

Key Global Challenges to Public Finance in Emerging Market Economies

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Key Global Challenges to Public Finance in Emerging Economies

1. Debt Sustainability

- Are current levels of public debt in EMDEs sustainable?

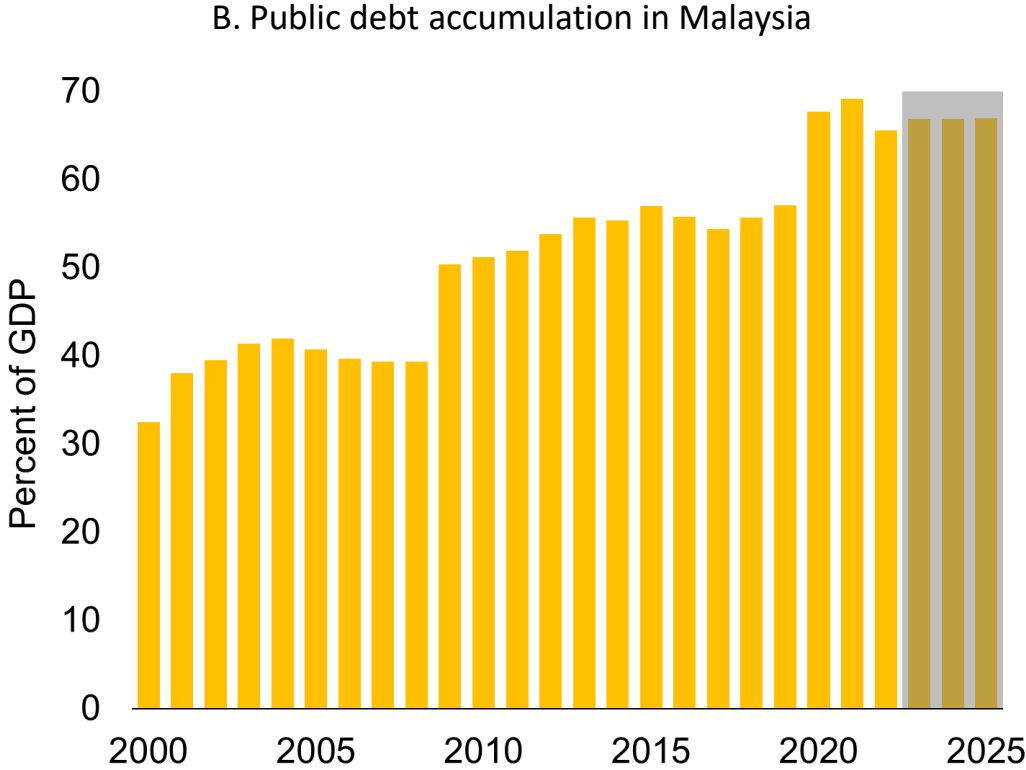
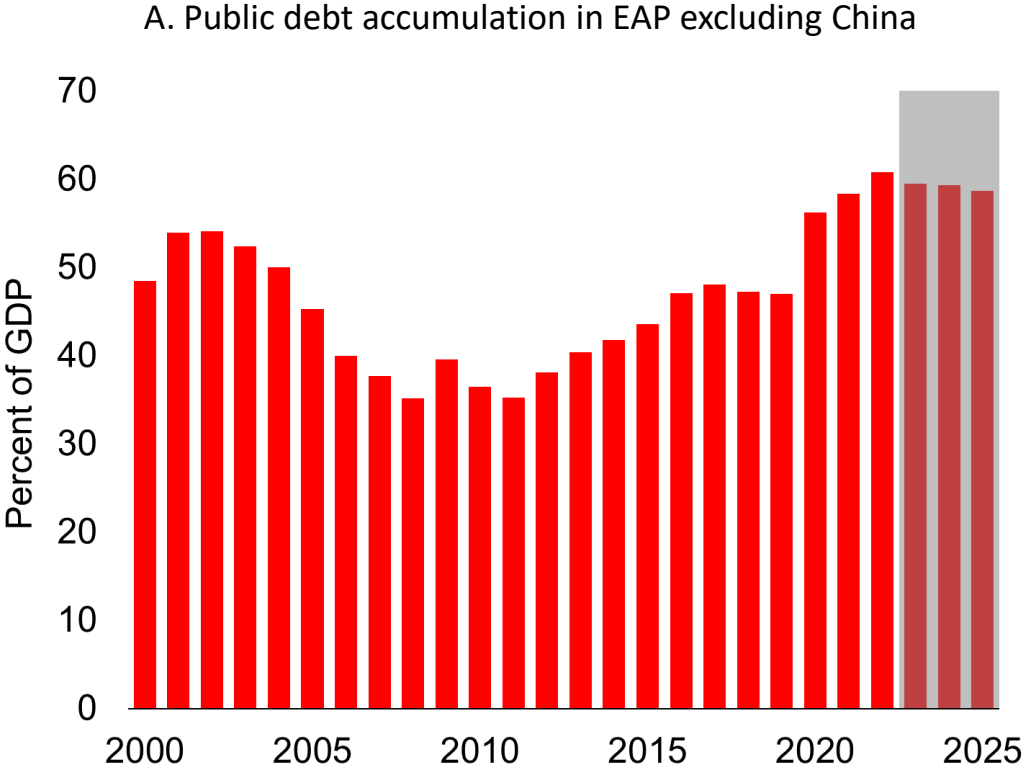
2. Expansionary Fiscal Consolidation

- How to mobilize resources without hurting growth?

3. Political Economy Constraints

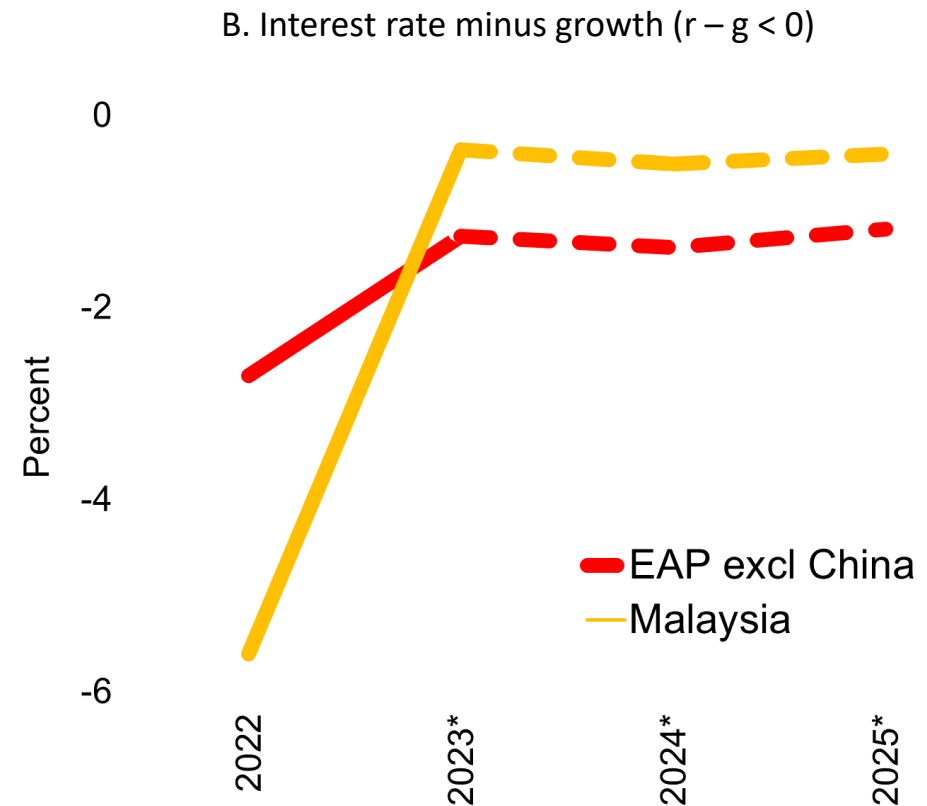
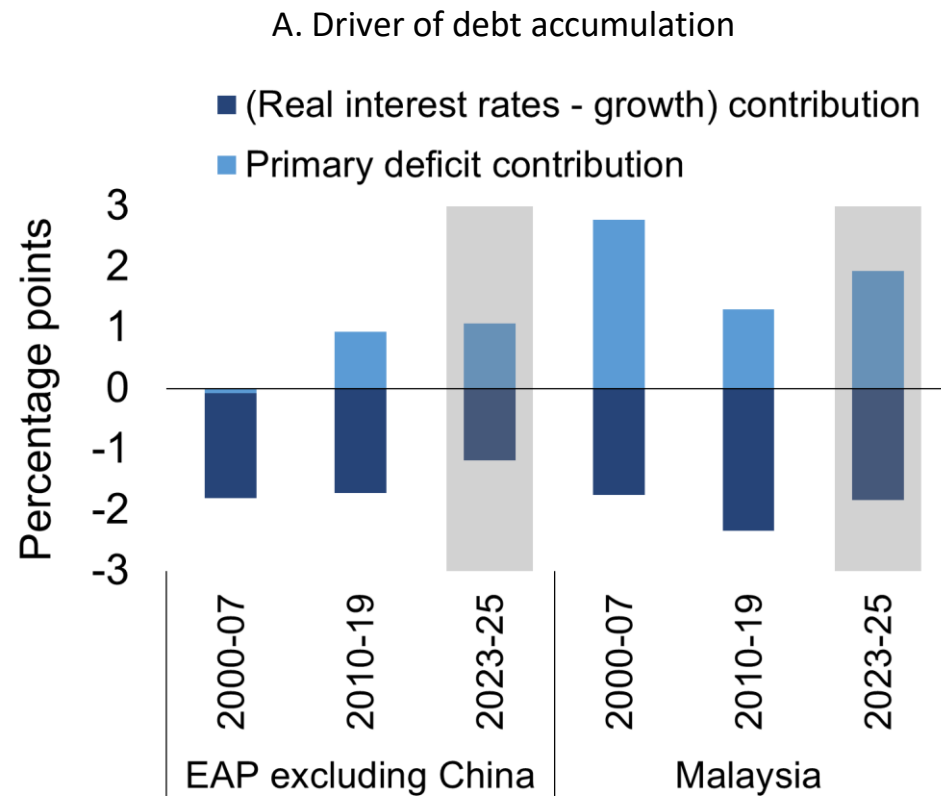
- We all know what to do but we don't know how to get re-elected once we have done it

The COVID-19 shock accelerated the upward trend in public debt accumulation observed in most developing EAP countries since the GFC



Sources: World Economic Outlook, IMF; World Bank staff estimates.
Notes: EAP excluding China considers Cambodia, Indonesia, Lao P.D.R., Malaysia, Mongolia, Papua New Guinea, Philippines, Thailand, and Viet Nam.
Gray area shows projections for 2023, 2024, and 2025.

Large deficits have been sustainable due to low interest rates and high growth rates... However, in the future, higher interest rates and lower growth rates are likely to add to debt to GDP ratio faster than in the past

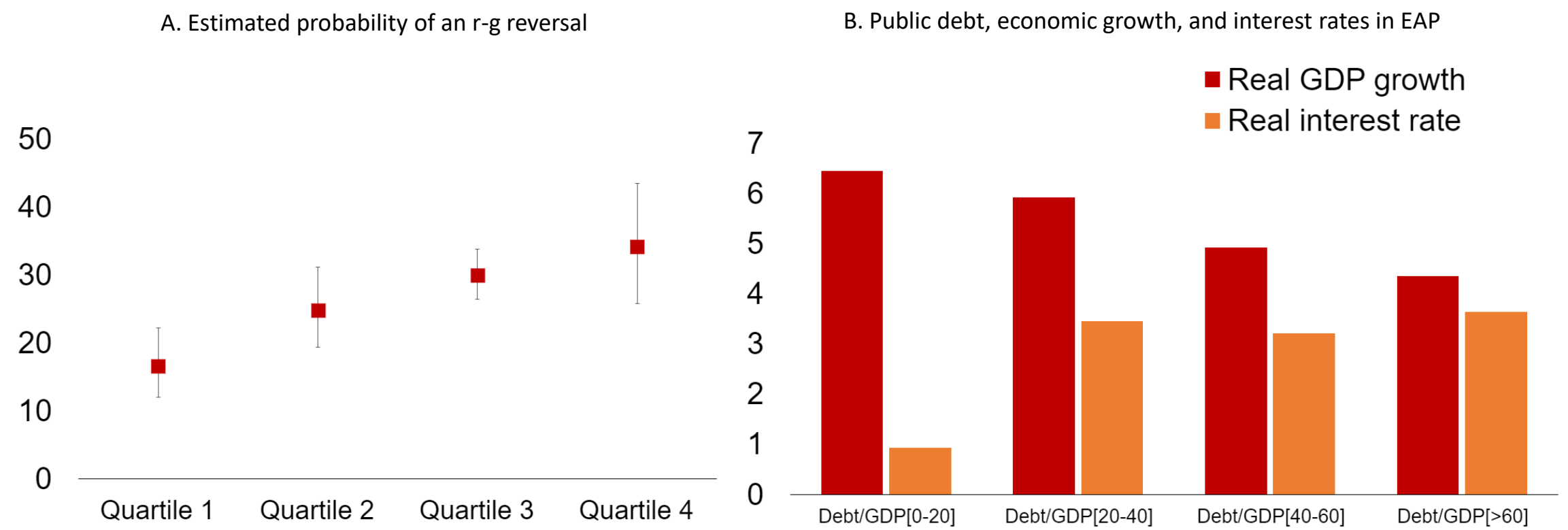


Source: World Economic Outlook, IMF; World Bank staff estimates.

Note: EAP excluding China considers Cambodia, Indonesia, Lao P.D.R., Malaysia, Mongolia, Papua New Guinea, Philippines, Thailand, and Viet Nam.

Dotted area shows projections for 2023, 2024, and 2025.

Furthermore, $r - g$ reversals are more likely when public debt is high, which could jeopardize public debt sustainability...



Source: World Bank staff estimates. Note: The chart plots the estimated probabilities (and the associated 90 percent confidence intervals) that the average $r - g$ over five years ($r - g_{t+5}$) is positive, given at least two consecutive years of negative $r - g$ (in year $t - 1$ and t), as a function of the current public debt-to-GDP ratio. The probabilities are estimated using a logit model and regressing an indicator of positive future $r - g_{t+5}$ on an indicator of negative current $r - g_t$, indicators of debt groups based on the quartiles of the public debt-to-GDP distribution, and their interaction terms. $r - g_t$ denotes annual $r - g$ in year t and $r - g_{t+5}$ denotes annualized 5-year average $r - g$ from year $t + 1$ to $t + 5$. Red squares denote point estimates and bars show 90 percent confidence intervals.

Overall, higher levels of public debt could...

- increase borrowing costs,
- limit fiscal space,
- constrain the ability of governments to respond to shocks, and
- lead to a debt crisis

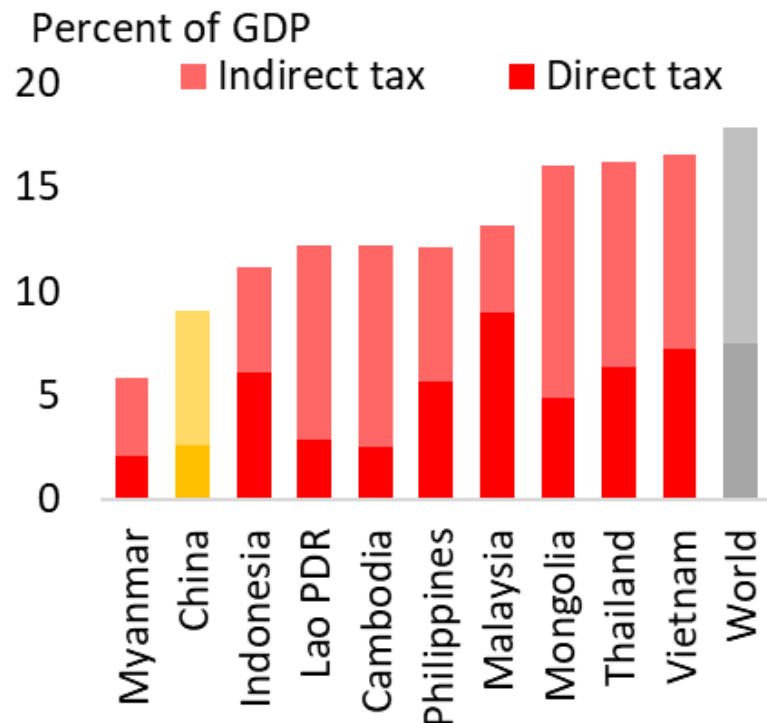
Therefore, it is crucial to mobilize resources...

- But, how?

How to mobilize resources without hurting economic growth?

➤ Taxing consumption rather than income

A. Tax revenue in EAP, 2000-2021



- Indirect taxes, with GST at the centre, drive revenues in middle income countries but Malaysia's consumption tax revenues are low.
- However, because GST is a broad-based consumption tax, it places a greater burden on poorer households than direct taxes.
- The regressive effect of a GST must be compensated either by targeted transfers or personalized rebates.

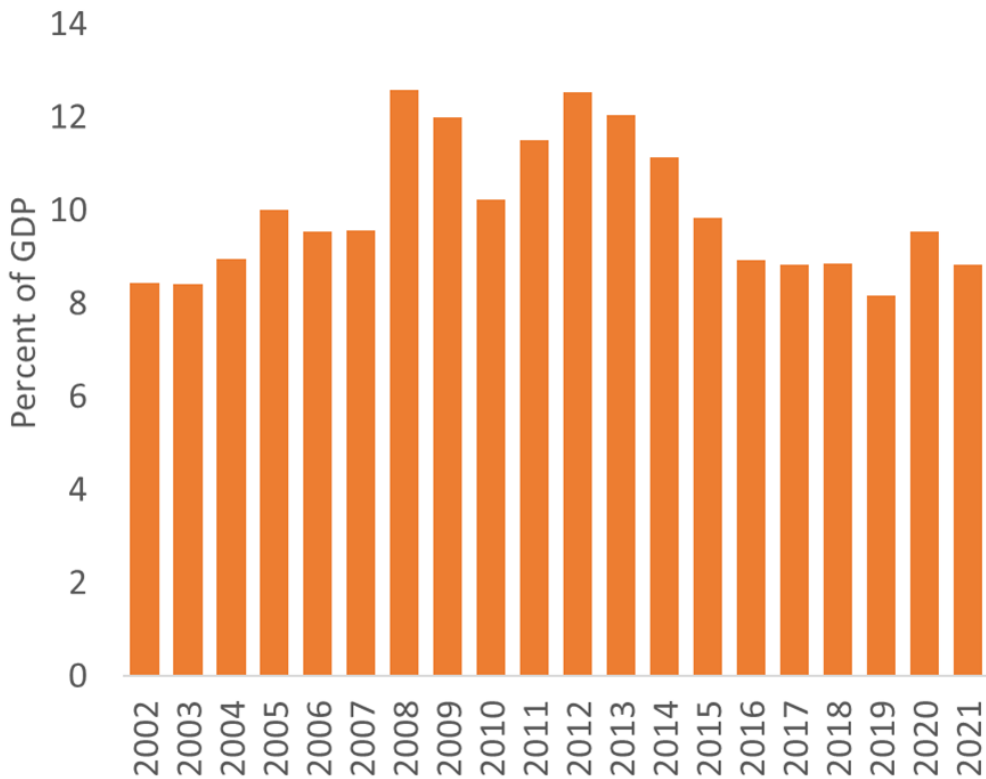
Source: Government Financial Statistics Dataset, IMF.

Note: Data for Cambodia starts in 2002 and Lao PDR starts in 2008. Data for Indonesia is only available between 2001-2007 and for Myanmar it is between 2012-2019. Mongolia is missing the observation in 2004 and 2005, while Vietnam is missing data between 2002-2006 and in 2021. Indirect tax include: taxes on goods & services, and international trade & transactions. Direct tax include: taxes on income, profits & capital gains, payroll & workforce, and property.

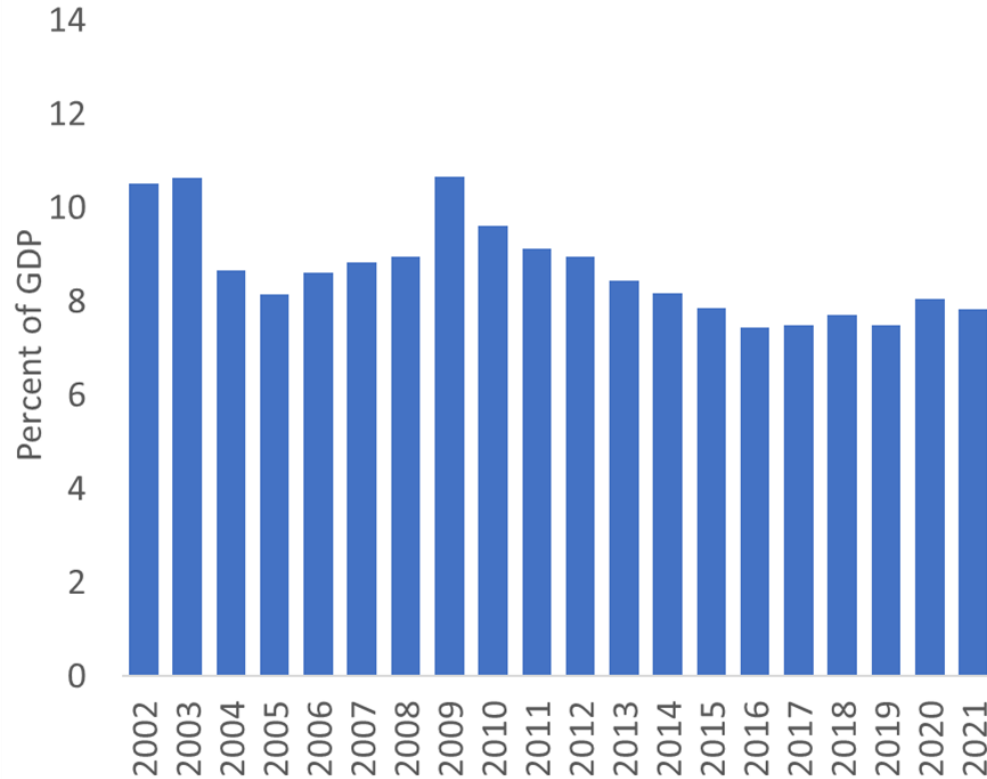
How to mobilize resources without hurting economic growth?

➤ Reallocating public spending from “non-productive” to “productive”

A. Non-productive Government Expenditure in Malaysia



B. Productive Government Expenditure in Malaysia



Source: Government Financial Statistics Dataset, IMF.

Note: A. Non-productive expenditure by government operating expense includes compensation of employees, use of goods and services, and subsidies. B. Productive expenditure by function of government includes expenditure on health, education, transport, and communication.

Tax policy reform is not only a technical exercise, but also a political one that can fail without strategic communications.

- The success of fiscal reforms require comprehensive stakeholder engagement and strategic communications throughout the planning and implementation of reforms to build trust, address stakeholder concerns, implement impactful messaging, and dispel potential misinformation
- A long-run fiscal plan could also provide more transparency, predictability, and accountability to build trust among taxpayers and investors...
- A long-run fiscal plan must include spending priorities, fiscal targets, and revenue sources

THANK YOU



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