Managing Fiscal Sustainability and Aging in Emerging Asia

Bart W. Edes
ADB

Peter J. Morgan
ADB Institute

ADBI-MoF (PRI) Conference
“Strategies for Maintaining Fiscal Soundness in Aging Societies”

Tokyo, 6 March 2014
Outline

I. Objectives of study
II. Fiscal conditions in emerging Asia
III. Social welfare spending in emerging Asia
IV. Aging populations and fiscal pressures
V. Policy options and recommendations
VI. Conclusions
I. Objectives of Study

- Identify fiscal conditions in emerging Asia
- Present age-related social welfare spending in emerging Asia
- Highlight implications of population aging for fiscal stability
- Recommend policies to support sustainability
  - Improve balance of revenues and expenditures
  - Adopt explicit fiscal rules
  - Stronger fiscal surveillance at the regional level
II. Fiscal Conditions in Emerging Asia

- Review of recent experience
  - Asian financial crisis and global financial crisis experiences
  - Current fiscal balance and debt levels
- Composition of revenues and expenditures by country
- Near-term risk assessment
Fiscal balances in Asian emerging economies generally improving after GFC

Manageable gross government debt ratios in emerging Asia

Source: IMF World Economic Outlook Database, Oct. 2013
Composition of expenditures and revenues

- Expenditures
  - Many low income economies have low investment rates in infrastructure
  - Social sector-related expenditures tend to grow rapidly with income

- Revenues
  - As expenditures tend to rise more than proportionately with income, adequate revenue sources must be generated to cover this
  - Many low income countries have narrow revenue bases
  - Greater reliance on indirect taxes (VAT or GST) could increase revenues in a relatively non-distorting way
Composition of expenditures by country

Central Government Expenditure, % of GDP, 2012

Japan
Malaysia
Korea
Thailand
PRC
Hong Kong, China
Indonesia
Philippines
India
Singapore
Taipei, China

Note: Japan social protection is general government basis
Source: ADB Statistical Database System
Balanced composition of revenues desirable

Composition of Tax Revenue, % of GDP, 2011

<table>
<thead>
<tr>
<th>Country</th>
<th>Taxes on goods and services</th>
<th>Taxes on income, profits and capital gains</th>
<th>Taxes on international trade</th>
<th>Other taxes</th>
<th>Tax revenue (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>PRC</td>
<td>6.5</td>
<td>2.4</td>
<td>0.5</td>
<td>0.1</td>
<td>10.5</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>1.1</td>
<td>5.5</td>
<td>0.1</td>
<td>1.8</td>
<td>14.2</td>
</tr>
<tr>
<td>India</td>
<td>2.5</td>
<td>5.1</td>
<td>1.5</td>
<td>0.0</td>
<td>10.4</td>
</tr>
<tr>
<td>Indonesia</td>
<td>3.5</td>
<td>4.2</td>
<td>0.5</td>
<td>0.3</td>
<td>11.8</td>
</tr>
<tr>
<td>Japan</td>
<td>3.5</td>
<td>4.2</td>
<td>0.2</td>
<td>0.5</td>
<td>9.8</td>
</tr>
<tr>
<td>Korea</td>
<td>3.9</td>
<td>4.7</td>
<td>0.6</td>
<td>1.2</td>
<td>15.6</td>
</tr>
<tr>
<td>Malaysia</td>
<td>2.4</td>
<td>8.4</td>
<td>0.3</td>
<td>0.7</td>
<td>16.1</td>
</tr>
<tr>
<td>Philippines</td>
<td>3.6</td>
<td>5.4</td>
<td>2.4</td>
<td>--</td>
<td>12.9</td>
</tr>
<tr>
<td>Singapore</td>
<td>3.5</td>
<td>4.7</td>
<td>--</td>
<td>2.4</td>
<td>13.8</td>
</tr>
<tr>
<td>Thailand</td>
<td>6.9</td>
<td>6.7</td>
<td>0.8</td>
<td>0.1</td>
<td>17.6</td>
</tr>
</tbody>
</table>

Note: PRC, 2010; Malaysia and Philippines, 2012.

Low fiscal risks in emerging Asia

Underlying Fiscal Vulnerability Index by Region, 2002–13 (Scale, 0–1)

Source: IMF Fiscal Monitor, April 2013
Interest rate repression a major contributor to debt stability in Asia

III. Status of social welfare spending in emerging Asia

• Social safety net coverage and benefit levels
  ➢ Pensions
  ➢ Health
  ➢ Unemployment
  ➢ Income transfer
  ➢ Focus on social insurance (mainly pensions and health insurance), since most closely linked to aging and rising incomes
Social protection expenditures show a broad range

Source: ADB (2011)
Social protection expenditure tends to rise with per capita income

Note: SPI is aggregate indicator of coverage of social protection programs
Source: ADB (2012)
Social insurance expenditures rise sharply with income levels

Source: ADB (2011) and CEIC Data Co.
Social insurance expenditures also rise with old-age dependency ratio

Social insurance coverage still very low in most of emerging Asia

Note: Breadth represents the proportion of intended beneficiaries who actually received the social protection benefits.
Source: ADB (2011) and CEIC Data Co.
IV. Aging populations and fiscal pressure

- Demographic trends
- Rising incomes
- Implications for social insurance spending demands
- Other risk factors
  - PRC contingent liabilities
  - Reduced interest rate repression
History/projections of aged dependency ratio (age 65+/age 15-64)—highest in Asian NIEs, followed by PRC and Thailand

Rising real per capita GDP also contributes to rising benefit levels

Source: ADB-ADBI (forthcoming)
### Regression Results

#### Determinants of Social Insurance Spending (% of GDP)

<table>
<thead>
<tr>
<th></th>
<th>Coefficient</th>
<th>t-statistic</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>-6.65***</td>
<td>-3.6</td>
<td>0.001</td>
</tr>
<tr>
<td>Old-age dependency ratio</td>
<td>0.34**</td>
<td>2.65</td>
<td>0.013</td>
</tr>
<tr>
<td>Real GDP per Capita (Log)</td>
<td>1.64**</td>
<td>2.22</td>
<td>0.035</td>
</tr>
<tr>
<td>Socialist Dummy</td>
<td>1.86*</td>
<td>1.73</td>
<td>0.095</td>
</tr>
<tr>
<td>Number of obs</td>
<td></td>
<td></td>
<td>32</td>
</tr>
<tr>
<td>F( 2,  29)</td>
<td></td>
<td></td>
<td>13.6</td>
</tr>
<tr>
<td>Prob &gt; F</td>
<td></td>
<td></td>
<td>0.0000</td>
</tr>
<tr>
<td>R-squared</td>
<td></td>
<td></td>
<td>0.6932</td>
</tr>
</tbody>
</table>

Note: 1) Estimated by OLS with robust standard errors.

2) Coefficient estimates marked with three, two and one asterisks are significant at the 1%, 5% and 10% levels, respectively.
3) Data for 2010.

Source: Authors' estimates.
Japan leads region in social insurance spending

Source: ADB (2011), authors’ estimates.
Model forecasts narrowing gap with Japan by 2030

Source: ADB (2011), authors’ estimates.
## Risks from PRC contingent liabilities

### PRC Government Liabilities, 2009

<table>
<thead>
<tr>
<th>Category</th>
<th>% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Official government debt</td>
<td>17.7</td>
</tr>
<tr>
<td>Local government debt</td>
<td>25.5</td>
</tr>
<tr>
<td>Ministry of Railways liabilities</td>
<td>3.8</td>
</tr>
<tr>
<td><strong>Total government debt</strong></td>
<td><strong>47.0</strong></td>
</tr>
<tr>
<td>Commercial bank NPLs</td>
<td>4.0</td>
</tr>
<tr>
<td>Asset management company bonds</td>
<td>2.9</td>
</tr>
<tr>
<td>Policy bank bonds</td>
<td>13.3</td>
</tr>
<tr>
<td>PBOC bonds</td>
<td>12.4</td>
</tr>
<tr>
<td>Local investment company debt</td>
<td>33.5</td>
</tr>
<tr>
<td><strong>Total contingent liabilities</strong></td>
<td><strong>66.1</strong></td>
</tr>
<tr>
<td><strong>Total government liabilities</strong></td>
<td><strong>113.1</strong></td>
</tr>
</tbody>
</table>

Source: Based on Hemming (2012)
Other risks: Potential ending of interest rate repression

- A large negative gap of the interest rate with the nominal GDP growth rate suggests a high degree of financial repression in the government bond market
- Though the correlation is loose, the interest rate gap tends to narrow as incomes rise, in line with greater financial liberalization and openness (Hong Kong and Singapore are major exceptions, though)
- A narrowing of the interest rate gap will make it more difficult for countries to “inflate away” their debt burdens, putting a greater burden on adjustment in the primary balance to achieve debt sustainability
- High holdings of government bonds by the banking sector could raise the risk of a “doom loop” of a sovereign debt and banking crisis
- This will require greater reliance on fiscal discipline, supported by fiscal rules
V. Policy Options and Recommendations

- Recommendations to improve funding of social insurance programs
- Role of fiscal rules
- Role of debt management office
- Regional fiscal surveillance
Recommendations to reduce medium-term fiscal risk of social insurance

• Direct measures for social insurance
  • Increase premiums, and ensure obligatory premium payments
  • Increase retirement age
  • Shift from defined benefits to defined contributions

• General fiscal management improvement to create space for expanded coverage of social insurance
  • Establish fiscal rules
  • Establish debt management office
  • Strengthen fiscal surveillance
    • National level: Finance ministry, central bank, financial supervisors
    • Regional level: AMRO can play role
## Role of fiscal rules in Asia

<table>
<thead>
<tr>
<th>Country name</th>
<th>Expenditure rule</th>
<th>Revenue rule</th>
<th>Budget balance rule</th>
<th>Debt rule</th>
<th>Key elements of fiscal rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong, China</td>
<td></td>
<td></td>
<td>1</td>
<td></td>
<td>The budget should always display an operating surplus, i.e. an excess recurrent revenue over recurrent expenditure.</td>
</tr>
<tr>
<td>India</td>
<td></td>
<td></td>
<td>1*</td>
<td></td>
<td>Originally the target was to reduce the fiscal deficit to 3 percent of GDP by 2008. The escape clause in the fiscal rule law (FRBMA) allows the government not to comply with the targets in exceptional circumstances &quot;as the central government may specify.&quot;</td>
</tr>
<tr>
<td>Indonesia</td>
<td></td>
<td></td>
<td>1</td>
<td>1</td>
<td>DR (since 2004): Total central and local government debt should not exceed 60 percent of GDP. BBR: The consolidated national and local government budget deficit is limited to 3 percent of GDP in any given year.</td>
</tr>
<tr>
<td>Japan</td>
<td>1</td>
<td></td>
<td>1</td>
<td></td>
<td>ER: The Fiscal Management Strategy in effect since 22 June 2010, introduced a Medium-term Fiscal Framework, including an “Overall Expenditure Limit” (the amount of the General Account Expenditure, excluding debt repayment and interest payment, should not exceed that of the previous fiscal year). BBR: The Fiscal Management Strategy introduced in 2010 (with effect of 2011) a pay-as-you go rule, which implies that any measure that involves increases in expenditure or decreases in revenue need to be compensated by permanent reductions in expenditures or permanent revenue-raising measures.</td>
</tr>
</tbody>
</table>

Notes. * implemented by Indian Government until 2008. 1- indicates it is in place or the rule applies.

V. Conclusions

- Fiscal sustainability conditions in emerging Asia are generally benign—only India among major countries has a debt-to-GDP ratio above 60%
- Social insurance expenditures generally still relatively low, but will rise as incomes grow and coverage expands
- Asian NIEs and (to a lesser extent) the PRC and Thailand have rapidly aging populations that point to rapidly rising entitlements
- Other risk factors may contribute to increasing fiscal pressure as well:
  - The PRC has large contingent liabilities
  - The PRC, India, Indonesia, Thailand and Viet Nam have high levels of interest rate repression that may not be sustainable
Conclusions (2)

- Medium-term fiscal sustainability risk for social insurance for the entire population can be reduced by:
  - Replacing subsidies with targeted income transfer programs
  - Prioritizing basic social protection for all
  - Containing social protection program costs and raising premiums to provide adequate funding

- More generally, fiscal management can be improved by:
  - Establishing rational framework for allocating expenditures
  - Achieving more balanced sources of direct and indirect revenue, and strengthening tax collection
  - Adopting fiscal rules
  - Establishing a debt management office
  - Strengthening fiscal surveillance by national as well as regional bodies (AMRO)
Thank you

For more information:

Bart W. Edes
Director, Regional & Sustainable Development Department, ADB
bedes@adb.org

Peter J. Morgan, PhD
Senior Consultant for Research
ADB Institute
pmorgan@adbi.org
# Role of debt management offices in emerging Asia

## Objectives of the Public Debt Management Offices

<table>
<thead>
<tr>
<th>Country</th>
<th>Objectives</th>
</tr>
</thead>
</table>
| **Indonesia** | 1. To establish government debt portfolio management in an effective, transparent and accountable manner  
2. To control debt issuance and procurement by maintaining a borrowing capacity that supports fiscal sustainability  
3. To establish development financing independence by prioritizing domestic financing sources and developing an efficient and stable domestic market  
4. To establish international cooperation in obtaining alternative financing sources as well as supporting regional financial market stability |
| **Thailand**  | 1. Manage public debt to achieve low costs subject to acceptable risks (Strategy 1)  
2. Develop the domestic bond market to be one of the three main pillars of the financial market (Strategy 2)  
3. Evaluate and mobilize feasible funds to finance government’s infrastructure products (Strategy 3)  
4. Modernize Technology to support PDMO’s operations (Strategy 4) |