

Taiwan's Tax Reforms Against the Backdrop of the Debt Crisis in Europe and America

By Chen Jinji

In late September the board of the Central Bank of China decided to leave the rediscount rate unchanged. The board decision meant that the economy has reversed course and that the scenario, which allowed for 0.5 percentage point rate hikes per quarter since June last year, has changed. The Council for Economic Planning and Construction (CEPD) just announced that its economic monitoring indicator flashed a “yellow-blue” light in August, for the first time in almost two years, indicating that the economy has lost steam and is headed toward a recession. Taiwan's economic growth is driven by exports. But export orders and other export-related economic figures already show signs of weakness. The natural reason behind this is the adverse international economic situation and slowing global demand. The international economic situation in particular gives people the impression that an economic winter is on its way. Directly after the U.S. bond crisis erupted in early August, news about the possible sovereign debt default by European nations such as Greece, Ireland, and Portugal caused a global financial panic and triggered market crashes around the world due to panic selling. The global economy is probably at risk of sliding into a second recession due to international economic difficulties such as the interruption of the industrial supply chain in the wake of the earthquake disaster in Japan earlier this year, and a rising risk of stagflation in China resulting from dramatically increased inflationary pressure and sputtering economic growth.

During the global financial crisis of 2008, governments around the world, without exception, rolled out monetary and fiscal policies to stimulate the economy into recovery. Fiscal policy is characterized by leaning against the wind. Aside from an endogenous increase of statutory welfare expenses such as unemployment benefits during economic downturns, policymakers often use an expansionary fiscal policy that increases the budget for public infrastructure expenditure to boost domestic demand and stimulate economic recovery. But when these fiscal tools have virtually been exploited, the government is saddled with debt and has no room left for issuing new debt. It is indeed worrisome that in the event of a second recession or other temporary governmental needs, Taiwan's fiscal policy will have little maneuvering space.

A close look at the central government's general budget¹ and special budgets for fiscal year 2012 shows that a total of NT\$209.8 billion have been earmarked for public infrastructure projects. If for profit and nonprofit special funds are included, the total adds up to NT\$408.6 billion, NT\$110.8 billion less than in fiscal year 2011. The public infrastructure budget has shrunk, because the government, out of policy considerations, opted for an expansion of current expenditures such as a pay rise for civil servants, although the fiscal situation is tight and mandatory spending is on the rise. At the same time it is not able to effectively curb other nonessential spending and waste correspondingly. This will naturally create a crowding-out effect on other government spending including public infrastructure and even cause fiscal policy to gradually lose its counter-cyclical character.

An Average NT\$412.4 Billion of New Debt per Year

Since taking power three years ago the government of President Ma Ying-jeou has issued new debt in excess of NT\$400 billion every year, causing public debt to rapidly increase, nearly hitting the statutory debt limit. Given that our fiscal maneuvering space is almost used up and we might face a global recession, we need to worry indeed whether our government's fiscal space suffices to handle the situation. In the central government's general budget for FY 2012, new public debt accounts for NT\$310.3 billion. While this is already less than the borrowings made in previous years - NT\$445.5 billion in 2011, NT\$479.7 billion on 2010, and 413.8 billion in 2009 – the Ma government has still incurred an average of NT\$412.4 billion in new debt per year during the past four years. An analysis of the reasons for the rapid increase in public debt shows that it is actually related to the annually rising gap between revenue and expenditure. The government budget has already moved to a structural deficit.

With revenue and expenditure severely out of sync, the government is heavily reliant on issuing new debt to balance the budget every year. And since its dependence on borrowings continues to grow, outstanding public debt is accumulating rapidly. According to the final

¹ The central government's FY2012 budget totals NT\$1.9390 trillion. On the surface this is an increase of NT\$150.6 billion over the FY2011 budget's NT\$1.7884 trillion. But if the NT\$69.6 billion are subtracted which were transferred back from special budgets into the general budget, other mandatory items (such as newly added health insurance premium payments from the second generation national health insurance (NHI) and from premium payments on behalf of the special municipalities, funds allocated to balance the NHI deficit, tax revenue that will be used after the introduction of an income tax for military officers and teachers to reimburse them fully for their tax payments, as well as funds to pay for the salary hike for military officers, teachers, and civil servants and so on) and funds for an increase of the veterans home care assistance as well as subsidies to cover the special municipalities' outstanding labor and national health insurance payments (for reference view attached table: Summary of Additional Items in the FY2012 Central Government General Budget), then the scope of the increase is quite limited with just NT\$17 billion.

audit report of the central government's FY 2010 general budget, the finalized audited figure for debt outstanding more than one year at the end of 2010 stood at NT\$4.5417 trillion. After subtracting finalized reserved accounts, the actual outstanding debt figure totaled NT\$4.4735 trillion. If the NT\$240 billion in debt outstanding less than one year is included, total debt outstanding reached NT\$4.7135 trillion. Based on the debt estimate in the 2012 budget, government debt will reach NT\$5.1377 trillion at the end of 2012, accounting for 35.49 percent of the average nominal GDP for the past three years. Compared to the NT\$3.7187 trillion in public debt outstanding more than one year that Taiwan had accumulated at the end of 2007, this represents an increase of more than NT\$1.4190 trillion. Although GDP has increased over the past few years, public debt as a percentage of GDP still edges closer to the 40 percent debt ceiling set in the *Public Debt Act*.² We cannot say that the fiscal situation is not severe. Public debt is estimated to nearly hit the legal debt limit next year, which means issuing new debt will become impossible.

In recent years the central government has incurred more and more debt to pay expenditures for general administration. The government compiles a budget to repay principal on these debts every year, but first the debt amount by far exceeds the mandatory repayment amount stipulated in the *Public Debt Act*, and second the repayments are made by issuing new debt under the motto "raising new debt to pay old debts." As a result the amount of accumulated debt keeps inching higher and remains stubbornly high. In its FY 2010 final audit report the National Audit Office therefore had the following to say: "The debt repayment budget does not suffice to repay debts that are due. It would be appropriate to consider raising the repayment limit and effectively curbing debt growth." The central government's non self-redeeming debt (with maturity of one year and above) has posted net increases – after issuance of new debt and repayment of old debt - since 1987 when it stood at NT\$88.2 billion. These increases reached the widest margins in 2009 and 2010 with 9.23 percent and 10.02 percent, respectively. Although debt will increase during the current fiscal year by a smaller margin of just 4.4 percent, the amount of debt outstanding will still hit a record high.

Heavy Interest Burden Affects Government Work

² Article 4 of the Public Debt Act stipulates: "The forecast outstanding of public debt extending more than one (1) year as taken out by the central and local governments, on the general budgets, special budgets, and in the form of extraordinary fund budgets beyond the operating funds and trust funds, shall not exceed forty-eight percent (48%) of the average gross national product (GNP) of the previous three years as forecast by the Executive Yuan Directorate General of Budget, Accounting and Statistics: 1. The central government level is at forty percent."

Recently the planned increase of the old-age farmers welfare allowance by NT\$1,000 per month became the focus of sparring between the ruling and the opposition parties in the legislature. A key reason why the Executive Yuan hesitated to implement the measure is that it will be difficult to raise the needed amount of NT\$8.4 billion given the current fiscal difficulties. In contrast to FY2008 when interest payments totaled NT\$117 billion, accounting for 5.5 percent of total expenditure in that year, the FY2012 budget for interest payments has increased to NT\$129.5 billion or 7.5 percent of total expenditure. If government debt hadn't risen so fast, causing interest payments to rise by NT\$12.5 billion, the old-age farmers welfare allowance could have been increased by NT\$1,500 a long time ago.

As outstanding debt climbs higher and interest spending increases year by year, the budget for interest payments accounts for 7.5 percent of the total budget amount. As a result the government needs to pay NT\$7.5 in interest for every NT\$100 spent. Of course this will lead to a crowding out effect on other government spending. Along with an increase of accumulated outstanding debt, interest payments will rise over the years when the economic situation changes and interest rates go up with the economic recovery. This will crowd-out the annual budget even more severely and impair the government's ability to carry out government affairs.

Fiscal Problems Undermine Government

High central government debt and resulting interest payments do not only crowd out the government budget, but the financial problems also affect the government's ability to rule the country. When running for president in 2008 Ma proposed various points in his political platform, which required the compilation of a budget or the establishment of special funds for implementation. But during the last four years we have not seen him earmark funds in the annual general budget that are needed to realize his election pledges, so naturally the promises were broken. Not only that these pledges were made without proper evaluation during the campaign and without thinking to gain votes, the reason why they cannot be realized has of course a lot to do with the government's failure to rein in spending in recent years, which has led to a very tight fiscal situation.

The following are examples for broken campaign pledges: Ma promised that if he wins election the government would pour NT\$2.65 trillion into the i-Taiwan 12 Projects for improving public infrastructure and establish a NT\$100 billion "Local Finances Reconstruction Fund." He promised to increase the culture and tourism budget to 4 percent of the general budget within four years, pledged to promote special regulations for water management in Kaohsiung and Pingtung to raise special funds for addressing flooding and water pollution there, he said the government's R&D funding would grow by 10 percent every year and that NT\$10 billion would be directly invested in a startup program for promising young entrepreneurs.

NT\$1 billion would be allocated annually for a micro enterprise fund to help women launch their own businesses, another NT2 billion would be used to set up a “labor rights fund” at the central and local government levels, and the defense budget would not be cut to less than 3 percent of GDP.

Structural Tax System Problems Behind Fiscal Difficulties

After relying on tax cuts as a tool for a long time the government has not only created a structural deficit for several years in a row, but the tax burden as the ratio of total revenues to GDP has continued to decline until reaching only 11.9 percent last year, which is virtually the lowest ratio worldwide. Not only has the tax system lost its fiscal autonomy, but taxation has even become enslaved to economic growth. With finances out of balance, fiscal revenue is severely insufficient, making it impossible to support the government in performing its regular duties as it should. On top of that the problem of unfair income distribution continues to grow worse, because the tax system lacks the ability to narrow the wealth gap.

Conclusion

Looking into next year, if the international economy is not able to stage a strong recovery, economic growth will probably be severely limited, given that government investment in public infrastructure will shrink next year and it won't be possible to boost private investment and domestic consumption due to the confidence crisis caused by the pessimistic economic outlook. As they fish for votes politicians keep bragging about last year's economic growth of more than 10 percent, but are not able to provide for the rainy days of next year's economy, be it with regard to fiscal policy or when compiling the government budget. This is certainly not what the electorate wants to see and not a blessing for democratic politics.