

Fiscal Policy Strategies for Long-term Growth and Price Stability

Bhanupong

Lecture 25



Chapter 11: Fiscal policy for long-term growth and stability

“Lessons from Thailand’s Fiscal Policy” *Asian Economic Papers* 14 (3) 2015.

FPO upgrades 2020 GDP decline from 8.2 to 7.7%

Figure based on trade partners' recovery

LATEST THAILAND ECONOMIC FORECASTS

Indicator	2020 forecast	2021 forecast
 Real GDP	-7.7	4.5
 Private consumption	-3	2.6
Public consumption	4	5.8
 Private investment	-9.8	4
Public investment	10.5	12.2
 Exports of goods and services	-20.9	5.4
Imports of goods and services	-14.4	5.7
 Merchandise exports in dollar terms	-7.8	6
Merchandise imports in dollar terms	-12.3	8
 Trade balance (US\$ billion)	34.4	32.7
Current account (\$ billion)	14.1	13.1
 Headline inflation	-0.9	1
Core inflation	0.3	0.4

Course Syllabus

Lecture 25

- Fiscal stimulus and recession
- Thailand's rules for fiscal sustainability
- Automatic fiscal stabilizers
- Fiscal policy and economic growth
- Rules for effective fiscal policy
- Lessons from Thailand's fiscal policy

Asian Economic Papers

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Lessons from Thailand's Fiscal Policy*

Bhanupong Nidhiprabha

Faculty of Economics Thammasat University 2 Prachan Road
Bangkok 10200 Thailand bhanupong@econ.tu.ac.th

[Full Text](#) | [PDF \(386.601 KB\)](#) | [PDF Plus \(366.252 KB\)](#)

Abstract

If rules of fiscal sustainability are observed, available fiscal space permits effective countercyclical fiscal programs. The importance of automatic fiscal stabilizers should not be underestimated. The discretionary impact of increased public spending and tax cuts can be amplified if implemented when consumer confidence investor sentiments are high. There is no evidence to support non-Keynesian effects of fiscal policy in Thailand. Unwarranted fears of unsustainable public debt and ultra-conservative fiscal policy has cost the country a lost opportunity for achieving high growth. After the military coups in 2006 and 2014, the Thai economy experienced the lowest economic growth among ASEAN countries. The budget spent on economic services was diverted into defense, increases in public sector's wages, and income transfer payments. The opportunistic political budget model predicts higher fiscal spending by incumbent democratic governments before an election to gain votes. In the case of Thailand, such spending comes after military coups, akin to a military business cycle spending.

Structural Fiscal Position

Fiscal stance

Ratio of Public Revenue/Expenditure (R/G)

Trend values: Obtained by removing cyclical values from the actual values
(percent)

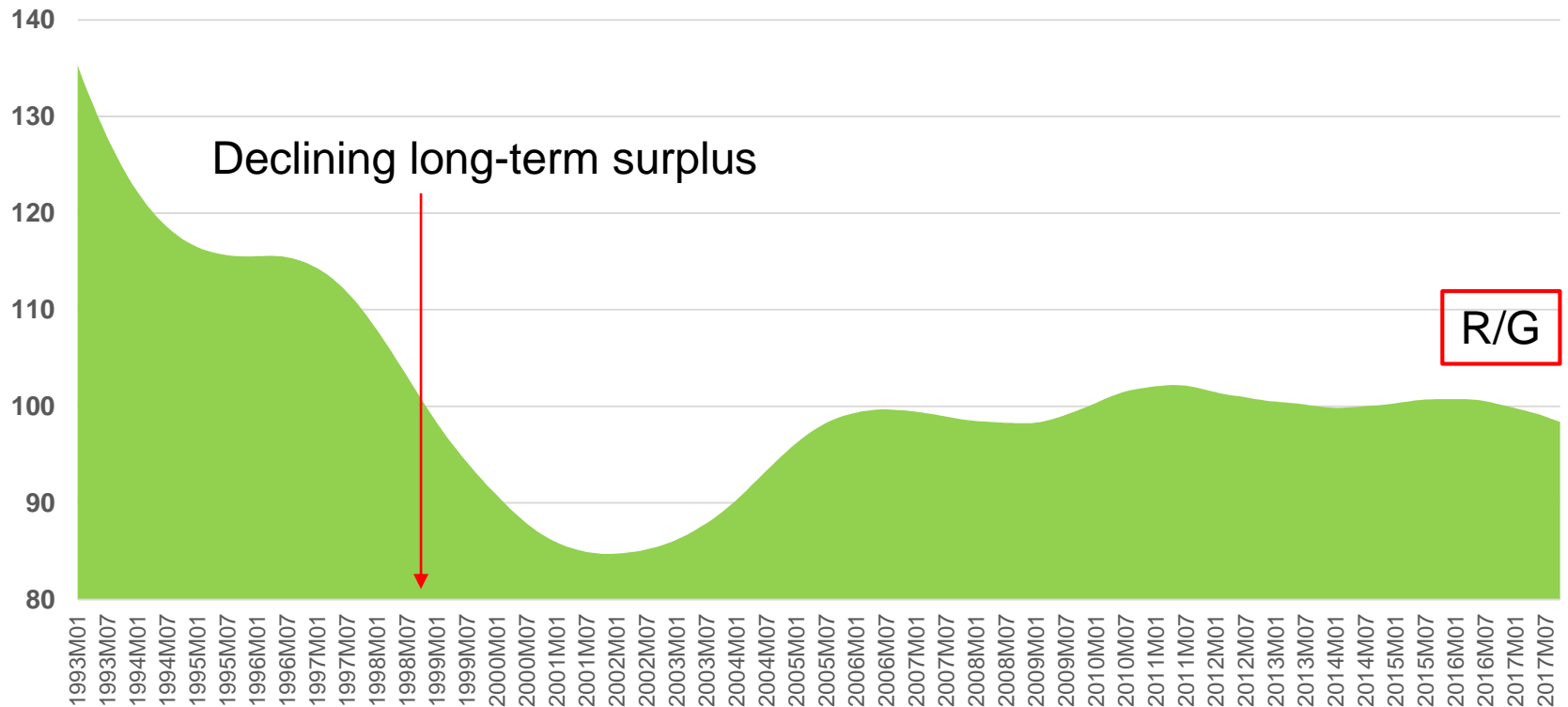
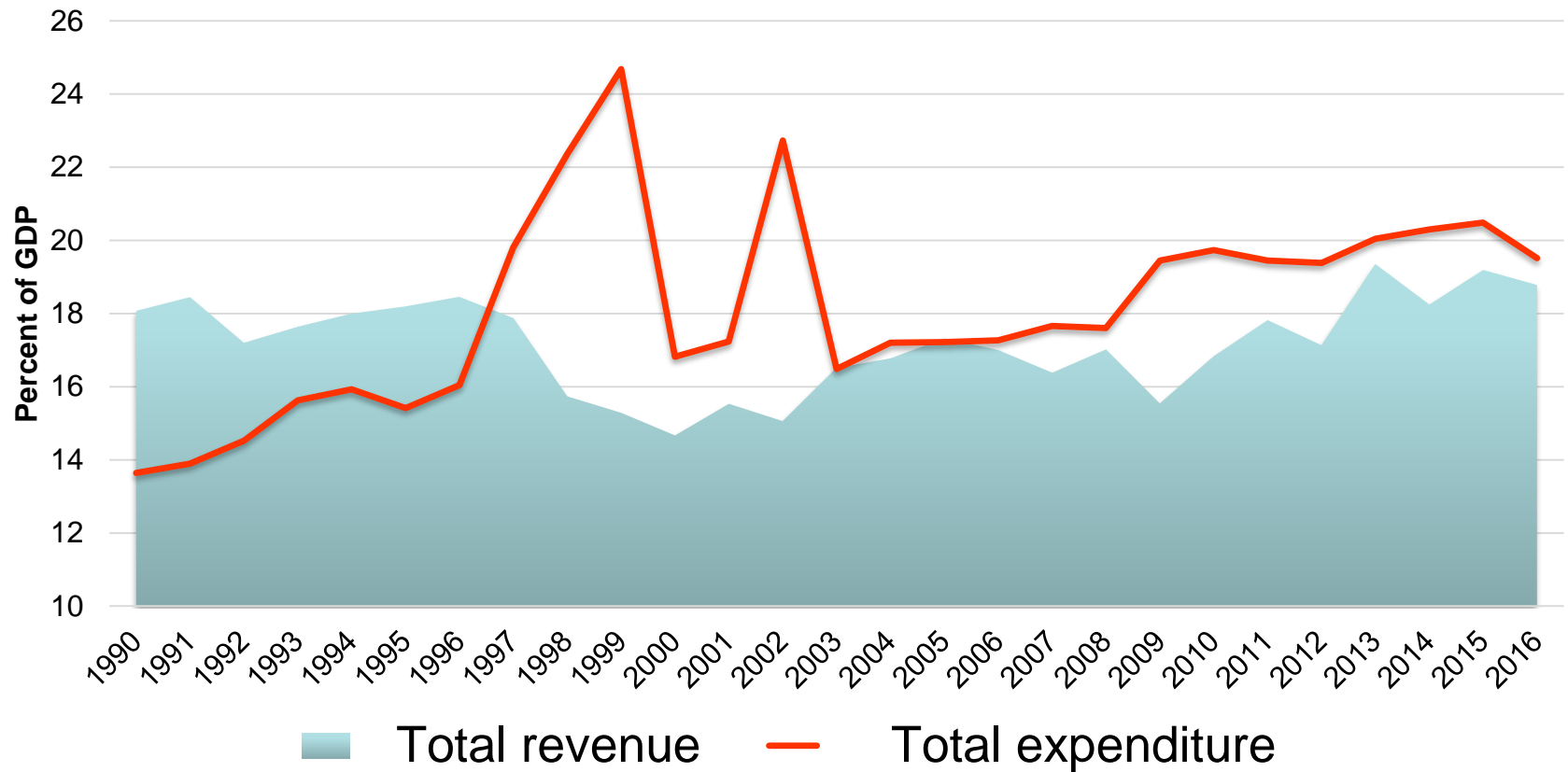


Figure 11.1 Public Revenue and Expenditure: 1990-2016



Three methods of deficit finance

(1) **Money finance**

The central bank buys bonds, injecting money supply to the economy.

Strong output expansionary impact when there is excessive supply and high level of unemployment.

No crowding out effect as the interest rate tend to decline.

High inflationary impact if output is near full employment

Seigniorage

- By providing the government with increased purchasing power at the expense of the public's purchasing power, it imposes what is metaphorically known as an **inflation tax** on the public.
- Seigniorage is a convenient source of revenue for some governments.

Three methods of deficit finance

(2) **Tax finance**

low expansionary impact since consumption declines offsetting government spending.

This method should be employed when the economy is near full employment.

(3) **Bond finance**

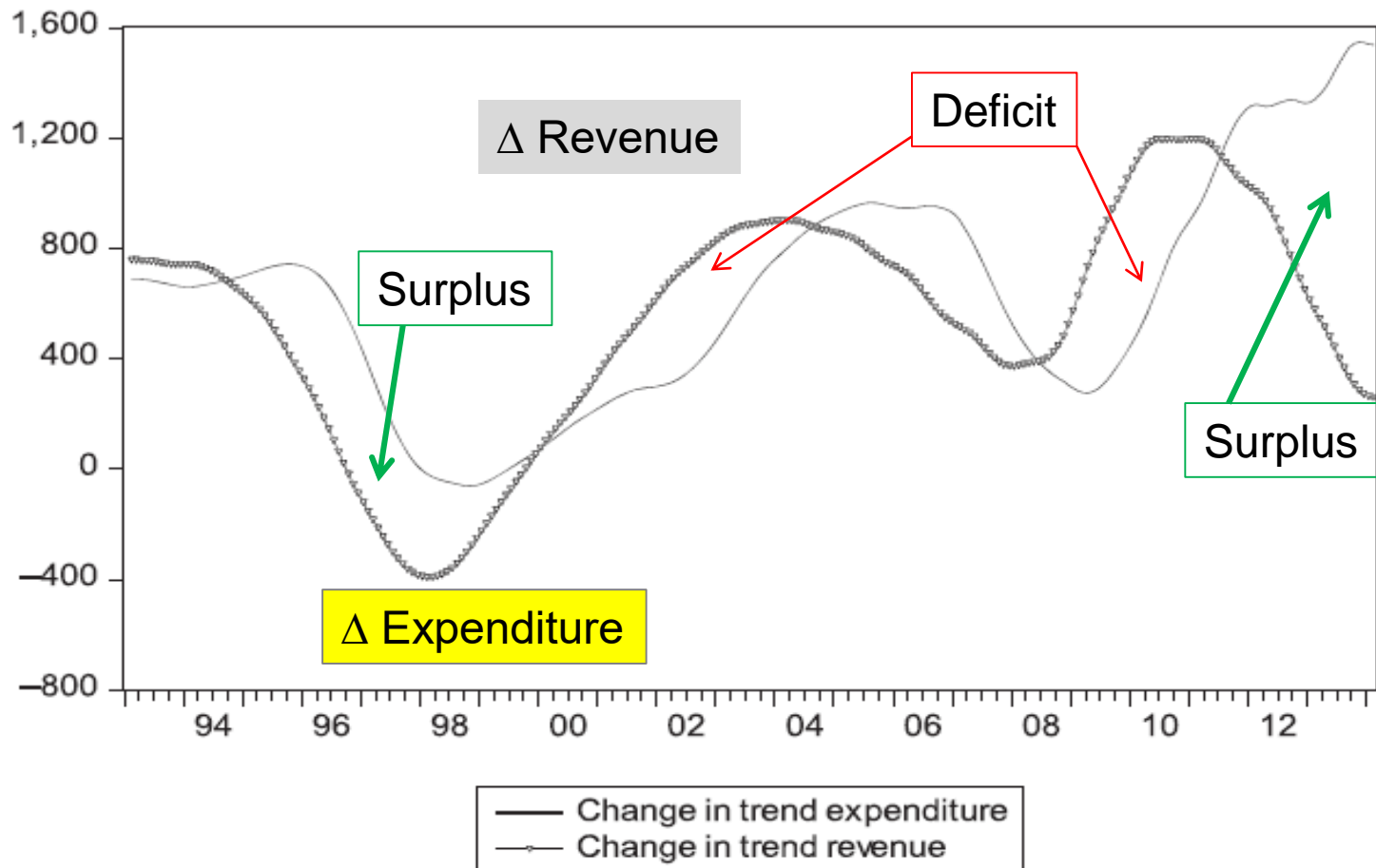
subject to **crowding-out effect**, because higher interest rates might decrease private investment, money supply remains constant₉

Thailand's 1 trillion baht borrowing program for economic stimulus

- At 1 trillion baht, the additional borrowing *is more than double the average annual budget deficit of recent years.*
- The borrowing is quite sizable and will put upward pressure on longer-term government yields.
- The BoT may try unconventional policy such as a large-scale asset purchase program and some form of yield-curve control.

Fiscal stance (expansionary vs. contractionary) shown by structural surplus and deficit

Figure 3. Fiscal stance: Structural changes in trend fiscal variables

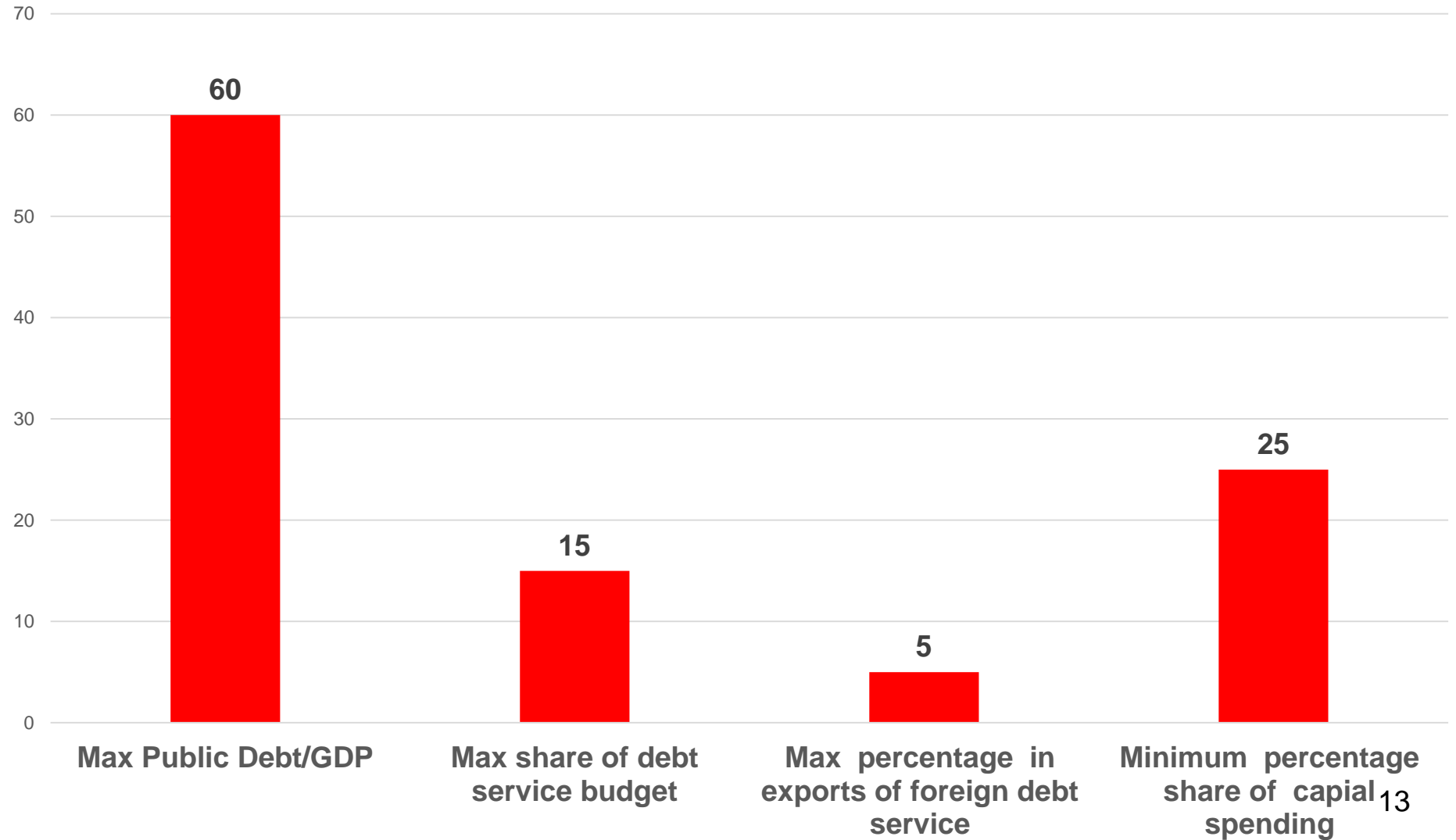


Fiscal budget and economic growth

- High deficits are associated with periods of low growth.
- High deficits are proxies for high public debt which imply **higher** taxes and **lower** public capital spending *in the future*.
- ***Large deficits*** are a symptom of macroeconomic **instability** which is detrimental to growth.

Thailand's Rules of Fiscal Sustainability

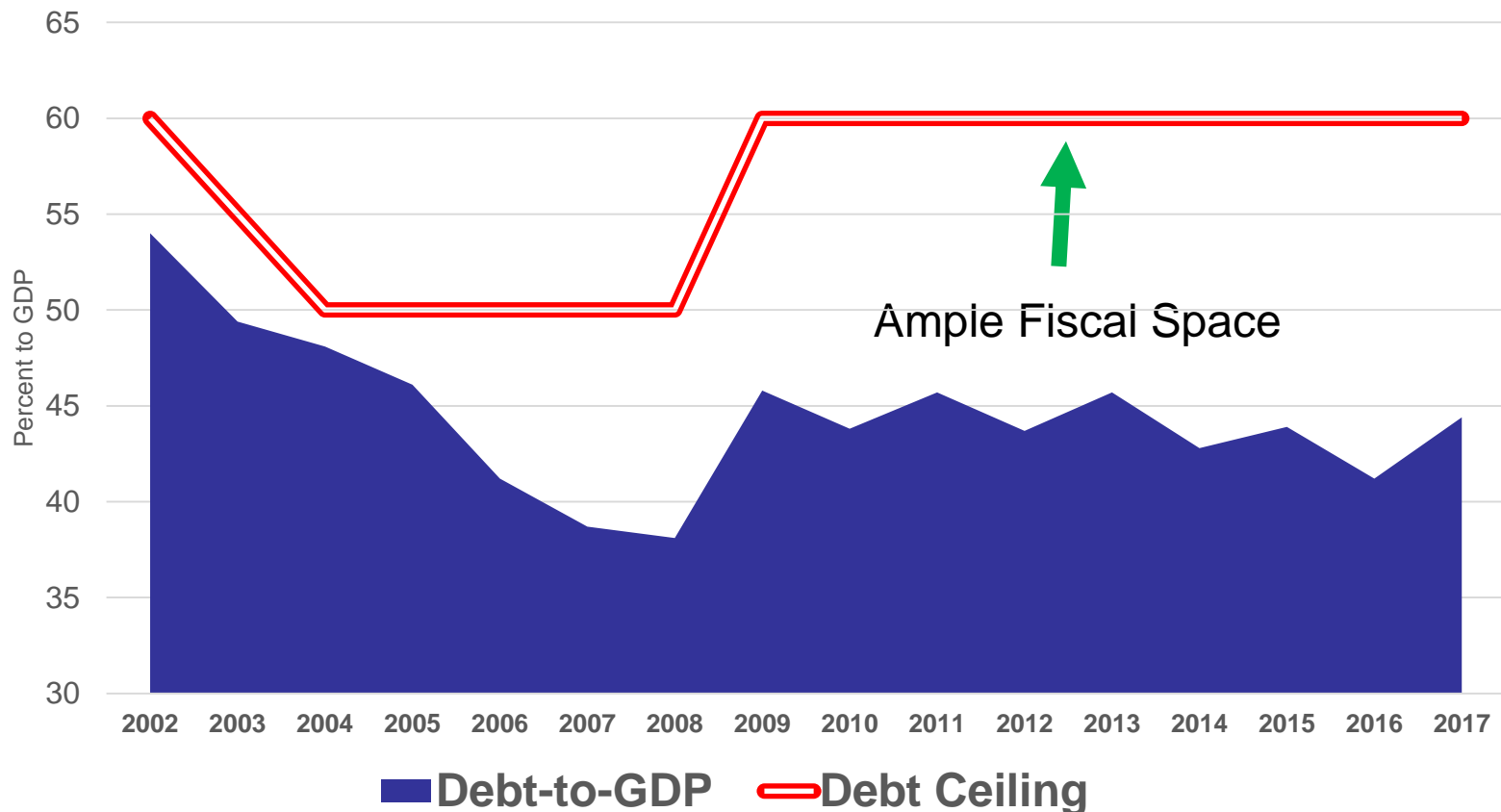
Maximin (percentage)



(1) Debt Ceiling (60%) and Fiscal Space

Figure 11.12 Ample Fiscal Space

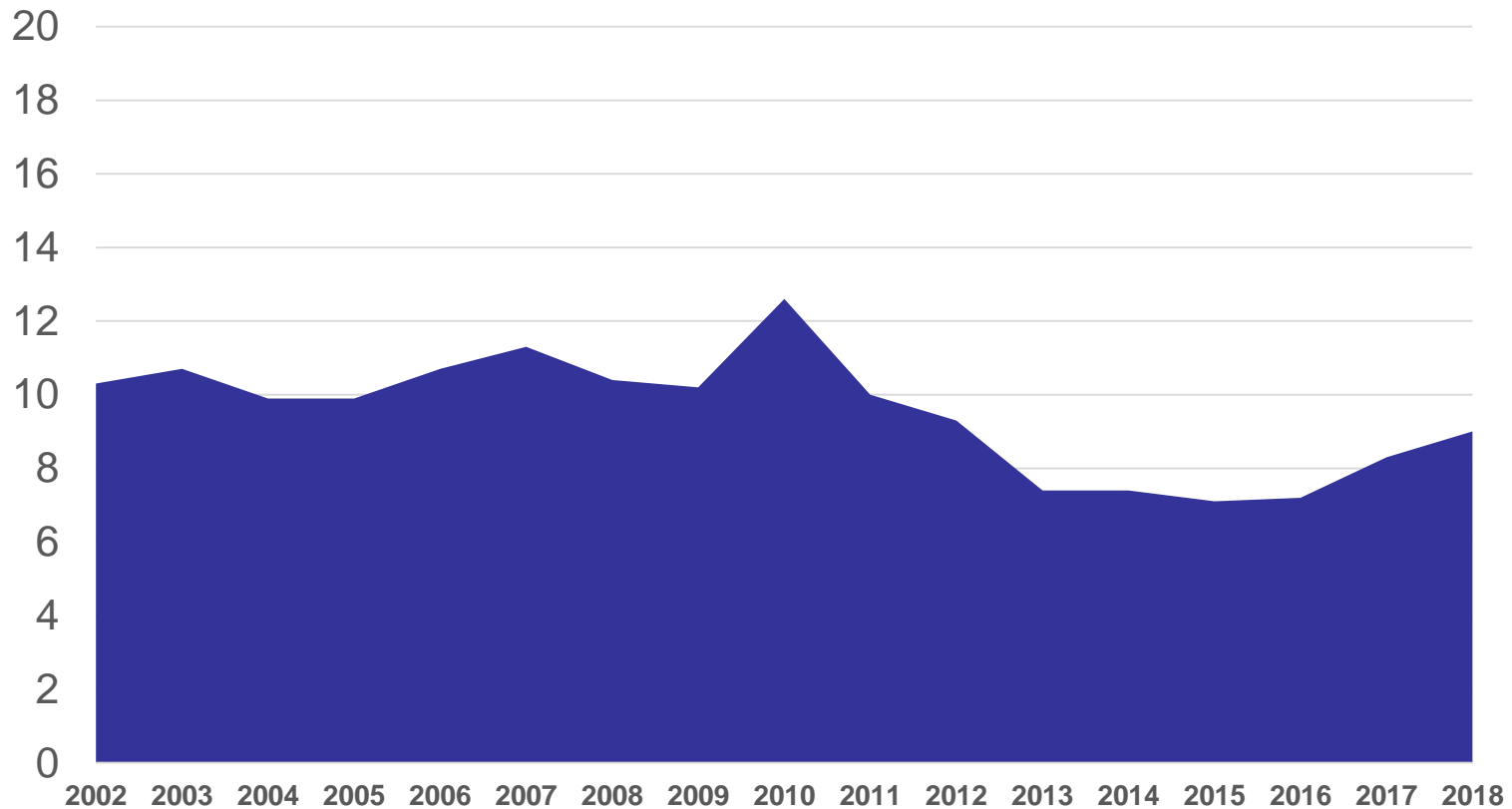
Source: Bank of Thailand



(2) Maximum Debt Service

15 % of total budget

Actual Debt service (%)



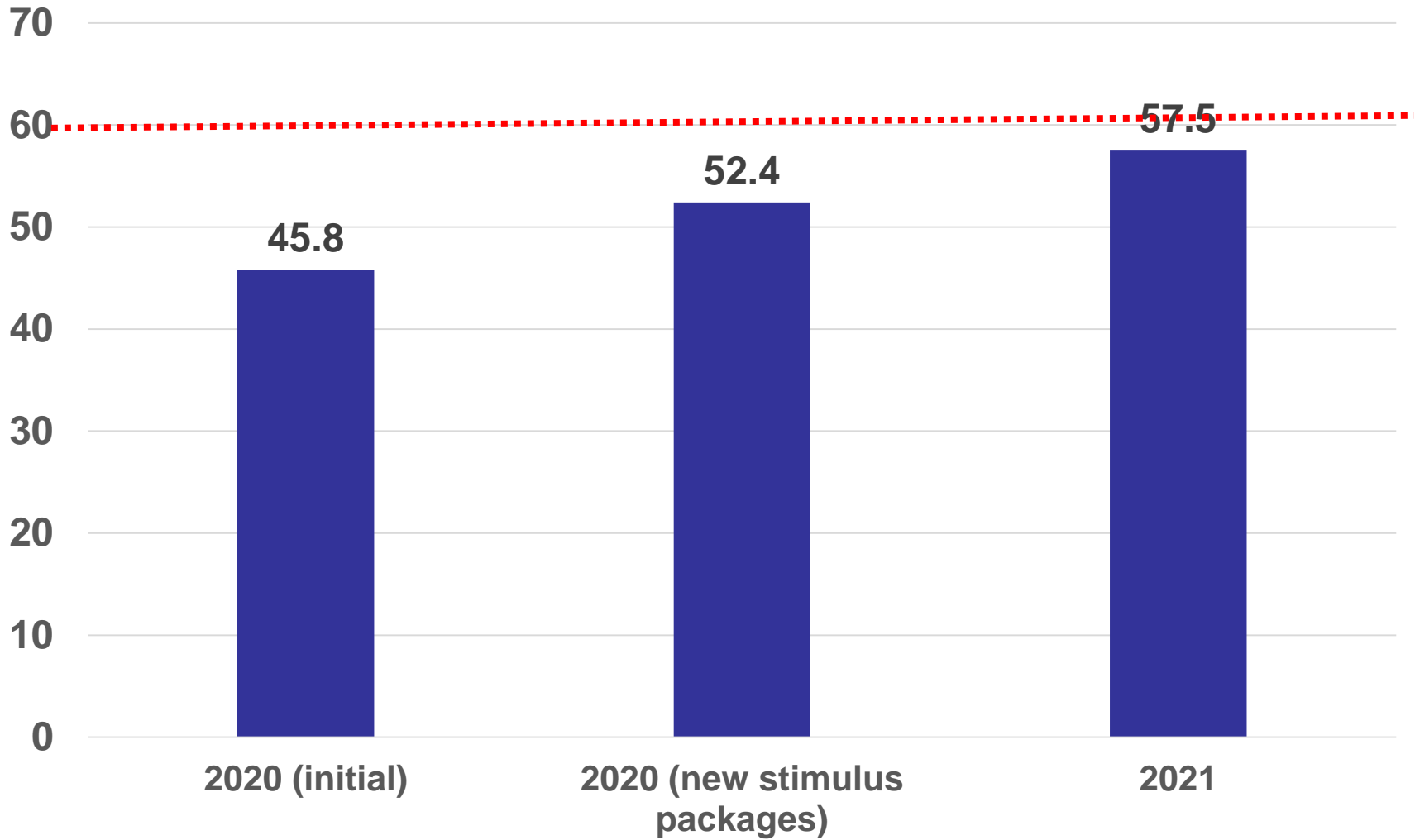
Running higher budget deficit: August 2020

- The cabinet's recent endorsement to approve an ***additional loan of 214 billion*** baht to compensate for the budget deficit is intended as a credit line in case public expenses exceed revenue.
- The amount of borrowing would have to be considered with the level of treasury reserves, expenditures and revenues.
- If the government borrows the full loan amount, this will increase the ratio of public debt to GDP to 52.4% in 2020 from the existing 45.8%, according to the PDMO.

Public Debt Management Office

- For fiscal 2021, the ratio of public debt to GDP is expected to rise to **57.8%**, depending on Thailand's GDP growth.
- The PDMO has taken out a sum of 338 billion baht under the 1-trillion-baht emergency loan decree.
- The government will issue a further 50 billion baht in **savings bonds** for sale to the public from next week to help finance the budget deficit.
- The bonds will be offered in two tranches: 5 billion baht in four-year bonds with a coupon of 1.7% and 45 billion of seven-year bonds with a 2.22% coupon.

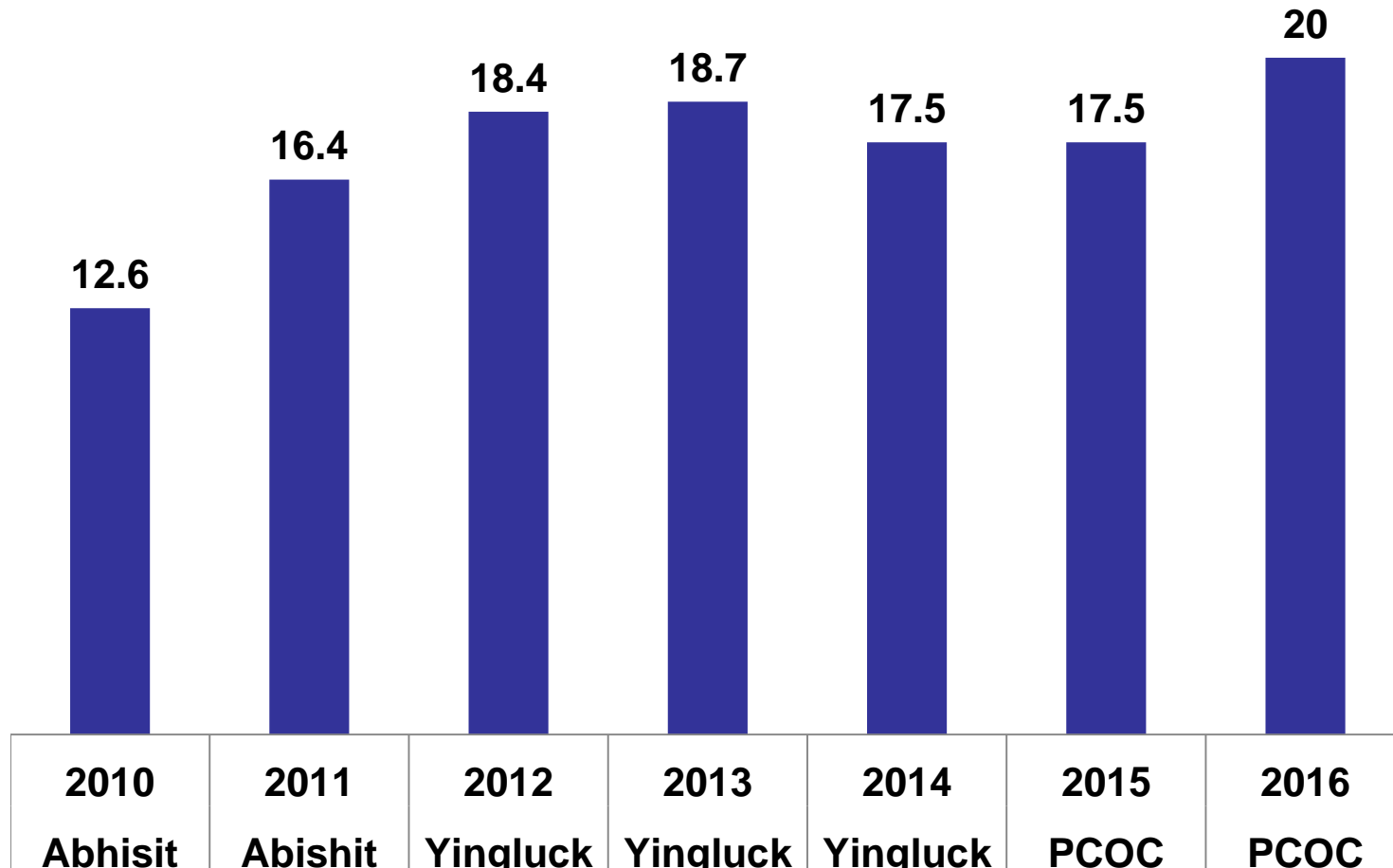
Debt/GDP



(3) Minimum Level of Capital Expenditures

At least 25% of total budget

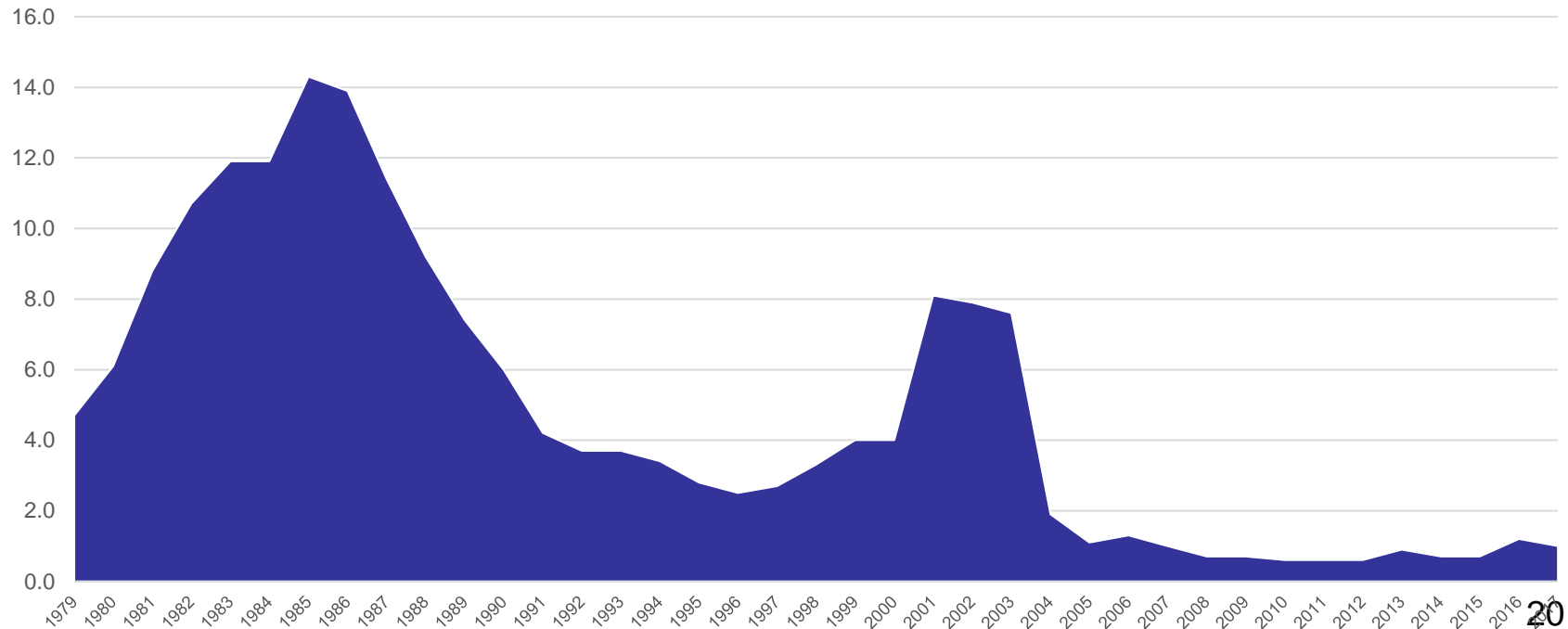
**Share of public investment in various governments
(% total budget)**



4. External Debt Service (Maximum 5 % of exports)

Figure 11. 13 Public External Debt Service Ratio
(% exports)

Source: Bank of Thailand



Fiscal variables, growth and output nexus

$$(1) \text{ Log}(R) = \alpha + \beta \cdot \log(Y) + \gamma \cdot \log(P)$$

$$(2) \text{ Log}(G) = \delta + \eta \cdot \log(Y) + \theta \cdot \log(P)$$

$$(3) = (1) - (2)$$

$$\text{Log}(R/G) = (\alpha - \delta) + (\beta - \eta) \log(Y) + (\gamma - \theta) \log(P)$$

$$\text{Log}(R/G) = (\alpha - \delta) + (\beta - \eta) \log(Y) + (\gamma - \theta) \log(P)$$

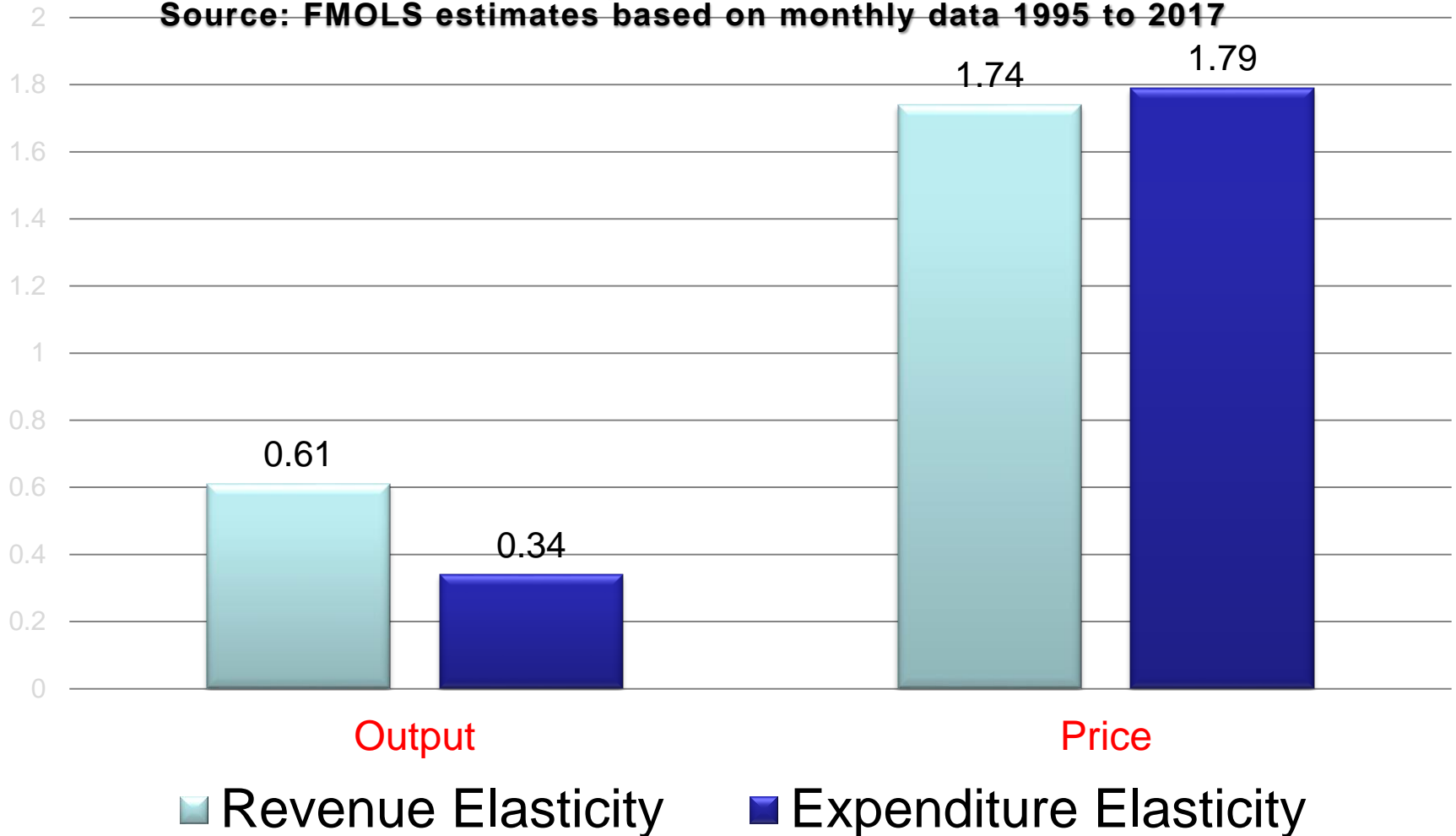
If $\beta > \eta$ and If $\gamma > \theta$

*automatic stabilizer mitigates
the impact of booms and busts
on aggregate demand*

Figure 11.10 Dynamism of automatic stabilizers

12 month-lag for revenue, 30 month-lag for expenditure

Source: FMOLS estimates based on monthly data 1995 to 2017

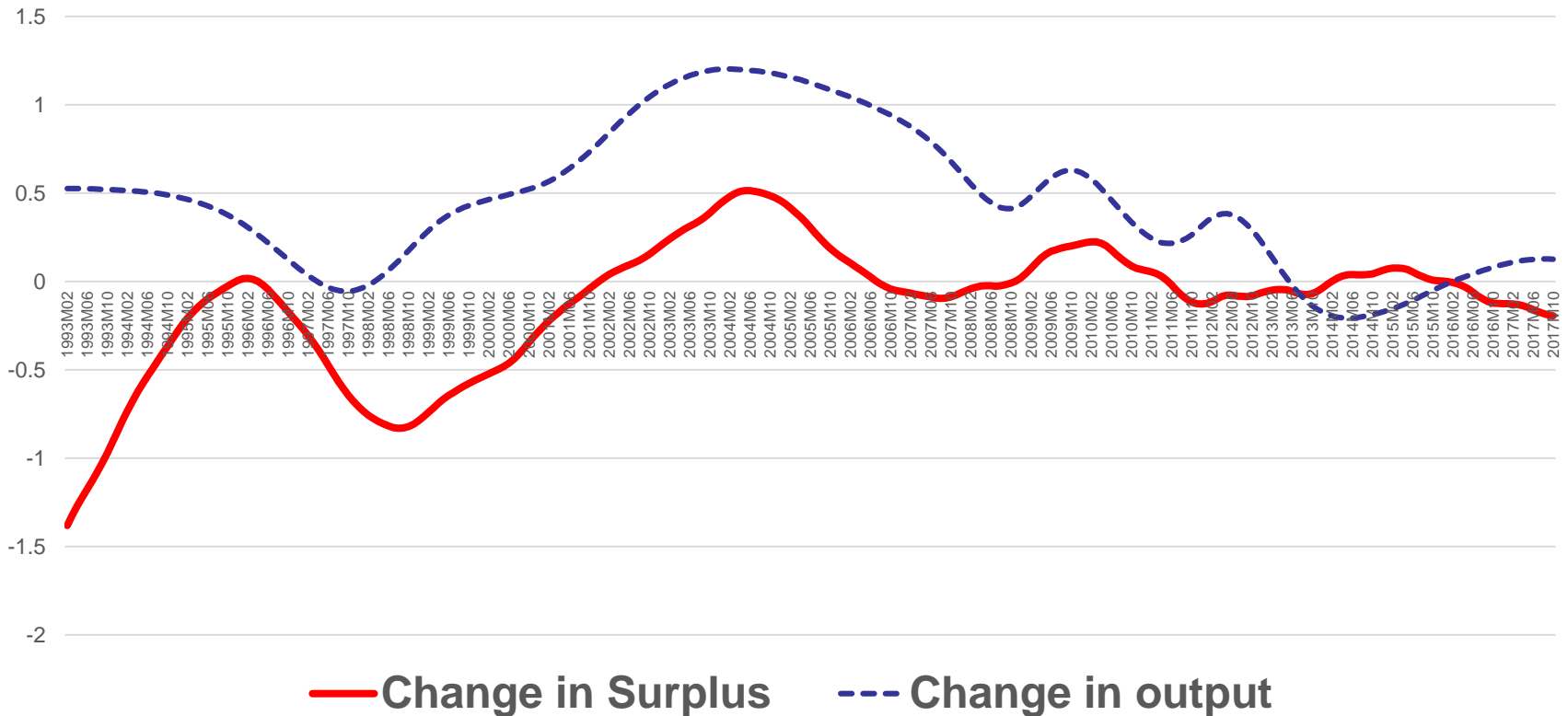


When GDP rises

- Public revenues increase faster than expenditures
- Revenue elasticity with respect to output is **greater** than expenditure elasticity ($0.64 > 0.34$)
- Therefore during the boom, budget tends to surplus
- During the slump, budget tends to deficit

Increasing tendency for budget surplus (deficit) during booms (slump)

Figure 11.9 Budget Surplus and output growth
Source: Bank of Thailand



When price increases

- Tax revenues tend to rise, and so do public expenditures
- But public expenditures rise faster than revenue, so deficit is enlarged with rising inflation (with different time lags)
- Public spending must be controlled during high inflation to avoid fueling inflationary pressure ($1.79 > 1.74$).
- The government cannot **forever** rely on inflation tax by printing money (through selling bonds to the BoT), since it would later on create more deficit as inflation is spiraling.

A caveat after recovery spurred by fiscal stimulus

- If a country has established fiscal automatic stabilizers, fiscal policy can be stabilizing and it does not have to depend on a long-delayed budgetary process.
- Expansionary fiscal policy employed to counteract short-term fluctuations must be withdrawn after the economy is on its recovery path.

Addiction to populism policy

- If not controlled, populism spending can be a burden to the government, resulting in a detrimental impact on the economy.
- The risk and adverse consequences of withdrawal of fiscal spending consequences must be considered before implementing fiscal expansion in response to insufficient aggregate demand during economic downturn.
- Irresponsible governments are only ***short-term goals.***

“Short-termism: the excessive focus of decision-makers on short-term goals at the expense of longer-term objectives. Short-termism results in insufficient attention being paid to the strategy, fundamentals and the long-term value creation of a firm or an institution.”

EY Report 2014.

Stylized facts about fiscal policy

- The level of development is related to fiscal structure: poor countries rely more on **indirect/trade taxes**, developed countries rely more on income taxes.
- Fiscal structure, influenced by the size of the economy (population and GDP level), dictates the **efficacy** of fiscal policy.
- Investment in transport and communication is consistently correlated with growth.
- Public spending on infrastructure (more spending on trains, airports, and highways) has **super high returns** than current consumption expenditures.

Expenditures by function: 2000-2015

Average percentage of GDP

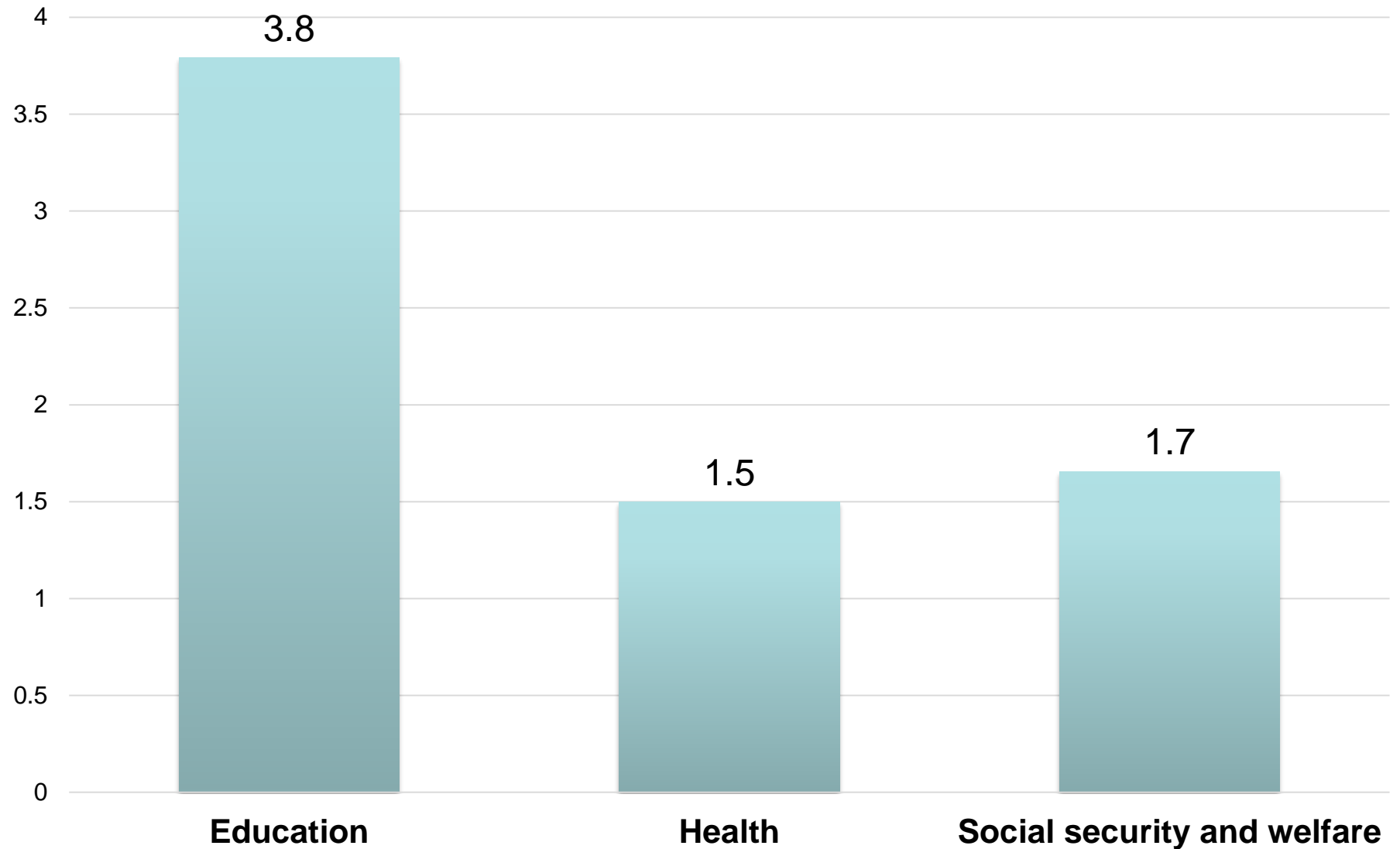
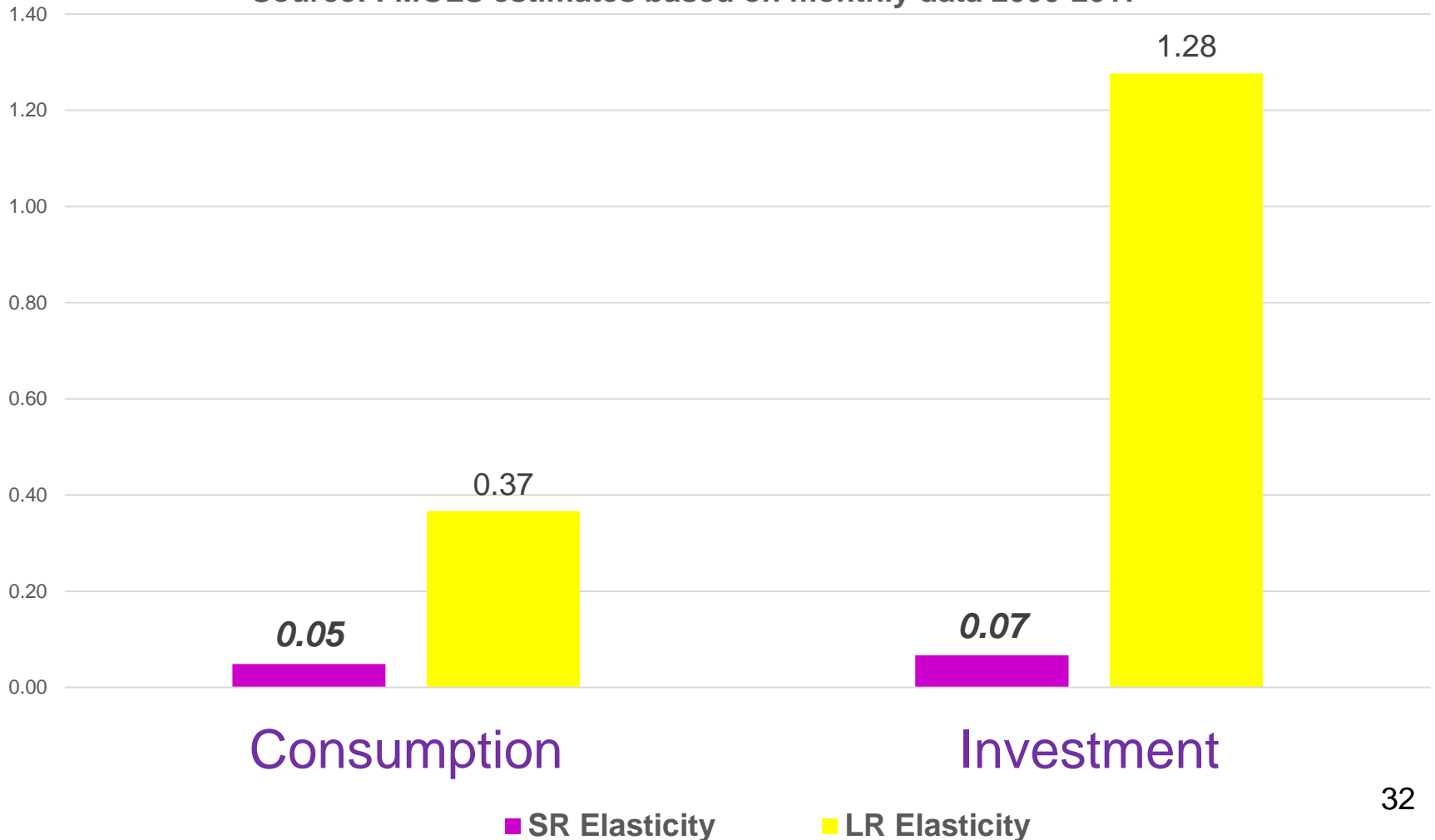


Figure 11.6 Short-run and long-run Impacts of public spending on private consumption and investment

Source: FMOLS estimates based on monthly data 2000-2017



Public consumption vs. public investment

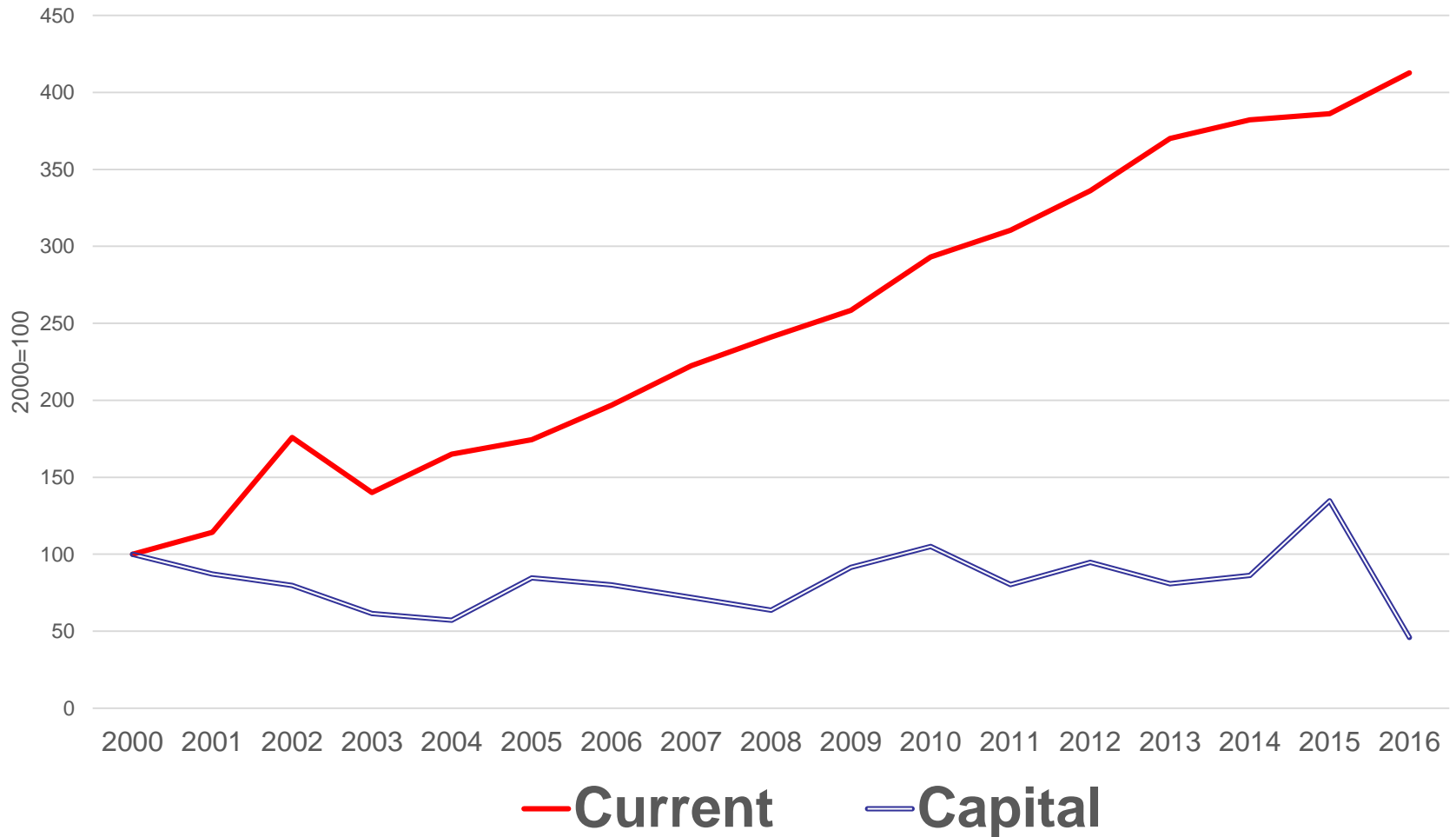
- Taxes on investment and income have a detrimental effect on growth since taxes reduce the private return to capital accumulation.
- **Government consumption has no permanent impact on growth** since the productivity of the private sector is unaffected.
- **Public investment** has positive impact since it enhances the productivity of the private sector (complementarity between public and private capital investment)

Capital vs. current (consumption) public spending

- Structure of public expenditure (ratio of public investment to public consumption) matters for long-term growth.
- *Rising share* of current spending is detrimental to long-term growth in the long-run (next slide)

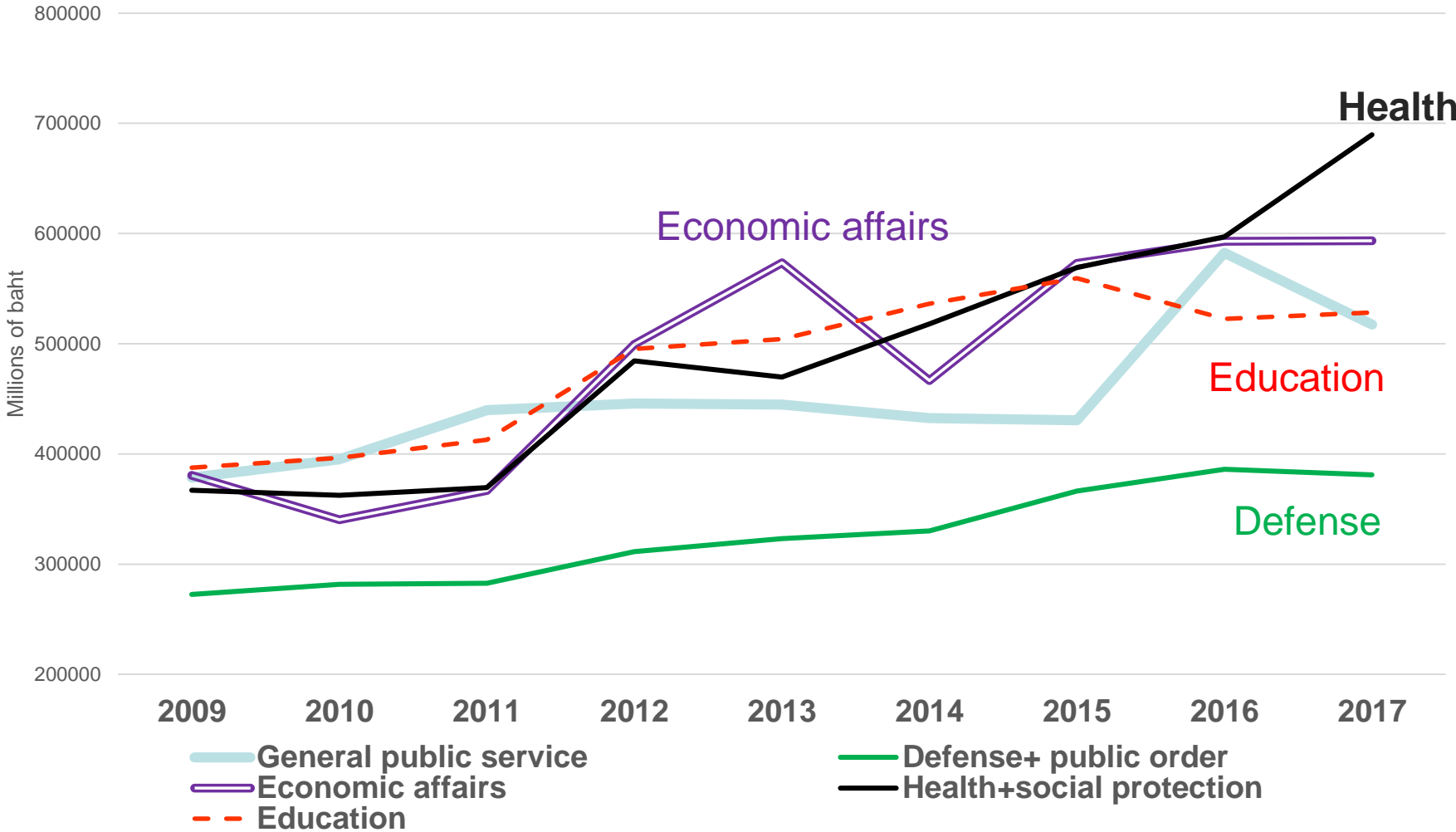
Figure 11.14 **Current and capital expenditures**

Source: Bank of Thailand



Government Expenditures

(classified by functions)



Aggregate spending matters, but some particular categories matter more than the others

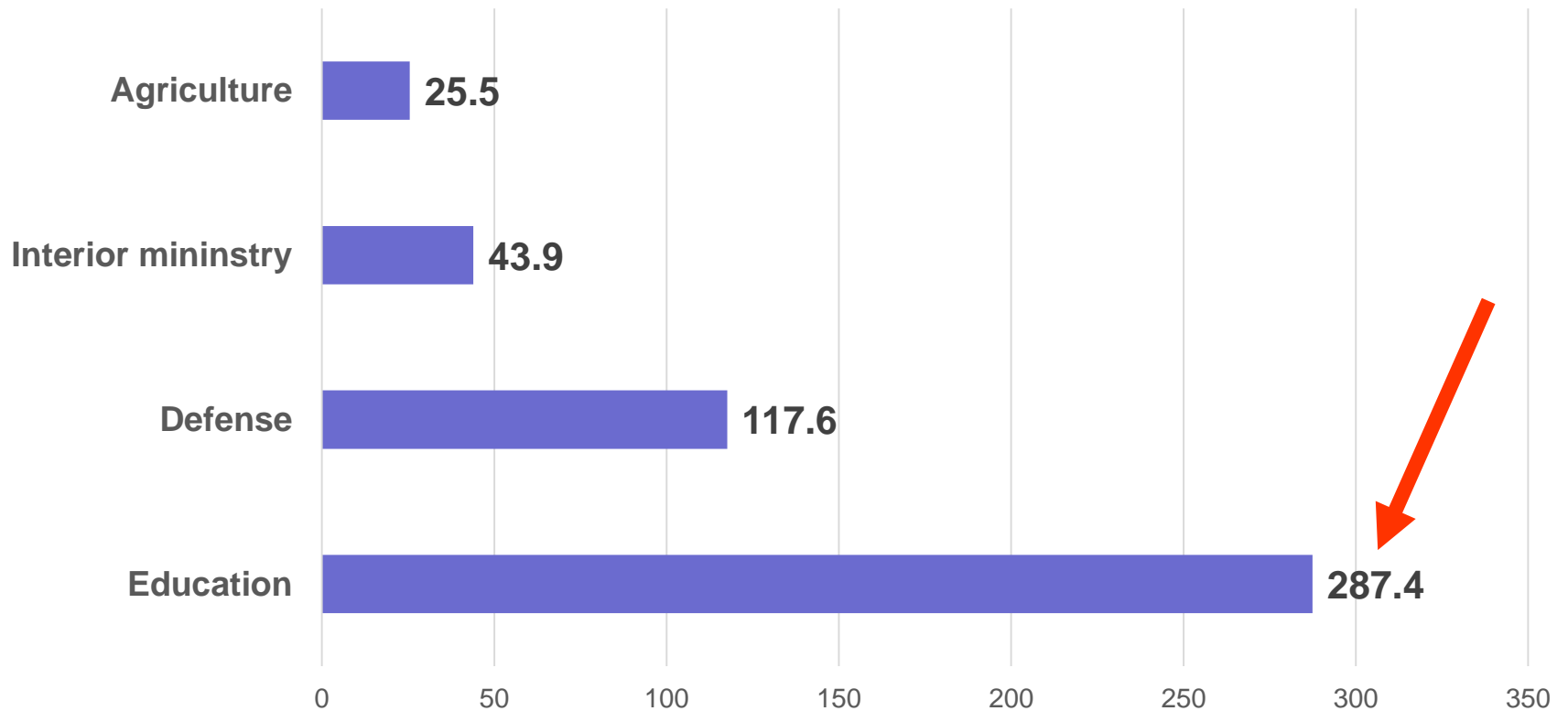
- The finding in chapter 11 unequivocally points out to the danger of military coups which could harm long-term growth path of the budget is diverted into defense spending rather than public investment in capital infrastructure, human and health capital.
- Public spending on economic activity produces a positive impact on the long-term growth of the economy, while ***spending on defense has a negative impact.***

Defense spending has a negative impact on long-term growth

- The reason can be attributed to *import leakages and corruption-prone type of defense budget.*
- Neither business sentiment nor consumer confidence can be improved by enlarging military budget in the same fashion as other public outlays on economic services and social development.
- There is also an opportunity cost of increasing share of defense spending (books versus bombs)

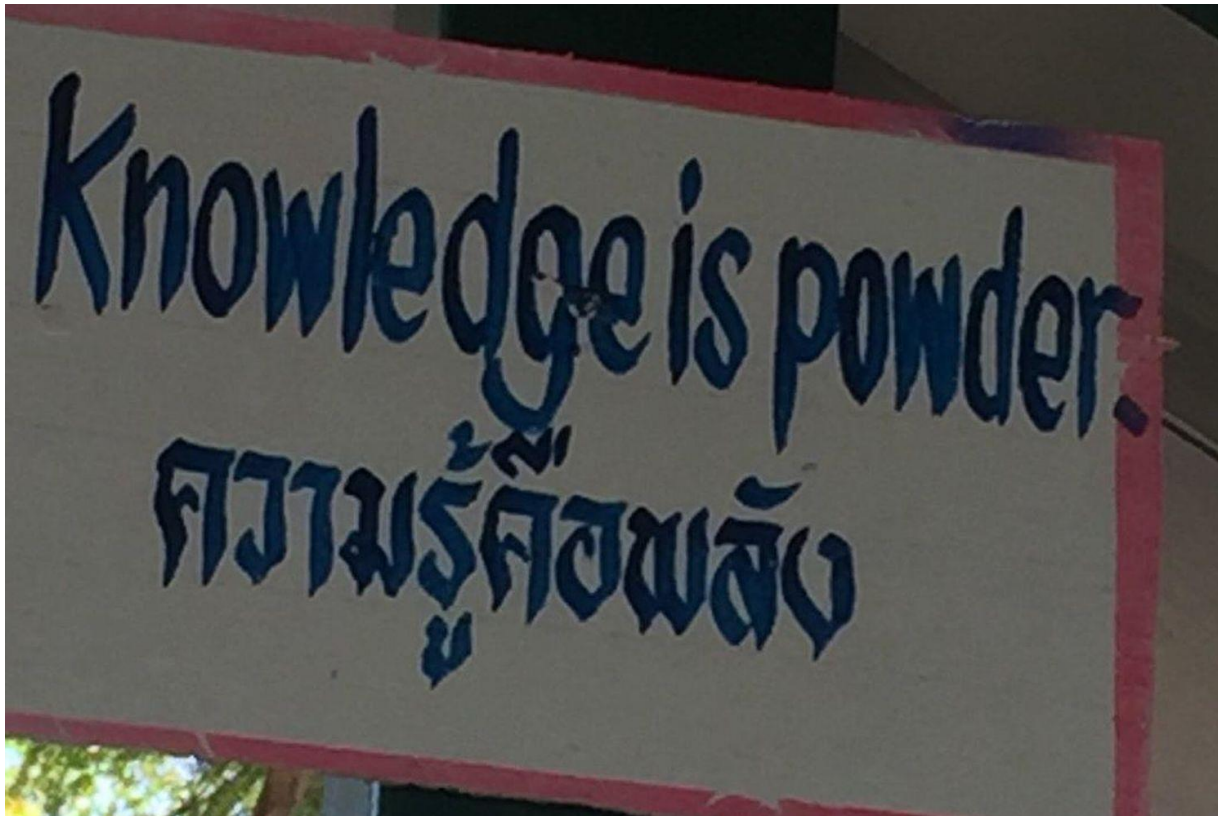
The 3.3-trillion baht- budget for fiscal year 2019 (beginning October 2018)

**2019 Fiscal Budget
(billion baht)**



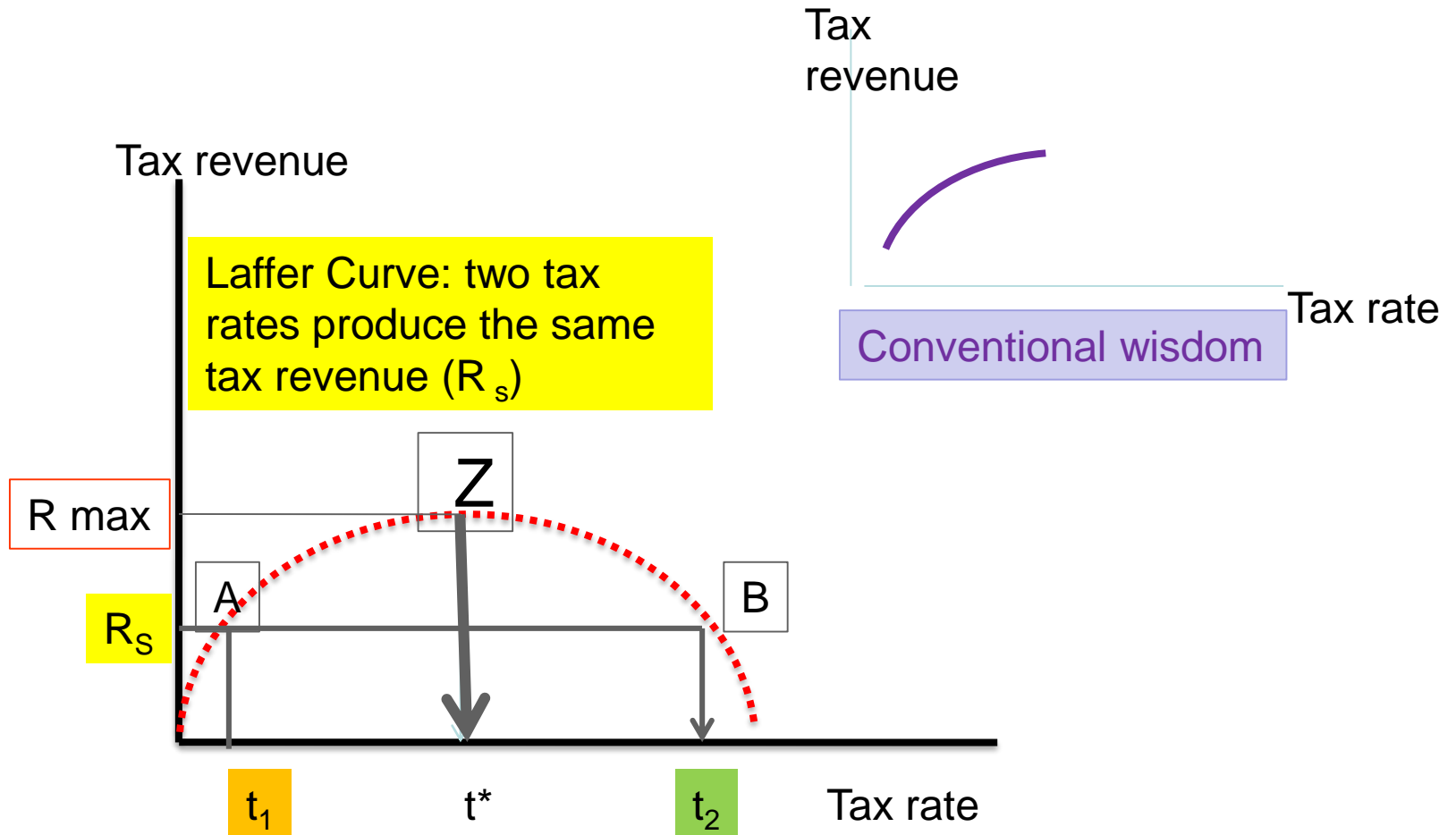
Thailand's English proficiency has fallen for the third year in a row, according to the annual English Proficiency Index conducted by the global education company EF Education First.

The 2018 report showed Thailand dropped to 74th out of 100 countries with a score of 47.62, which is considered "very low" proficiency.



Laffer curve: tax rates and tax revenues

An Inverted U-shaped Relationship



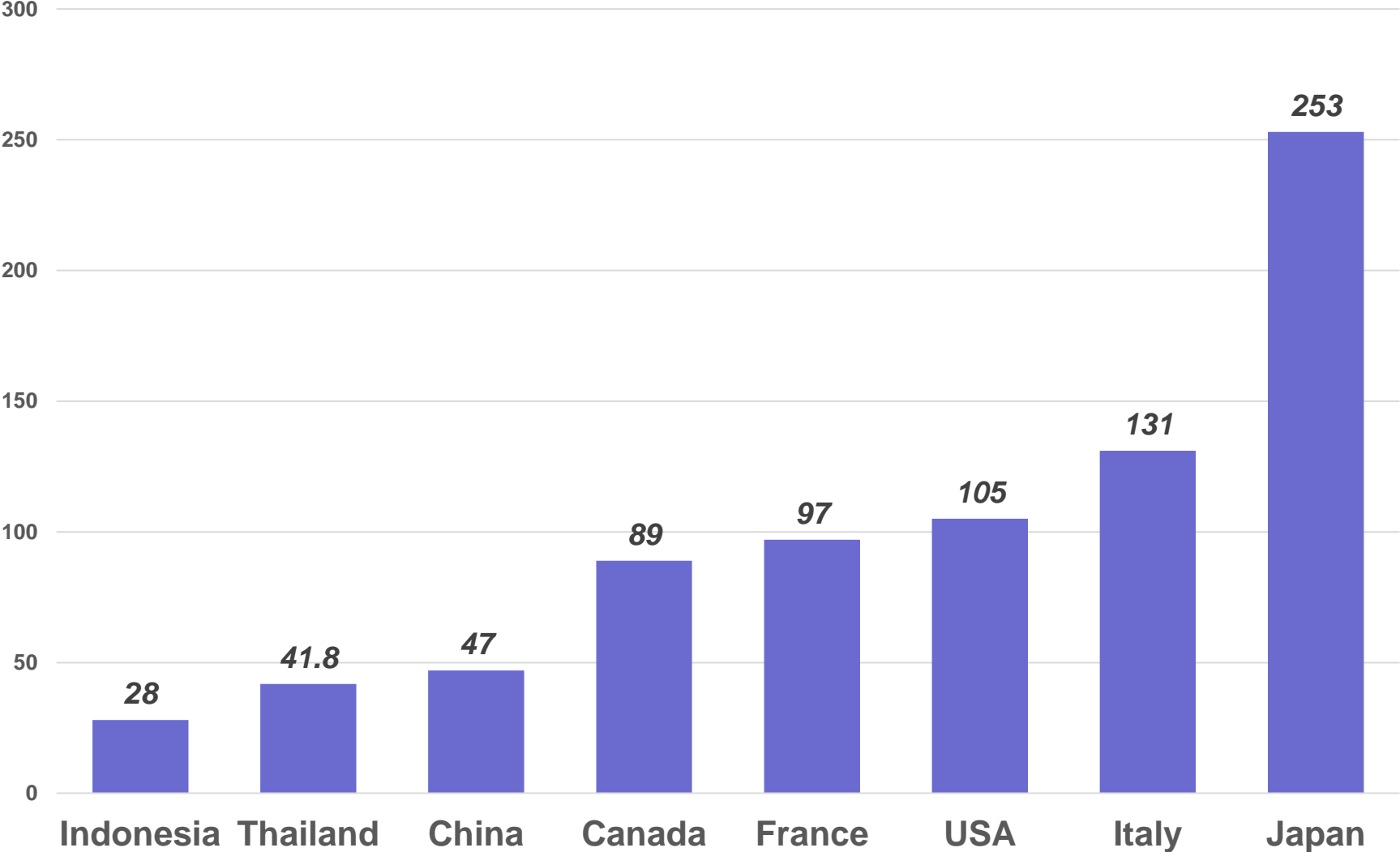
Will a tax cut increase tax revenue?

- The shape of the Laffer curve is determined by the elasticity of labor with respect to the net wage.
- Critics of supply-side economics argue that tax reductions can lead to increased revenue is absurd.
- Which side on the Laffer curve (left or right of the point t^*) the economy is operating?
- Even if tax revenues fail to increase when tax rates fall, it does not mean that tax reduction is necessarily undesirable.

To raise or not to raise, that is the question!

- The effects of taxation on growth are difficult to insolate (other factors as well as the two-way causations).
- **Fiscal space** is impaired by high debt-GDP ratio. The small fiscal space reduces the government's ability to counteract recession.
- If the government cannot raise tax revenue while expenditures keep on rising, the country will accumulate higher and higher debt over the years.
- Should the government reduce the value added tax rate from 7 to 5 % in 2020?

Public Debt (% GDP): international comparison in 2018



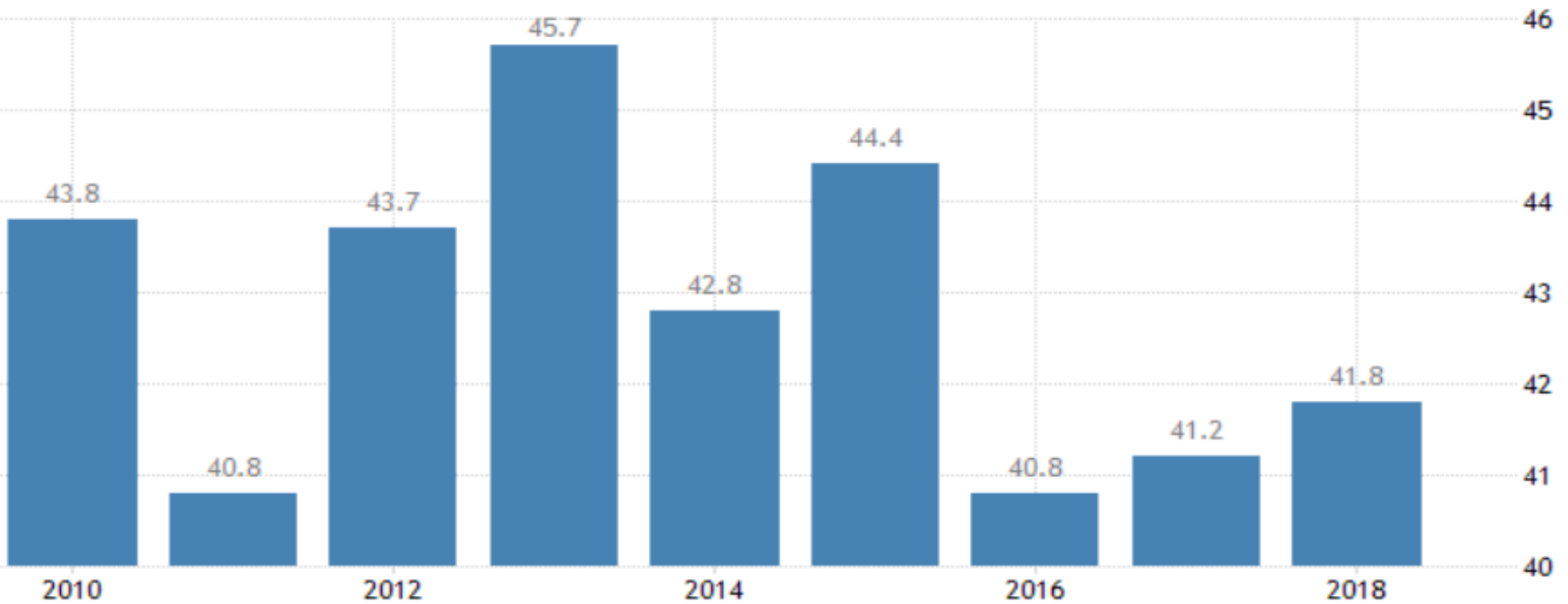
To stabilize the public debt

- To keep the Debt-to-GDP constant, the government must increase its **primary surplus** in line with the increase in $(r-g)$.
- The spending cuts or tax increases are likely to prove politically costly, generating even more political uncertainty and the need for an even higher interest rate.
- A ***sharp fiscal contraction*** is likely to lead to a recession, decreasing the growth rate.

$$\frac{B_t}{Y_t} - \frac{B_{t-1}}{Y_{t-1}} = (r - g) \left(\frac{B_{t-1}}{Y_{t-1}} \right) + \frac{(G_t - T_t)}{Y_t}$$

- The increase in the ratio of debt (B) to GDP will be larger,
- The higher the real interest rate (r)
- The lower the growth rate of output (g)
- The higher the *initial* debt ratio $(B/Y)_{t-1}$
- The higher the ratio of the *primary deficit* to GDP: $(G-T)/Y$
- G excludes interest payments for public debt

To reduce Debt/ GDP ratio, GDP growth rate (g) must exceed the cost of borrowing (r)

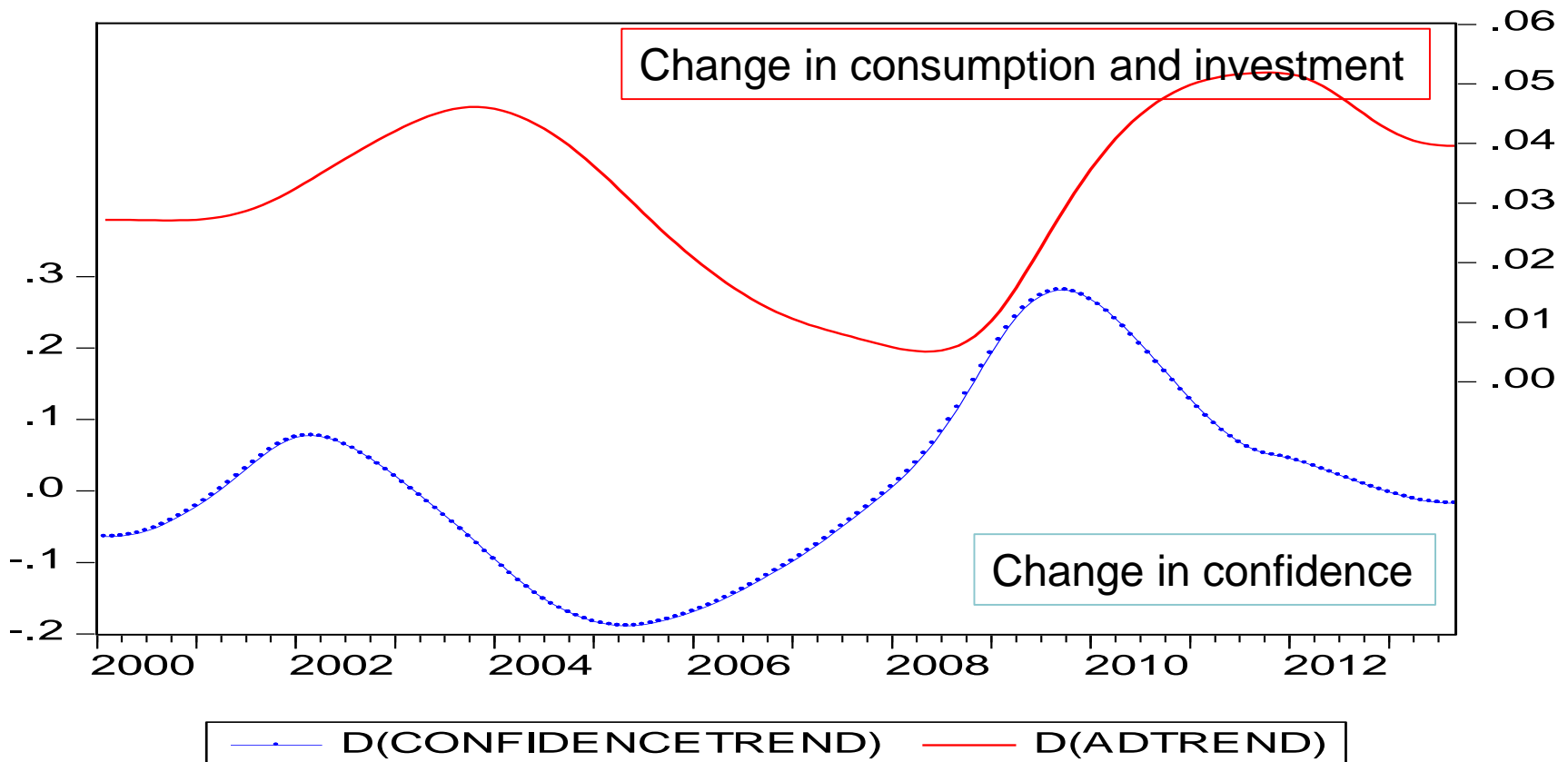


SOURCE: TRADINGECONOMICS.COM | MINISTRY OF FINANCE, THAILAND

Will fiscal stimulus work?

- Fiscal policy was the only option left during export collapse and uncertain times.
- Fiscal multiplier effect might be limited if the government's income transfer is regarded as transient.
- **Consumer confidence** and favorable investor sentiment (measured by BSI) are required for effective fiscal stimulus.

Confidence (lead) and Private Aggregate Demand (lag)
Causation runs from investor sentiment and consumer confidence to private spending

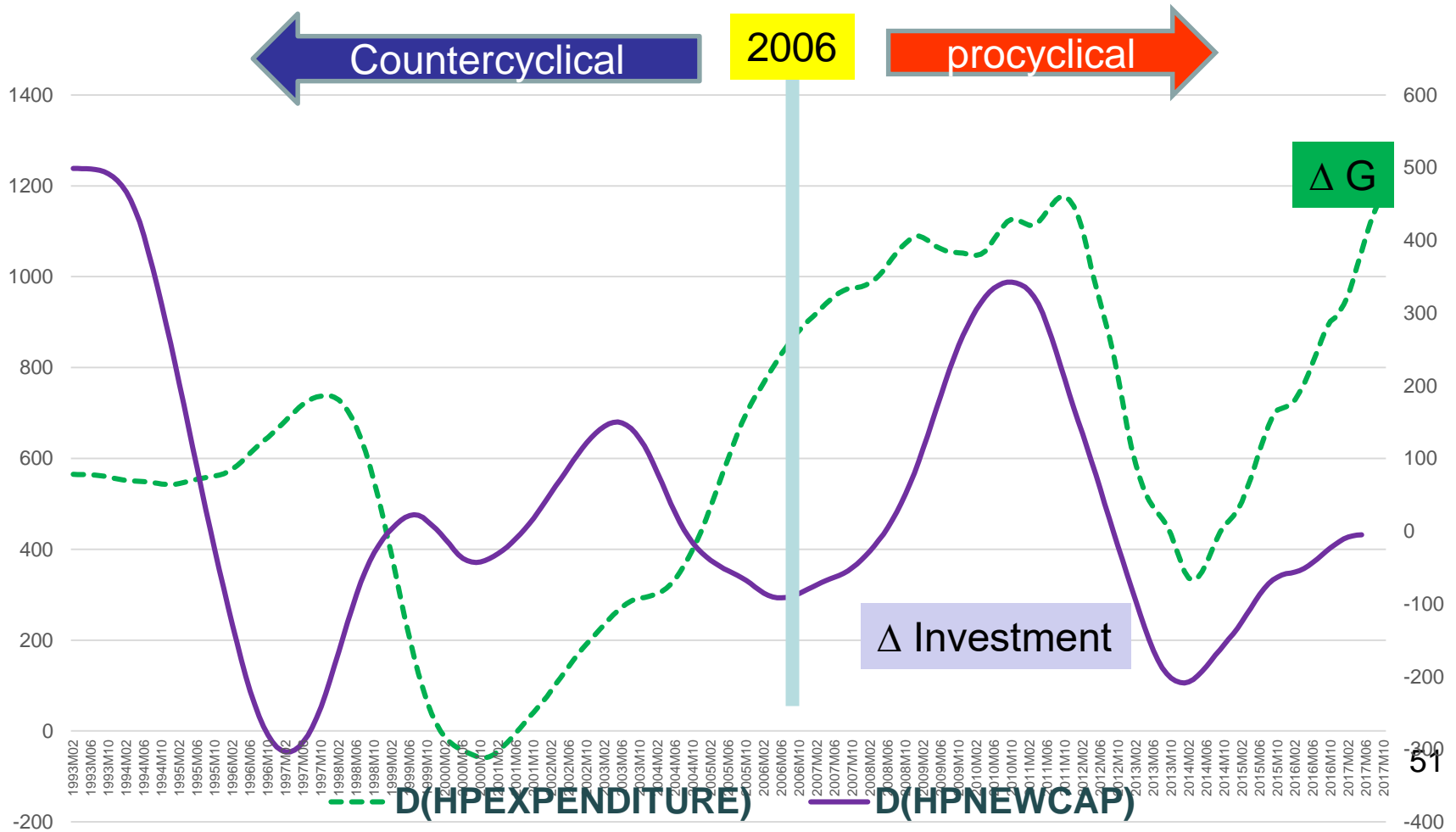


Conditions for effective fiscal stimulus

- Well-timed spending and taxing
- Fiscal sustainability must be maintained.
- Well-targeted spending to ensure the largest demand impact (spending towards high MPC groups)
- Aim towards macroeconomic stability (**counter-cyclical** rather than procyclical fiscal policy)

Figure 11.4

A sea change: From countercyclical to procyclical public spending (Changes in G and Private Investment)



Conditions for effective fiscal stimulus

- Economy-wide (pervasive) liquidity constraints situation (sure spenders: spending should increase right after tax cuts)
- How is the liquidity condition right now? Check Loan/Deposit ratio.
- **Permanent** vs **temporary** policy changes (tax reform vs. temporary tax relief or spending e.g. Temporary tax cut and handouts to stimulate retail sales)

Fiscal strategies *for long-term growth*

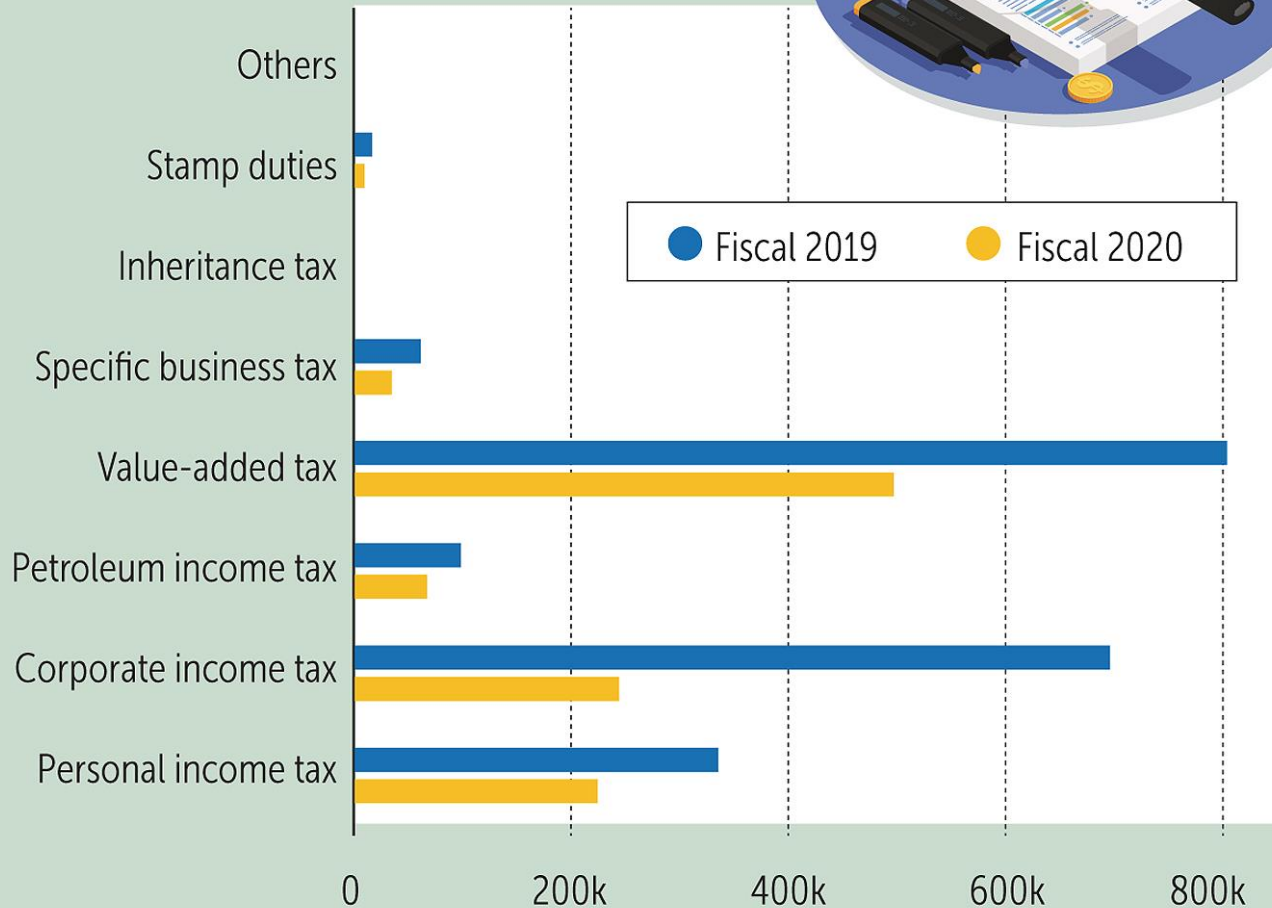
1st strategy: The role of **automatic stabilizers** must be emphasized

- It is desirable to establish built-in stabilizers such as progressive income tax system.
- When *corporate income tax* is reduced, the fiscal automatic stabilizers become less powerful (30% in 2011 to 20% since 2014).

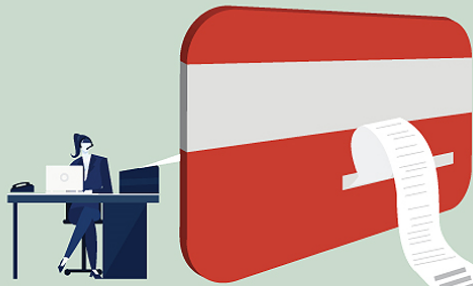
Only 10 % of the Thai work force pay income tax
Income tax revenue is about 2 % of GDP

- **Personal income tax** collections at just 2% of GDP are particularly low, partly because only ***one-tenth*** of the workforce pays tax, while the corporate income tax base has been eroded through excessive exemptions and deductions.
- The top bracket was reduced from 37% in 2011 to 35% since 2012.
- The government must remain committed to its plan of tax reform as tax revenue is too low.

RESULTS OF REVENUE DEPARTMENT'S REVENUE COLLECTION



Source: Digital Government Development Agency (Public Organisation)



REVENUE COLLECTION IN FIRST EIGHT MONTHS OF FISCAL YEAR

Unit: million baht

Source of revenue	FY 2020	FY 2019
Revenue Department	1,086,974	1,219,725
Excise Department	362,122	394,761
Customs Department	64,384	73,550
Revenue from three departments	1,513,480	1,688,036
State-owned enterprises	149,283	138,755
Other agencies	130,521	139,894
- Other government agencies	121,582	131,553
- Treasury Department	8,939	8,341
Total gross revenue	1,793,284	1,966,685
Deductions and VAT distribution for local administrative organisations	293,023	323,183
Total net revenue	1,500,261	1,643,502

Sources: Revenue Department, Excise Department, Customs Department, Treasury Department, Comptroller-General's Department, State Enterprise Policy Office

BANGKOK POST GRAPHICS

Fiscal strategies for long-term growth

2. Current expenditures must only be financed by contemporaneous taxation.

While capital expenditure can be financed by issuing government bonds: Fiscal sustainability and fairness over generations.

3. The rule of marginal benefits and marginal cost must be strictly obeyed.

Choices of spending: submarine, tanks vs. schools and hospitals.

4th Strategy: Ample fiscal space

- The reason behind this fiscal prudence is related to conservative budgetary laws.
- If Debt-to-GDP is low, it provides fiscal space for the government to counteract future external shocks (e.g. exports or investment collapses) through fiscal ease.
- What does monetary policy space mean?

5th Strategy: Strike the balance between long-term growth and price stability

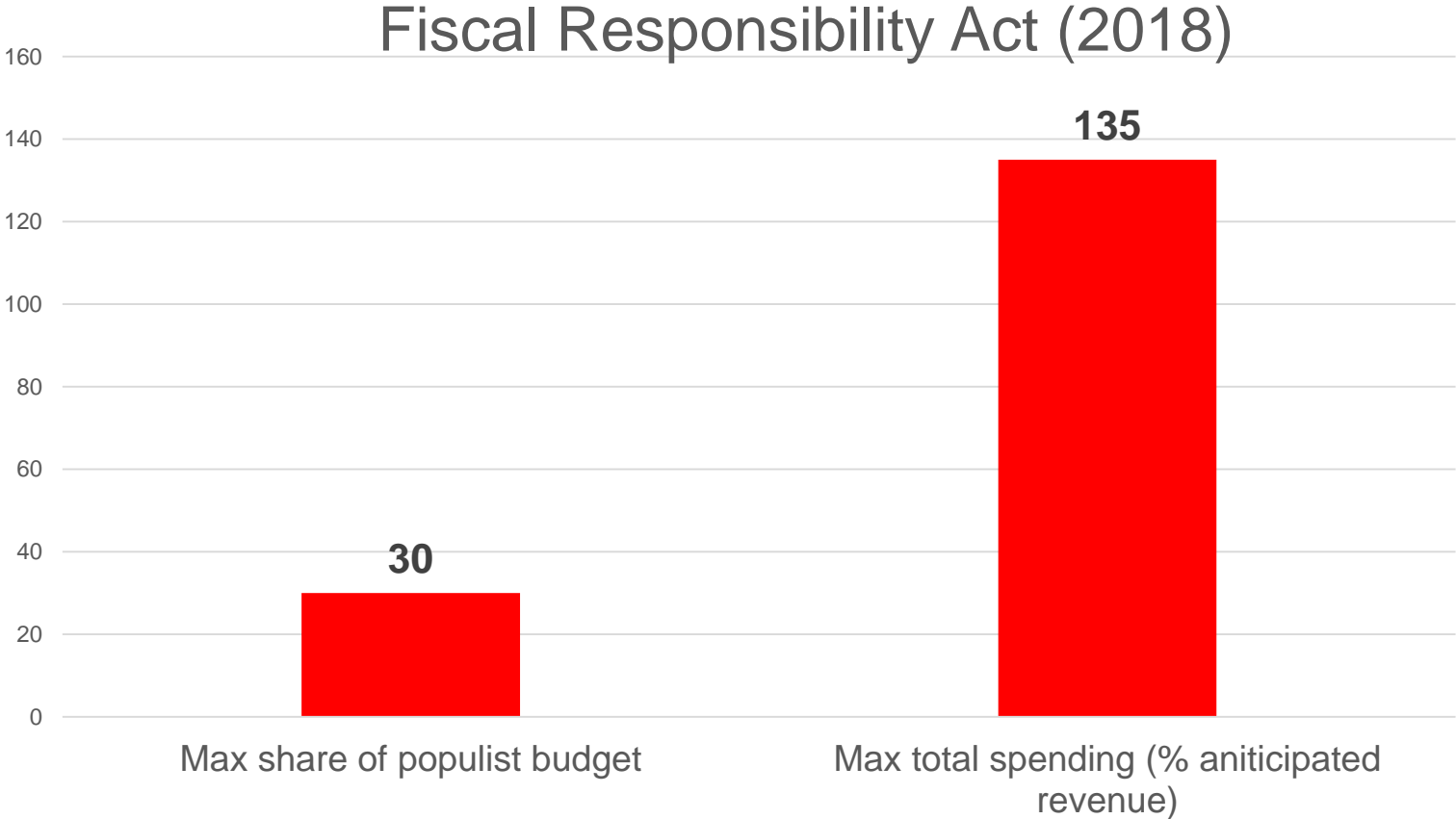
- Overconservative fiscal policy has a high cost in terms of the *lost opportunity* to achieve high long-term growth path
- However, *over expansionary* fiscal policy can turn into populism expenditures and inflation bias.

7th strategy

Fiscal Responsibility Act (2018)

- There is a cap on populist budget at 30% of annual budget expenditure.
- The 30% ceiling is design to maximize budget spending and prevent politicism from using off-budget borrowing to finance populist projects.
- When National Legislative Assembly (NLA) passed the 2019 budget, no lawmakers questioned the 40-billion baht *Pracharath* projects, which aim to boost local economy.

Fiscal Responsibility Act (2018)



How effective is the fiscal stimulus (2019)?

STIMULUS II

The government has launched the second phase of its cash handout and rebate scheme, with property stimulus measures included.



G-wallet 1 (1,000-baht cash handout)



- Available to 3 million people
- Those who received a 1,000-baht handout in the first phase are exempted
- Sign up at www.ชิมช้อปใช้.com
- Starting Oct 24, two rounds of registration per day: 6am for 500,000 people and 6pm for 500,000 people
- Money transferred to successful registrants via Pao Tang app's wallet 1

G-wallet 2 (cash rebate)



- Spending through Pao Tang app's wallet 2
- Those who received 1,000-baht handout in first phase can apply
- 15% cash rebate on spending up to 30,000 baht (maximum 4,500 baht rebate)
- 20% cash rebate on the amount spent from 30,001 to 50,000 baht (maximum 8,500 baht rebate)

Property stimulus scheme



- Property transfer fee cut to 0.01% from 2%
- Mortgage fee cut to 0.01% from 1%
- Privileges will cover the purchase of a house, condominium or shophouse priced at no more than 3 million baht
- The scheme will cost the state coffers 2.6 billion baht

Why fiscal stimulus is needed

- The scheme is part of an additional stimulus package valued at 5.8 billion baht aimed at boosting economic growth to at least 3% this year.
- Thailand's economy had its weakest annual growth rate in four years, expanding just 2.3%, in the second quarter of 2019 as exports declined amid rising international trade tensions and a strong baht.
- The additional package is part of the government's 316-billion-baht stimulus program which was rolled out earlier in 2019.

The mother of all handouts

- Thailand's economy had its weakest annual growth rate in four years, expanding just 2.3%, in the second quarter as exports declined amid rising international trade tensions and a strong baht. In the first quarter of 2019, the economy grew 2.8% from a year earlier.
- *The ministry recently downgraded the Thai economic outlook for this year to 2.8% from 3%, while the Bank of Thailand slashed its growth forecast to 2.8% from 3.3%.*
- *According to the minister of finance, the multiplier will be between 5 to 6.*

Officials expect cash subsidy to reach 24 million people

Handout uses funds from B1tn decree

18 SEP 2020



51 billion baht cash handout

- The Finance Ministry predicts the 51-billion-baht cash handout to cover one-third of the population, aiming to sustain private consumption in the final quarter.
- The scheme will cover 24 million people in total, with 14 million holders of state welfare cards and the remainder individuals aged 18 and up.
- The handout measure will use funds from the 1-trillion-baht loan decree, specifically the portion allocated for public aid for the crisis, worth 600 billion baht.
- Monthly financial assistance will see an additional 500 baht given to 14 million low-income earners who have state welfare cards in the three months from October to December, totaling 21 billion baht.

Co-payment Scheme

- The government will also offer 3,000 baht per person to 10 million people, totaling 30 billion baht, to buy goods during the final quarter of the year, scaling back from an earlier plan to give 45 billion baht to 15 million people.
- The 50/50 co-payment scheme will allow registered people to buy at small shops, with the government subsidizing 50% of the payment, up to 50 baht per day, for customers spending 100 baht.
- An individual who spends 200 baht to buy goods would pay 100 baht, and the government would subsidize the remainder of the bill the next day.

Conclusion I

- Fiscal policy can become an effective means to spur growth during the time when consumer and investor confidence is strong.
- When business **sentiment is low**, expansionary impact of fiscal deficit will have **minimal impact** on the economy.
- **This is the case when consumer confidence hit the lowest level during the outbreak of the coronavirus and economic lockdown.**

Conclusion II

- Rules of fiscal sustainability must be strictly obeyed (even in the case of the global recession caused by the lockdown?)
- Tax instruments have become an important stabilizing tools, while public spending should have exhibited counter-cyclical response.

Concluding remarks

- Tax-financed budget deficit is less inflationary (and less expansionary) than bond financing deficit.
- Tax-financing deficit should be used during the near full employment level.
- A sharp fiscal contraction is likely to lead to a recession or decreasing the growth rate.

Concluding remarks

- **Consumer confidence** and business sentiment are crucial to sustainable recovery and effective fiscal policy.
- Long-term growth is adversely affected by the slowdown in public investment.

Discussion questions

- In response to a global recession, how should the Thai government conduct fiscal policy?
- For distribution and revenue purposes, should the government employ ***inheritance and property taxes***?
- What are likely impacts of the 3.3 trillion baht mega infrastructure spending programs on output, price levels, the exchange rate, and the current account?

Review questions on lecture 25

- What were the consequences of the 2019 populism policy?
- What are the impacts of the coronavirus rescue package?
- What is the appropriate level of public debt?
- How is the long-term growth path affected by fiscal structure and fiscal space?
- *Evaluate the effectiveness and efficiency of the Co-payment scheme.*