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The New Mediocre in Asia: What Can Fiscal Policy Do?

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Summary of the main points (1/2)

(FISCAL CHALLGENS)

Because of age-related spending (pension and health care), government debt in Asian countries will significantly increase over the long term

(FISCAL REFORM PROPOSAL)

Well designed fiscal policy can change the situation and boost economic growth

① public infrastructure push (mostly for developing Asian countries)

② rebalancing taxes toward VAT and excise taxes (for all Asian countries)

③ labor sector reform (adjustment of retirement age, child care, ALMP)

Summary of the main points (2/2)

(Cautionary suggestion)

Take advantage of low inflation & low interest rate environment

- some Asian countries can *efficiently* increase the government debt level (about 10% for Korea)
  - monetary accommodation with debt financing
- (a big if) as long as the sovereign risk premium is contained

(Reforms of pension and health care systems)

Rising age-related spending can be controlled by structural reform

- parametric reforms on pension system
- structural reforms in the health care sector

Overall comments (1/3)

A comprehensive assessment of and policy proposals to fiscal challenges faced by many Asian countries

- especially relevant for the current situation of Korea
- the paper shows that the impact of fiscal reform packages is limited in the case of Japan which has a government debt to GDP ratio of about 250% ("the window for action is now")

A useful recommendations on fiscal reforms

- tax reform
- pension reform
- health care reform

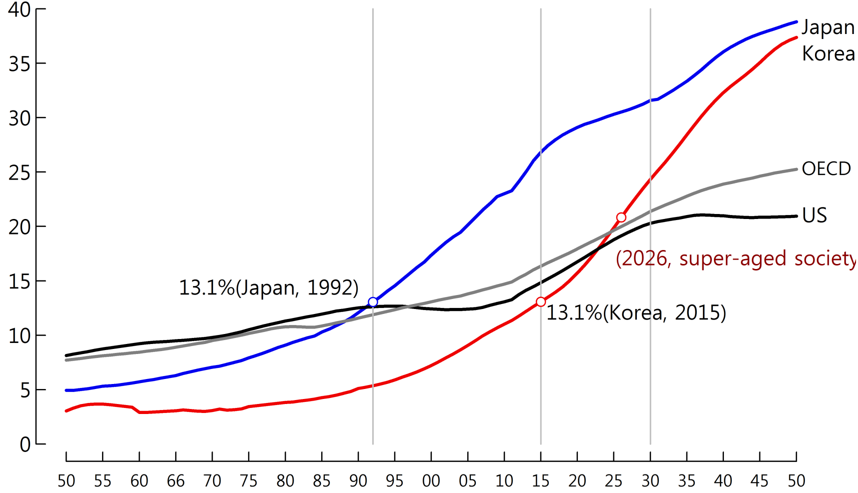
* these reforms tend to get postponed because of political economy challenges

Some remarks (1/4)

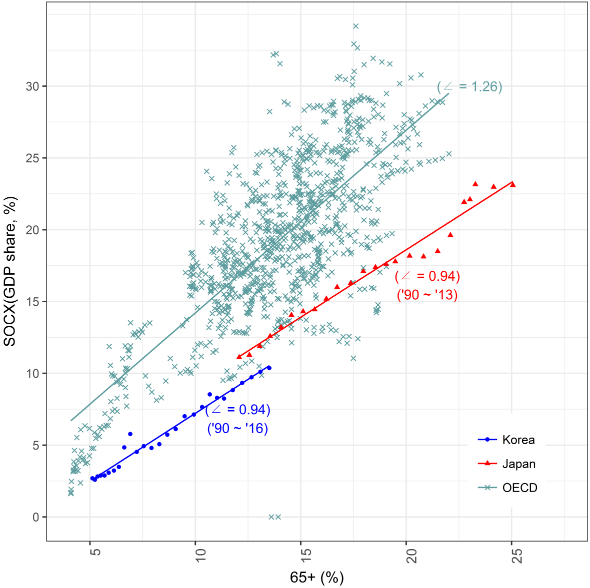
(Long-term projection of social expenditures)

- Pension and health spending projections (holding constant the coverage as well as replacement ratio) are likely to be underestimated – at least for Korea
  - SOCX (social expenditures) in Korea is projected to increase by almost 20%p of GDP by 2060
    - a very close relationship between SOCX and aging
  - the level of OECD social expenditures plays the role of "gravitational force" in the debates on welfare expenditures
    - although Korea (and Japan) cannot follow the spending pattern of OECD due to extraordinary aging process

Aging process of selected OECD countries



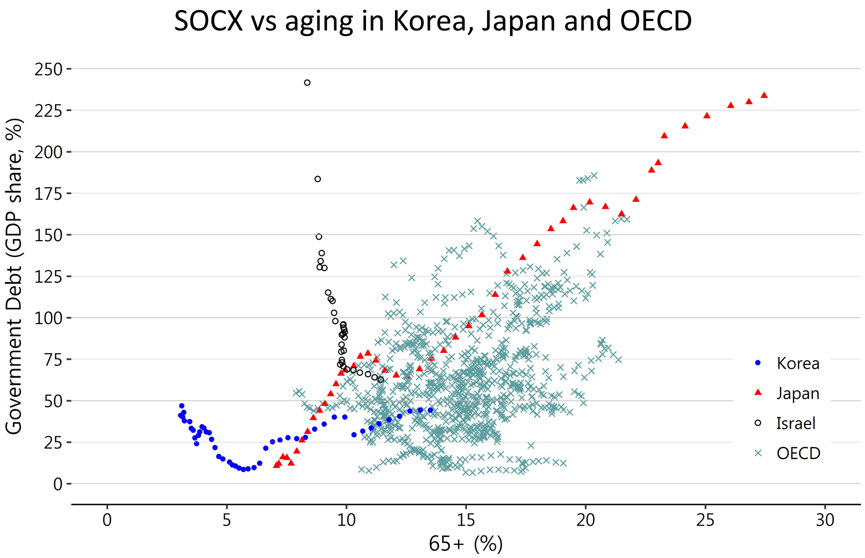
SOCX vs aging in Korea, Japan and OECD



Some remarks (2/4)

(TAX & SOCIAL SECURITY CONTRIBUTIONS)

- Revenue mobilization (closing VAT gaps, reducing exemptions, enforcing tax administration, etc.) will not be enough for fiscal sustainability (of Korea)
  - tax and social security revenue needs to be significantly increased
    - much more than is implied by the current system of pension and health care
  - Japan failed on this, and has accumulated a sizable amount (250 % of GDP) of government debt


SOCX vs aging in Korea, Japan and OECD
Government Debt (GDP share, %)
0
25
50
75
100
125
150
175
200
225
250
0
5
10
15
20
25
30
65+ (%)
Korea
Japan
Israel
OECD

Some remarks (3/4)

(Rebalancing taxes toward VAT)

- Right direction in principle, but hard to implement in reality due to institutional constraints
  - pension and health care in Korea are (i) outside the general accounts of government and (ii) rely on levies on income
    - so pension and health care contributions cannot be replaced by VAT
  - in the long run, pension and health care maybe financed by general taxes
    - but this will be a big change that won't materialize in the short run regardless of its desirability
    - a big constraint to "the window for action is now"

Some remarks (4/4)

(Low inflation and low interest rate environment)

- The recommendation of the paper needs to be paid attention to
  - increasing the debt level of government accounts of Korea (say 10%p) won't increase the sovereign risk premium
    - the debt level is still lowest among OECD countries

  * however, fiscal risk of Korea will come from pension and healthcare in the long run

Final comments

- A very important and appropriate assessment of the fiscal challenges faced by Korea and other Asian countries
  - especially in terms of general direction and guiding principles of fiscal reform

- For each country, implementation of fiscal reform packages will require finding its own second-best solutions
  - that take into account both the characteristics of fiscal institutions and political economy constraints of each country