supporting the latter based on the assumption that this would allow time for improving efficiency.[13] While more research is required to answer these questions, data suggest that it is not just public investment (flow), but the total public capital stock which matters for private investment (see figure 5). This thinking is in line with theoretical models of economic growth in which capital stock is a direct input factor of the production function, contributing to higher productivity growth.

Figure 5. Public capital stocks and private investment (estimates from 1960 to 2015)



Source: ESCAP, based on IMF capital stock and investment dataset. *Note:* The shaded area shows public capital stock. The red line represents private investment flows. The y-axis shows billions of constant 2011 international dollars.

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[2] United Nations, Economic and Social Commission for Asia and the Pacific, *Economic and Social Survey for Asia and the Pacific 2016: Nurturing Productivity for Inclusive Growth and Sustainable Development*, Sales No. E.16.II.F.10 (Bangkok, 2016).

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[4] Atish Ghosh and others, "Fiscal fatigue, fiscal space and debt sustainability in advanced economies", *Economic Journal*, vol. 123, No. 566 (2013), pp. F4-F30.

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[8] Lawrence Christiano, Martin Eichenbaum, and Sergio Rebelo, "When is the government spending multiplier large?", *Journal of Political Economy*, vol. 119, No. 1 (2011), pp. 79-121.

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[10] United Nations, Economic and Social Commission for Asia and the Pacific, Economic and Social Survey for Asia and the Pacific 2013: Forward-looking Macroeconomic Policies for Inclusive and Sustainable Development. Sales No. E.13.II.F.2 (Bangkok, 2013).

[11] Xin Wang and Yi Wen, "Is government spending a free lunch? Evidence from China", Working Paper, No. 2013-013A (St. Louis, MO, United States: Federal Reserve Bank of St. Louis, 2013).

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[13] Manuk Ghazanchyan and others, Collect more, spend better: public investment in Asian frontier markets. Working Paper, No. 17/10 (Washington, D.C.: International Monetary Fund, 2017).

The MPFD Policy Briefs aim at generating a forward-looking discussion among policymakers, researchers and other stakeholders to help forge political will and build a regional consensus on needed policy actions and pressing reforms. Policy Briefs are issued without formal editing. The content of this issue was prepared by Daniel Jeongdae Lee, with research assistance from Kiatkanid Pongpanich. For further information on this issue, please contact Hamza Ali Malik, Director a.i., Macroeconomic Policy and Financing for Development Division, ESCAP (escap-mpdd@un.org).

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