

Fiscal Policy 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.

Course Syllabus

Lecture 25

- The role of fiscal policy as a tool for stabilization.
- Can fiscal expansion lead to sustainable growth?
- How sustainable is Thailand's fiscal deficit?
- What is the role of institutions in shaping the country's financial stability?
- What would be the consequences of the 2019 populism policy?
- What is the appropriate level of public debt.
- How is the long-term growth path affected by fiscal structure and fiscal space?

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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.

Main Themes

- 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

Structural Fiscal Position

Fiscal stance

Ratio of Public Revenue/Expenditure (R/G)

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

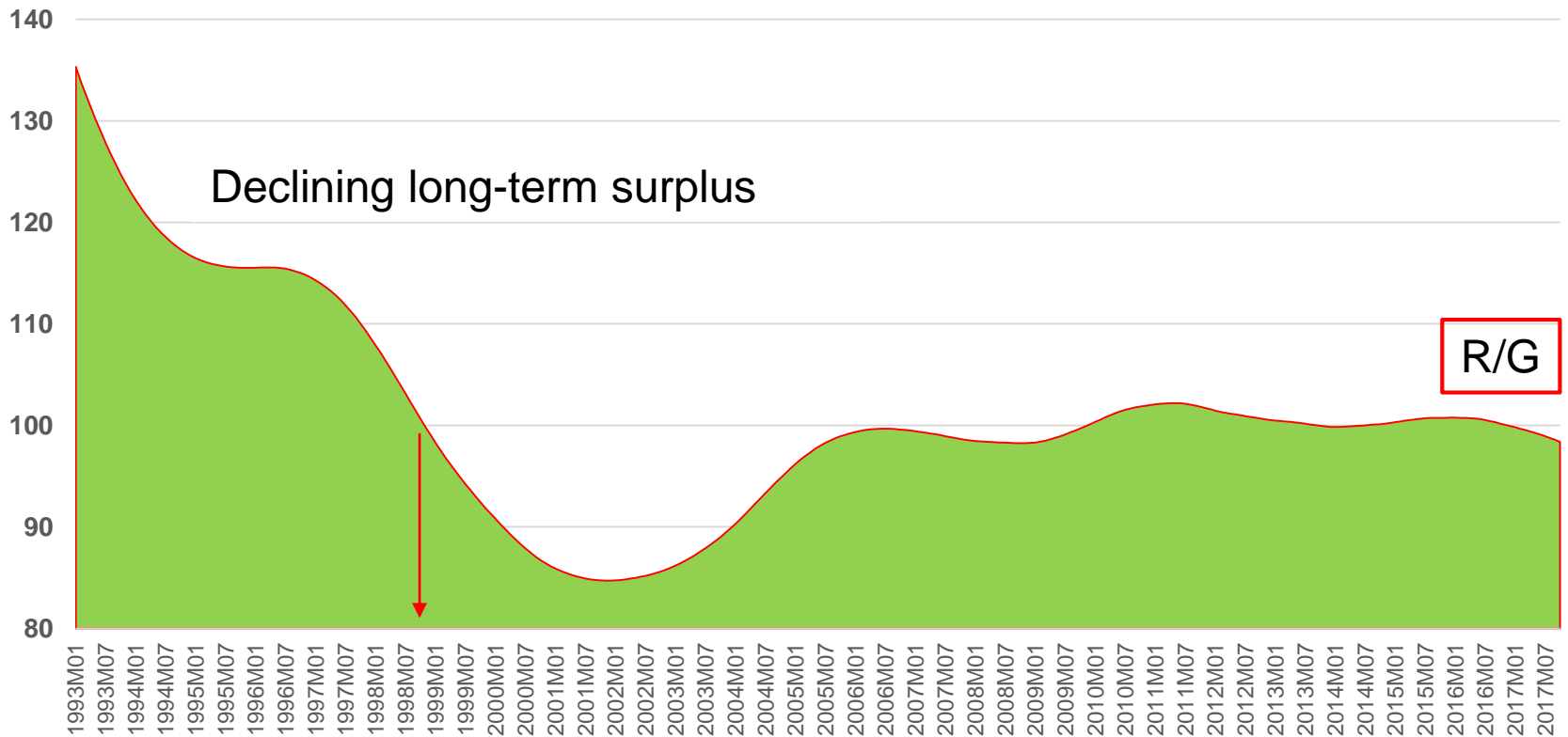
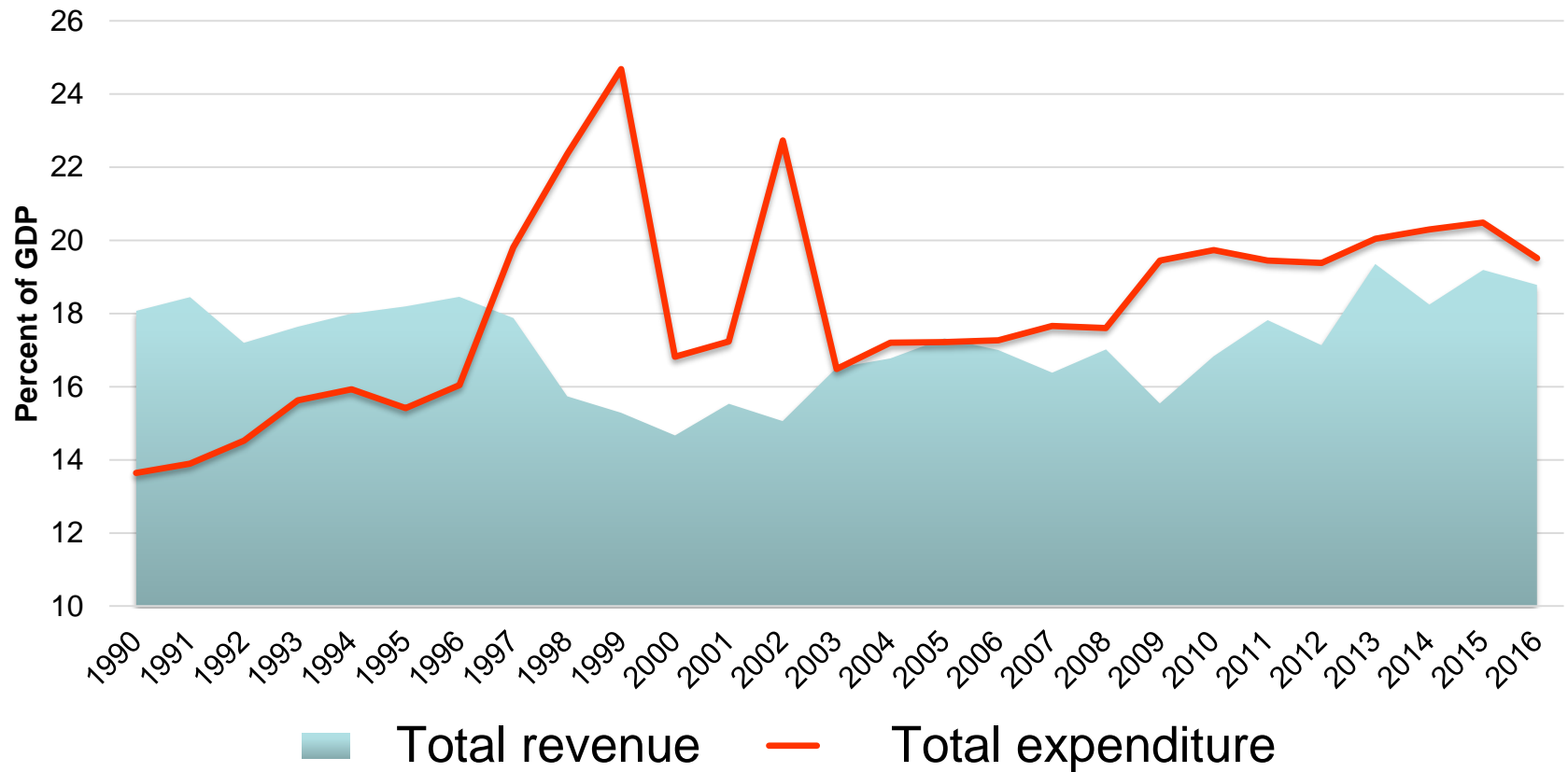


Figure 11.1 Public Revenue and Expenditure: 1990-2016



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.

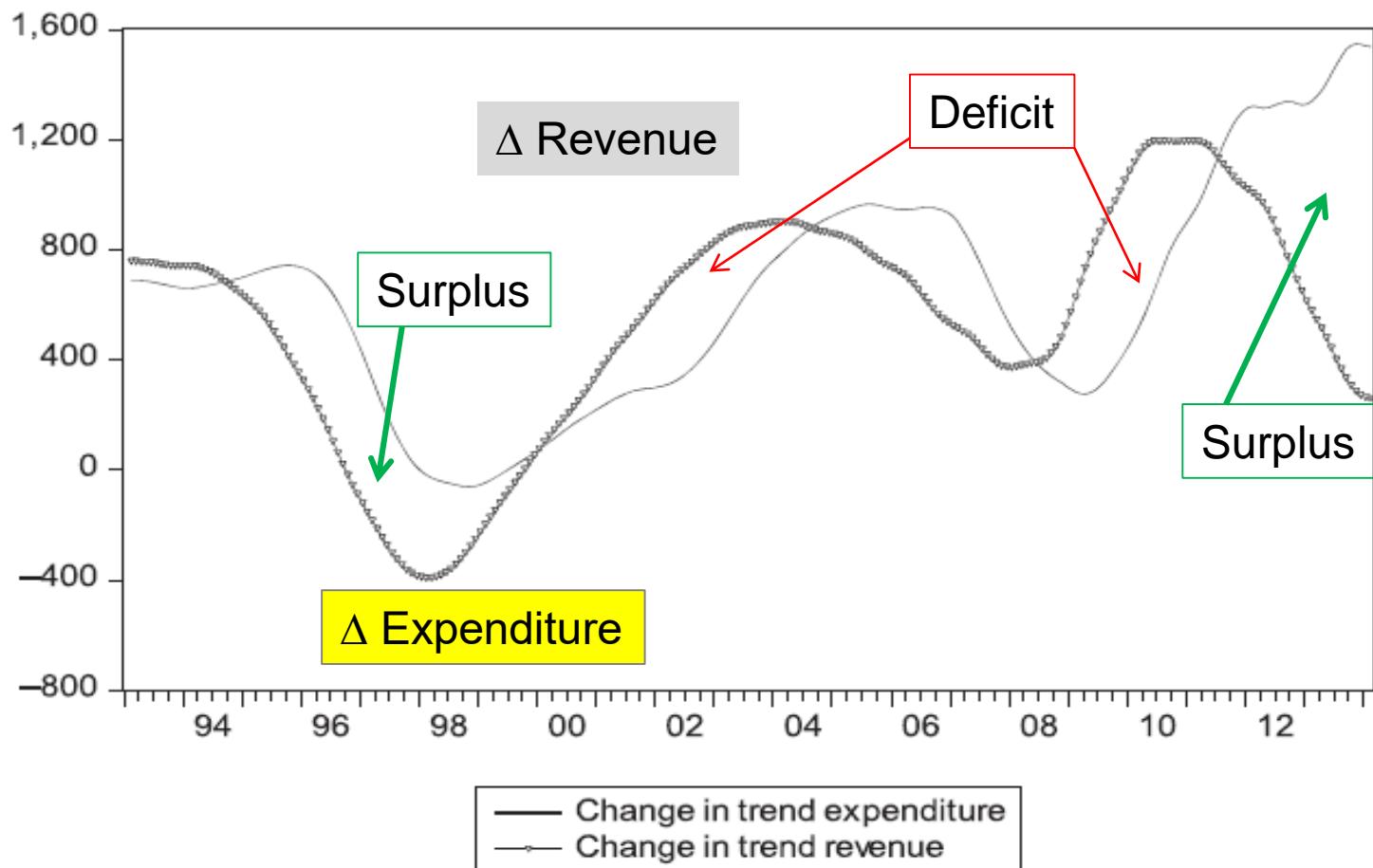
This method should be employed when the economy is near full employment.

(3) **Bond finance**

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

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

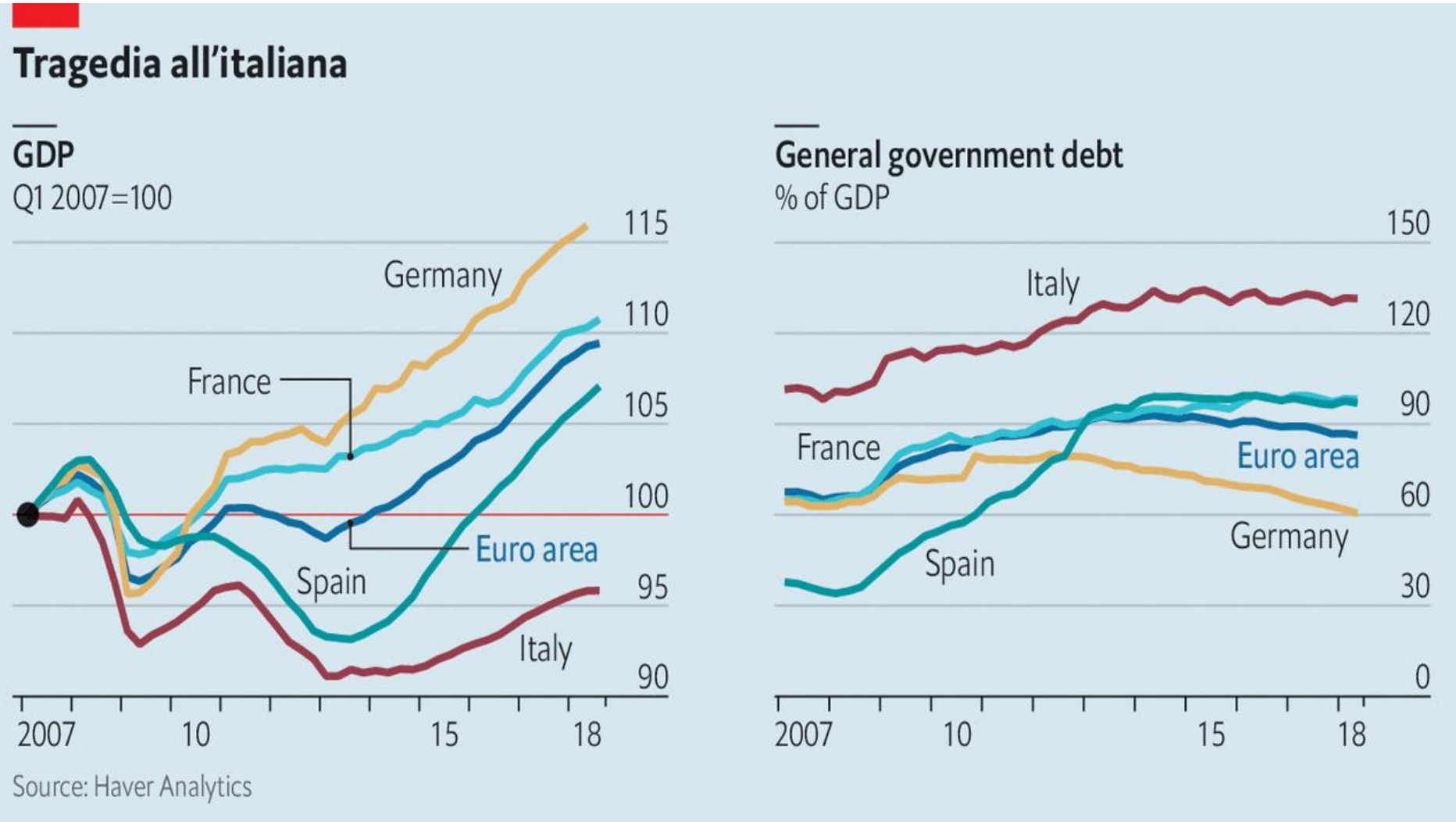
Figure 3. Fiscal stance: Structural changes in trend fiscal variables



Fiscal budget and economic growth

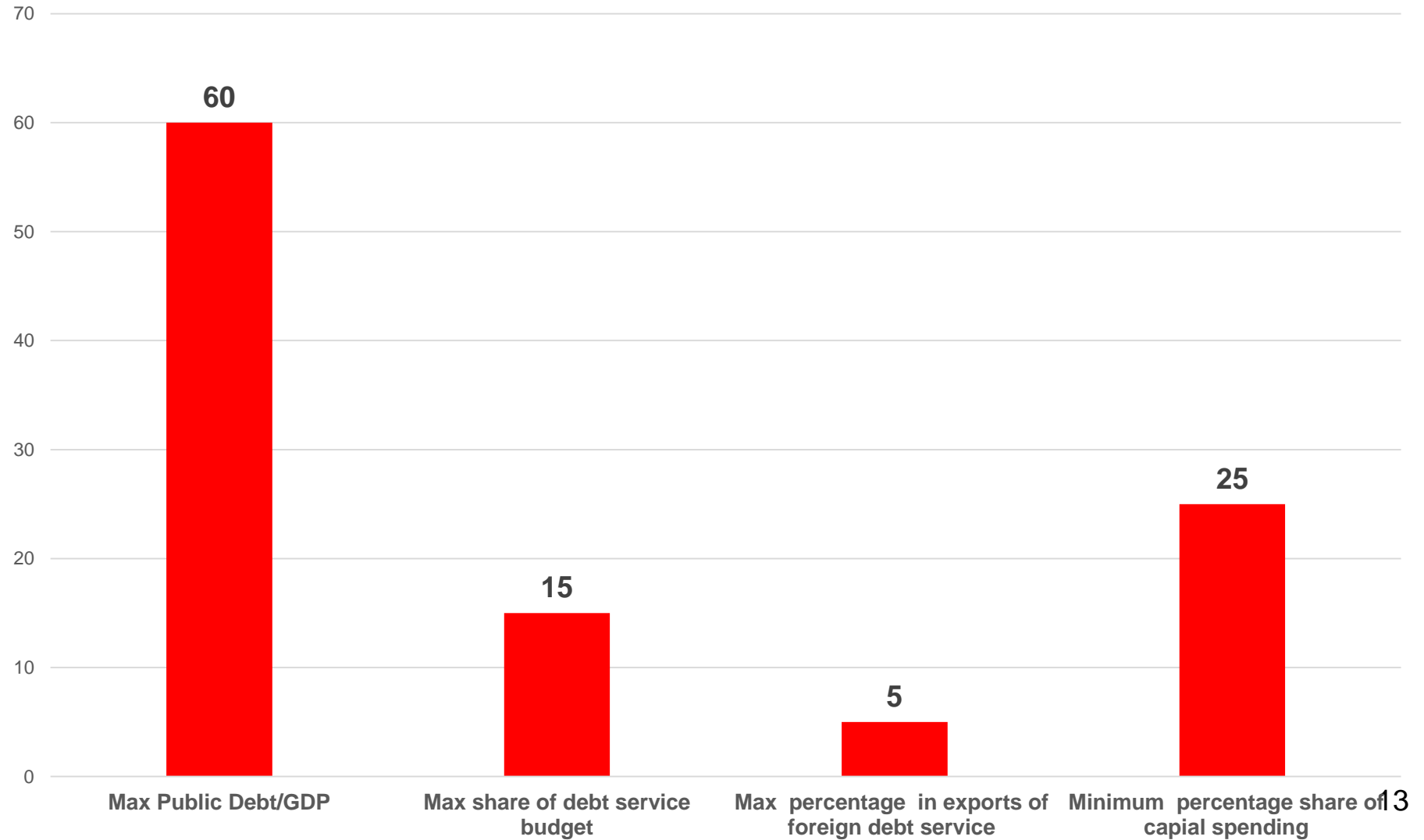
- High deficits are associated with periods of low growth.
- High deficits are proxies for high public debt which imply **higher** taxes and **lower** public capital spending *in the future*.
- ***Large deficits*** are a symptom of macroeconomic **instability** which is detrimental to growth.
- The case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

Italy's slow growth reflects serious structural problems. The European Commission estimates that the country's natural unemployment rate has risen from about 8% in 2007 to 10% now, suggesting that boosting employment is a matter more of *reform* than stimulus.



Rules of Fiscal Sustainability

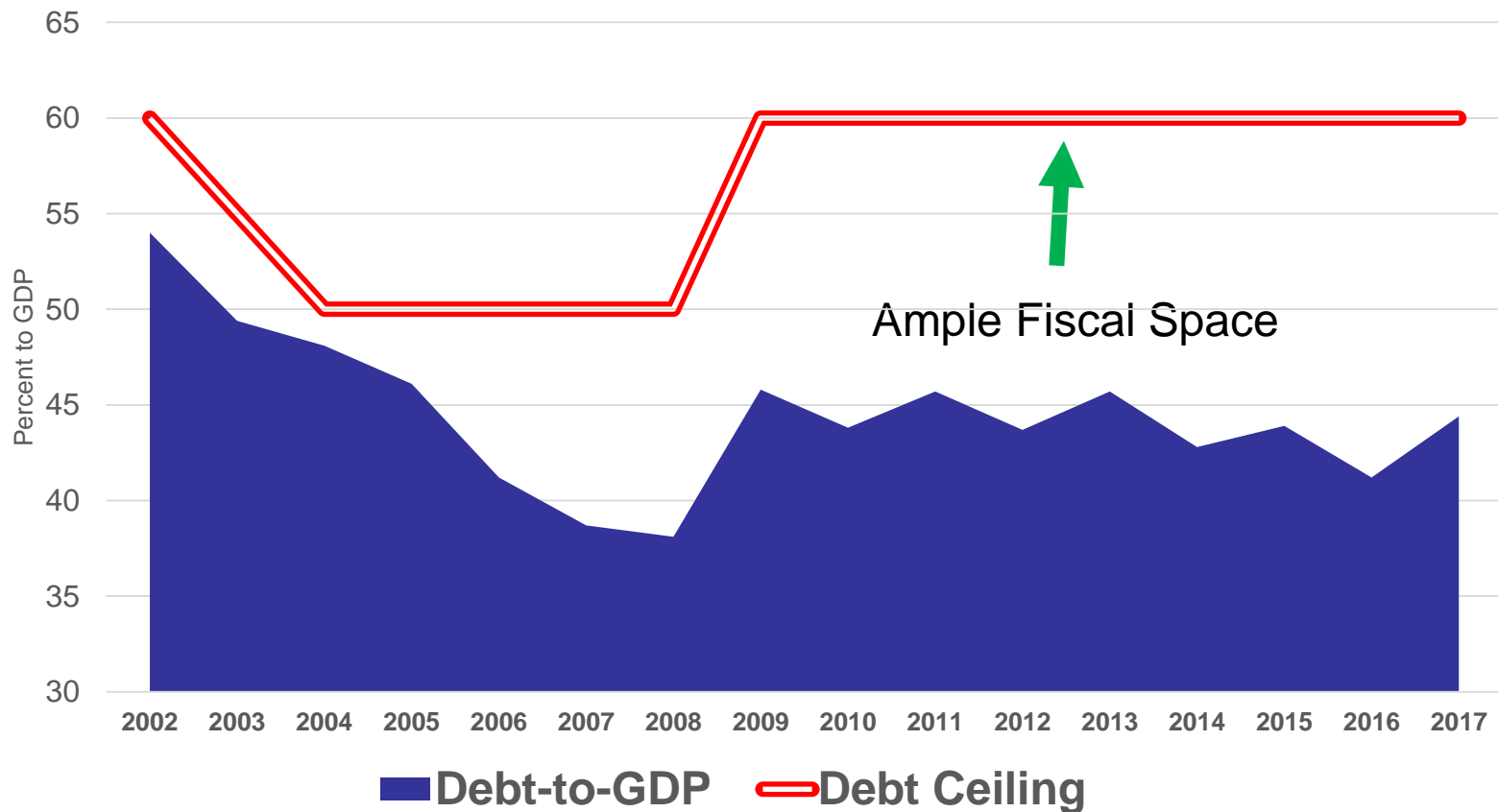
Maximin (percentage)



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

Figure 11.12 Ample Fiscal Space

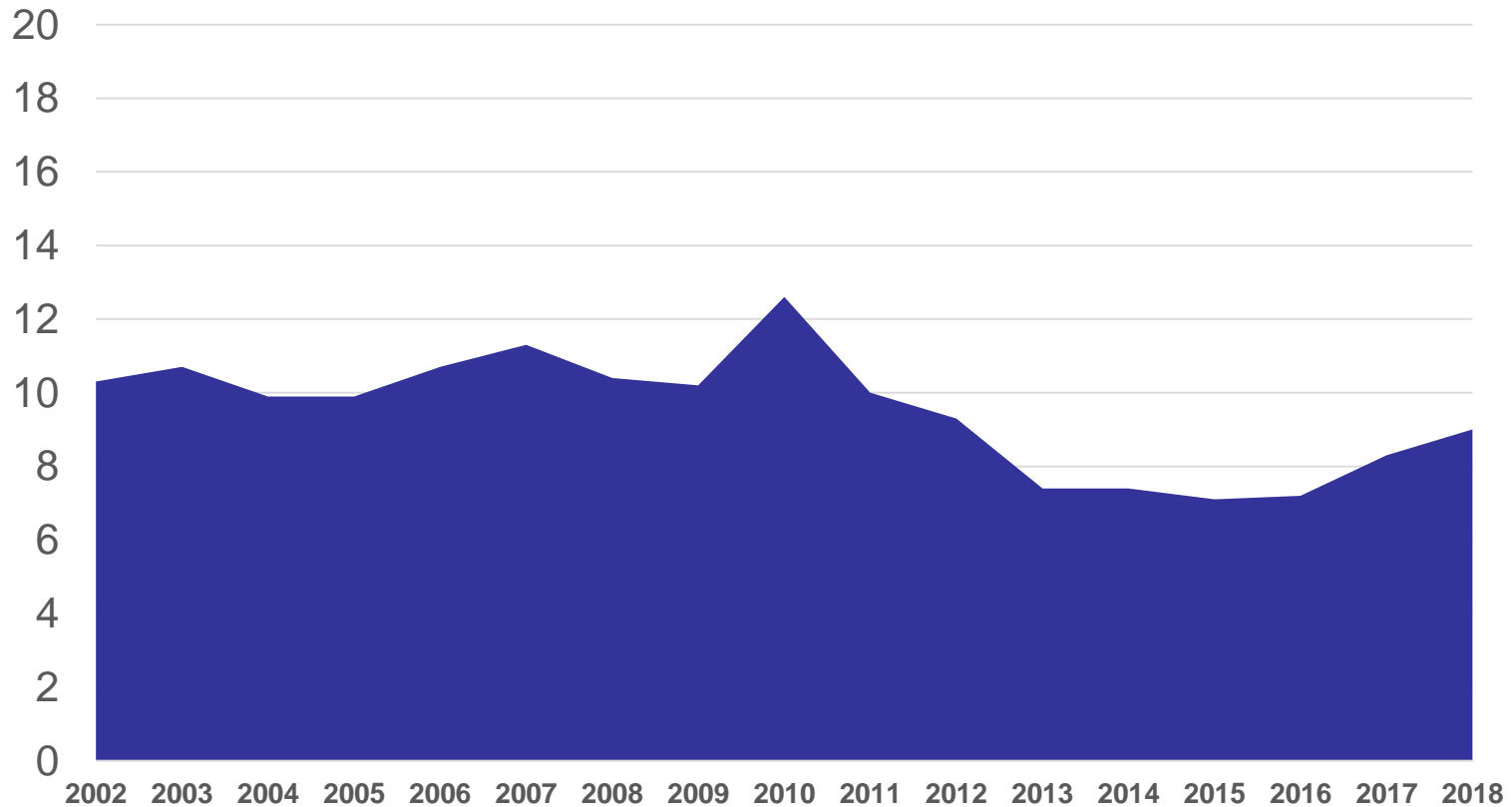
Source: Bank of Thailand



(2) Maximum Debt Service

15 % of total budget

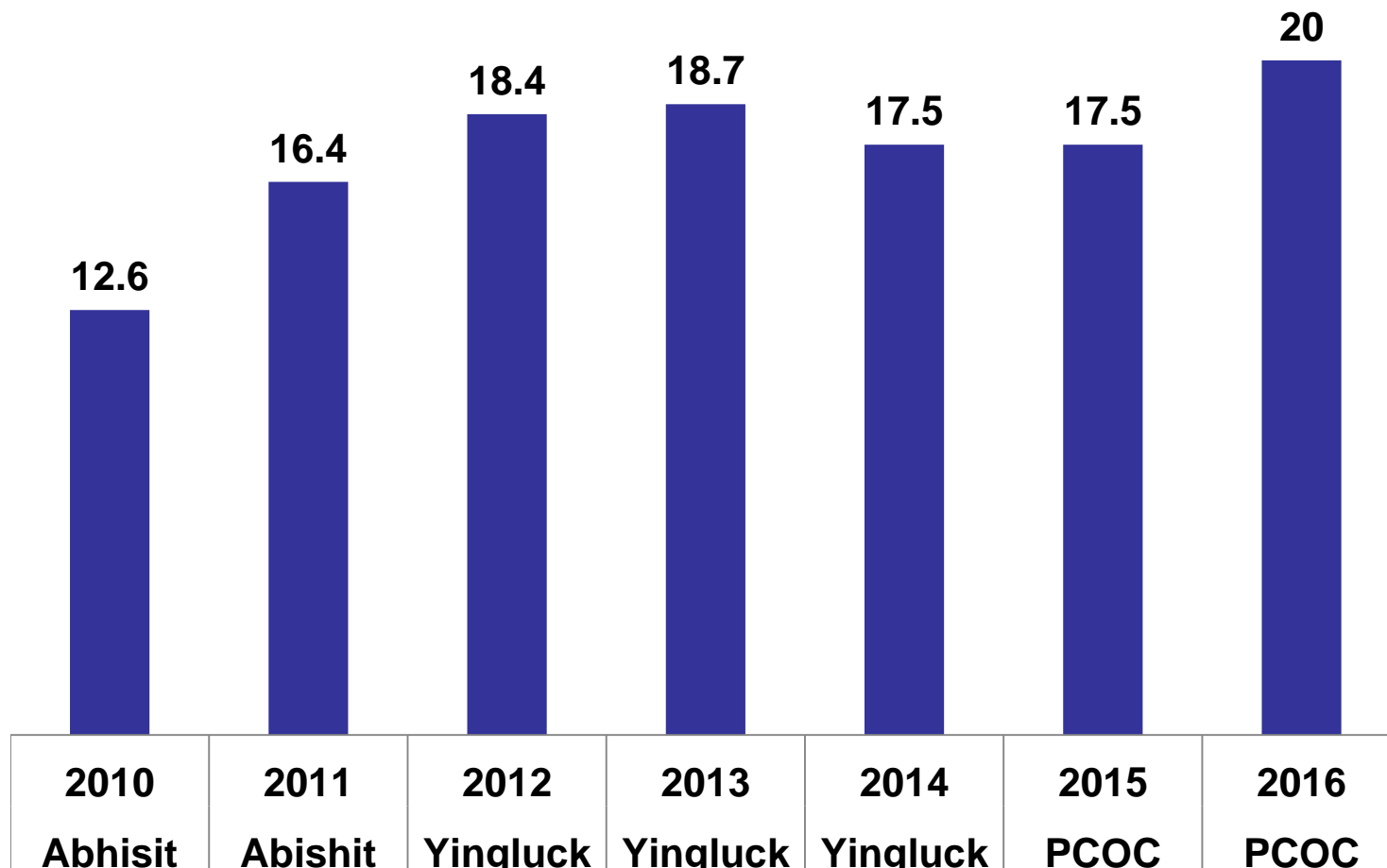
Actual Debt service (%)



(3) Minimum Level of Capital Expenditures

At least 25% of total budget

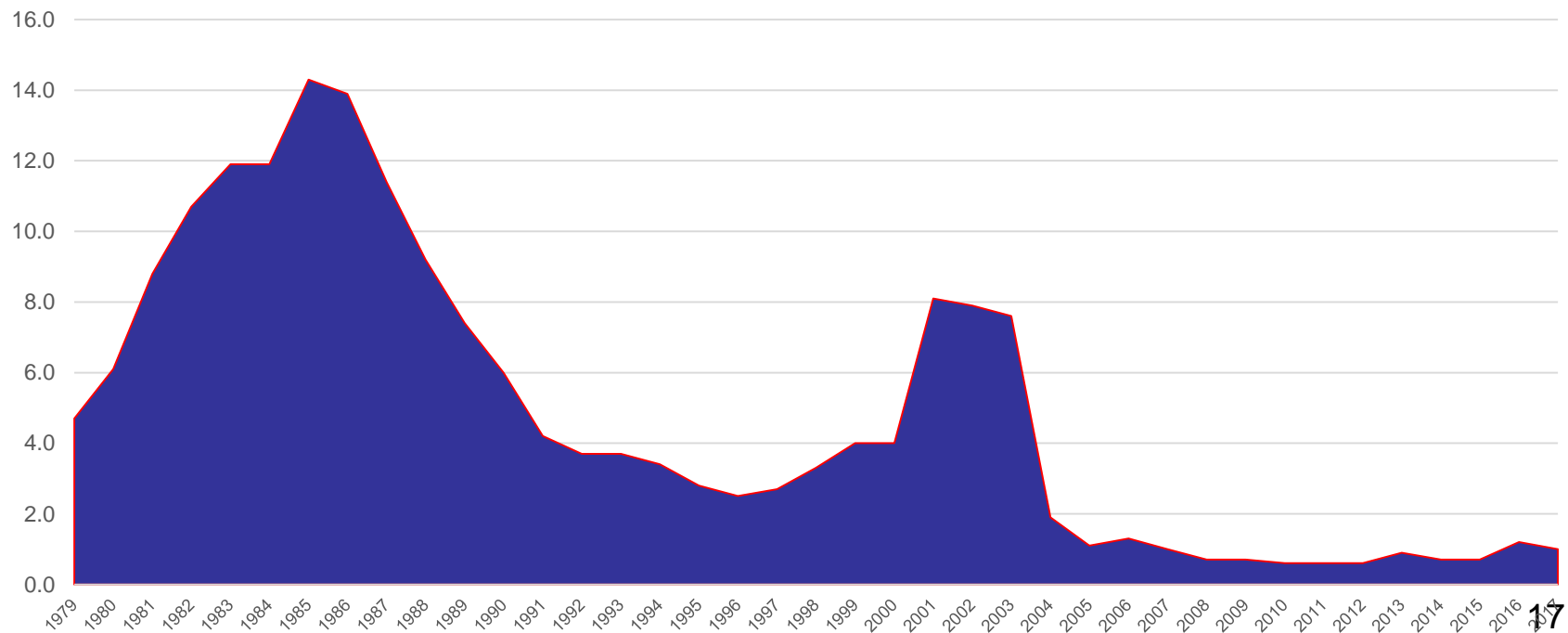
**Share of public investment in various governments
(% total budget)**



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

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

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

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

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

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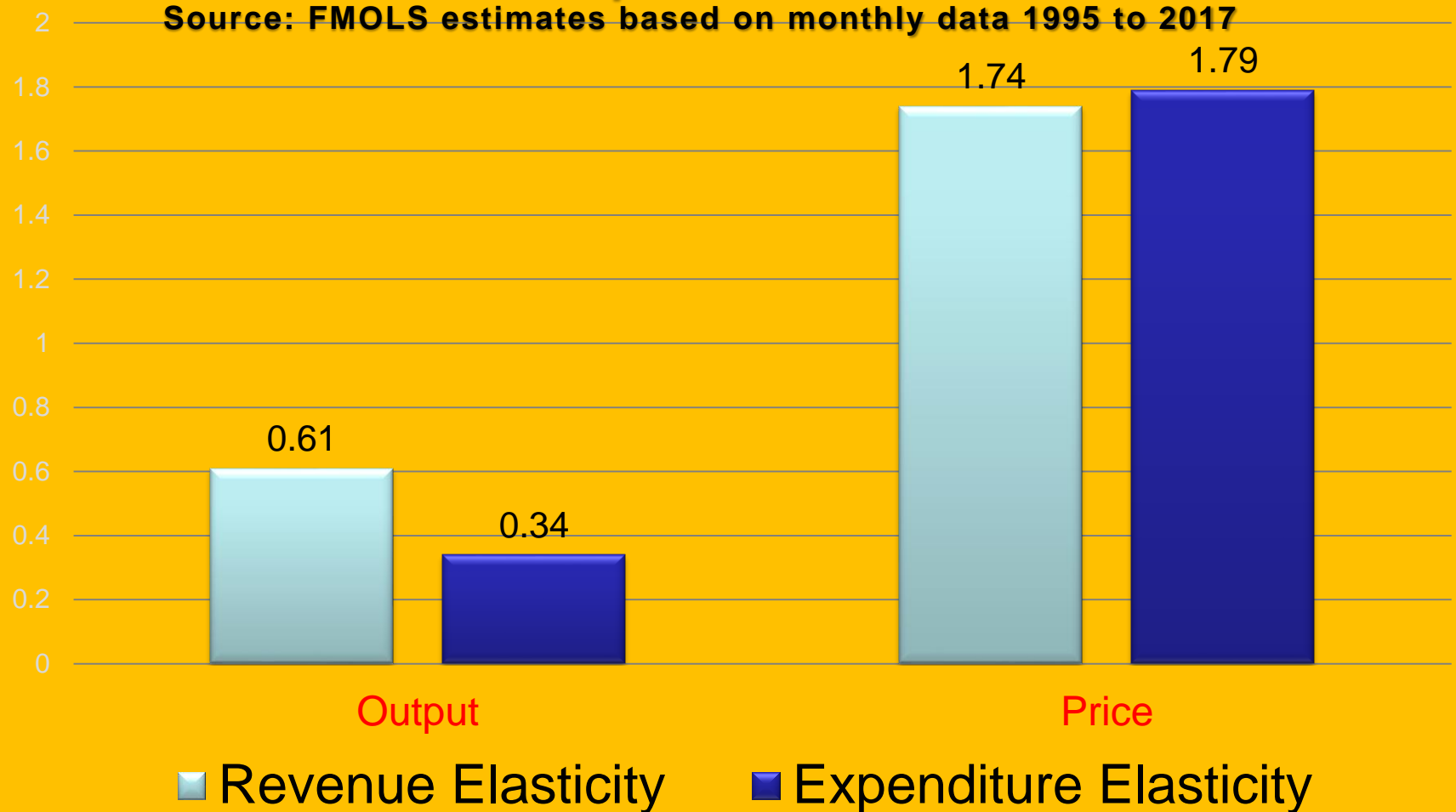
If $\beta > \eta$ and If $\gamma > \theta$

*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

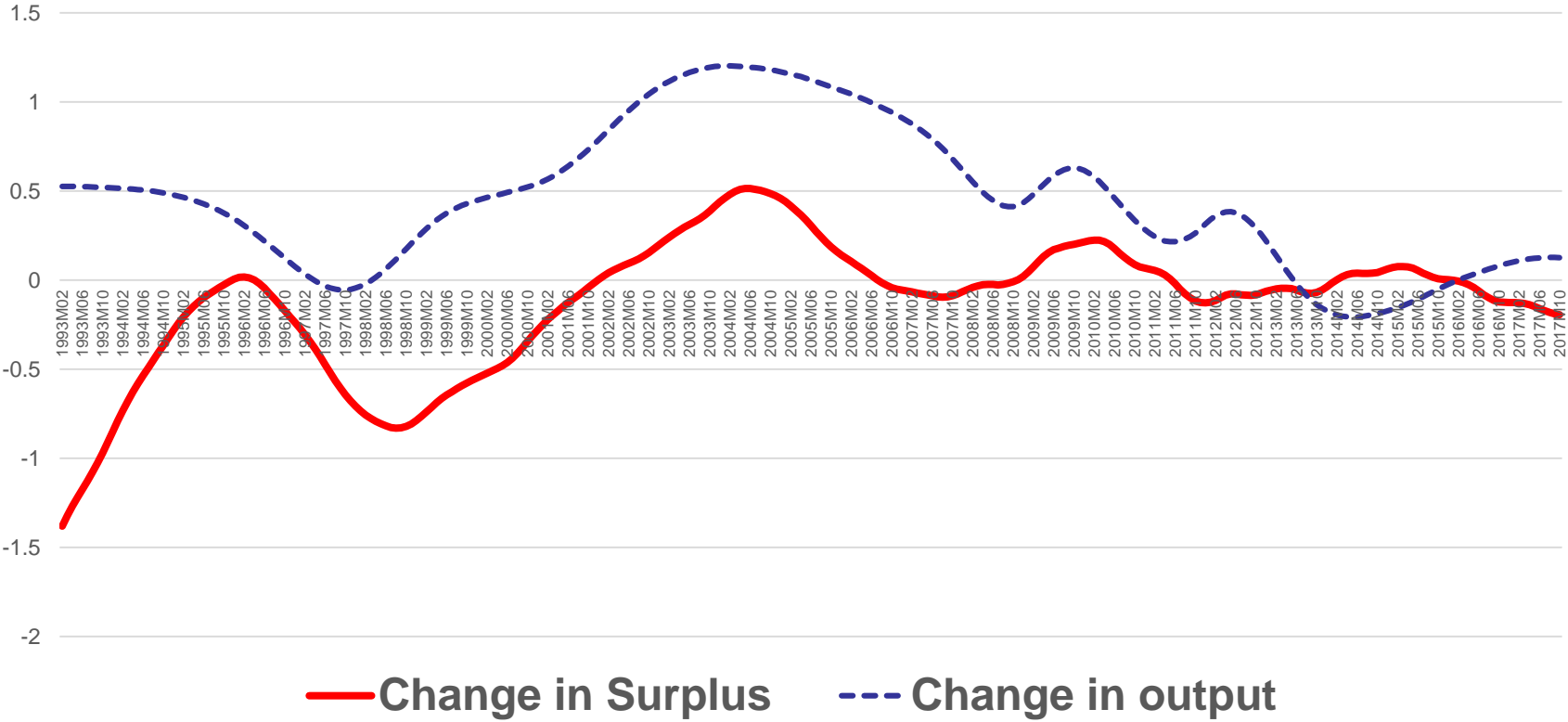


When GDP rises

- 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.
- President Kennedy once said “***the time to repair the roof is when the sun is shining.***” Instead, we (the US government) are punching more holes in the fiscal roof. ²⁴

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.”

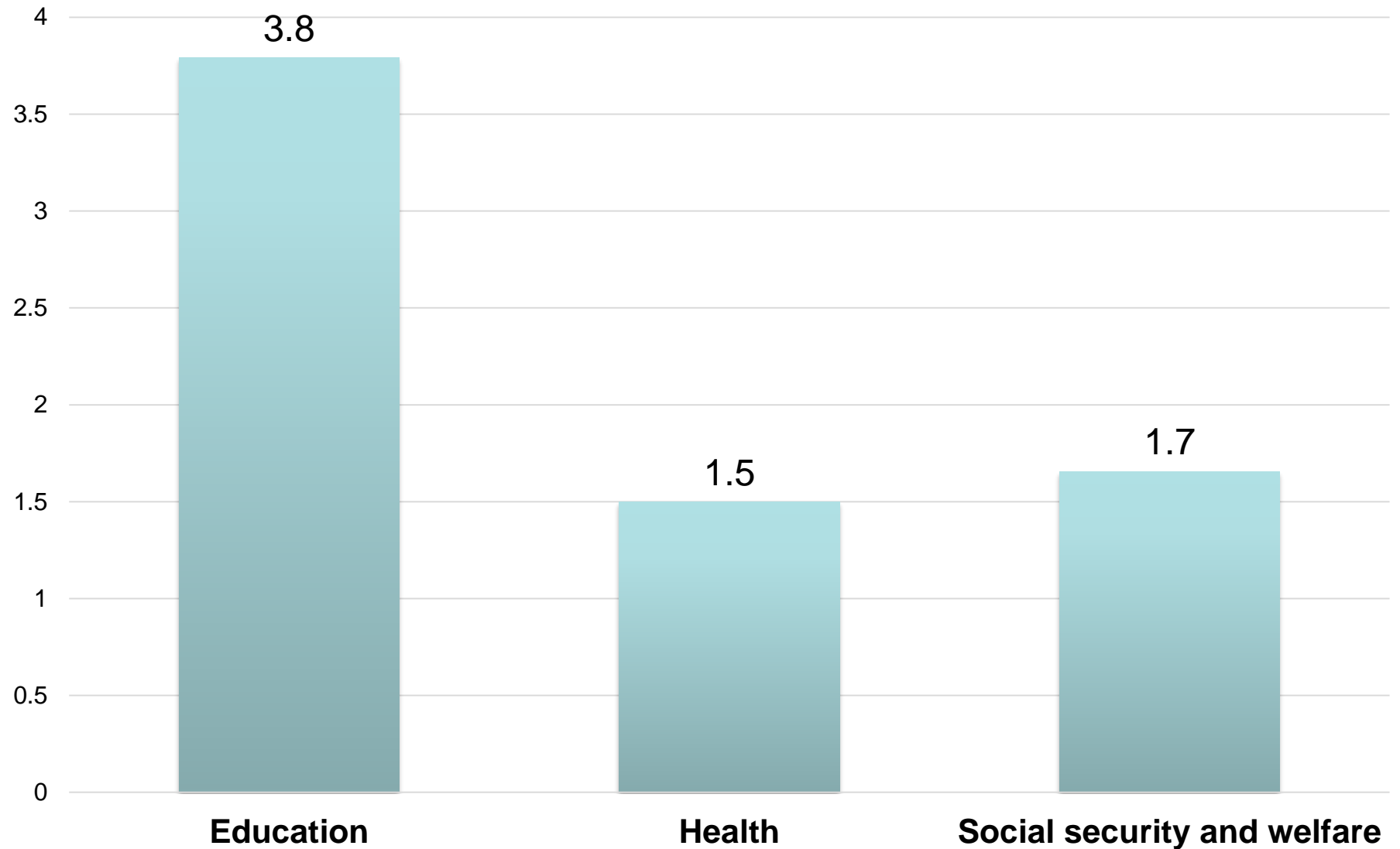
EY Report 2014.

Stylized facts about fiscal policy

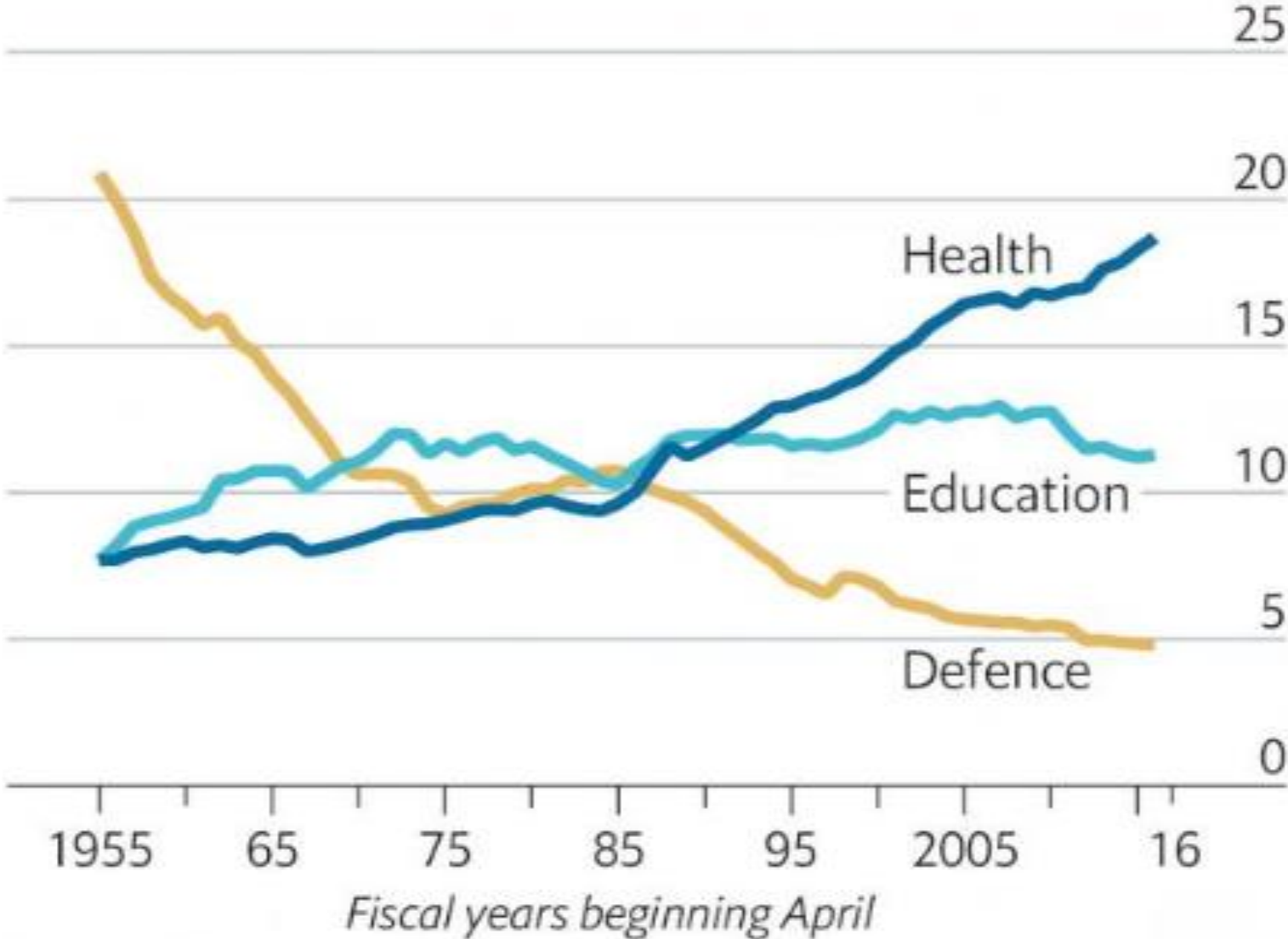
- The level of development is related to fiscal structure: poor countries rely more on **indirect/trade taxes**, developed countries rely more on income taxes.
- Fiscal structure, influenced by the size of the economy (population and GDP level), dictates the **efficacy** of fiscal policy.
- Investment 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



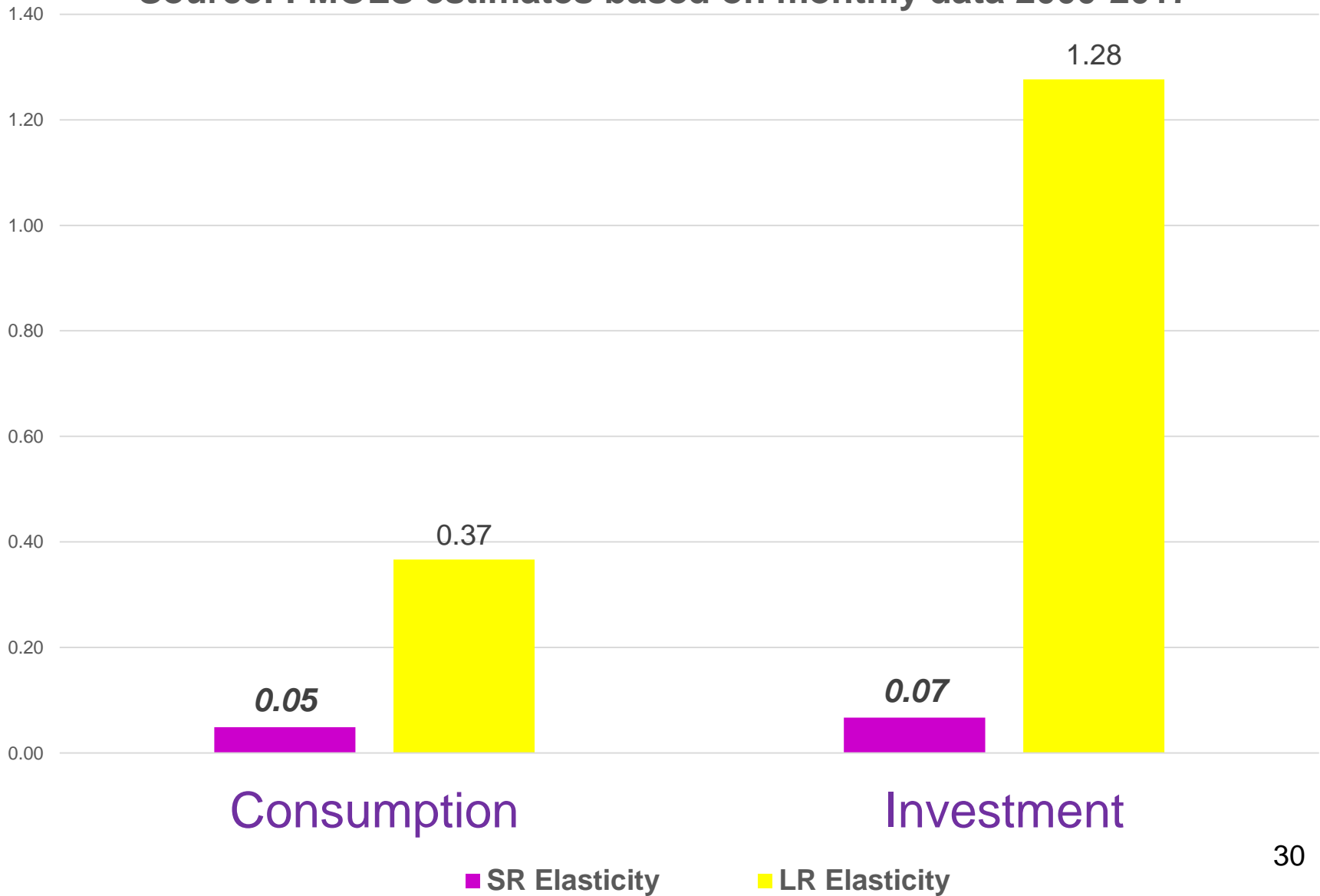
Britain, % of government spending



Source: IFS

Figure 11.6 Short run and long run Impact of public spending

Source: FMOLS estimates based on monthly data 2000-2017



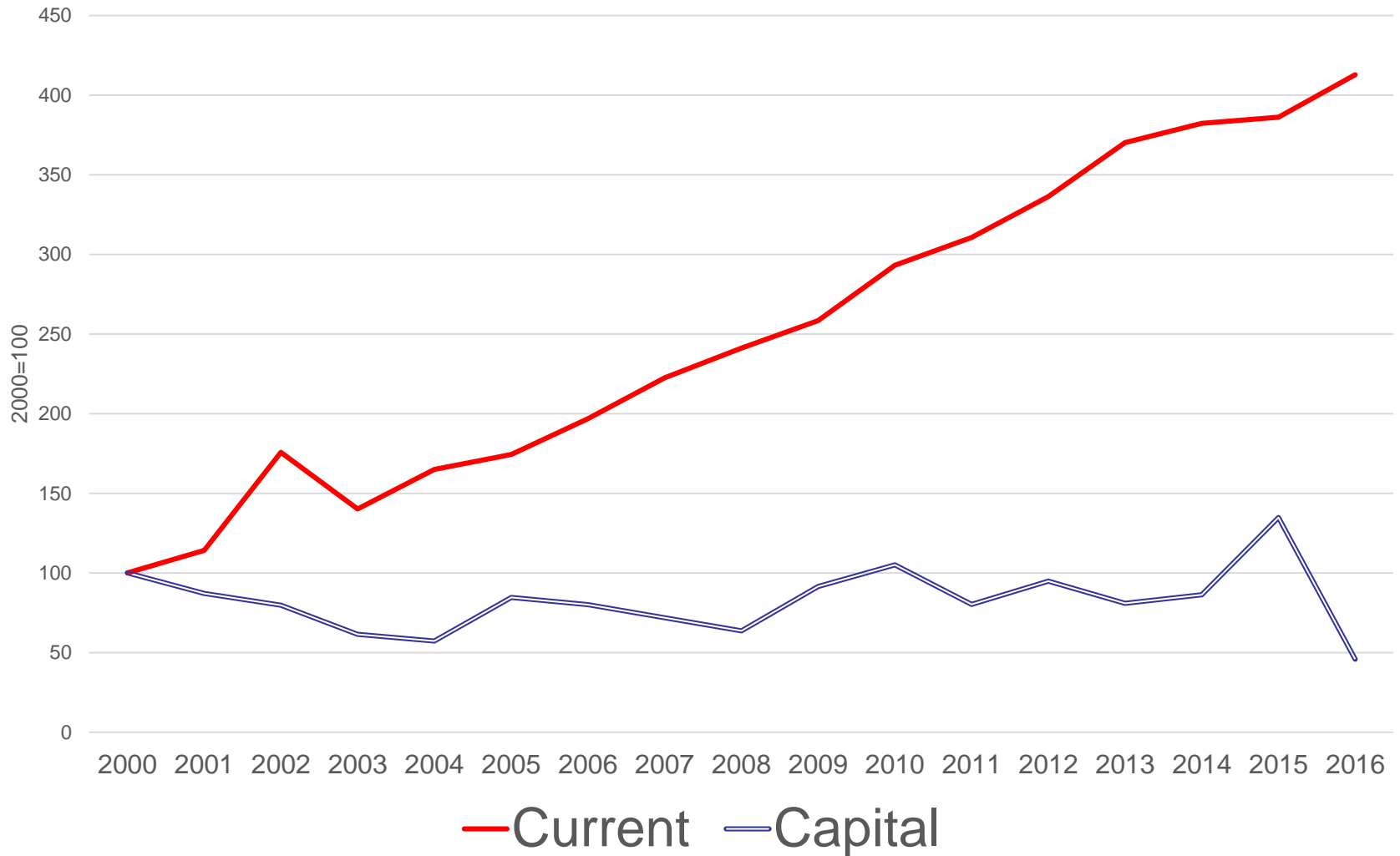
Public consumption vs. public investment

- 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)

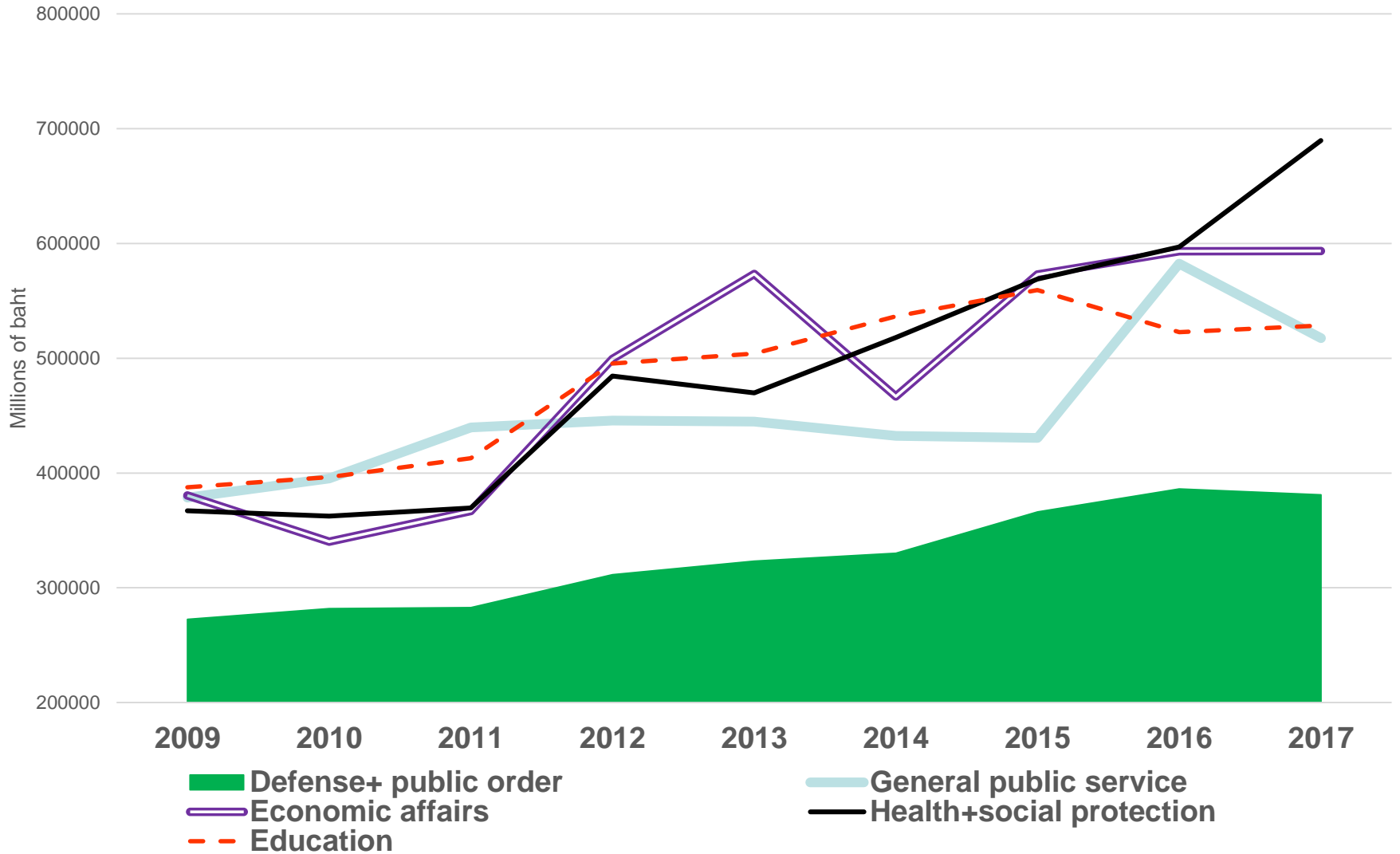
Capital vs. current (consumption) public spending

- 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)

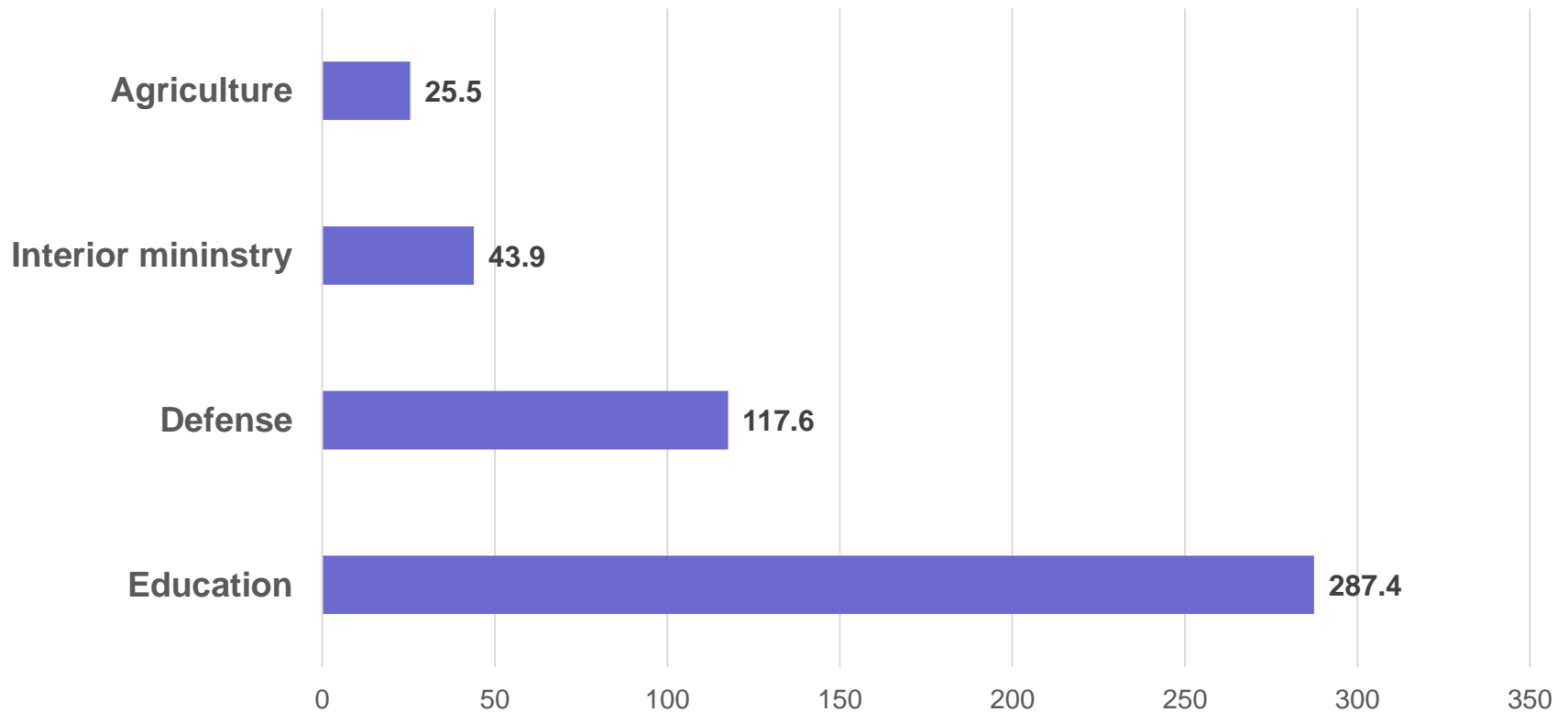


Aggregate spending matters, particular categories matter more than the others

- The finding in this chapter 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.***
- 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 an opportunity cost of increasing share of defense spending.

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

**2019 Fiscal Budget
(billion baht)**



Words matter, but deeds matter more

DAY OF RECKONING

POLICIES OF KEY GOVERNMENT COALITION PARTIES PROMOTED DURING ELECTION CAMPAIGN

Agriculture

- subsidy of 12,000 baht for white rice and 18,000 baht for jasmine rice
- subsidy of 1,000 baht per tonne for sugarcane and 65 baht for rubber
- subsidy of 5 baht/kg for palm and 3 baht/kg for cassava

Palang Pracharath Party



Social welfare

- monthly subsidy for welfare card holders for 10 months: 100 baht for tap water bills; 230 baht for power bills; and 400 baht for rent
- monthly allowance of 500 baht to buy goods at Thong Fah Pracharath shops

Labour

- daily minimum wage of 400-425 baht
- salary of 20,000 baht for university graduates/18,000 baht for vocational college graduates

General welfare

- monthly allowance of 3,000 baht for pregnant women
- monthly child allowance of 2,000 baht from birth to six years old

Elderly welfare

- a monthly allowance of 1,000 baht
- coupon to buy equipment for the elderly
- extended retirement age to 63

Democrat Party

- monthly child allowance of 1,000 baht from birth to eight years old
- monthly old-age living allowance of 1,000 baht
- Annual wage guarantee of 120,000 baht for workers
- income guarantee for farmers
- monthly allowance of 800 baht for the poor
- drug suppression

Bhumjaithai Party

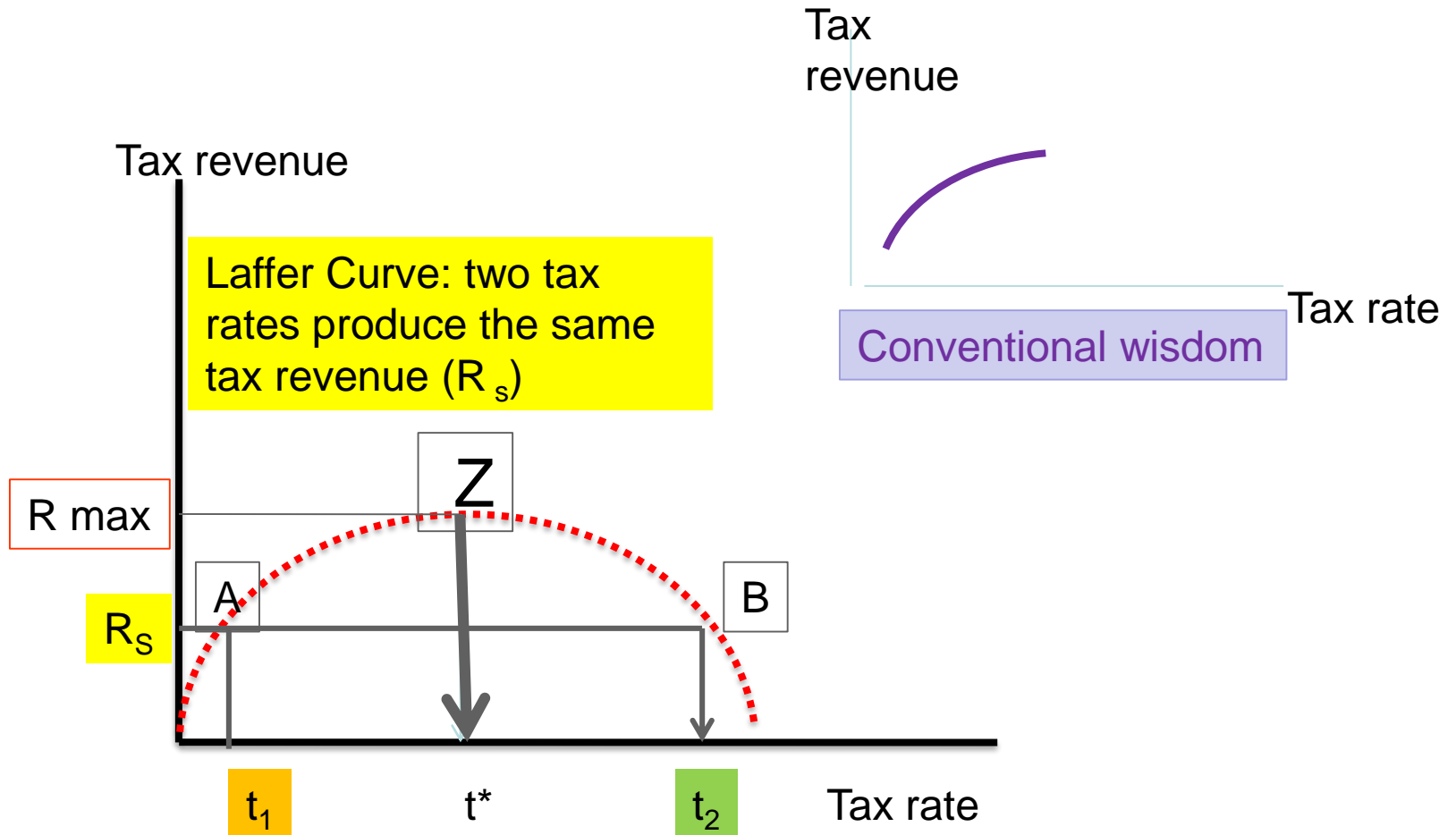
- liberalisation of cannabis
- legalisation of Grab services
- work/study from home a day per week
- online study
- solving student loan debts

Chartthaipattana Party

- moving on past conflict
- increasing funds for local bodies
- reducing costs for farmers
- creating community health centres in urban areas
- promoting tourism to boost income

Laffer curve: tax rates and tax revenues

An Inverted U-shaped Relationship



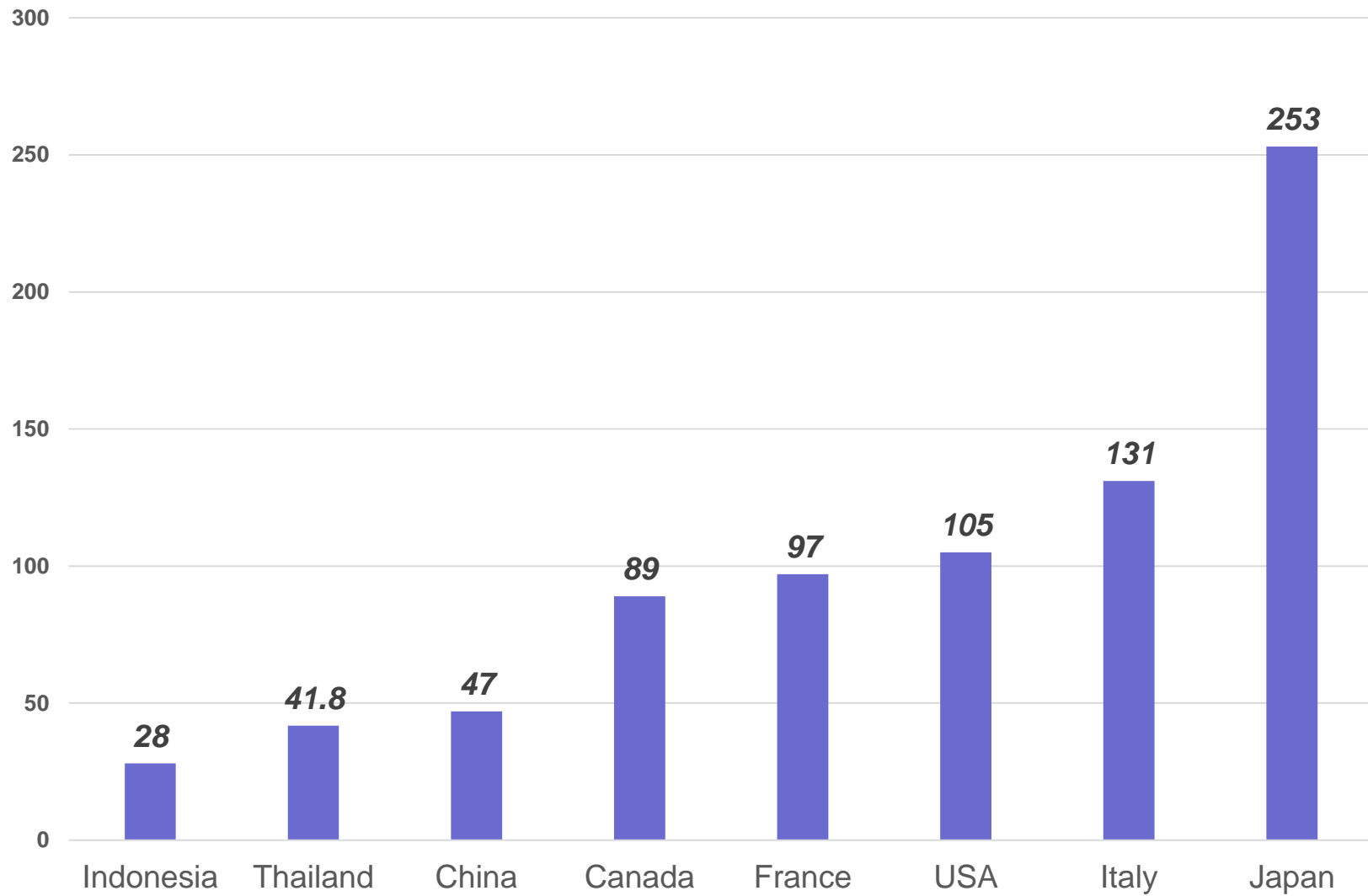
Can a tax reduction increase tax revenue?

- 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.
- Should the government raise the value added tax from 7 to 10% in 2020?
- If the government cannot raise tax revenue while expenditures keep on rising, the country will accumulate higher and higher debt over the years.

Public Debt (% GDP): international comparison in 2018



To stabilize the public debt

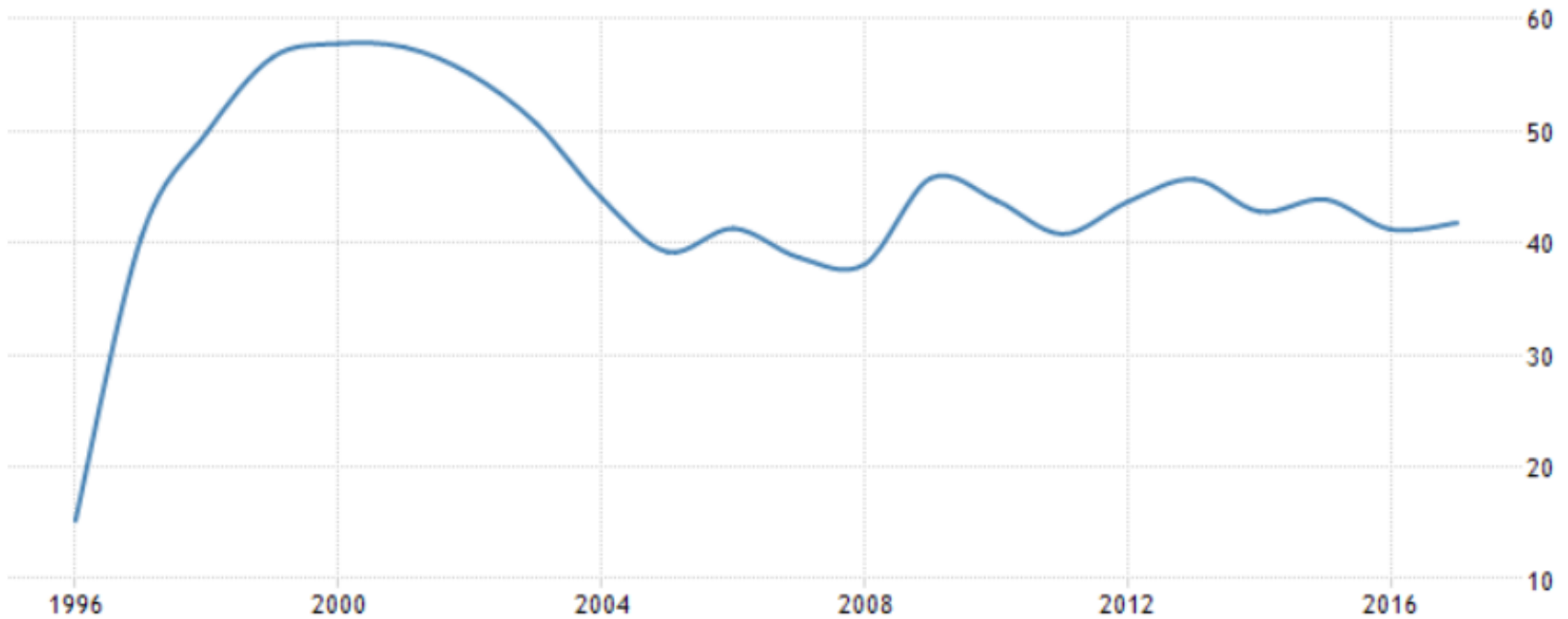
- To keep the Debt-to-GDP constant, the government must increase its **primary surplus** in line with the increase in $(r-g)$.
- The spending cuts or tax increases are likely to prove politically costly, generating even more political uncertainty and the need for an even higher interest rate.
- A ***sharp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

THAILAND GOVERNMENT DEBT TO GDP

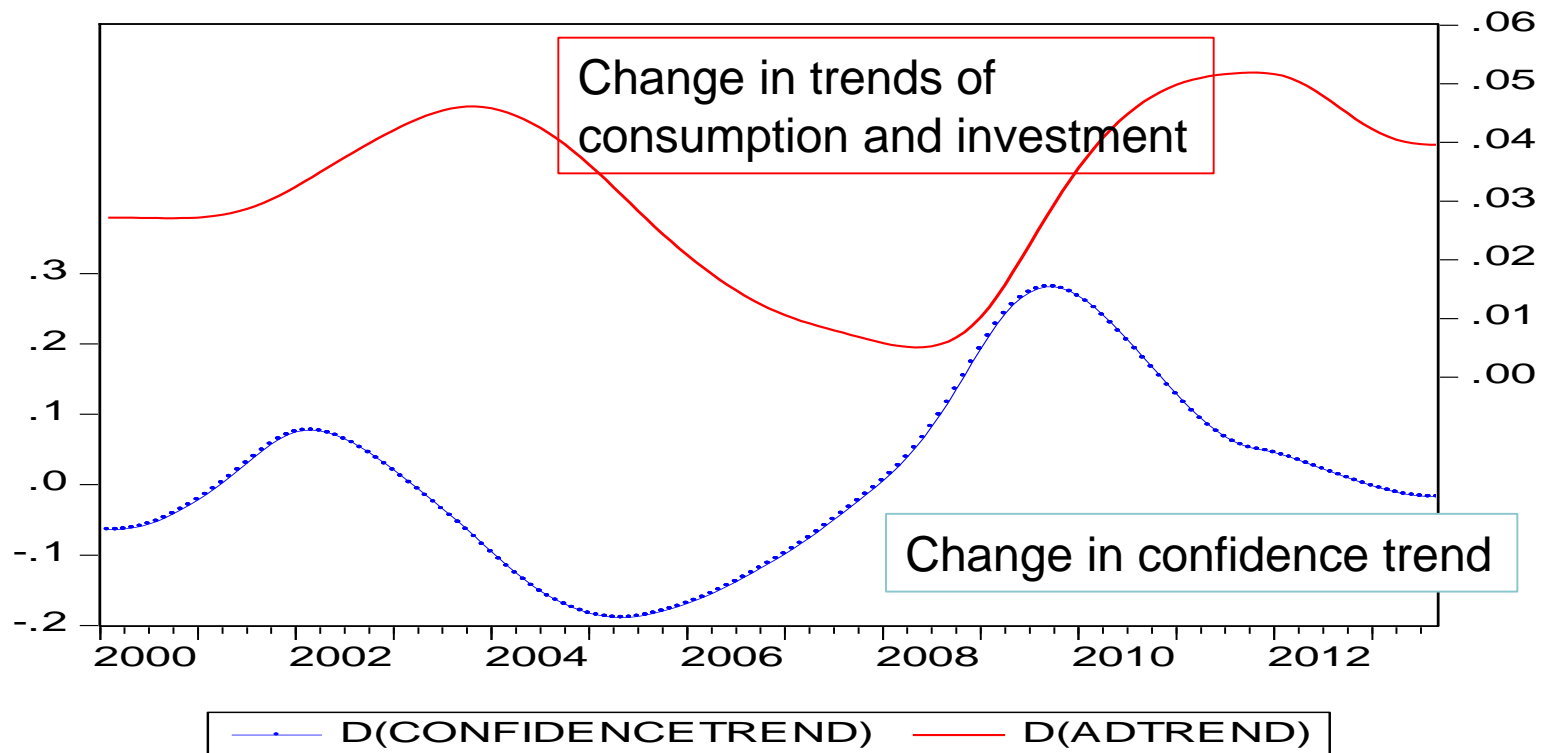


Will fiscal stimulus work?

- 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 confidence to private spending

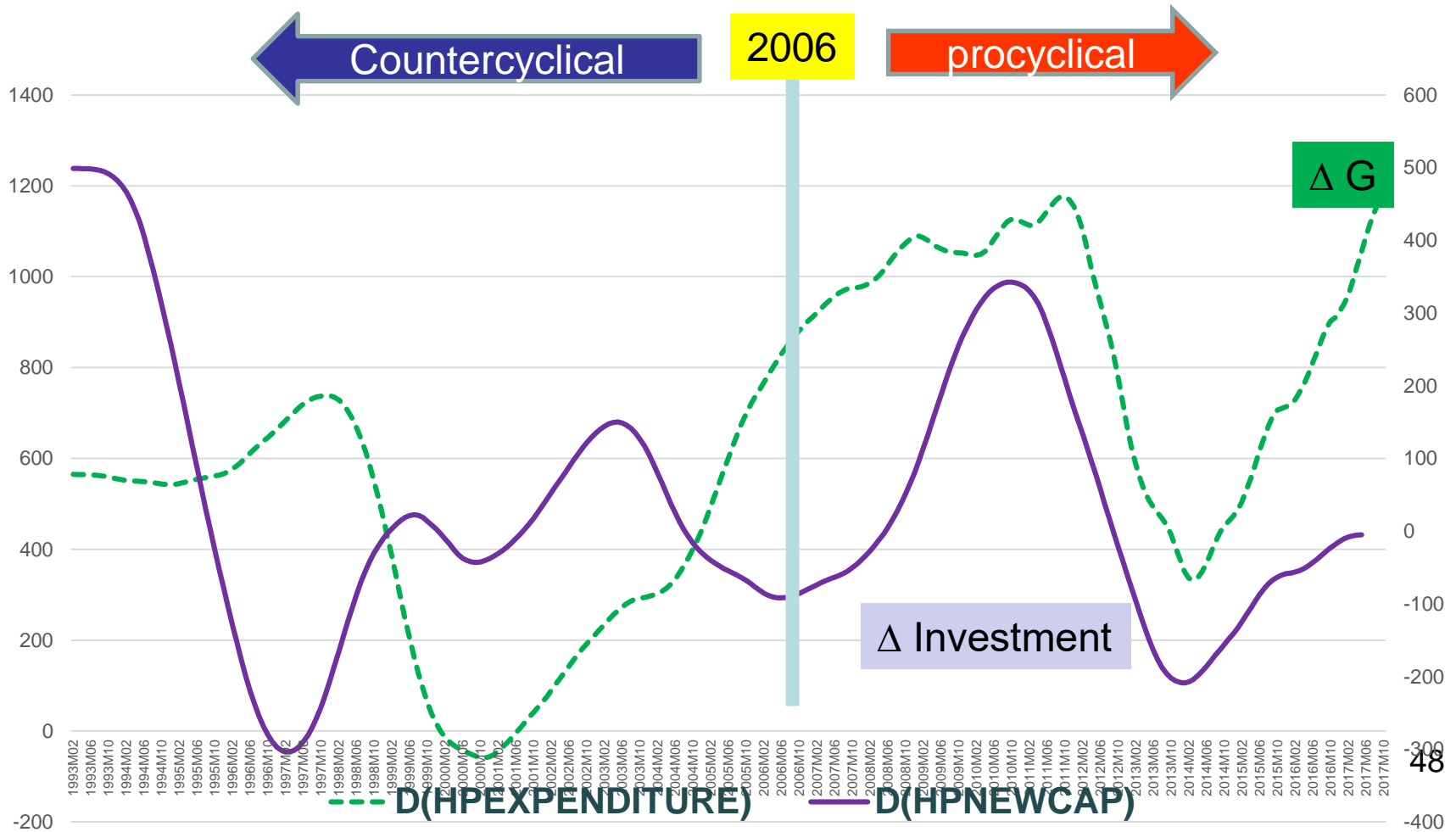


Conditions for effective fiscal stimulus

- 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.

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.

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

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

6th Strategy

Fiscal Responsibility Act (2018)

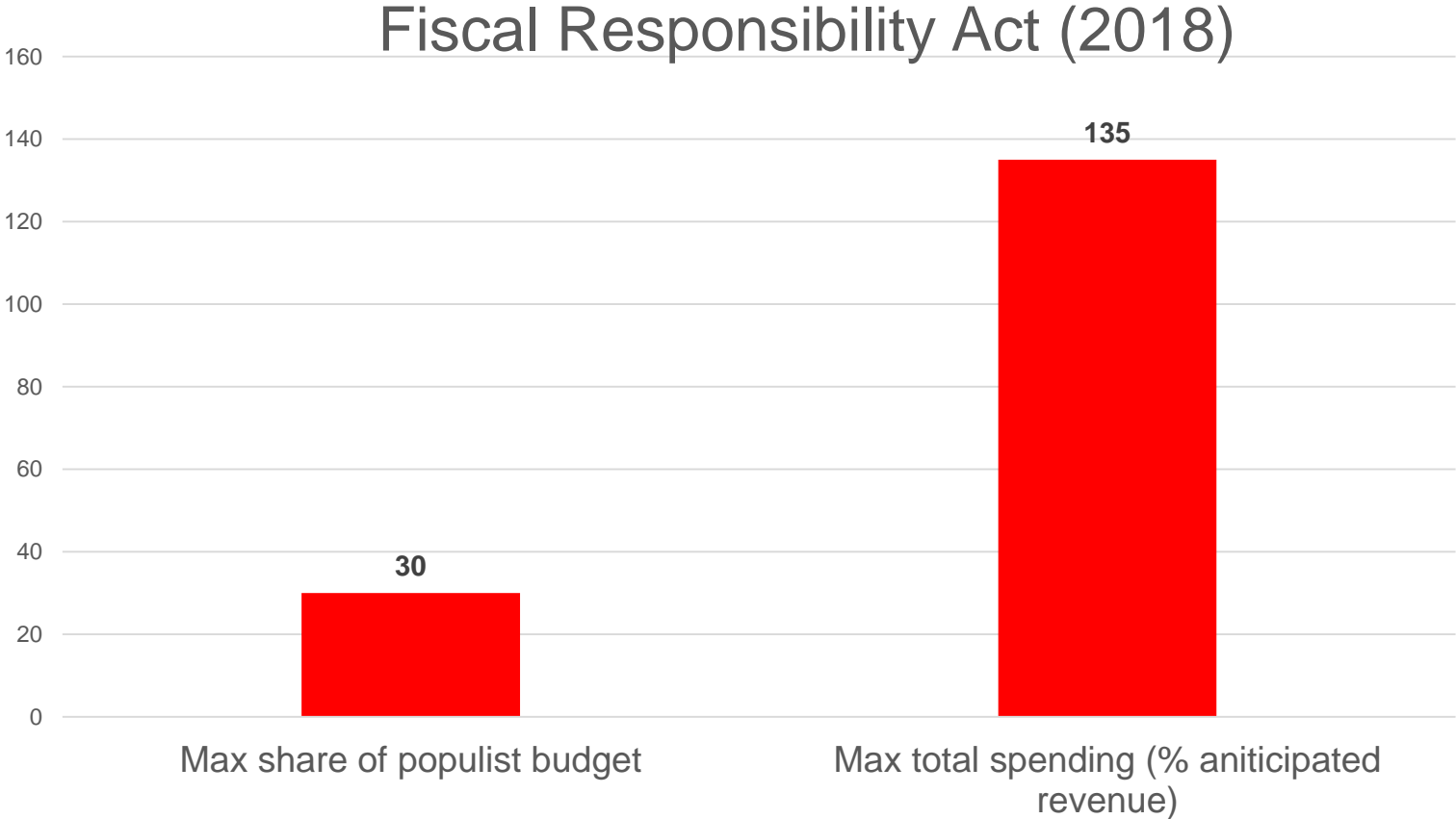
- Maximum borrowing must not exceed 35% of the estimated revenue of that fiscal year. (Implications on fiscal sustainability and long term growth)
- **G must not exceed R by 35%**
- Thailand's fiscal policy was conservative because spending was constrained by tax capacity.
- Foreign-denominated public debt must not exceed 10% of the overall public debt (implication on financial risks and long-term growth)

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)



Critical Thinking 1

PPRP ready to fulfil vows: It will cost less than 200 billion baht in the first year

Palang Pracha Rath Party (PPRP)

Bangkok Post: April 13, 2019

PPRP spokesman Kobsak Pootrakool said that the party had seven campaign policies that can be carried out with a budget of no more than 200 billion baht.


They are the Pracharath cards; the One Million House project; a three-year debt moratorium on village fund loans; a policy to shore up prices of farm commodities such as rice, sugar cane and rubber; a policy to strengthen small-and-medium-sized businesses; a policy that would allow farmers holding Sor Por Kor documents to seek commercial gain from their properties; and a policy that will pay 3,000 baht a month to pregnant women until the birth, 10,000 baht for delivery costs, and another 2,000 baht per month to take care of newborns until the age of six.

Mr Kobsak said the party estimated that carrying out the policies would cost no more than 200 billion baht in the first year. He also said the party had plans to seek revenue to support the projects such as tax reform and investments in other areas.

Critical thinking 2: Analyze the 2019 budget

Under the deficit budget, revenue is projected at 2.55 trillion baht with the deficit of 450 billion baht funded by loans.

The 3 trillion baht accounts for 17.1% of GDP.



IN THE KITTY

The 2019 Budget Bill proposed for deliberation yesterday compared with last year's budget

	2019	2018	Change
Total budget	3 trillion	2.9 trillion	Increased by 3.4%
Expected revenue	2.55 trillion	2.45 trillion	Increased by 4%
Loan designated for budget deficit	450 billion	450 billion	Same
Budget for each of the six national strategies:			
1. National security	329.2 billion	274 billion	Increased by 20.14%
2. Competitiveness building	406.5 billion	476.6 billion	Decreased by 14.7%
3. Human resource development	560.8 billion	575.7 billion	Decreased by 2.6%
4. Battling poverty and disparity	397.5 billion	332.6 billion	Increased by 19.5%
5. Water management and quality of life	117.2 billion	125.5 billion	Decreased by 6.6%
6. Public sector administration development	838.4 billion	784.2 billion	Increased by 6.9%
7. Emergency reserve	350.1 billion	331.5 billion	Increased by 5.6%

Critical thinking 3: How effective is the fiscal stimulus (CSC)?

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 the year.

The cash handout: II

- In the second phase, the consumption promotion program which requires a budget of 2 billion baht, a reduction of real estate transfer fees worth 2.6 billion baht, and low-interest loans from the Government Housing Bank, valued at 1.2 billion baht.
- Under the second phase of the cash giveaway, participants will still enjoy the same 1,000-baht cash handout as well a cash rebate of up to 20%.
- About 10 million people who registered under the first phase, which kicked off on Sept 23 and offered a 15% rebate, are also now entitled to 20%,
- The second phase of the campaign runs until the end of the year. Online registration begins tomorrow. Based on a first-come, first-served basis, registration is limited to 1 million people a day.

DPM Somkid

- Deputy Prime Minister Somkid Jatusripitak hailed the cash handout, saying it will boost consumer spending, which in turn will stimulate economic growth.
- The scheme will also encourage more people to travel and spend in the provinces
- The measure is also expected to attract several hundred thousand more shops and business operators to join the scheme

CSC round 2

- To be eligible for the cash handout and the 20% cash rebate of up to 50,000 baht for tourism-related spending, Thais aged 18 and older are required to sign up at the Chim, Shop, Chai(CSC) website and download the Pao Tang mobile app from Krungthai Bank.
- *The rebate will be paid by the government later.*
- The cash handout needs to be spent using the Pao Tang app at participating shops in specified provinces within two weeks.
- Neither perk can be used in the recipient's home province.

CSC round 3

- The scheme provides up to a 20% cash rebate to 2 million recipients.
- Registration for those who missed out on the first two phases.
- Unlike the previous two phases, the third will allow cash back for spending at participating merchants anywhere in Thailand, including recipients' home provinces.
- ***Recipients will receive 15% cash back for spending of up to 30,000 baht at participating merchants.***
- The rebate rises to 20% for more than 30,000 to 50,000 baht spent, with up to 8,500 baht available in cash back.
- The third phase will run until the end of January 2020.
- Some 10 million participants in the first phase and 3 million in the second phase received a 1,000-baht cash handout as well a cash rebate of up to 20%.
- To be eligible for the cash handout and the 20% cash rebate of up to 50,000 baht for tourism-related spending, Thais aged 18 and older were required to sign up at the Chim, Shop, Chai website and download the Pao Tang mobile app from Krungthai Bank. The rebate will be paid by the government later.

CSC round 3

- The cash handout needs to be spent using the Pao Tang app at participating shops in specified provinces within two weeks. Neither perk can be used in the recipient's home province.
- The Tourism Authority of Thailand's 'Visit Thailand With 100 Baht' campaign is limited to 10,000 people per day starting on Nov 11. The government is trying several campaigns to rev up a limp economy.
- The ministry has encouraged people to spend their money through Pao Tang's G-wallet 2, but only 700 million baht has been spent so far.
- The ministry expects the taste, shop, spend scheme will trigger a spending spree and create money circulation in the economy of 60 billion baht.
- For the cash handout alone, spending tallied 12.3 billion baht.

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 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.*

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.

Conclusion II

- Rules of fiscal sustainability must be strictly obeyed.
- Tax instruments have become an important stabilizing tools, while public spending did not exhibit counter-cyclical response (This is bad).
- 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.

Concluding remarks

- A sharp fiscal contraction is likely to lead to a recession or decreasing the growth rate.
- **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 its 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?