FISCAL POLICY AND PUBLIC FINANCE

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Ministry of Finance of Thailand

fiscal policy The government's spending and taxing policies.

ธนาคารแห่งประเทศไทย
BANK OF THAILAND

monetary policy The behavior of the central bank concerning the nation's money supply.

WHERE WE ARE HEADED FROM NOW

- Understanding fiscal authority and fiscal policy
  - Chapter 9
- Understanding financial sector and monetary policy
  - Chapter 10

- Develop a model that allows us to see a more detailed interaction in macroeconomy – to understand effects of fiscal and monetary policy

AGENDA

- Meaning of fiscal policy
- Objectives of fiscal policy
- Fiscal policy tools
- Types of fiscal policy

MEANING OF FISCAL POLICY

- Government policy involves with
  - Spending
  - Taxation
  - Public debt

- Setting the policy to best “achieve” the goals of government

GOALS OF THE GOVERNMENT

- Enhance the efficiency of resource allocation
- Improve the outcome of income distribution
- Enhance the long-term economic growth
- Stabilize macroeconomy

GOALS OF THE GOVERNMENT

- Enhance the efficiency of resource allocation
  - Market allocation can be **inefficient**: *Externality, Monopoly* etc.
  - Government sets some policies to *fix the inefficiency*
  - **Example:** Environmental concerns → Carbon emission and Externality → Global warming → *Carbon tax*

GOALS OF THE GOVERNMENT

- Improve the outcome of income distribution
  - While the market outcome could be efficient, the allocation may not be fair – income inequality
  - Government aims to improve the income distribution by setting policy that generates the so called "redistributive effect"
  - **Example:** *Income-based Tax and transfer system*
    - Rich pay more; poor pay less
    - Rich receives less; poor receive more

GOALS OF THE GOVERNMENT

- Enhance the long-term economic growth
  - Aims to increase the growth of long-term GDP level, and hence the income per capita
  - **Example:** Educational policy → Public education → More accessibility and more attainment → *Human capital built up*

GOALS OF THE GOVERNMENT

- Stabilize macroeconomy
  - Macroeconomy is always hit by *shocks* –
    - e.g. world GDP growth contraction, oil price surges, Flooding situation and weather condition
  - These shocks impact our GDP, and causing the *unstable movements of GDP* – boom and recession
  - Government's role is to "*stabilize*" the impact of shocks
  - **Example:** World GDP growth contraction → Raise G to avoid the recession

FISCAL POLICY TOOLS

- Fiscal policy tools involve with the management of
  - *Government expenditure* : Outlays
    - What program should the government run?
  - *Government* receipts :
    - Securing financial resource to finance the spending

FISCAL POLICY TOOLS

- **Government expenditure**
  - *Government purchase of goods and services*: ($G = GC + GI$)
    - Consumption expenditure: GC
    - Investment expenditure: GI
  - *Government transfer payment:* R

FISCAL POLICY TOOLS

- **Consumption expenditure: GC**
  - Current expenditure: Salary paid to government worker
- **Investment (Capital) expenditure: GI**
  - Infrastructure investment, road maintenance etc.
- **Government transfer payment: R**
  - Child-care support, Pension pay-out, Elderly-care support

FISCAL POLICY TOOLS

- **Government receipts**
  - *Government revenue*
    - Tax revenue: T
    - Non-tax revenue
  - *Public debt*
  - *Treasury cash balances*

FISCAL POLICY TOOLS

- Classifications of tax revenue
  - *Income v.s. non-income tax*
  - By the economic burden: Direct tax v.s. Indirect tax
    - Legal incidence v.s. Economic incidence
  - By tax rate: *proportion/ progressive / regressive*

- Non-tax revenue
  - Transfer of SOE's revenue, Fees, Fines etc.

FISCAL POLICY TOOLS

- **Public debt**
  - Government budget: how to finance government spending
  - Government spending > Government tax → need to fill up the deficits through financial tools
  - Sources of borrowing: Financial markets
    - Issuing "government bond"
    - Domestic and external
- **Treasury cash balance**

GOVERNMENT BUDGET PLANNING

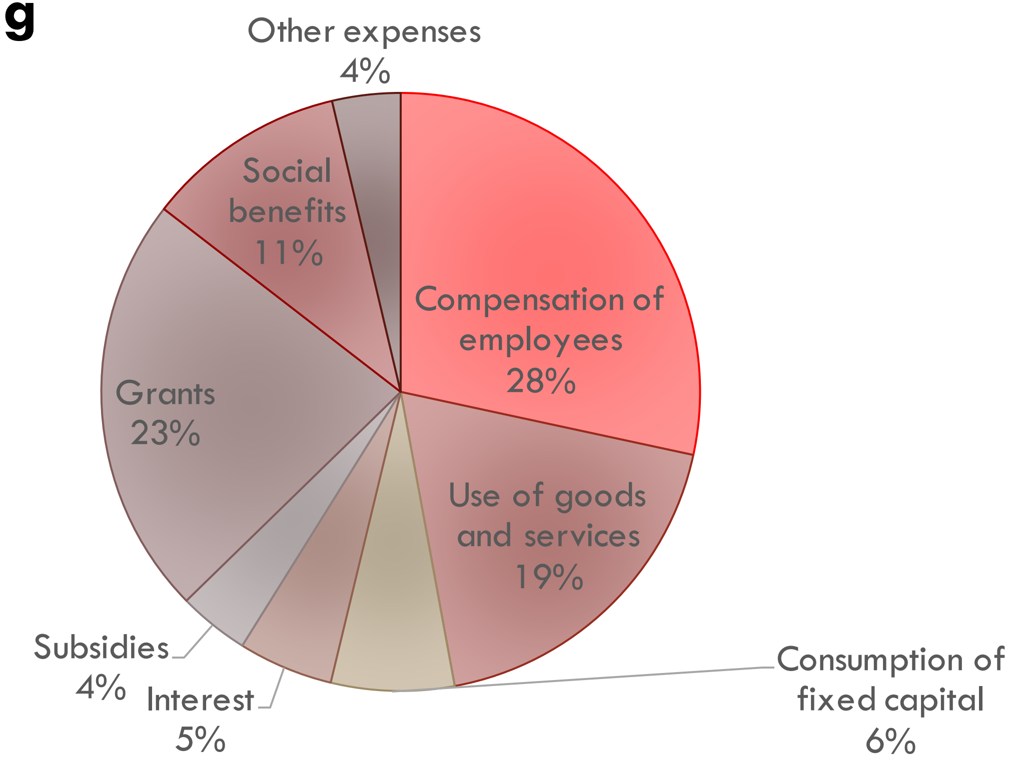
- Typically, fiscal policy is planned one-year ahead of time.
- The process of budget approval will go through the parliament.
- Each ministry will submit their request for budgeting.
- Ministry of finance will do projection on the revenue, review the viability of projects proposed by each ministry, and consider financial planning.

GOVERNMENT BUDGET PLANNING

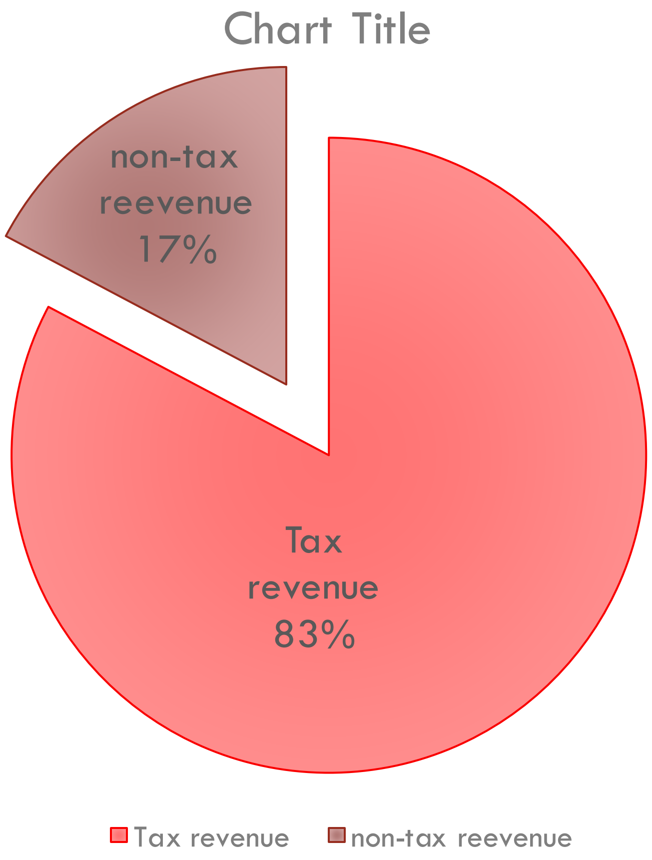
- Types of government budget
  - Balanced budget: $G + R = T$
  - Budget deficit: $G + R > T$
  - Budget surplus: $G + R < T$

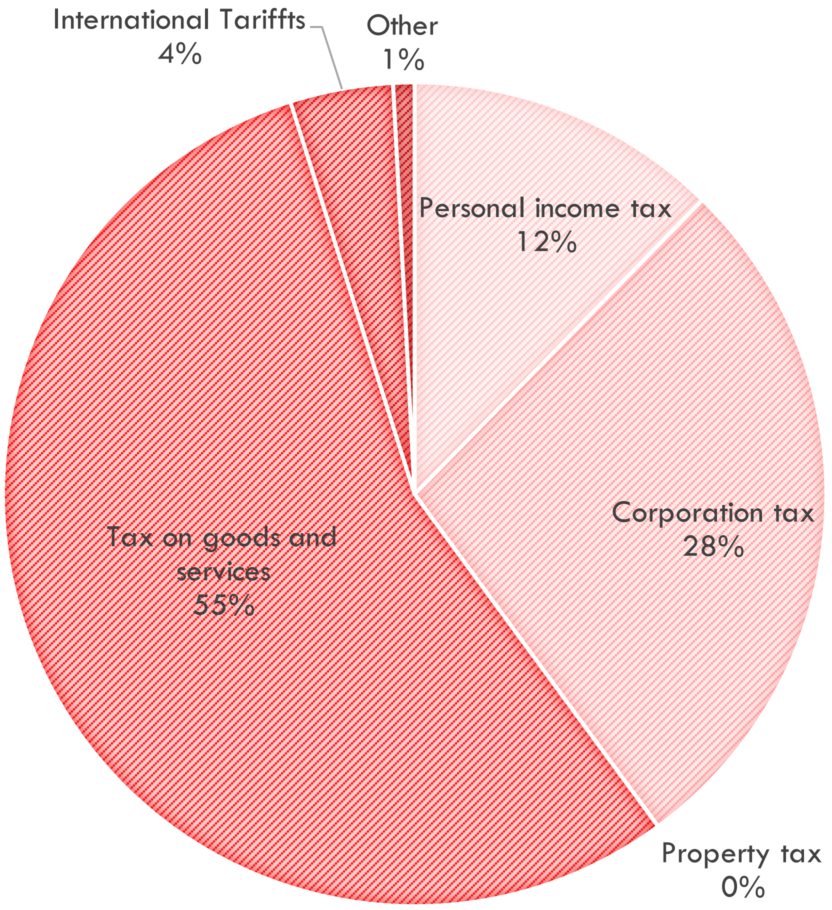
STRUCTURE OF GOVERNMENT SPENDING

Government spending



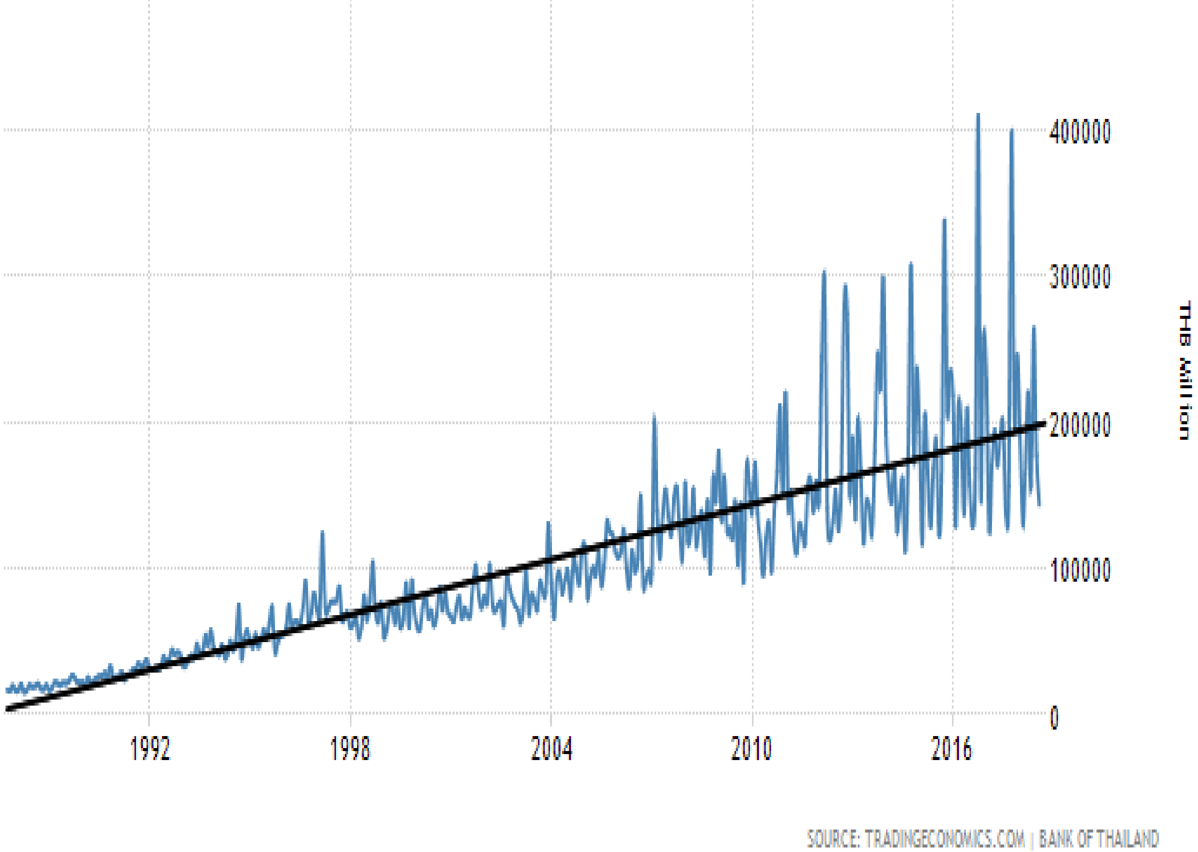
STRUCTURE OF GOVERNMENT REVENUE



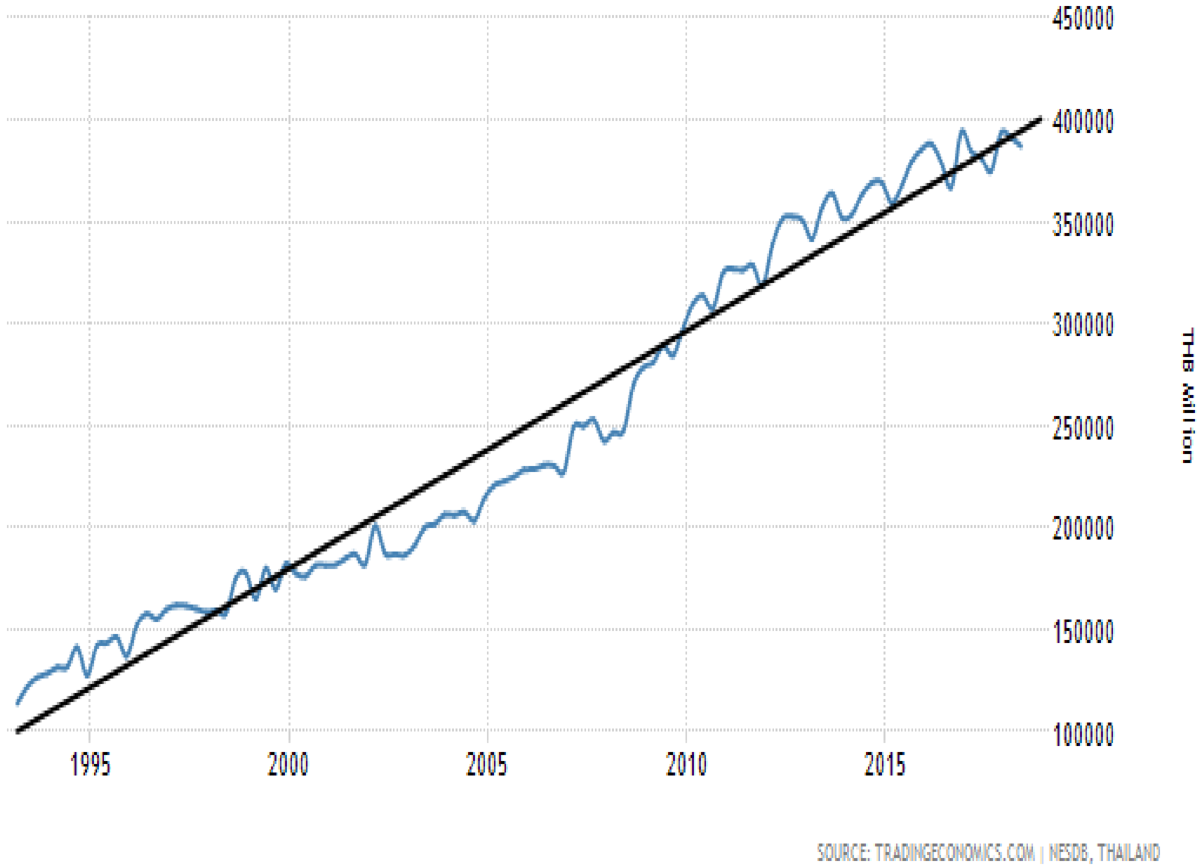


GOVERNMENT INDICATORS OVER TIME

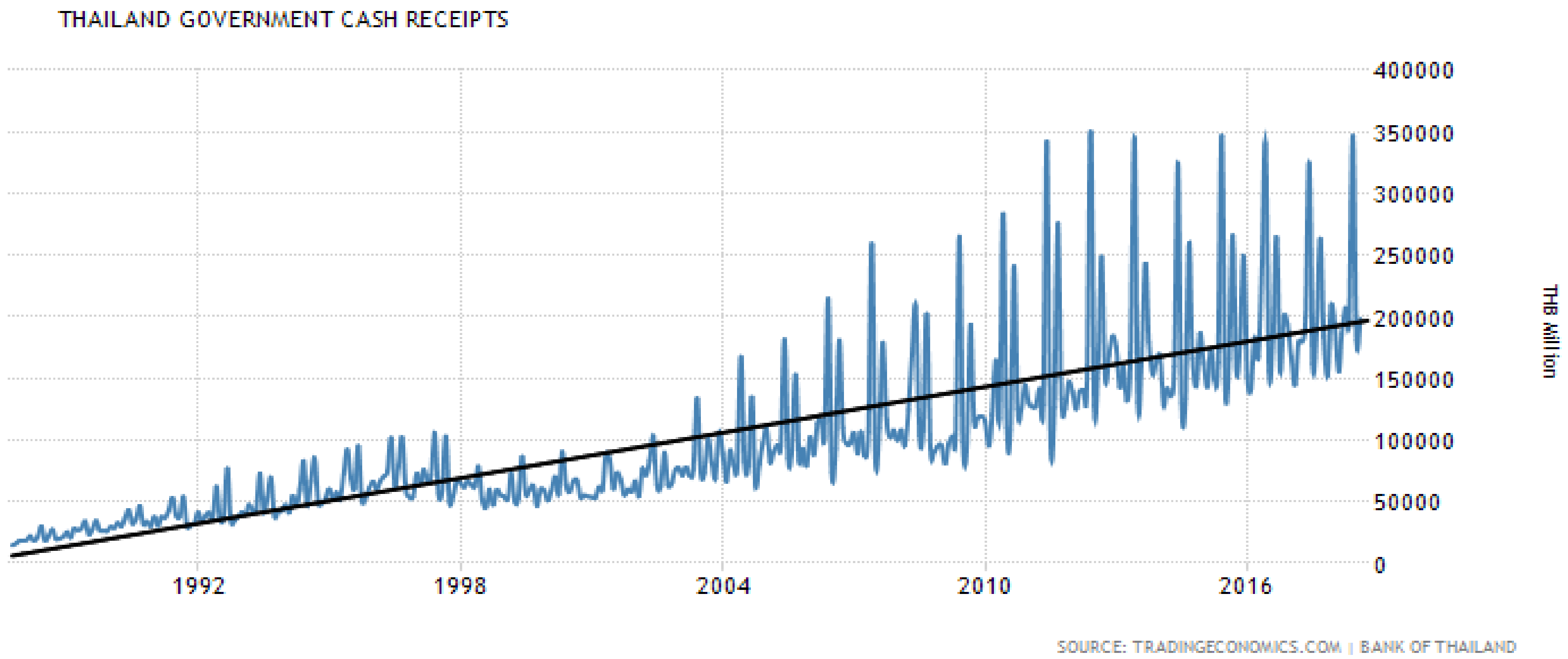
Total government spending
Spending on various programs combined



GC + GI



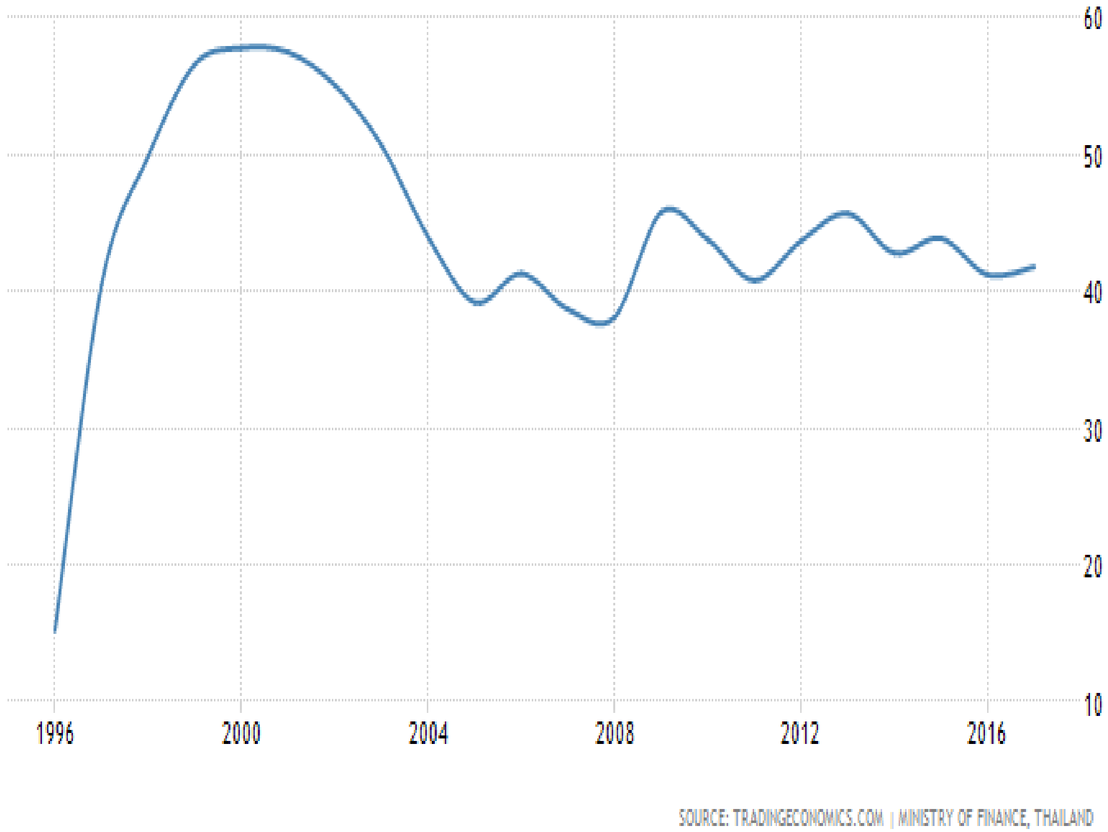
GOVERNMENT INDICATORS OVER TIME



GOVERNMENT INDICATORS

Budget: Deficit v.s. Surplus

Debt-to-GDP ratio



TYPES OF FISCAL POLICY 1

- Classifications linked by the types of economic problem
  - **Expansionary fiscal policy:** used to resolve/fix *the deflation gap problem (recession)*
  - **Contractionary fiscal policy:** used to resolve/fix *the inflation gap problem (boom)*

TYPES OF FISCAL POLICY 1

- To implement the **expansionary fiscal policy**, government may choose one of the followings (or the combination of)
  - Increase in G
  - Decrease in Tax → lower tax rate; lower lump-sum tax
  - Increase Transfer → Adding more programs, making the existing one more generous
- To implement the **contractionary fiscal policy**, government may choose one of the followings (or the combination of)
  - Decrease in G
  - Increase in Tax → lower tax rate; lower lump-sum tax
  - Decrease Transfer → Terminate existing programs, making the existing less generous

TYPES OF FISCAL POLICY 2

- **Discretionary fiscal policy**
  - Management of G, T, Public debt made upon the *judgments or discretion* of government – require passing a new law.
  - Eg. Road-improving expenditure program, the adjustment of income tax rate etc.
- **Non-discretionary fiscal policy / Automatic-stabilizer fiscal policy**
  - Rule-based fiscal policy; *pre-commitment*
  - Eg. Social insurance program, Transfers program linked to income, income tax system

BUILT-IN AUTOMATIC STABILIZER

- **Some non-discretionary fiscal policies have the automatic stabilizing features**
  - To reduce the impact of shocks on Thai GDP
- The payouts or receipts of some government programs are directly tied to the economic conditions.
  - Pay more under recession; pay less under boom
  - Receiving more under boom; receiving less under recession

BUILT-IN AUTOMATIC STABILIZER

- **Example:** Income-tax system and Income-linked transfer program
- **Consider a scenario:**
  - Rising world GDP growth might impact Thai economy – causing an upswing of Thai GDP, and hence resulting in an inflation GAP or economic boom.
  - Non-discretionary fiscal policies can help stabilizing the impact on Thai economy.

BUILT-IN AUTOMATIC STABILIZER

- Income tax system
  - Rising GDP growth tends to raise the Thai GDP
  - Under the income tax system, tax revenue will rise
  - Households cannot increase their spending as much as when there is not income tax system.
  - GDP will not sizably increase – self-stabilizing effect.

BUILT-IN AUTOMATIC STABILIZER

- Income-linked transfer system
  - Rising GDP growth tends to raise the Thai GDP
  - Under the Income-linked transfer, transfer will fall
  - Households cannot increase their spending as much as when there is only lump-sum transfer program.
  - GDP will not sizably increase – self-stabilizing effect.

BUILT-IN AUTOMATIC STABILIZER: MULTIPLIER

$$Y = C + X$$

$$C = \bar{C} + C_1 Y_d$$

$$X = \bar{X}$$

$$T = \bar{T}$$

$$Y = C + X$$

$$C = \bar{C} + C_1 Y_d$$

$$X = \bar{X}$$

$$T = \bar{T} + T_1 Y$$

BUILT-IN AUTOMATIC STABILIZER: MULTIPLIER

$$Y = C + X$$

$$C = \bar{C} + C_1 Y_d$$

$$X = \bar{X}$$

$$R = \bar{R}$$

$$Y = C + X$$

$$C = \bar{C} + C_1 Y_d$$

$$X = \bar{X}$$

$$R = \bar{R} - R_1 Y$$

BUILT-IN AUTOMATIC STABILIZER: MULTIPLIER

- Under the built-in automatic stabilizer system, multiplier is smaller

- Shocks generate smaller impact -- *more stabilizing outcome*

TYPES OF FISCAL POLICY 3

- Fiscal policy also concerns with the public debt management
  - public debt = Government borrowing, used to finance the public spending
- Objective of public debt creation
  - Long-term government investment project
  - Finance budget deficit
  - Stabilizing the macroeconomy

TYPES OF FISCAL POLICY 3

- Negative effects of public debt creation
  - Crowing-out private spending
  - Rising borrowing cost: high debt is considered risky

- Excessive debt creation
  - Credibility of government to honor debt
  - Exclusion from global financial markets
  - Inflation

LIMITATIONS OF FISCAL POLICY

- Automatic-stabilizer fiscal policy
  - Advantages:
    - Timely respond to the economic situation (need no government monitory; problem is self-mitigating)
  - Drawbacks:
    - Does not resolve the problem; reduce the severity of the problem.
    - Incentive distortion; fiscal drag

LIMITATIONS OF FISCAL POLICY

- Discretionary fiscal policy
  - Advantages:
    - When the scale of problem is too big, discretionary fiscal policy might be more effective
  - Drawbacks:
    - To properly conduct, government needs to know the size of multiplier
    - A lot of operational concerns: *the Lag problems*

LIMITATIONS OF FISCAL POLICY

- The lag problems
  - *Recognition lag:* identify when the problem exists
  - *Implementation lag:*
    - Decision lag: legislative work required
    - Execution lag: Delay in procurement process; delay in payments
  - *Response lag:* Injected cash program might take some times before it can generate the intended outcome.