Fiscal Policy for Growth and Stability

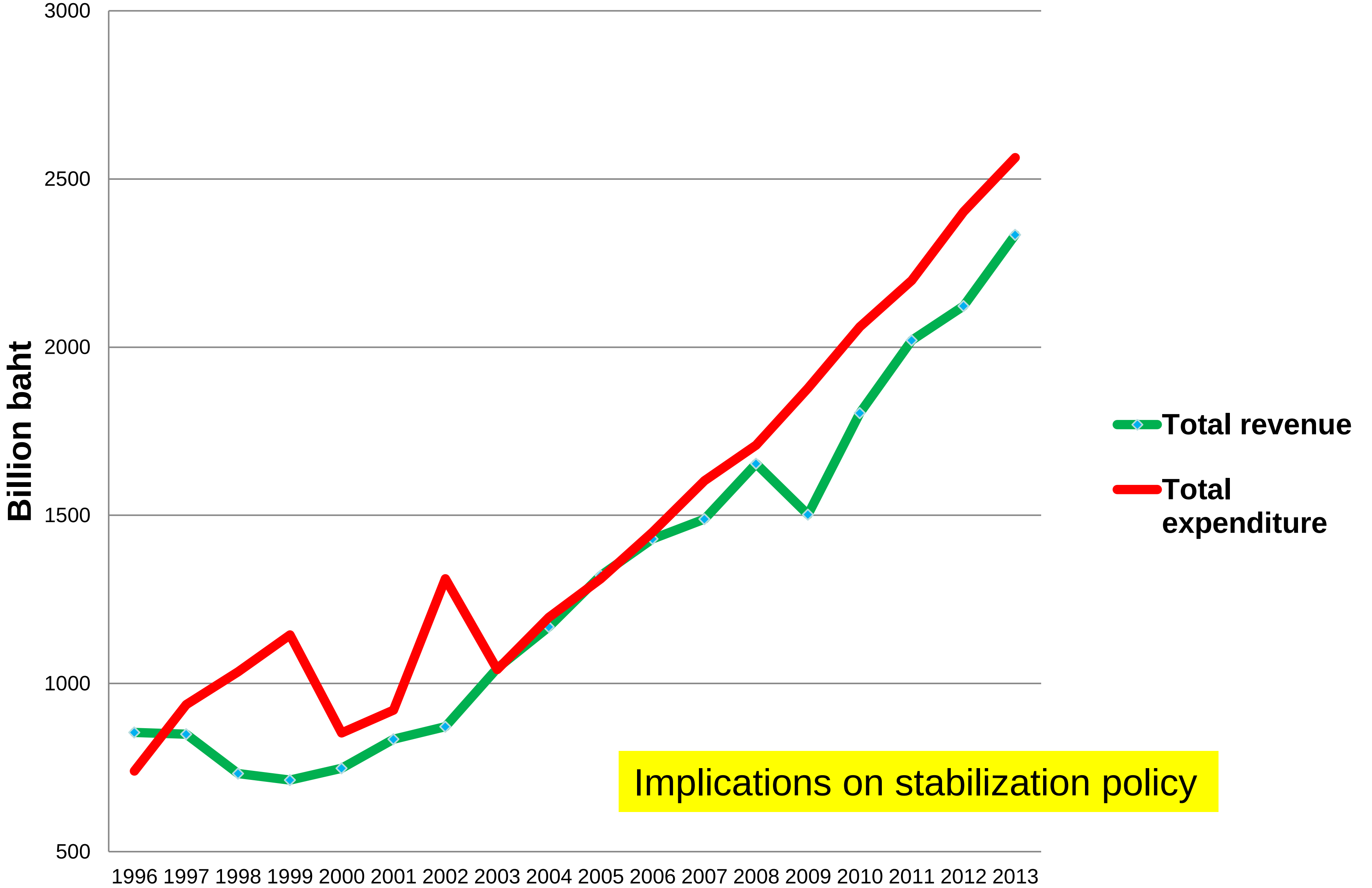
Bhanupong

Lecture 25

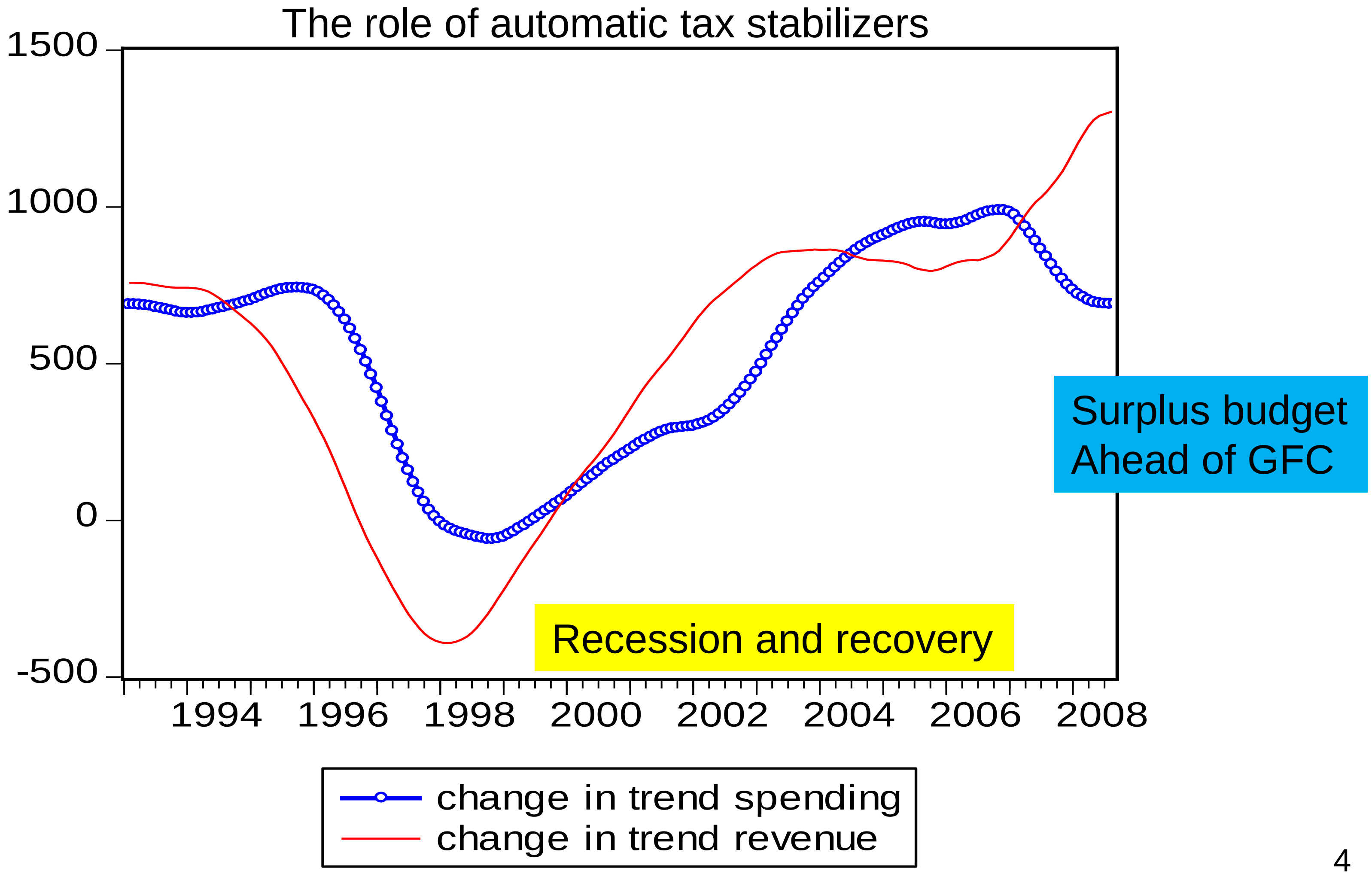
Outline

- **Fiscal stimulus and recession**
- **Spending and taxation: long-term relationship**
- **Rules for fiscal sustainability**
- **Automatic fiscal stabilizers**
- **Fiscal policy and economic growth**

Central Government Finance



Fiscal stance shown by structural budget deficit

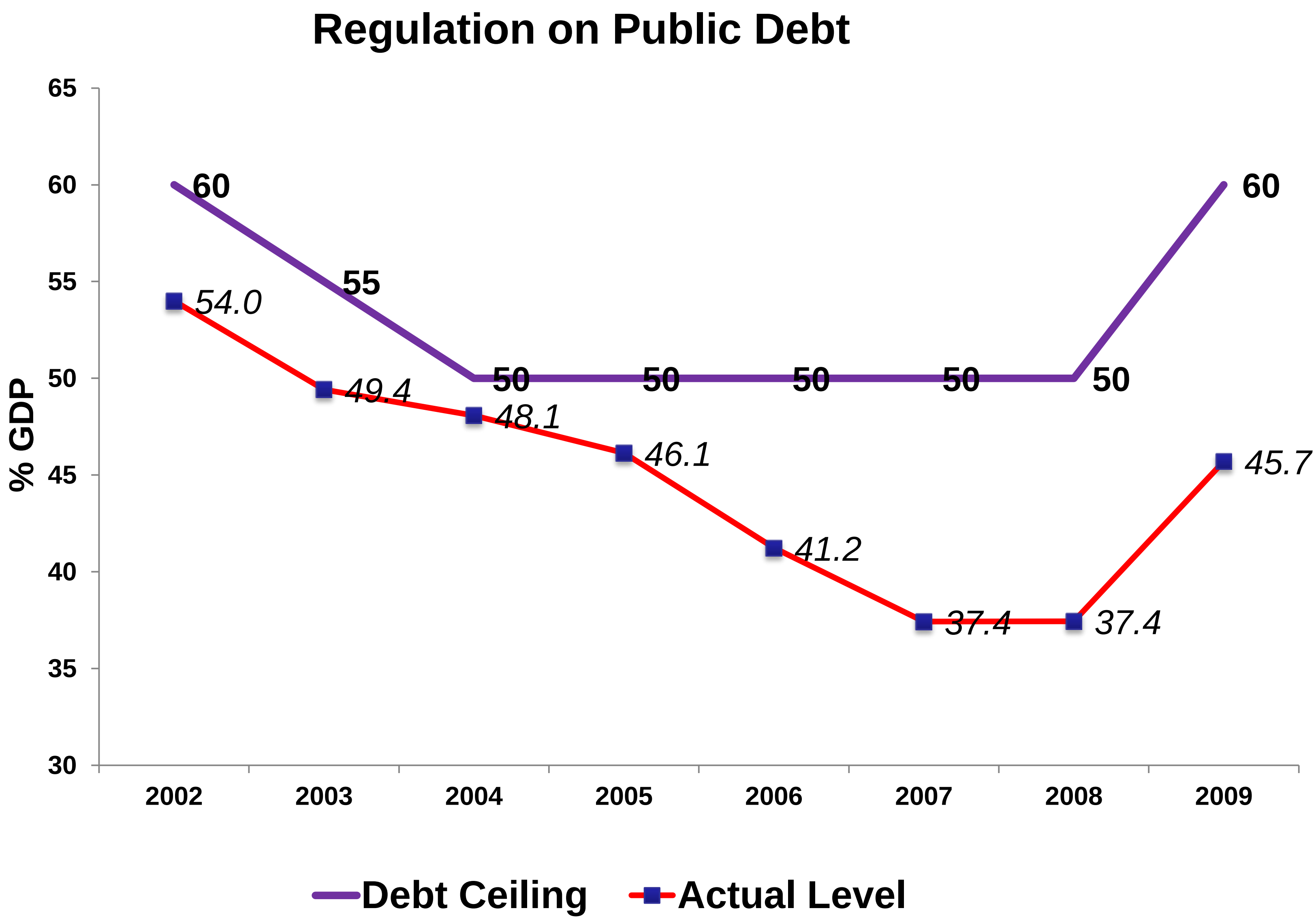


Growth and Budget deficit

- 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.

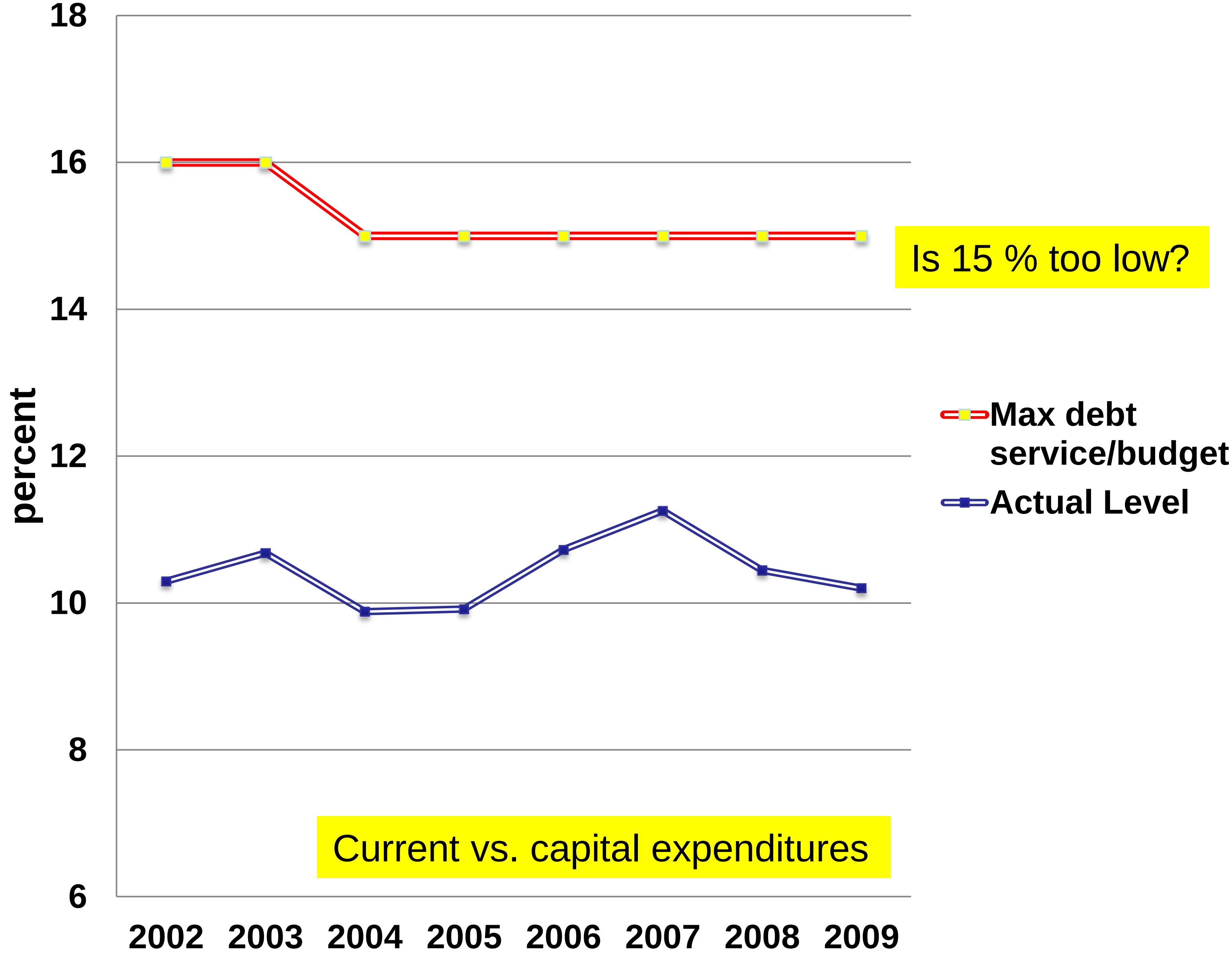
Thailand's rules of fiscal sustainability

- Size of public debt (below 60% of GDP)
- Size of debt service (below 15% of total budget)
- Public capital spending (above 25% of total budget)
- Ratio of foreign debt-service to exports (Debt service ratio below 10%)

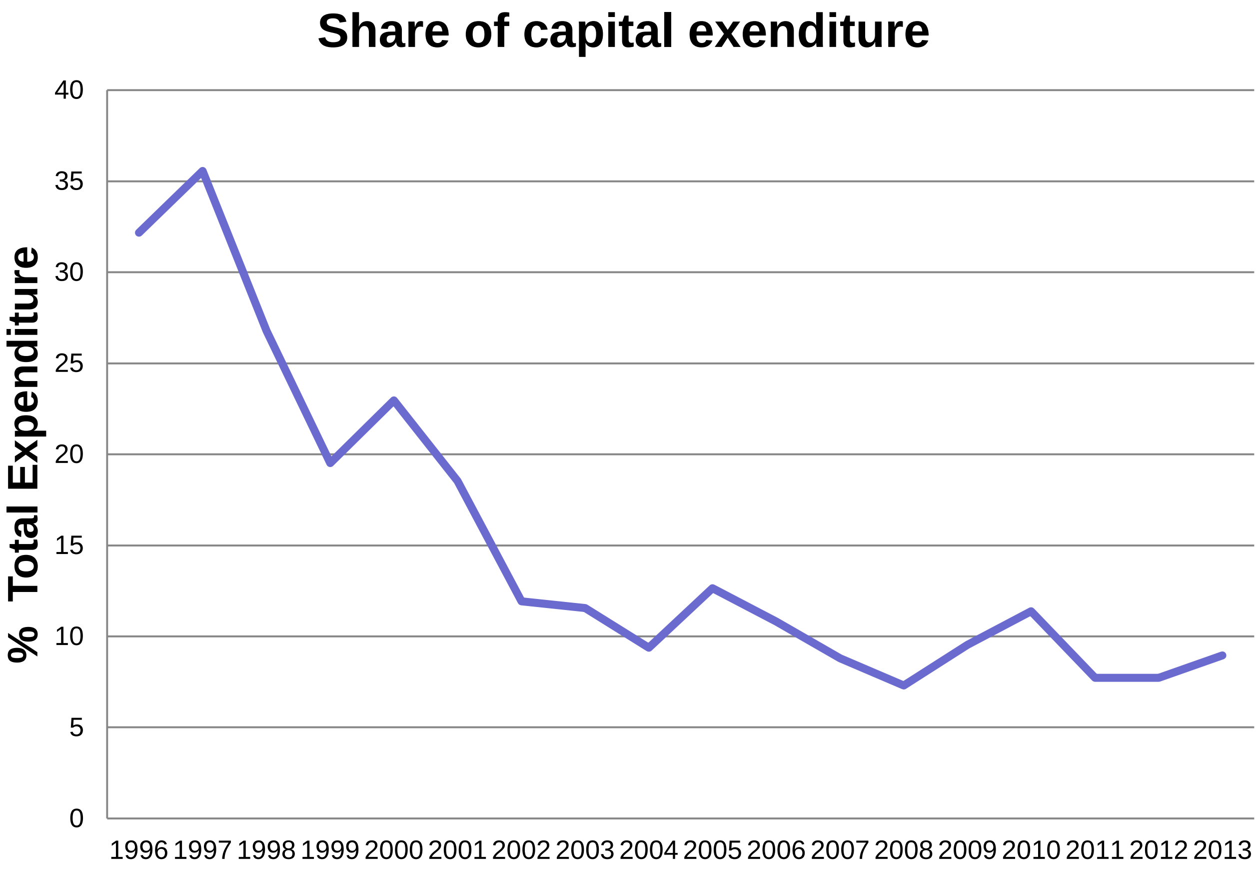


Should debt ceiling be reduced to strengthen fiscal sustainability?

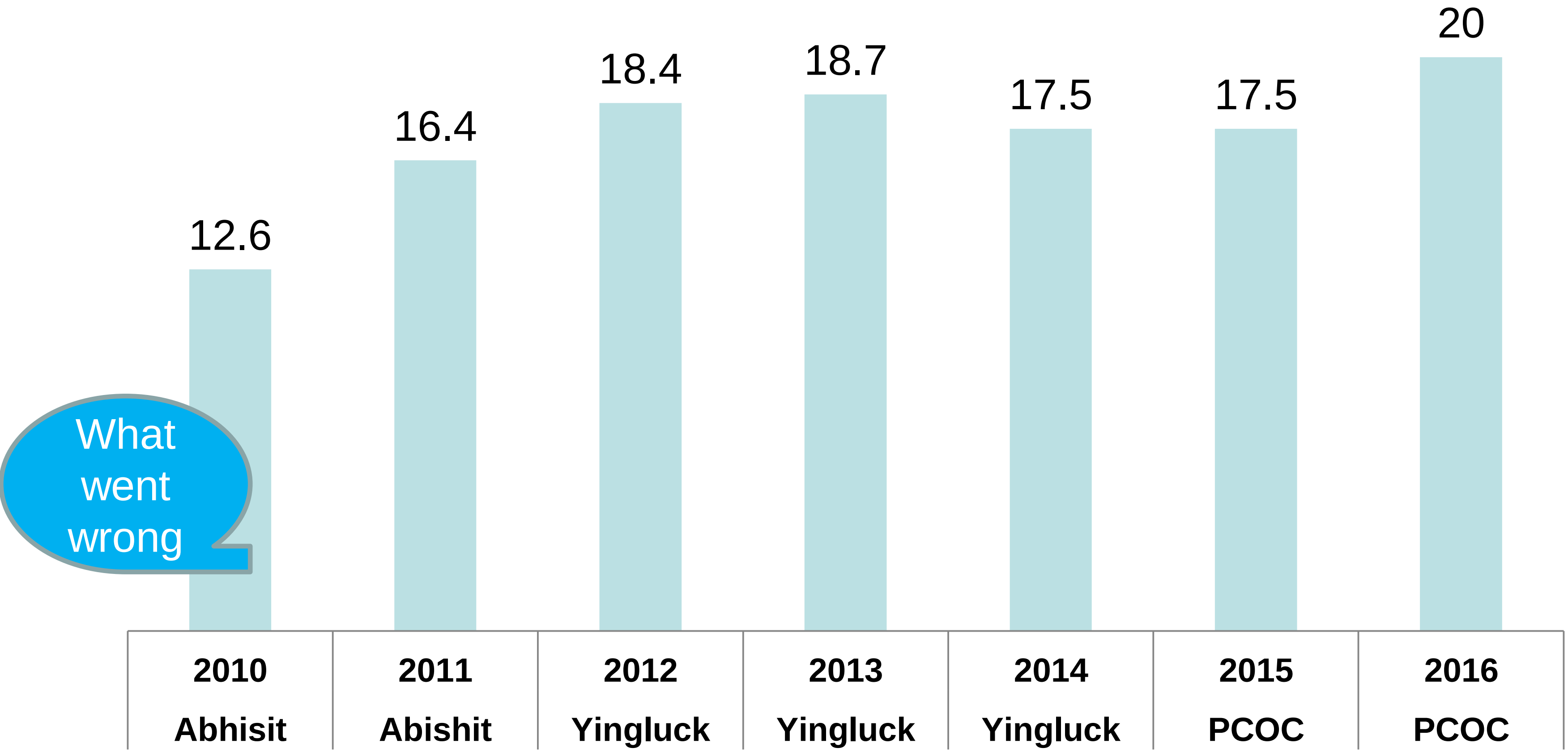
Debt Service to Total Planned Spending

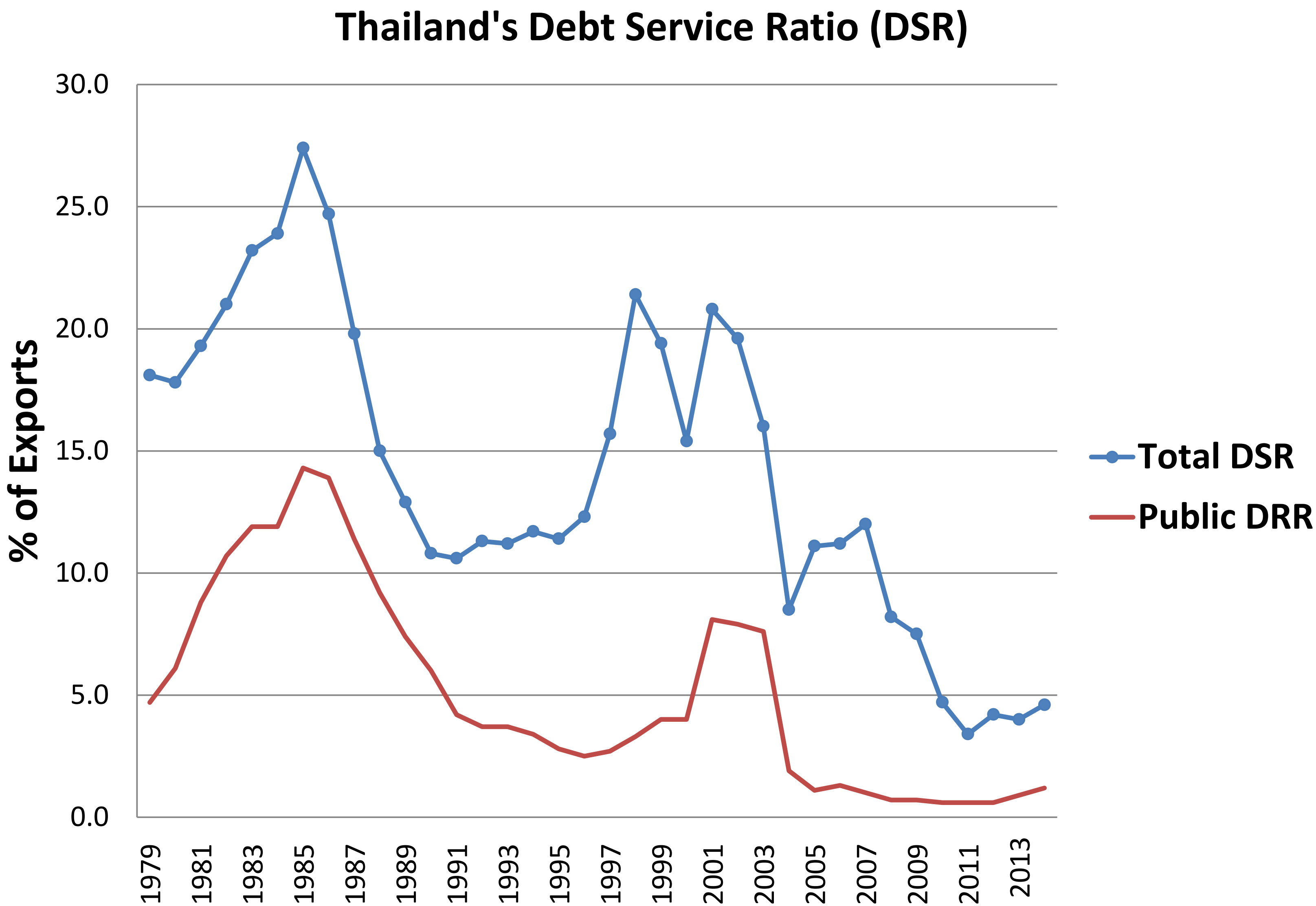


Capital spending must not fall below 25% of total budget



Share of public investment in different Administrations (% total budget)





Thailand's Debt Service Ratio (DSR)
% of Exports
30.0
25.0
20.0
15.0
10.0
5.0
0.0
1979
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
Total DSR
Public DRR

Inflation tax

- Public spending must be controlled during high inflation to avoid fueling inflationary pressure.
- Inflation can be spiraling if the government insists on maintaining the level of ***real expenditure*** during the time of high inflation.

Automatic fiscal stabilizers

- Revenue elasticity with respect to output is ***greater*** than expenditure elasticity.
- Increasing tendency for budget surplus (deficit) during booms (slump)
- The government cannot rely on inflation tax.
- There is a deep-seeded belief that public investment can contribute to growth during stagnation, particular in 2015.

A caveat after recovery

- 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.
- Nevertheless, expansionary fiscal policy employed to counteract short-term fluctuations must be withdrawn after the economy is on its recovery path.
- Free bus programs, rubber and rice subsidies

Addicted to populism

- If not, it can be a burden to the government and result in adverse impact on the economy in the long run.
- The risk and adverse consequences of withdrawal of fiscal spending consequences must be considered before implementing fiscal expansion in response to insufficient aggregate demand (exports slump and investment collapses) .

Public consumption vs. public investment

- Taxes on investment and income have a detrimental effect on growth since taxes reduce the private return to accumulation.
- **Government consumption has no permanent impact on growth** since the productivity of the private sector is unaffected. (why raise civil servant salaries when there is no productivity improvement?)
- **Public investment** has positive impact since it enhances the productivity of the private sector.

Capital vs. current spending

- **Structure** of public expenditure matters for long-term growth (C_g/ I_g).
- Rising share of current spending is detrimental to long-term growth in the long-run (slide no.9)
- How to finance capital and current spending matter
- Tax, bond, and money financing budget deficits give different expansionary impacts.

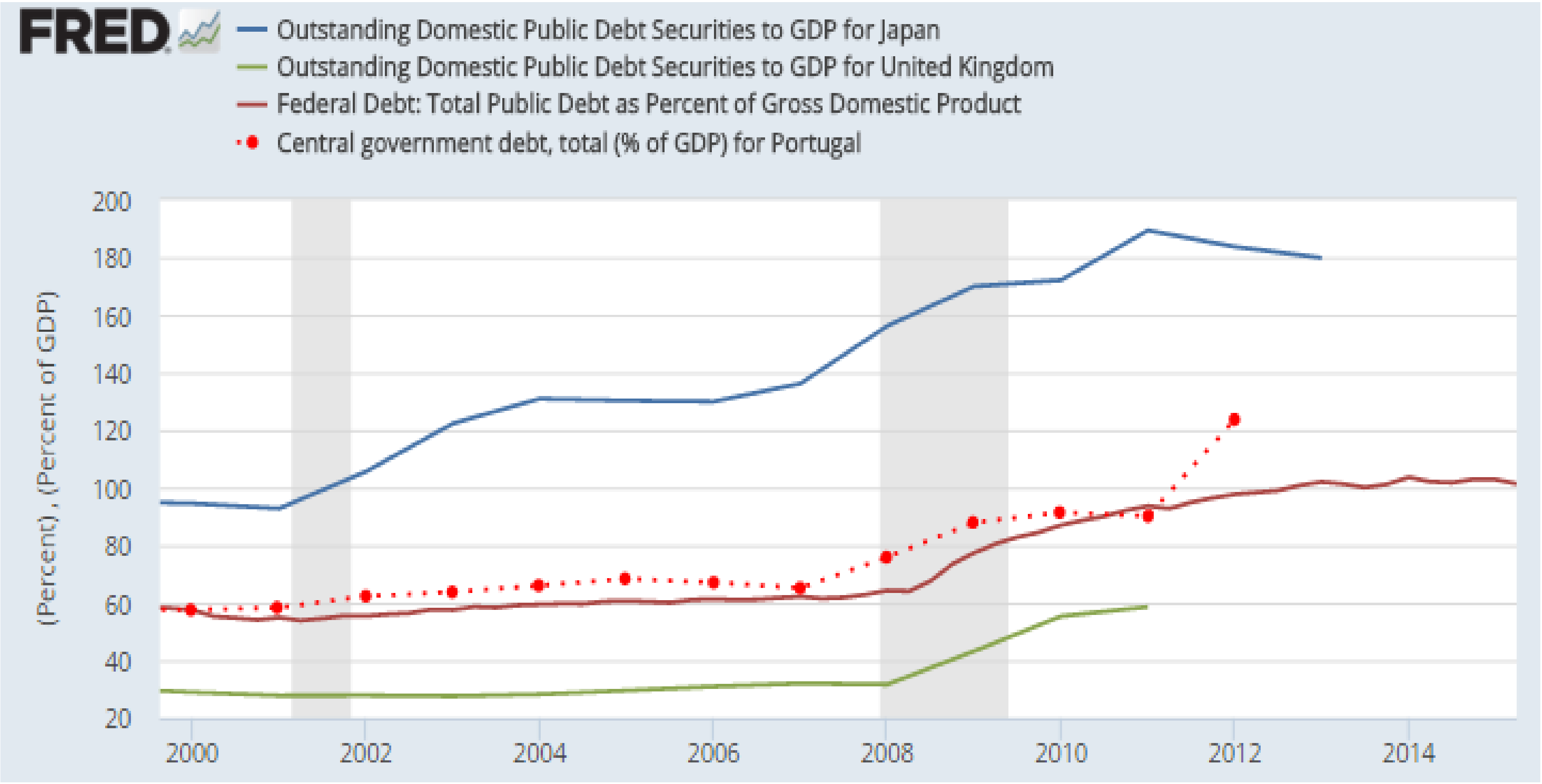
Stylized facts

- The level of development is related to fiscal structure: poor countries rely more on trade taxes, developed countries rely on income taxes.
- Fiscal policy is influenced by the size of the economy (population and GDP level).
- Investment in transport and communication is consistently correlated with growth.
- Public spending on infrastructure has supernormal returns.

Further questions

- Because the effects of taxation on growth are difficult to insolate,
- Should the government raise the value added tax rate to 10%?
- Is there any limit to government spending?
- Fiscal space is impaired by high debt-GDP ratio.
- A small fiscal space constrains the government to counteract recession by fiscal stimulus.

Time for fiscal austerity?



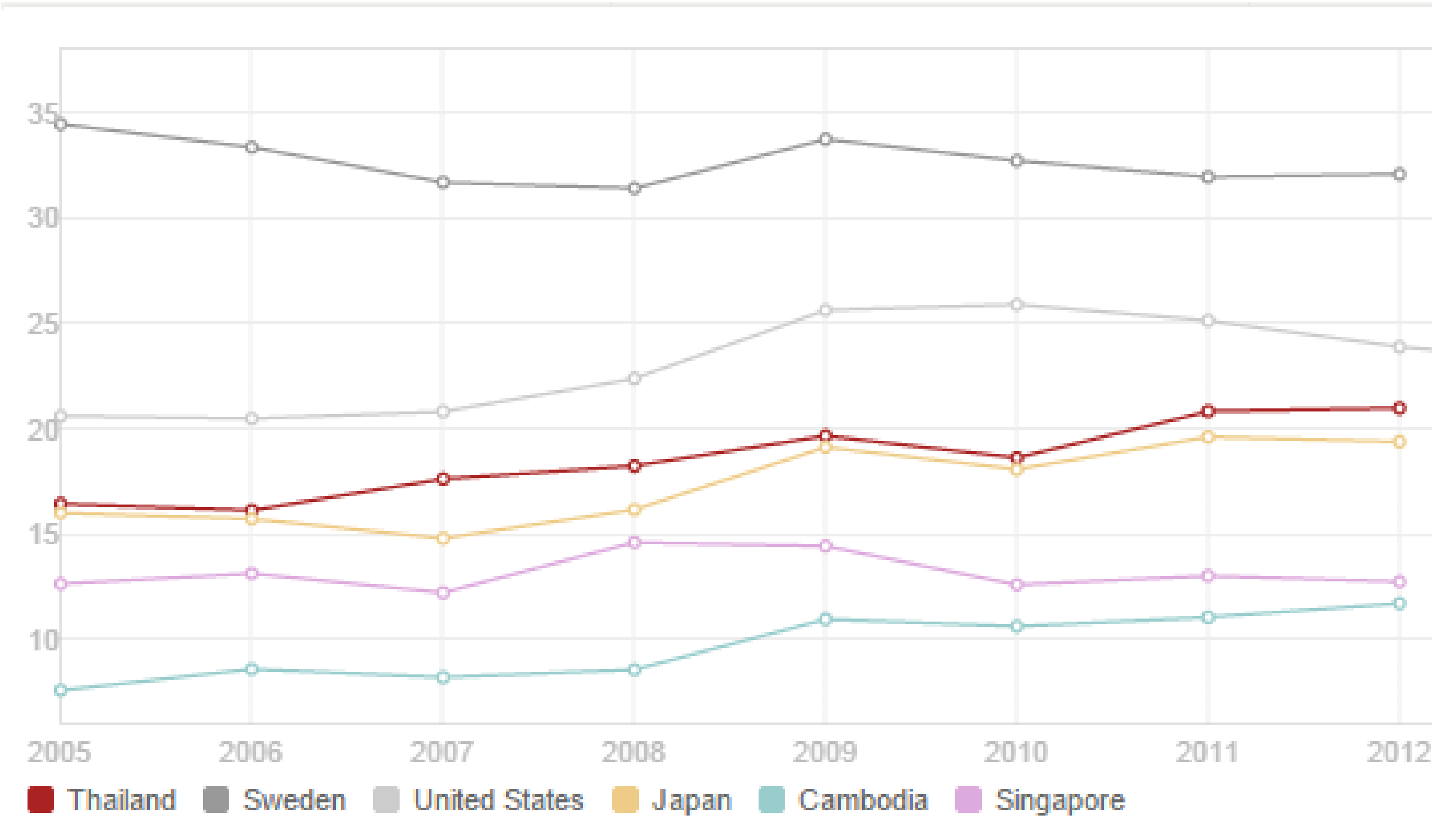
To stabilize the public debt

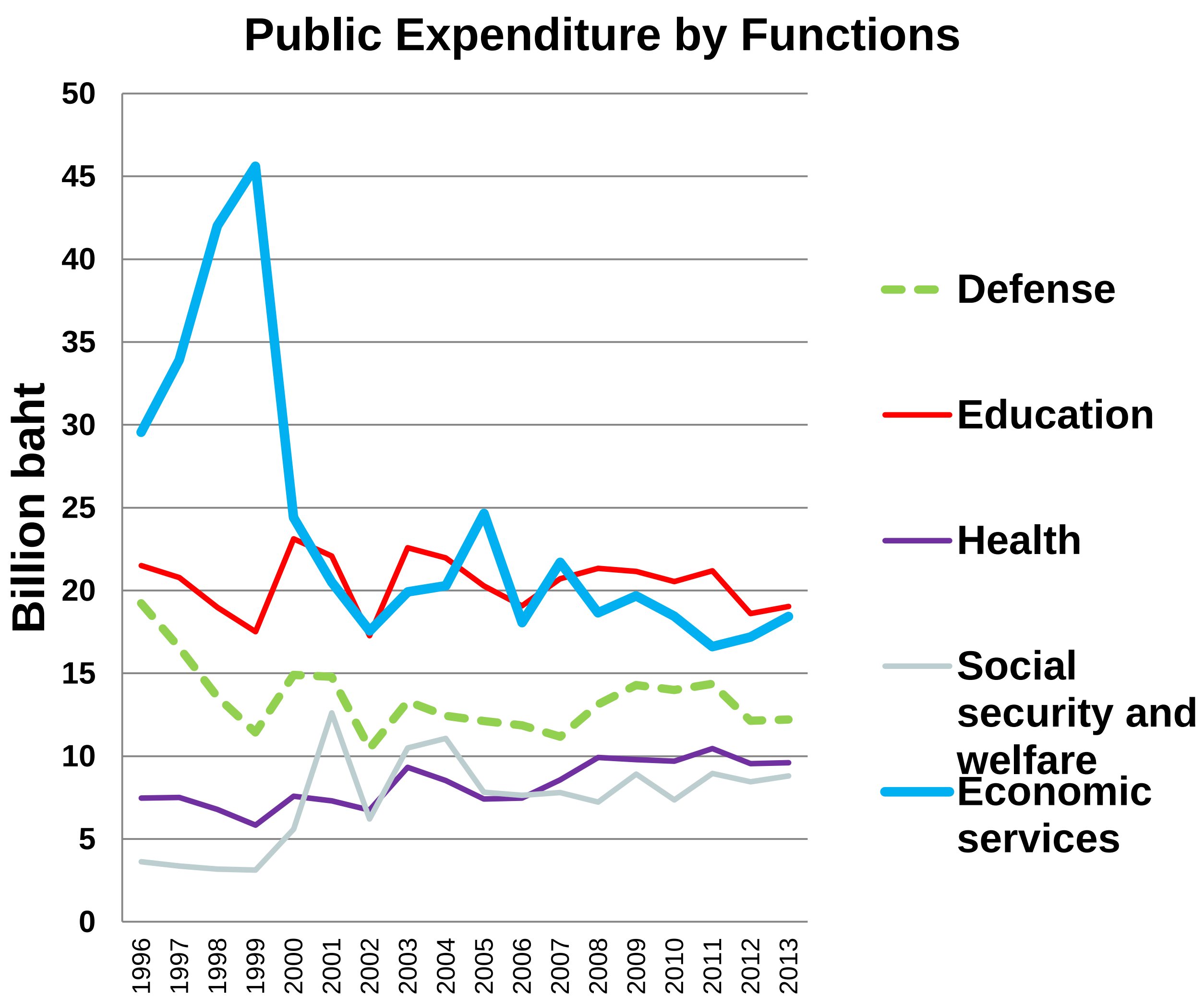
- To keep the Debt-to-GDP constant, the government must increase its primary surplus
- Growth rate must be higher than the interest rate (cost of borrowing)

To stabilize the public debt

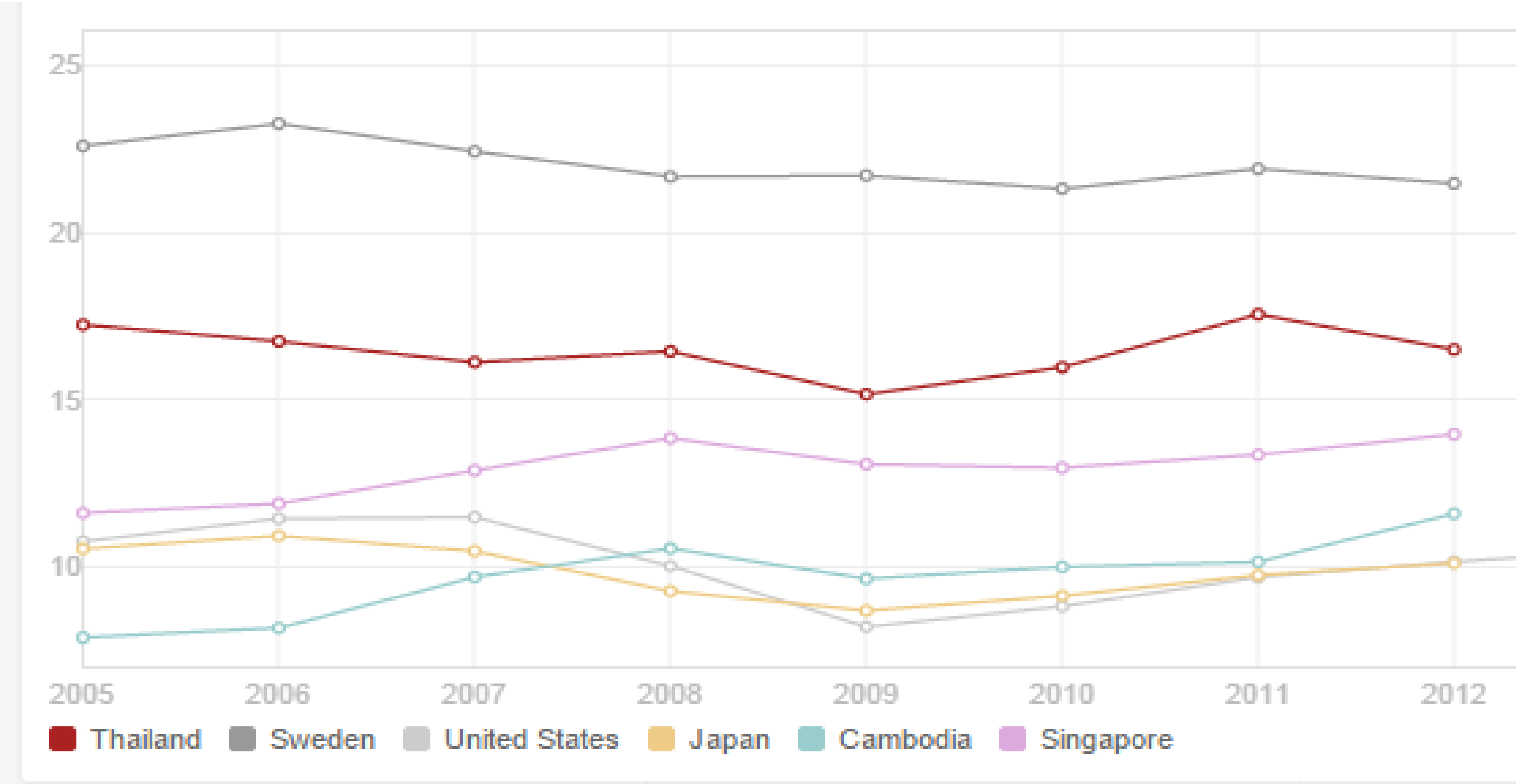
- The spending cuts or tax increases are likely to bring about political cost, generating even more political uncertainty and the need for an even higher interest rate.
- A sharp fiscal contraction is likely to lead to a recession, decreasing the growth rate.

Public expense (%GDP)

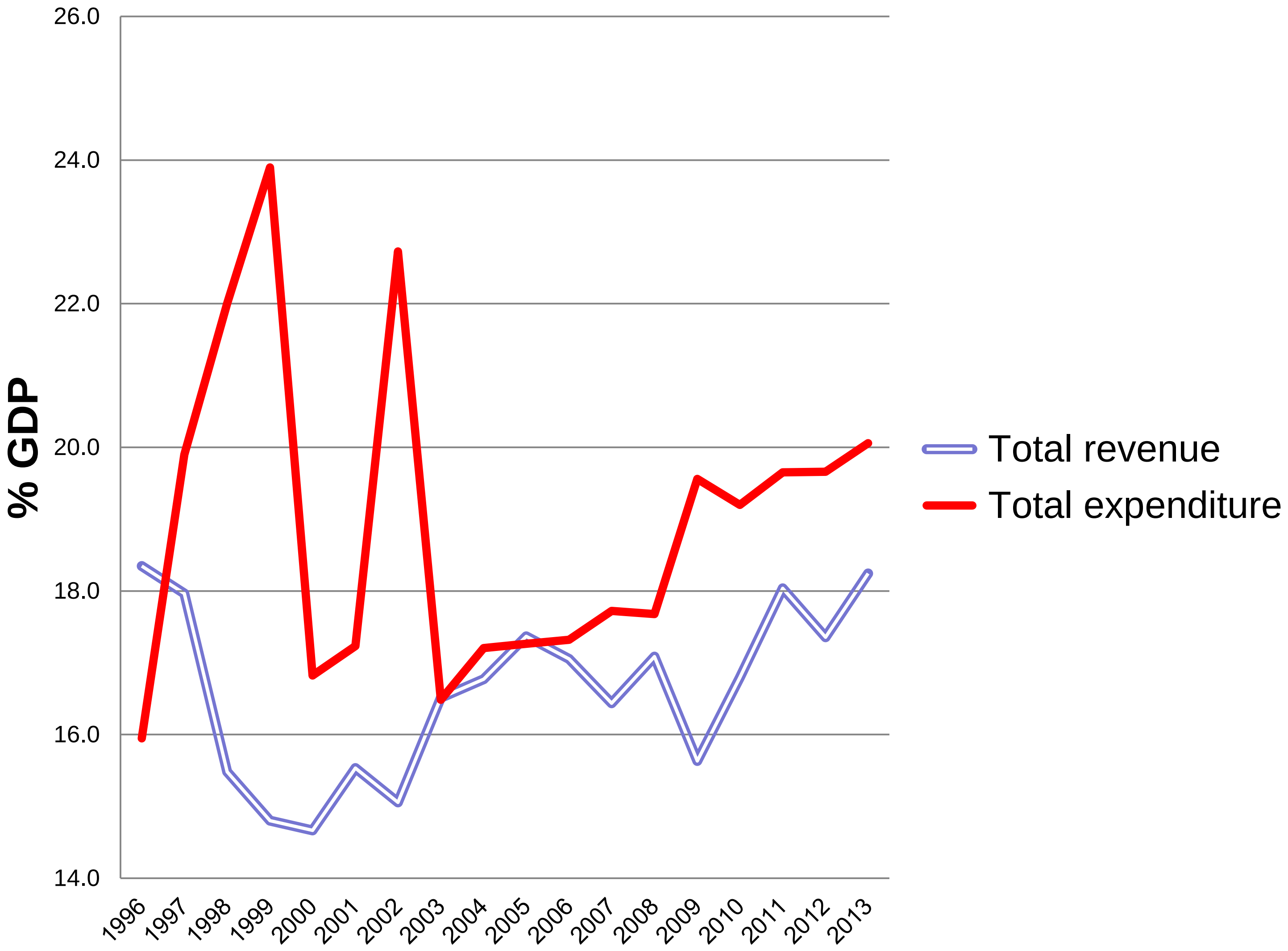



Public Expenditure by Functions
Billion baht
50
45
40
35
30
25
20
15
10
5
0
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
Defense
Education
Health
Social security and welfare
Economic services

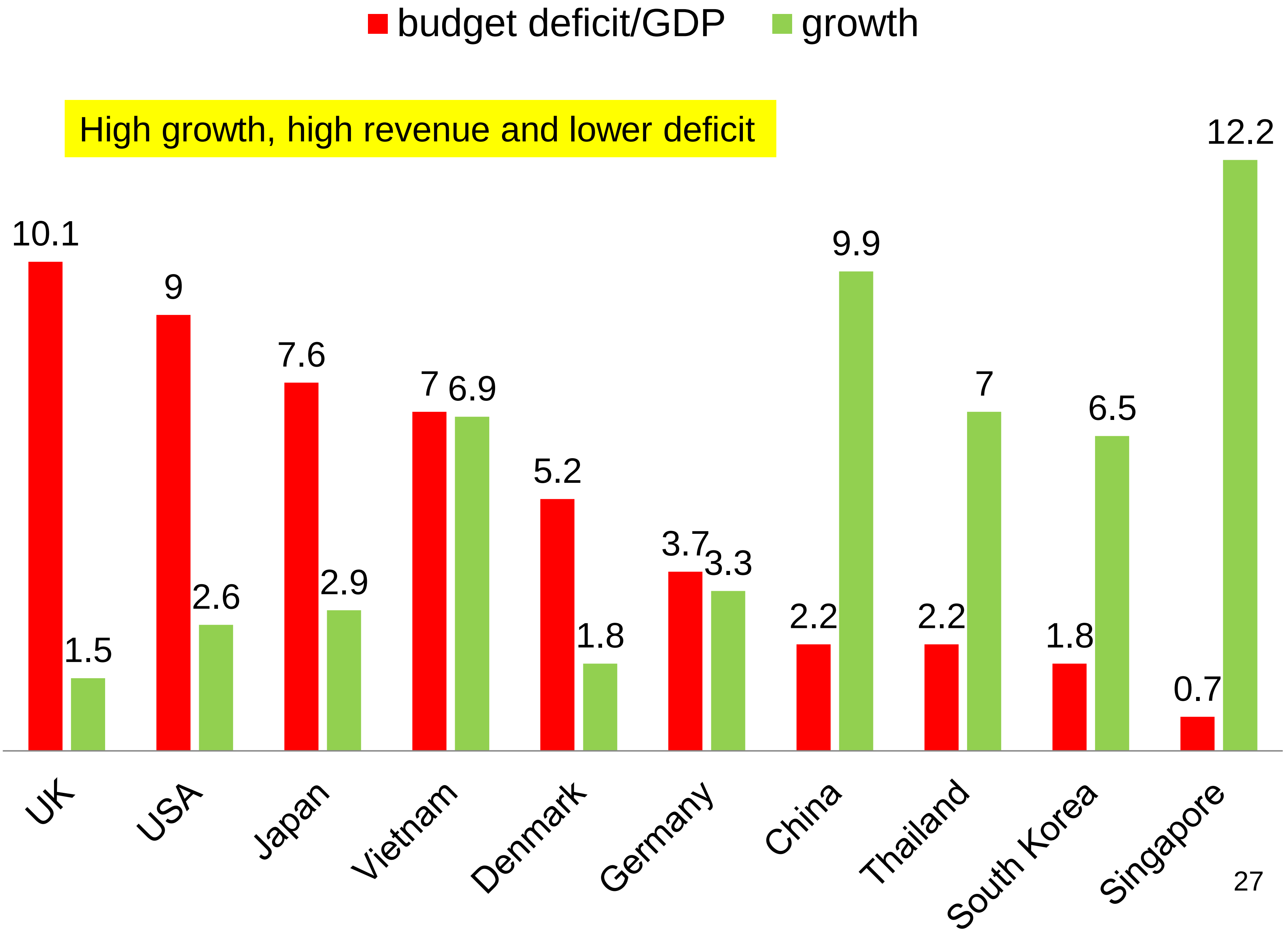
Tax revenue (% GDP)



Public Revenue and Expenditure

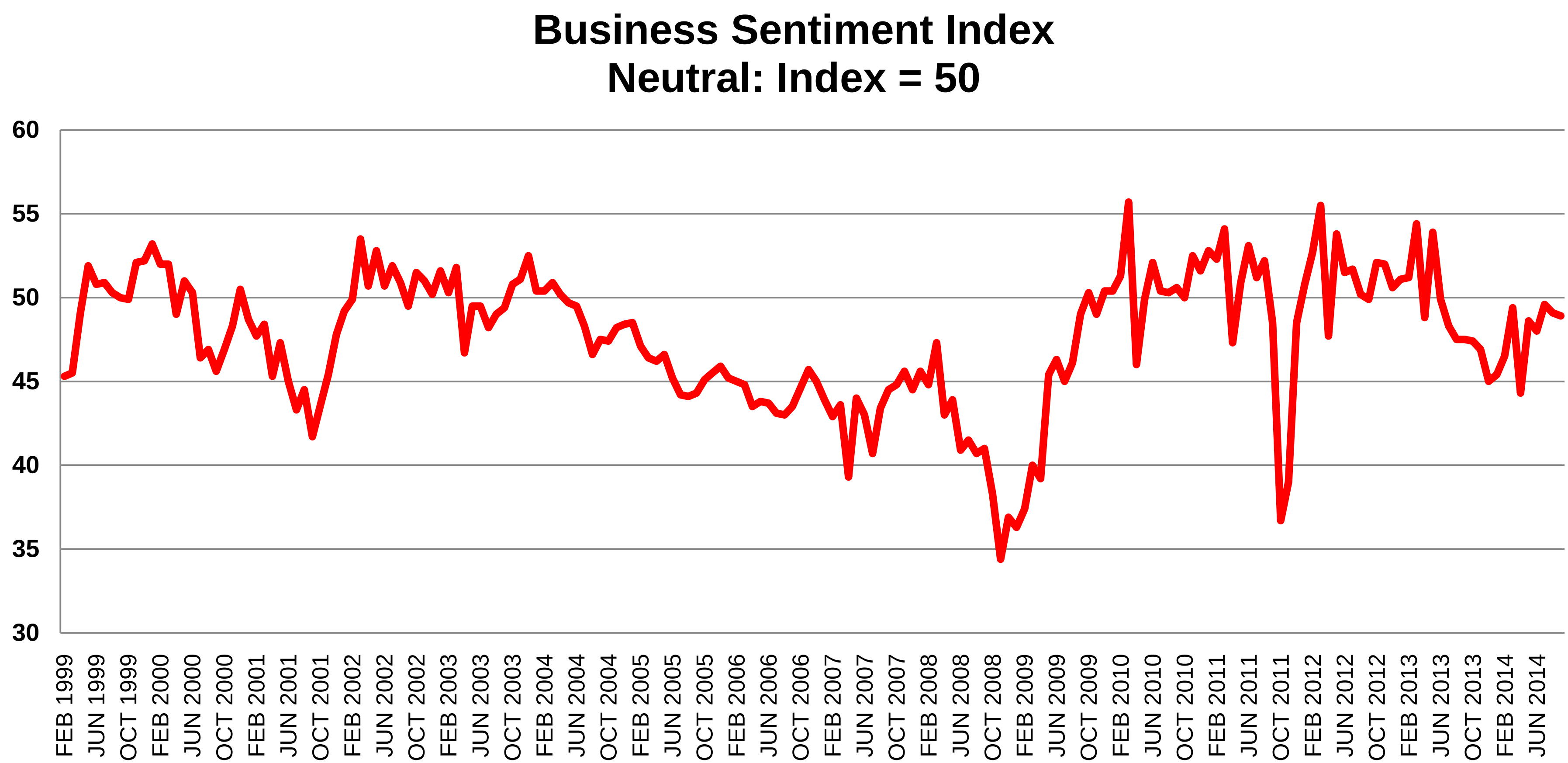


Budget deficit and GDP growth: 2010



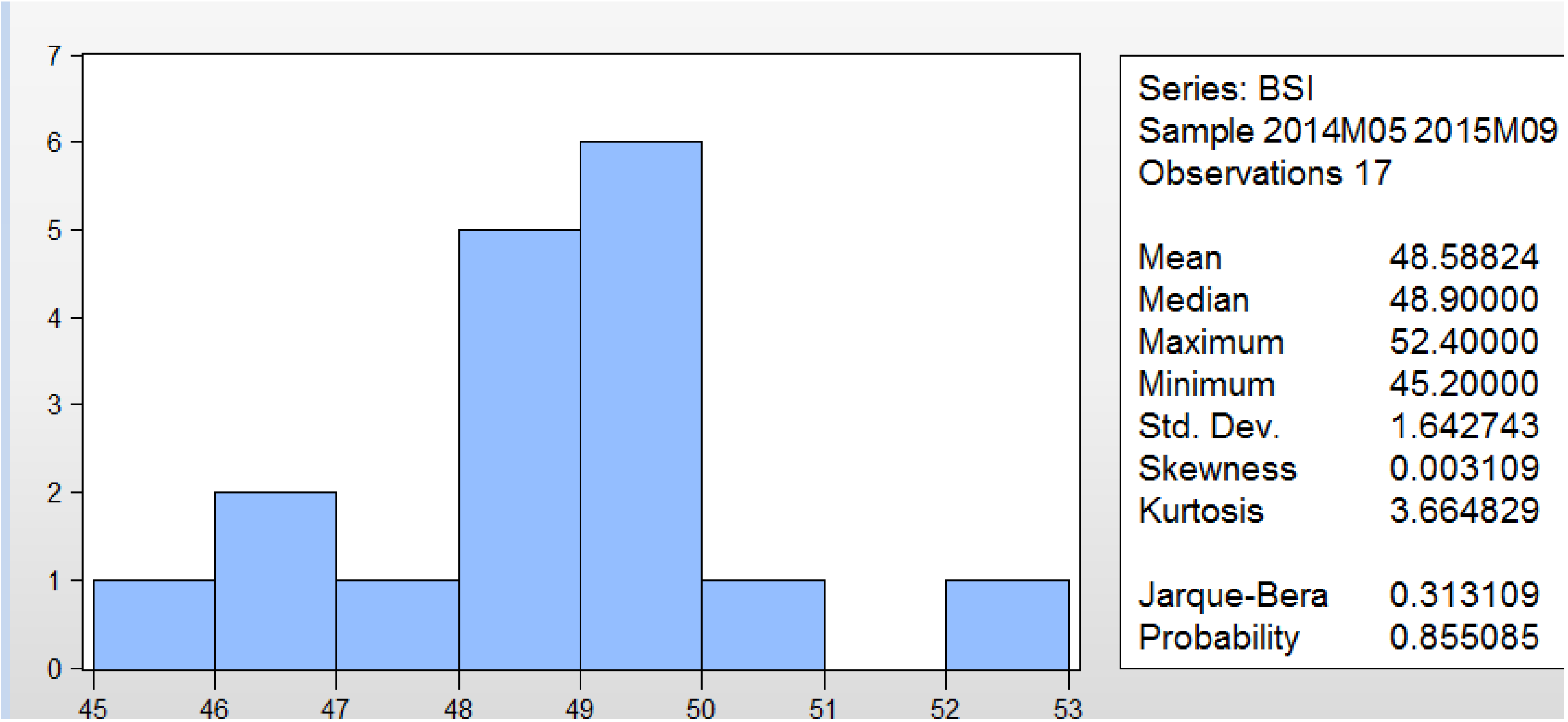
Will fiscal stimulus work?

- Fiscal policy was the only option left during uncertain time.
- Multiplier effect might be limited if the income transfer is regarded as transient.
- In a mild cycle, pessimistic expectations can turn a mild recession into a deep economic depression (JM Keynes).



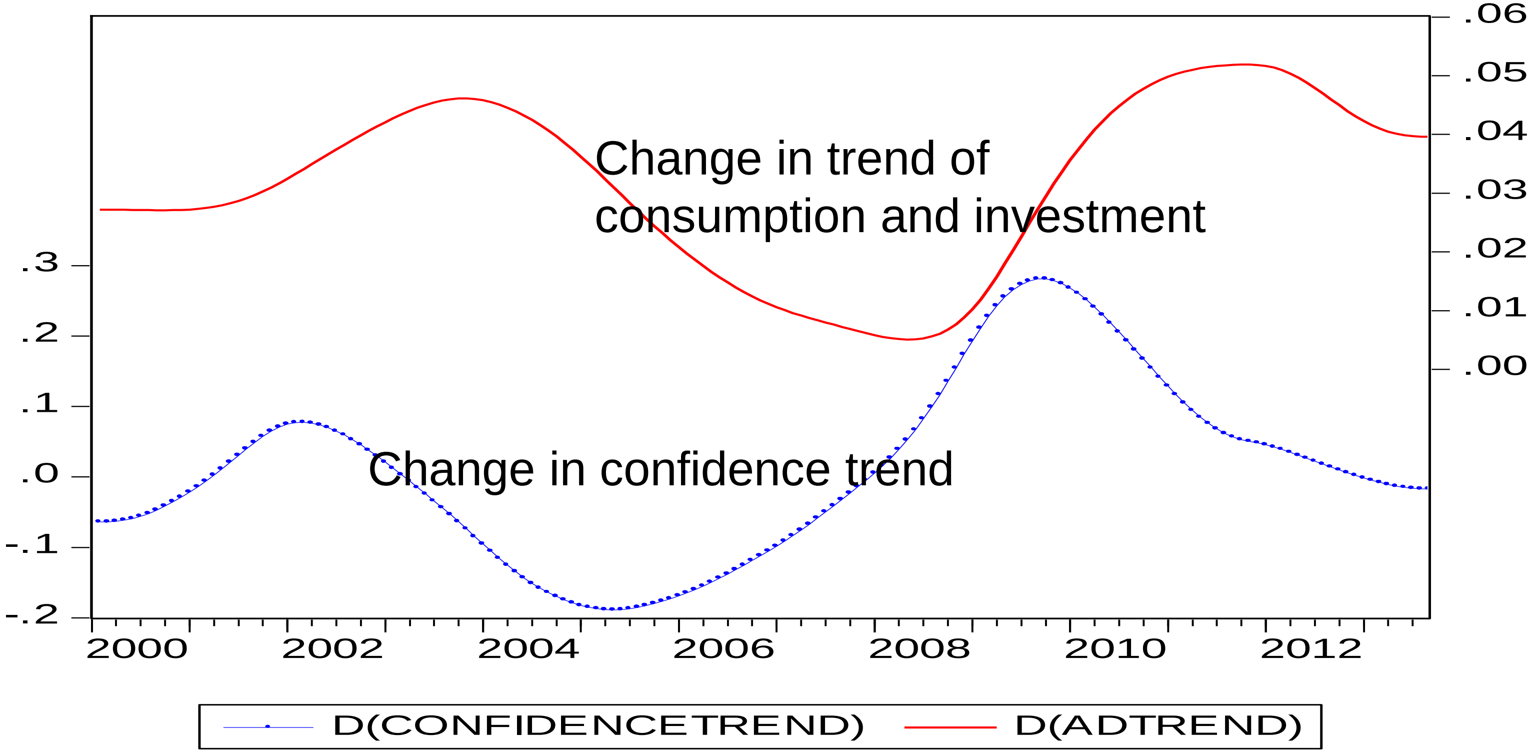
Index below 50: pessimistic

Consumer confidence and investor sentiment since May 2014



When can we observe rising consumer confidence?

Confidence and Private Aggregate Demand: lead and lag relationship



Improvement in confidence leads to higher private expenditures

Conditions for effective fiscal stimulus

- Well-timed stimulus
- Macroeconomic stability (price stability)
- Well-targeted spending to ensure the largest impact on private spending.
- Pervasive liquidity constraints (fiscal policy can unleash pent-up demand)

Those Thais who pay income taxes

- 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.

Tax Reform

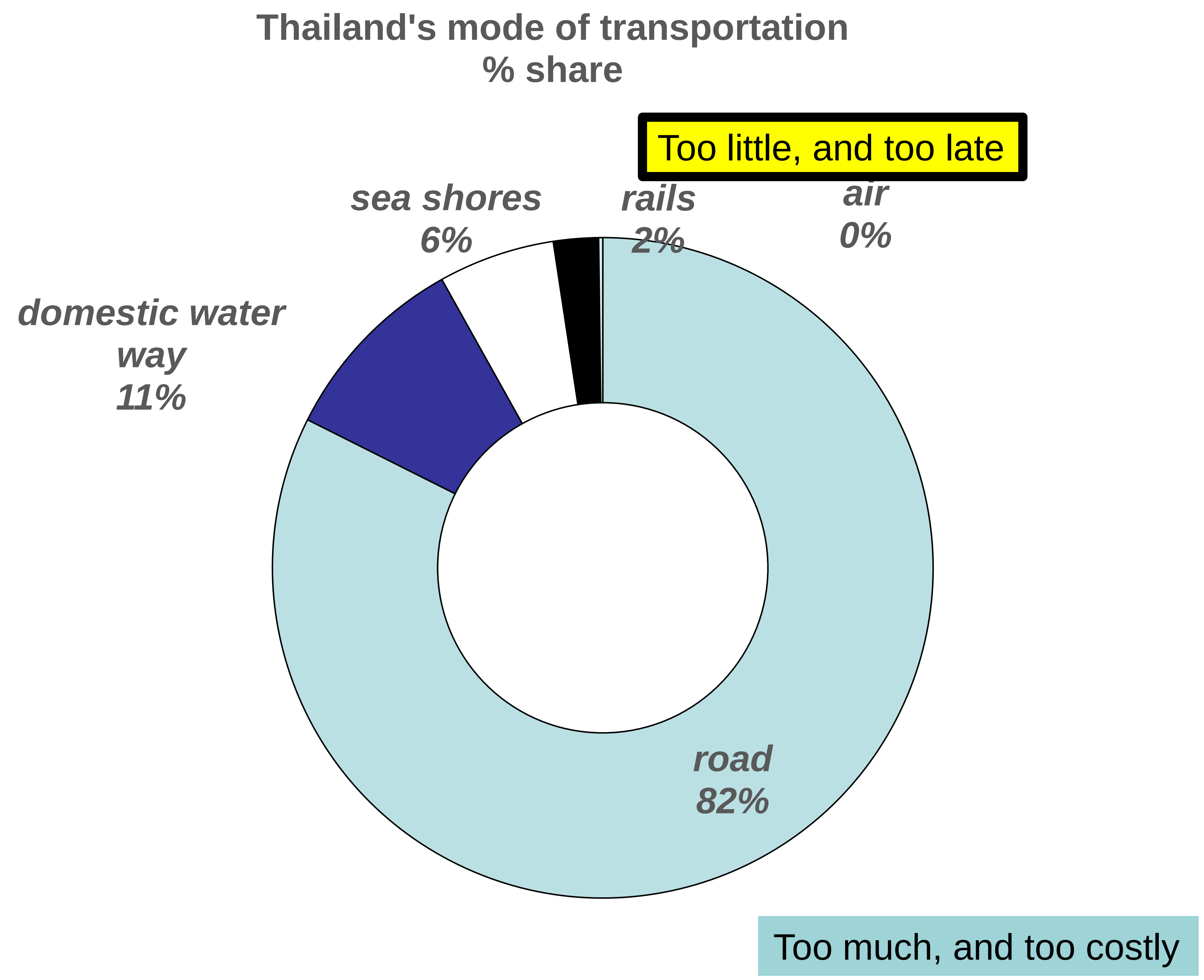
- Among 30 million labor force, only 11 million people file income tax.
- And there are only 400, 000 people whose income is high enough to pay taxes.
- E-payments, even for 20 baht purchase, (Swedish Model) can prevent tax avoidance and evasion and raise tax revenue by 100 billion baht a year (tax reform in the pipeline)

Fiscal space

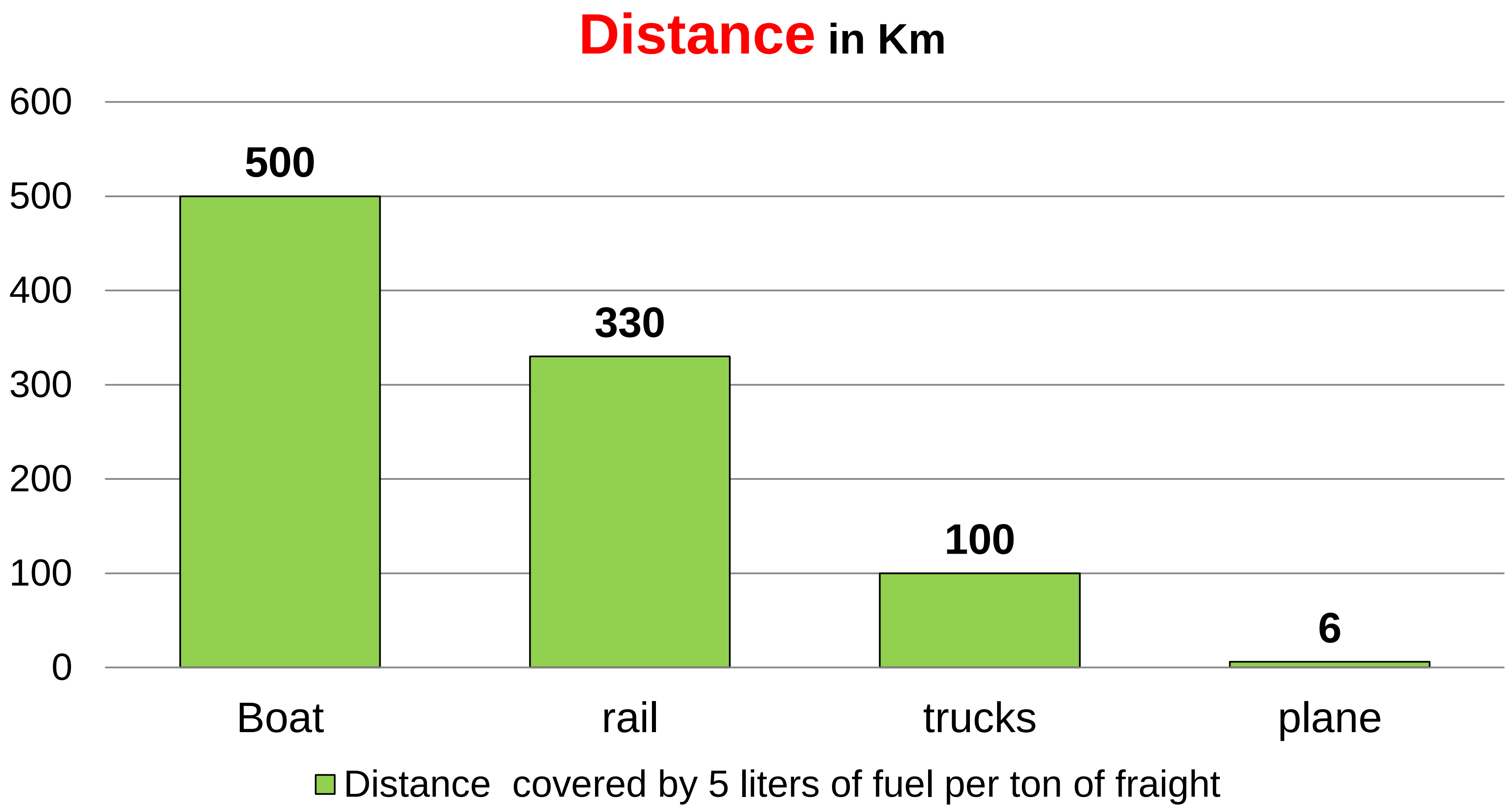
- Thailand’s fiscal policy was conservative because spending was constrained by tax capacity (low household income, low tax revenue).
- The conservative policy has been very costly to Thailand in terms of missed opportunity.
- The reason behind this fiscal prudence is related to conservative budgetary laws.
- **When Debt-to-GDP is low, it provides fiscal space for the government to counteract the external shocks.**

Fiscal strategies for long-term growth

- Role of automatic stabilizers cannot be underestimated
- Contemporaneous tax finances only current expenditure, while capital expenditure can be financed by issuing government bonds
- Marginal Cost and Marginal Benefit principle must be applied to high speed trains mega projects in 2016.


Thaiand's mode of transportation
% share
Too little, and too late
sea shores
6%
rails
2%
air
0%
domestic water
way
11%
road
82%
Too much, and too costly

Efficiency of different transportation modes



Supporting evidence for rail mega projects

Conclusion

- 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

- 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.
- Tax-financed budget deficit is less inflationary than bond financing deficit.

Concluding remarks

- A sharp fiscal contraction is likely to lead to a recession, decreasing the growth rate.
- Private consumption and business confidence are crucial to sustainable recovery.
- Long-term growth is adversely affected by the slowdown in public investment.

Discussion questions

- In response to a triple-dip 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 the likely impacts of 3.3 trillion baht mega infrastructure spending programs on output, price levels and current account?