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Introduction

Takatoshi Ito and Andrew K. Rose

This volume contains a selection of papers presented at the sixteenth annual East Asia Seminar on Economics. EASE 16 was held in Manila, the Philippines, on June 23–25, 2005. The local sponsor was the Philippine Institute for Development Studies (PIDS), and we gratefully acknowledge their support and help in organizing the conference.

EASE-16 was organized around the topic of "Fiscal Policy and Management." This is a topic of perennial interest to economists since fiscal institutions and outcome are both intrinsically important and vary widely across countries. This volume highlights the problems and challenges that East Asian developing countries face, as well as the United States and Japan.

Rich countries are plagued by regulation and taxation that seem excessive, resulting in avoidable inefficiencies that still do not provide enough revenue to cover government spending. Still, policy outcomes do not seem to have been particularly egregious in rich countries, especially at the macroeconomic level. By way of contrast, some poor countries do have consistently poor policy outcomes. For instance, inflation and trade taxes among developing countries are consistently higher in developing countries than in the OECD average. Why do developing countries tend to rely so much on inefficient tax systems? Tackling this important topic head on, Gordon and Li present a pair of models that might account for the differences be-

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tween fiscal outcomes in rich and poor countries. One political-economy theory for the poor performance of developing countries rests on the idea that vested interests that represent only a small part of the economy capture the policy apparatus and use it to distort outcomes to their benefit. Another idea rests on the hypothesis that information on taxable activities is simply more difficult both to obtain and use in developing countries because of the difficulty of monitoring financial transactions. After developing these alternatives, Gordon and Li perform the important task of taking their predictions to the data to compare and contrast the actual performance of their theories. They find serious problems with the traditional political economy model, while there is considerable (but not definitive) support for the financial transactions theory. We think this pair of hypotheses set the stage for the subject matter of the book and points the direction for an important and interest future research program.

The relationship between public and private sector economic behavior is one of the largest issues in the broad area of fiscal policy. Understanding the interplay between public and private activity is critical to formulating good policy. If public-sector activity stimulates private-sector activity by providing complements like social and physical infrastructure, then there is a strong case to be made for government intervention. But if private and public spending are actually substitutes so that the latter crowds out the former, then the case for public intervention is diminished accordingly. Thus it is appropriate that the next three papers of this volume address the relationship between activity of the public and private sectors. Kwan takes a direct and empirical approach using macroeconomic data for a number of East Asian countries. Using time-series techniques he finds that considerable heterogeneity in the degree of complementarity between private and public spending in the nine countries he considers. That said, the elasticities are typically small and indicate that for most countries, the two types of spending are substitutes rather than complements; Indonesia and Singapore provide the only evidence of public sector complementarity, and Thailand and Malaysia are countries with strong substitutes between public and private sector spending. A similar approach is taken by Hur, who focuses on Korea. Hur's paper is typical of a large literature that analyzes the efficacy of fiscal policy at the individual country member. Hur measures the effects of different types of fiscal policy using a structural time-series technique. In essence, he regresses the behavior of detrended GDP on detrended current and past government expenditures and revenues. Hur finds that most fiscal multipliers are strikingly small and only have transient real effects. Keynesian-style stabilization policy via the fiscal channel is accordingly difficult for Korean policymakers.

One need not examine this issue using aggregated data. Chetty and Looney address the same problem while taking advantage of a pair of microeconomic panel datasets that follow people in a rich large country (the

United States) and a poor large country (Indonesia). They are interested in a fundamental economic activity, in particular the consumption of food. Their results are striking in that they find a similar economic shock—unemployment—is followed by similar responses of food consumption in these very different countries. Still, there is also a striking difference between the countries; unemployment in Indonesia is associated with considerable economic dislocation, in stark contrast to the American experience. One particularly troubling issue is the fact that Indonesian spending on education drops significantly during a spell of household unemployment. This converts a transitory shock into an economic cost with a long-run consequence, and provides a compelling argument for a more effective social safety net.

Man is different from most other species of animals in that an abundance of resources tends to reduce rather than increase fertility. The enormous increase in the standard of living experienced in East Asia and the OECD since the Second World War has led to a dramatic reduction in birth rates. This fact, combined with increased longevity, has led to potentially explosive fiscal problems. In particular, the future obligations that governments have undertaken to provide pensions and health care for their citizens look far more costly than the revenues governments will have with which to provide these expenditures, given that the dependency ratio (the ratio of the retired to the working age population) is expected to rise. This problem of fiscal sustainability is a widespread phenomena that includes aging countries from Europe (e.g., Italy, Spain, and Germany), North America (the United States and Canada), and East Asia. All this is made worse by the fact that governments have run large fiscal debts during recent decades with more favorable demographic patterns. How then can governments cover their future spending? Research that investigates this issue is of the highest importance; the figures involved are simply astronomical. The next two chapters address the international aspects of the coming problem of double fiscal crunch.

Fehr, Jokisch, and Kotlikoff investigate long-run issues of fiscal sustainability and are particularly interested in the relationship between rich Northern and poor Southern countries. They use a complex simulation model that includes models for large aging Western economies (Europe, the United States, and Japan). The innovation here is to include China, a country that is also aging quickly but is large, poor, and growing quickly. Fehr, Jokisch, and Kotlikoff still find the standard set of depressing findings; future governments of the three advanced countries will only be able to find the funds to pay for their promised spending if taxes are raised dramatically. Still, the news is not all bad, since Chinese savings and labor enable not only dramatic growth in China but also continued growth in the rest of the world. In a sense China is expected to become the saver for the world, provided that future generations continue to save.

Villanueva and Mariano also use a model that focuses on external debts, while providing an explicit set of economics dynamics that links borrowing to growth, capital accumulation, and productivity. They apply their model to Philippine data. Their key findings are eminently reasonable; they imply that increased saving by both the public and private sectors is the only way to escape future disaster. If this seems like common sense, it is; the depressing realization is that increasing savings is still a task beyond the ability of most governments.

Clearly, international movements of factors, goods, and prices will have substantial effects on the long-run sustainability of fiscal burdens. Still, the most important effects and policies are likely to be domestic in nature. Accordingly, the next six chapters in this volume deal with different aspects of the problem of fiscal sustainability from an essentially national perspective. Au-Yeung, McDonald, and Sayegh look at how Australia should deal with risks to funds it saves for pensions provided to the public sector (referred to as *superannuation* by those down under). Using a model that optimizes the weights of the government's portfolio from a mixture of domestic and foreign stocks and bonds, they find, as expected, that the portfolios depend on the nature of shocks that are striking the economy. But, they provide some evidence that the Australian economy has been subject to more demand shocks than supply shocks, which supports purchasing domestic national bonds. They also show that to reduce overall risk, foreign equities are an appropriate investment. Llanto is also interested in future government liabilities but is particularly concerned with their implicit nature in the Philippines. He proposes a number of ways for the government to measure and handle its contingent liabilities, such as guarantees of private infrastructure projects.

Two chapters are particularly concerned with fiscal sustainability in Korea, a rich but rapidly aging society. Koh provides a lucid overview of fiscal developments and institutions in Korea over the last thirty years. He shows that government policy has generally been restrained, aside from an appropriate fiscal stimulus that results from automatic stabilizers that kicked in during the crisis of 1997–1998. Nevertheless, the legacy of the financial crisis is a nontrivial government debt, and this burden along with unfunded pension liabilities has resulted in a potentially unsustainable path for the Korean public sector. Chun corroborates this finding by employing a generational accounting framework so as to be able to disentangle the impact of flows and policies across different generations. He uses a standard model of behavior over the life cycle to predict savings rates, and forecasts a dramatic reduction in Korean savings as the population continues to age.

The final pair of chapters are also devoted to fiscal sustainability but are focused on Japan. The world's second largest economy has considerable liabilities as well as another rapidly aging population. As a critical part of both the regional and global economy, Japanese fiscal trends are thus highly worthy of careful scrutiny. Doi, Ihori, and Mitsui focus on the financial management of the public debt, and are particularly interested in the problem of maturity structure. Japanese long-term interest rates are quite low, despite the fact that government obligations appear to be quite high relative to both GDP and comparable levels in other developed countries. Doi, Ihori, and Mitsui accordingly analyze the sustainability of a set of Japanese fiscal policies and recommend a set of policies to alleviate the fiscal burden while enhancing confidence in the government's ability to service its debt. Fukui and Iwamoto are also interested in fiscal sustainability, but with particular reference to the burden of providing health- and long-term care to Japan. They propose a method and assumptions different from the government projection to forecast required funding in the future, in particular with regard to the labor participation rate, per capita health, and long-term care costs. Economists will be reassured to note that the well-understood generational transfers of a pay-as-you-go system are greatly alleviated by an alternative strategy of self-funded payments. On the other hand, the magnitude of the payments required to finance future health care is frightening; Fukui and Iwamoto find that an increase by at least one third is required, and conduct extensive sensitivity analysis on their simulation model to check the insensitivity of this result.