

Macroeconomic Policy for Emerging markets

Lessons from Thailand

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Chapter 11

Fiscal policy for long-term growth and stability

1. Introduction

Most Asian countries which suffered from the global financial crisis between 2007 and 2009 employed expansionary fiscal policy to counteract the shortfall in exports. Thailand's exports continued increasing in 2008 despite the impact of the global economic slowdown that began in 2007. The temporary commodity boom and the food price crisis gave rise to such impressive performance of Thai exports in 2008. From 2000 to 2008, there was an increasing trend in Thailand's exports. However, when the global financial crisis finally hit the Thai economy, exports declined sharply in 2009. It was also the period when domestic investment and consumer spending were subdued. Thus, the contraction of external and internal demand reduced real GDP growth to 2.3 % in 2009, the lowest growth rate since the massive output contraction of 10 % in the aftermath of the Asian Financial Crisis (AFC). The 1998 recession was short-lived, despite the massive destroyed value of financial assets during the meltdown of financial institutions. It was the rapid growth exports caused by currency depreciation that restored growth. Since the AFC did not spread to the rest of the world, Thailand was able to export its way out of recession through currency devaluation.

However, the global economic environment was different in 2009, when developed economies cut down imports from Asia, as households in high-income countries were trying to restore wealth by raising saving and subsequently reducing imports. Furthermore, appreciation of the baht caused by quantitative easing in the US made it difficult for Thai exporters to reap the benefit they used to obtain in the aftermath of the AFC. During the 2009 Global Financial Crisis episode, many Asian scholars started questioning traditional Asian model of export-led growth, arguing that Asian countries should depend less on exports and pay more attention to the role of domestic demand to minimize impacts of world business cycle. Monetary policy can be conducted through changing the domestic interest rate, but it

has to concern with impact on capital flows and exchange rates, which is why fiscal policy is called upon during the period of sluggish demand growth. In developing countries where monetary policy instruments have some limitations, fiscal stimulus is the only policy measure available to compensate declining export demand.

2. Fiscal stance and macroeconomic variables

Whether the size of the budget deficit or surplus differs from the planned level depends mainly on how the budget interacts with output and the price level. If the planned budget surplus causes output contraction, the actual size of the surplus budget can differ significantly from the planned level. High inflation may lead to a burgeoning budget deficit if the government insists on maintaining the level of real public spending. Thus, macroeconomic variables such as the price and output levels interact with the fiscal stance.

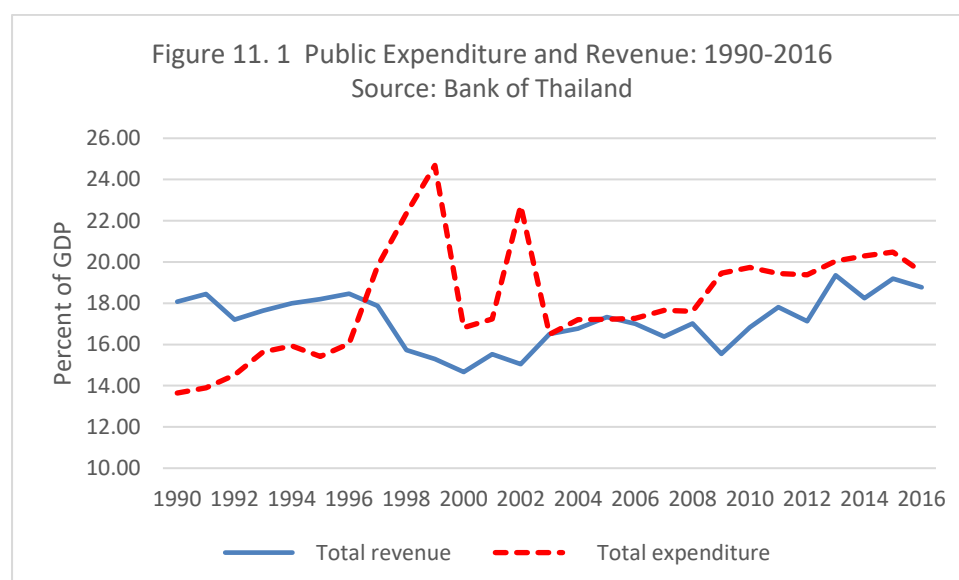
The boom in the early 1990s was followed by growth collapse after the 1997 financial crisis. It took seven years before the output regained its pre-shock growth path in 2004. Since then output had risen above the trend path until it sharply declined after the Global Financial Crisis in 2008.

The impact of the global financial crisis has previously been overestimated. The robust growth of India and China generated a strong export demand for goods from Thailand. A V-shaped recovery of exports was observed in 2010. Sustainability of export recovery depends on the strength of economic recovery in high-income countries. If developed economies experience a prolonged recession, developing countries must brace for another round of export contraction, and they must increase the volume of trade among themselves. There is a limited possibility for having a market substitution between advanced economies and emerging Asian economies because a large part of the final import demand for manufactured goods is originated from developed areas.

The role of domestic demand must be emphasized. In particular, if domestic investment and consumption are weak as a result of uncertainties and pessimism, the government must act immediately and stimulate the economy by the appropriate strength of expansionary fiscal and monetary policy. However, when the world economy recovers, public spending must return to its regular pattern observed before the global financial crisis. The collapse of exports in 2009 can be thought of as a temporary shock. The long-term output level should not be affected once exports return to its normalcy. The export shortfall in 2011 was mainly due to the supply shocks caused by floods that disrupted manufacturing production. However, in 2014 Thailand's exports grew less than one percent was the result of the global economic downturn. Because of political turmoil and the 2014 military coup, investment uncertainty and pessimistic consumers further aggravated contraction in domestic demand

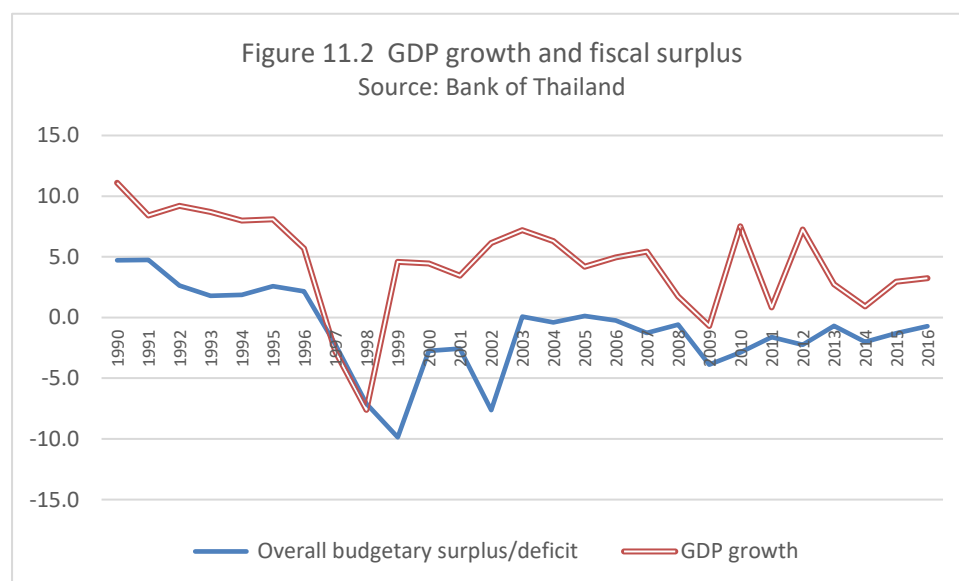
In the past decade, the Thai government did not employ fiscal policy to stabilize growth and price stability. The size of the government, measured by public spending, between 1996 and 2013, averaged 18.9 percent of GDP, while the average public revenue was 16.6 percent. During this period, the average budget deficit was 2.4 percent of GDP, which was relatively small and manageable. The size of the deficit was reduced from 4.2 percent between 1966 and 2003 to 1.3 percent on the average between 2004 and 2013.

As Figure 11.1 illustrates, the size of public spending relative to GDP increased gradually after 2006. There was no sign of countercyclical movement, unlike the period between 1996 and 2002. During this period, there was a discretionary policy applied in response to the economic recession in 1998, 2001, and 2009. In 1999, the spike in public spending in was attributed to spending on economic services. The sharp increase in 2002 was due to increases in general public services. In 2009, a defense spending hike raised public spending to 19.6 percent of GDP. It is essential to analyze what type of public spending categories gives the highest expansionary impact.



According to Afonso et al. (2010), government spending and revenue can be decomposed into three components: responsiveness, persistence, and discretion. Using data from 132 countries, they concluded that fiscal policy is more persistent than responsive to economic conditions, implying that the authorities have less leeway in the short-run to curb spending. Less discretion and responsiveness reflect weak institution capability. In the case of Thailand, the government was incapable of employing countercyclical policy measures, which have been limited by political constraints such as unstable governments and political turmoil. However, the lack of discretionary fiscal policy can be mitigated by the working of automatic fiscal stabilizers.

Thailand's fiscal balance, measured as a percent of GDP, seems to be counter-cyclical. (Figure 11.2). Public revenue might be countercyclical due to automatic tax stabilizer. The Asian Financial Crisis in 1998 and the Global Financial Crisis in 2009 resulted in growth collapses. The booms were associated with surplus budget, as tax revenue increased in line with economic activity. On the other hand, growth collapse led to a decline in tax revenue, resulting in a budget deficit.



A severe contraction in aggregate demand led to a deep recession in 1998, causing revenue reduction and subsequent budget deficit. Similarly, in 2009, a mild recession resulted in an increased budget deficit, which is a stabilizing feature of countercyclical fiscal policy. With growth acceleration, budget deficit tends to decline.

Hernandez and Moral-Benito (2013) argued that successful fiscal consolidation to reduce budget deficits and public debt requires growth-enhancing policies and cuts in public wages. If the government raises public wages in line with rising price level, it will be difficult to curb the budget deficit. It is not surprising to find that government spending rises as a result of rising price levels. In general, price stability is not a significant threat to the Thai economy, where inflation from 1977 to 2017 average 4.2 percent, reaching an all-time high of 24.6 percent in June of 1980 and a record low of -4.38 percent in July of 2009. Inflation exerts its impact on public revenues and expenditures. Excluding years of unusually high inflation, budget balance seems to move in line with inflation.

From 1990 to 2012, fiscal surplus is negatively related to current account surplus. Current account deficit brings in more customs revenues as imports increase, implying that deteriorating external balance does not exacerbate fiscal position. Strong GDP growth leads to higher imports and current account deficit. As a result, high GDP growth is associated with strengthening fiscal position, with a coefficient of correlation of 0.81 in the period 1990-1999

and 0.44 in the period 2000-2012 (Table 11.1). The decline in the correlation coefficient reflects continued trade liberalization which lowered tariff rates. The inflation rate is positively related to the size of the fiscal surplus, with 0.65 value of correlation coefficient in the period 2000-2012. Inflation can lead to higher tax revenues through bracket creeps and higher corporate income tax revenues.

Table 11.1 Correlates of fiscal surplus (%GDP)			
	Growth	inflation	Current Account surplus
1990-2012	0.66	0.55	-0.83
1990-1999	0.81	0.21	-0.87
2000-2012	0.44	0.65	-0.53
2013-2016	0.88	-0.11	0.06
Source: Calculation based on data provided by the Bank of Thailand			

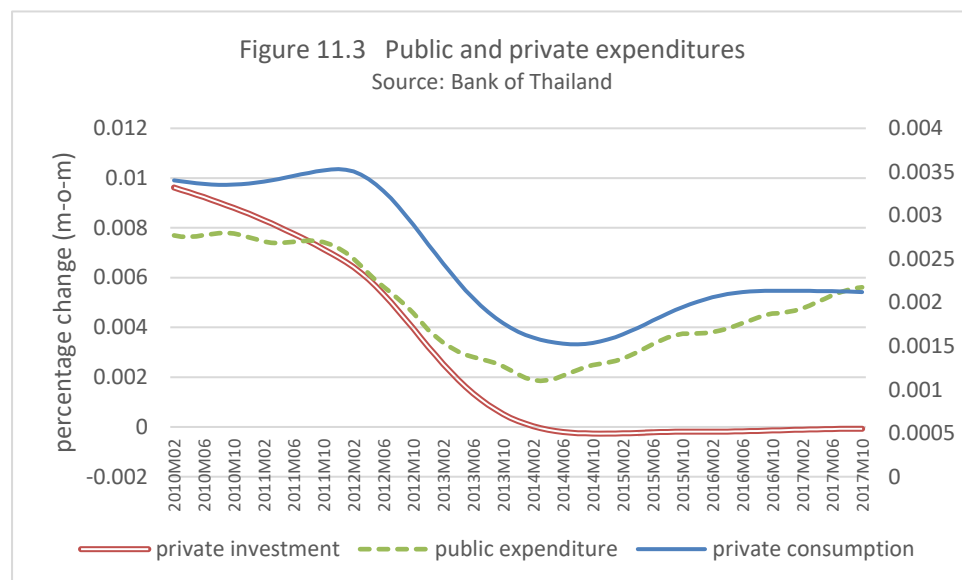
Although the correlates between fiscal surplus and output growth remain high in 2013 and 2016, the strong positive correlations between fiscal surplus and inflation rate and negative correlation with current account surplus entirely disappeared, which could be attributed to the flattening of the Philipps curve when there is a little trade-off between inflation and unemployment. China's slowdown, low global inflation, and regional trade integration are the culprit. The crucial role played by automatic stabilizer has been diminished. Before 2013, high inflation was associated with a fiscal surplus.

Similarly, the current account deficit brought high customs tax revenue, leading a negative correlation between current account deficit and fiscal position. This stabilizing feature of the interaction between fiscal policy stance and external imbalances and inflation has come to an end. The implication is that fiscal policy must be proactive. It cannot rely heavily on the built-in stabilizer as it did in the past.

3. Analysis of public spending

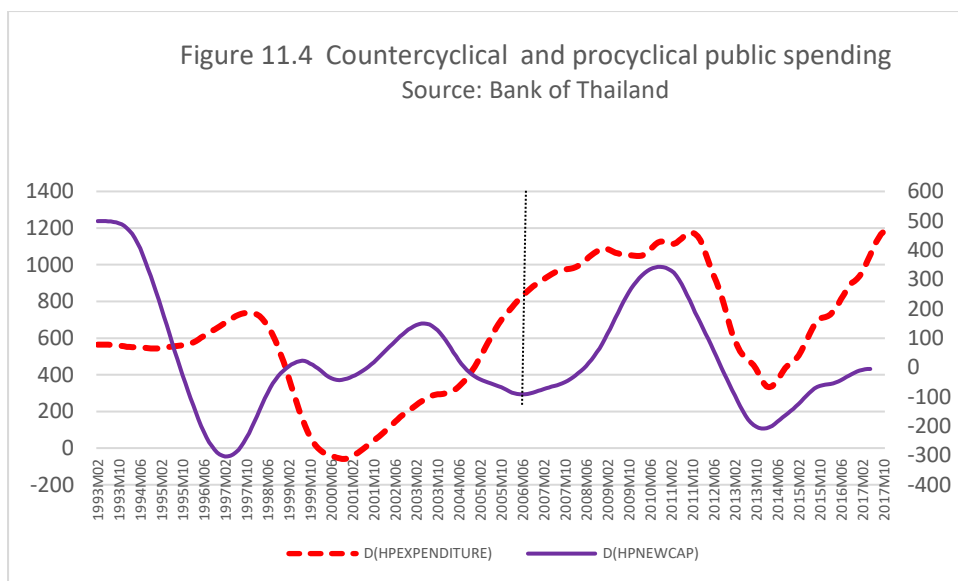
The crowding-out effect from public spending implies that the expansionary impact of fiscal spending is offset by a rise in the interest rate, which would result in a fall in private spending. If public spending is money financed, rather than bond financing, the increased public expenditure will not lead to a rise in the interest rate. The fiscal multiplier associated with higher money supply would be more significant than when the deficit budget is financed by issuing bonds. However, there can be a crowding-in effect of public spending, which is the case when public spending is complementary to private spending. For example, investment in public infrastructure encourages to the private sector to invest more because

more public infrastructure raises the expected rate of return of private investment through raising expected sales and because the new infrastructure reduces production cost in the private sector.

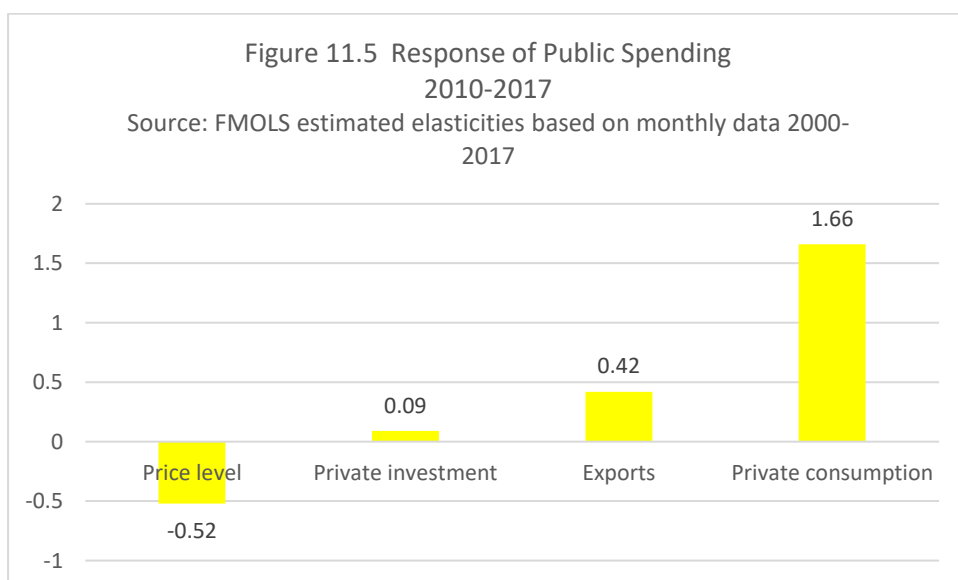


After using the HP filter to remove cyclical variations from actual values of public expenditure, private consumption, and private investment, we obtain the trend values of these magnitudes. Figure 11.3 shows month-on-month percentage changes of the trend magnitudes. From 2010 to 2017, public expenditure moved in line with private consumption. From 2010 to 2014, there was a sharp fall in private investment, which remained stagnant from 2014 to 2017. An increase in public spending did not stimulate growth in private investment and consumption. It is evident that the slowdown of Thailand's growth stemmed mostly from contraction in private investment growth.

Interestingly enough, public expenditure also moved in line with private consumption. From Figure 11.3, we cannot make any definite conclusion about the crowding out or crowding-in effect of public spending. Not until the third quarter of 2014 did the public spending started to rise. From 2011 to 2013, the Thai government was unable to use fiscal policy to offset the fall in private spending. Political unrest and unstable governments had precluded the government from effectively using fiscal expenditure to counteract the economic slowdown. Low quality of institutions in the form of ineffective government and the lack of the rule of law hampers effective stabilization policy.



There is a negative correlation between changes in public expenditure and private investment trends from 1993 to 2006. (Figure 11. 4) The amount of newly registered capital represents the investment trend. Fiscal spending increased and decreased to counteract fluctuations in private investment (as measured by the amount of newly registered capital). Nevertheless, after the 2006 coup, public spending has become procyclical rather than countercyclical. In particular, newly registered capital reached its peak in September 2011. The sharp drop in new investment was also followed by a sharp decline in public expenditures, rather than a boost in the spending which could have offset declines in economic activity.

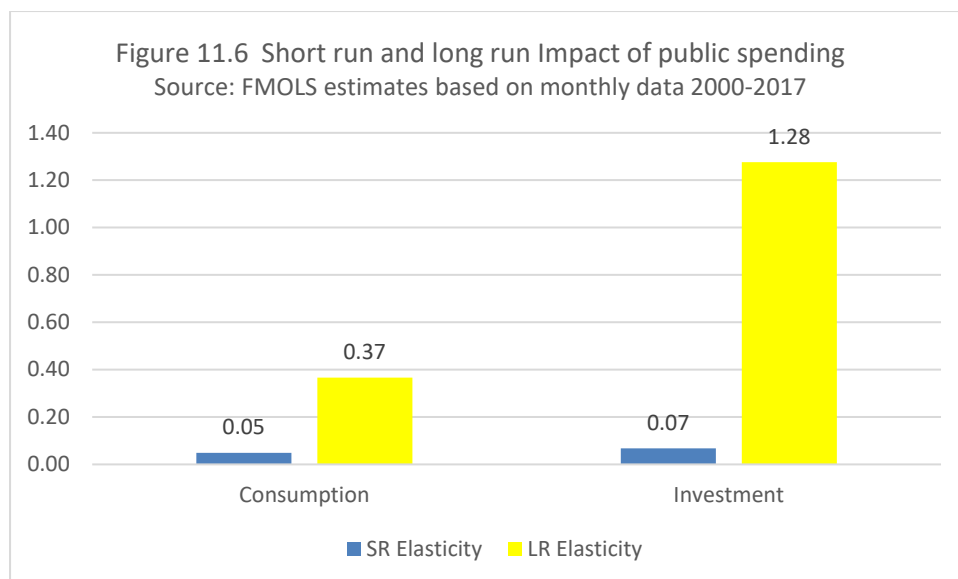


It can be seen from Figure 11.5 that between 2010 and 2017 government spending is complementary to private expenditure spending and negatively related to the price rises. Thus, public spending is procyclical. Public expenditure responds vigorously to private consumption, with an elasticity of 1.66. It can be explained by the fact that increased consumption raises tax revenue, which in turn gives rise to public revenue. The increased revenues enhance the ability of the government to spend more.

Similarly, rising exports and private investment permit the government to spend more. Nevertheless, public expenditures respond to surges in exports and private investment are not significant. The reason why private consumption produces a stronger response from the government is the fact that private consumption is the most significant component of aggregate demand. High consumption generates output expansion, which results in higher tax revenues, enabling the government to spend more. Also, a value-added tax is based on consumption expenditures. Since the consumption elasticity of public expenditure is greater than unity, a fall in private consumption also implies a fall in public spending. View in this light, fiscal expenditure can be destabilizing since public and private expenditure move up and down together over the business cycles.

When price level rises, public spending declines, which has nothing to do with the government's desire to reduce pressure on the price level. The fact that inflation reduces the purchasing power of the government, some public procurement cannot be implemented due to the high cost. Cost overrun leads to delay of public spending. The fact that public spending in real terms declines during inflation implies that there will never be inflationary pressure from government spending because the government does not try to maintain public spending in real terms.

The causation runs both ways from between public and private spending. However, the impact of public spending lasts longer due to the multiplier effect. Rather than measuring the multiplier effects on output, we examine the short run and long-run impacts of public spending on private investment and output. Figure 11.6 provides the estimated coefficients from double-log linear equations. In the short run, the impacts of public spending on private consumption and investment are small, and they are statistically different from each other (between 0.05 and 0.07). Nevertheless, the long run multiplier effect on investment (1.28) is more significant than consumption (0.07). In sum, public spending can mitigate the contractionary effect of a global slowdown.

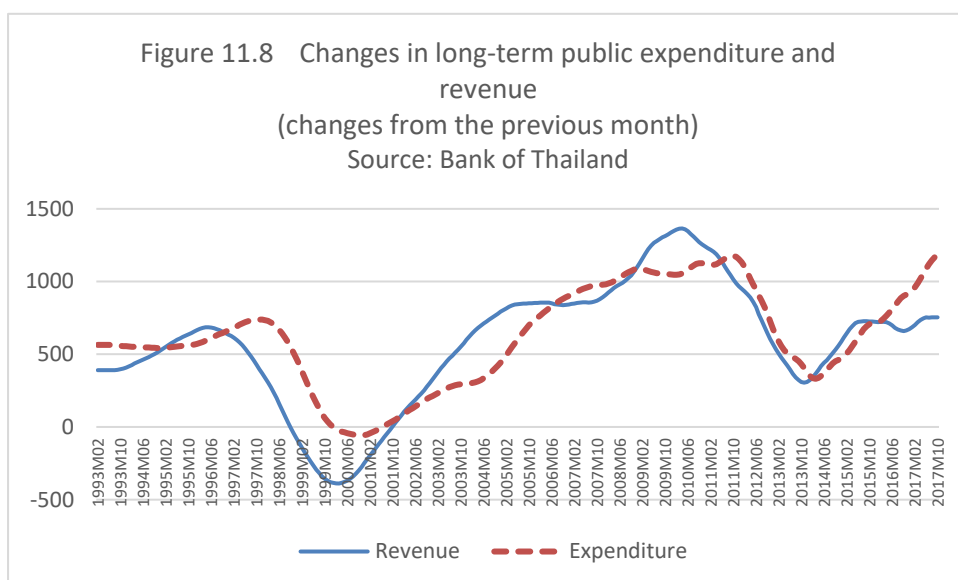
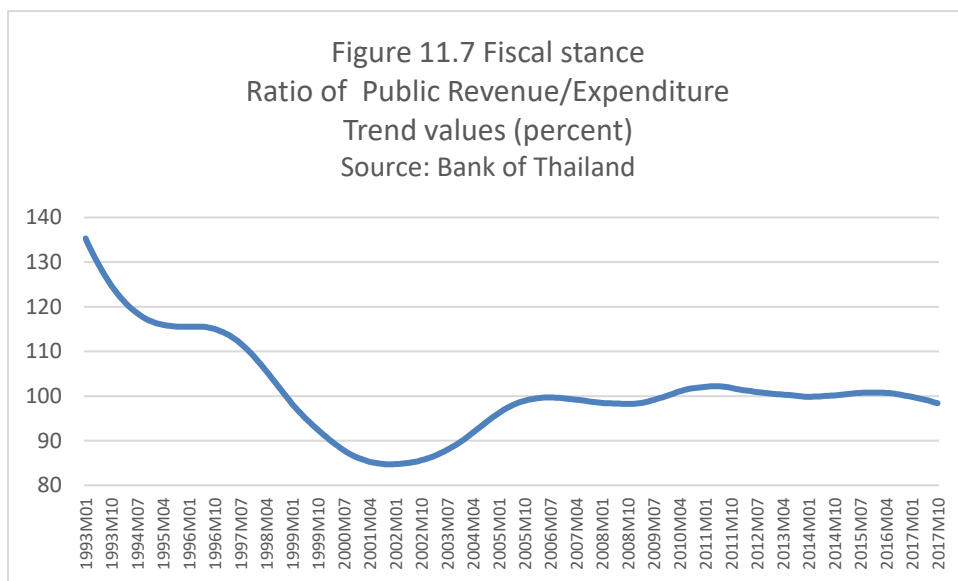


We can conclude that fiscal policy stimulus has a stronger effect on investment than consumption. Private consumption also depends on household debt, liquidity constraints, aside from the propensity to consume, which varies according to target groups of public spending. Furthermore, there is no evidence of the non-Keynesian effect of fiscal policy, where public spending leads to a contractionary impact on output. The presence of a non-Keynesian effect seems a remote possibility because Thailand's level of public debt is relatively low. We can attribute the low level of the public to rule of fiscal discipline. The issue of the sustainability of public debt will be discussed in the subsequent section.

4. Automatic fiscal stabilizers and dynamic adjustments

By removing cyclical components from actual public spending and revenue, and by utilizing monthly data from January 1993 to November 2017, we can obtain the long-term trends of public expenditure and revenue. Using the first difference of these trend variables, we can approximate patterns of fiscal stance, which reflect the outcome of both discretionary fiscal policy and automatic fiscal stabilizers (Figure 11.7). Thailand fiscal stance, expressed in percentage, reflects the working of automatic stabilizers. During the boom years before the 1997 financial crisis, the revenue exceeded the expenditure more than 30%. However, the trend declined as the economy went to the recession.

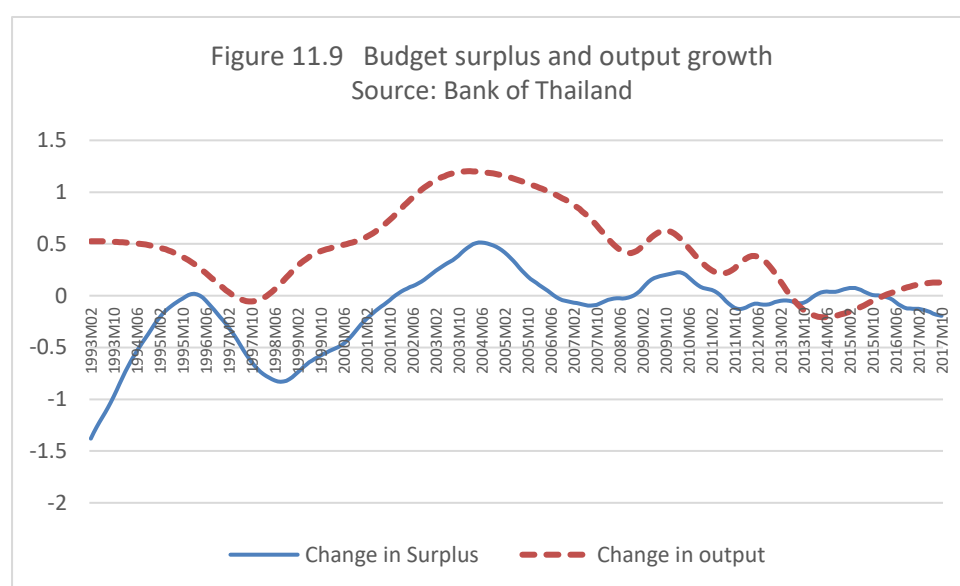
Nevertheless, expenditure rose faster than the revenue when the economy rebounded. By 2006, the ratio of revenue to expenditure seems to stabilize somewhat. It implies that from 2014 to 2017, the government failed to use discretionary fiscal policy to offset the collapse of growth in private expenditures.



When considering the movements of revenue and expenditure, the two series moved together (Figure 11.8). There is a long run relationship between revenue and expenditure. The causation runs both ways. Higher revenues permit the ability to spend for the government, while higher public spending creates expansion output, providing higher tax bases. Hence, there will never be a runaway budget deficit, as financing is done through tax and bond financing. Public borrowing from the Bank of Thailand is minimal. Government bonds held by the central bank is small. Hence there is not of financing the budget deficit by printing money.

There is also a possibility that a fiscal stimulus is self-financing in the long run if fiscal stimulus packages can effectively raise the revenue. Ultra-conservatism in conducting fiscal policy limits the potential growth of the economy. Preoccupation with a low level of public debt leads to the opportunity cost of attaining a high-income level.

Discretionary fiscal policy can be delayed because of implementation lags caused by the lengthy parliamentary process of budget approval. If a country has established fiscal automatic stabilizers, fiscal policy can be stabilizing, because it can do away with the long budgetary process.

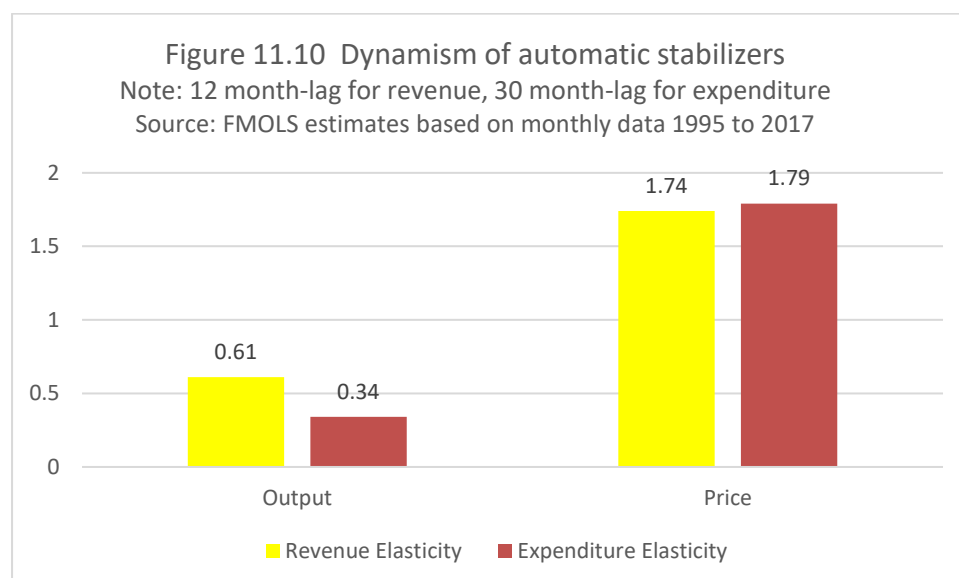


Employing monthly data, whose cyclical components have been removed by HP filter. We can obtain the trends of surplus and output. Figure 11.9 depicts changes in the trend values of the two series. The first difference is used in order to remove the spurious relationship between the level of budget surplus and output level. Similar to the observations of annual data in Figure 11.2, there is a strong correlation between output expansion and a budget surplus. The output path shown in Figure 11.9 is represented by monthly data of the manufacturing production index, which confirms the earlier conjecture from annual data that the built-in-stabilizer operates, providing stability of fiscal position.

Fiscal stimulus can also be carried out through tax reduction in addition to increased spending, but the impact of the tax cut on public debt will be more significant than increased spending. In theory, the tax-financed budget deficit is less expansionary than the bond-financed budget deficit. If bonds are net wealth and wealth has a significant impact on private consumption, the bond-financed budget deficit can lead to more expansionary impact because bonds holders would start spending more if they feel wealthier by holding more government bonds. The Thai military government attempted to sell government bonds to finance the budget deficit. Since some of the proceeds from selling government bonds will be to increase

current expenditures, instead of capital expenditures, there is also an issue of the burden of public debt for a future generation.

Let's examine the role of automatic stabilizers in both taxation and expenditure when they change in response to changes in output and prices. Cointegration analysis indicates the existence of long-run relationships between fiscal variables, output, and the price level.



We obtain estimated coefficients from running a double-log regression of revenue and expenditure on manufacturing production and consumer price indexes. It takes longer for expenditure than revenue to respond to changes in prices and output. Twelve months are required for the response of revenue to changes in output and price level, while it takes 30 months before expenditure to react to changes in output and the price level. The lengthy budgetary process causes more extended adjustment of public spending, while revenue responds faster although with a 12-month delayed adjustment due to lag in tax collection. Both revenue and expenditure respond more to changes in the price level. The price elasticities range between 1.74 and 1.79. Because of the value of the elasticities are more significant than unity, fiscal variables respond more to price changes than output changes. Note that the price elasticity of spending is a bit higher on the expenditure side than revenue. It implies that inflation can make the budget deficit higher.

When examining the output elasticity, both revenue and expenditure elasticities are less than unity. The former is greater than the latter, implying that output expansion would tend to raise budget surplus. When output contracts, the budget would tend to the deficit because revenue elasticity (0.61) is higher than expenditure elasticity (0.34), which is a nice feature of an automatic stabilizer. The main finding from this analysis is that Thailand's fiscal sustainability can be attributed to the working mechanism of the tax and public expenditure, which tend to offset the fluctuations of the aggregate demand throughout volatile business cycles.

5. Impacts of specific public expenditures

Increasing in government spending stimulates growth in private consumption and investment, which in turn give rise to output and expanding tax bases. In a dynamic framework, there is a feedback effect from the public to private spending and vice versa with long-term lag effects. We employ a VAR framework to examine these dynamic impacts of various types of public spending, using five variables: Indexes of private consumption expenditure, private investment, and changes in the HP trends of public spending on economic service, health and education, and defense. Using monthly data from January 1993 to December 2017, an impulse response functions of private investment and private consumption after an increase in the three types of public spending are obtained.

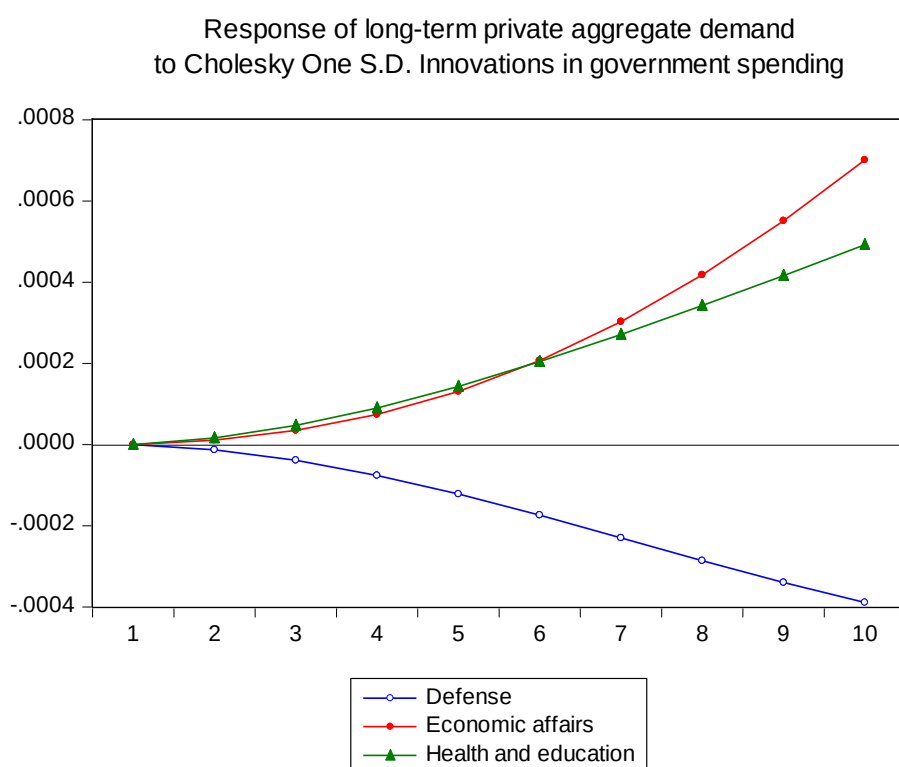


Figure 11. 1 Impacts of public spending on long-term private consumption and investment

We can interpret the values of the responses of consumption and investment as fiscal multipliers of specific types of public spending. It is shown that health and education spending provide the highest expansionary impact on consumption and investment. On the other hand, the defense budget generates a negative impact on private aggregate spending of the economy. Within a year after an increase in the spending, we have seen an increasingly positive impact on private expenditures, which would imply higher output growth. Public

spending on economic affairs raises both investment and consumption, although the short-run impact is not as substantial as the health and education expenditures. There might be a lag effect of this type of spending on the perception of consumers and investors. It is important to stress that the impact on output expansion would be stronger in the medium term because it takes time for the increased consumption and investment to work out their multiplier effects. The long-run impacts on output depend on the magnitudes of marginal propensity to consume and to invest by investors.

The finding 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. Given the same level of budget, a rise in military spending implies a fall in the budget for other more productive activities. For the 2017 defense budget, the defense budget was raised by 2 %, while the education budget was cut by 4.7%. After the 2014 coup, the defense budget hike was 5% in 2015, and 7% in 2016. The National Assembly approved the 2018 budget, increasing the defense budget by 5% (\$6.5 billion). Indeed, the coup has far-reaching economic impacts on the economy. If expenditures on economic services, health and education are cut, while military spending is raised, the impact on the long-term growth would be devastating because the contractionary impacts on output will be larger. Fiscal austerity on education and health implies output contraction, while defense splurge also intensifies output contraction.

The empirical evidence from this VAR framework supports the argument that fiscal policy can be used to stabilize the long-run output growth path. However, the fiscal expenditure must be allocated to productive uses such as economic services, health, and education. There are some spillover effects of these categories of spending on private investment and consumption.

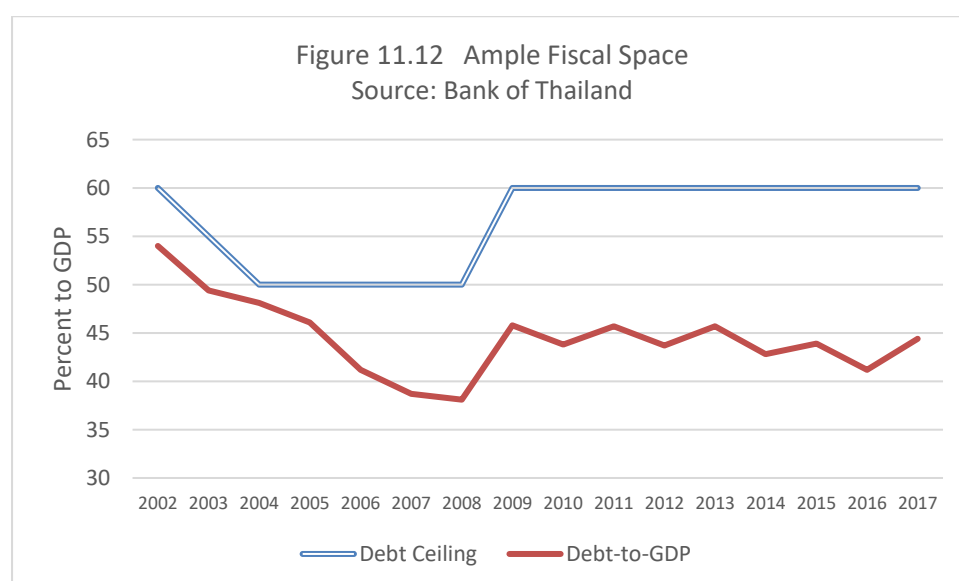
6. Rules for fiscal sustainability

Financial discipline is required if a government wishes to maintain fiscal sustainability. Public debt must be contained by resisting runaway public deficit. Tax revenue must be enhanced to keep up with rising public expenditure. Nevertheless, the government must have a forward-looking behavior, aiming to strike a balance between long-term growth and public debt. Too high level of public debt would prevent the government from using fiscal stimulus during the recession. On the other hand, the too low public debt would preclude the government from financing infrastructure development, which would adversely put a limit on the long-term growth of the economy.

If the primary deficit cannot be curtailed, public debt will keep on rising and would threaten the sustainability of the fiscal system. The primary deficit must be cut, to stabilize the debt/GDP ratio. Furthermore, the GDP growth rate must exceed the real rate of interest, which is the cost of public borrowing. Thus, during an economic recession, the government must ensure that fiscal stimulus can bring about economic growth rate that is higher than the real interest rate.

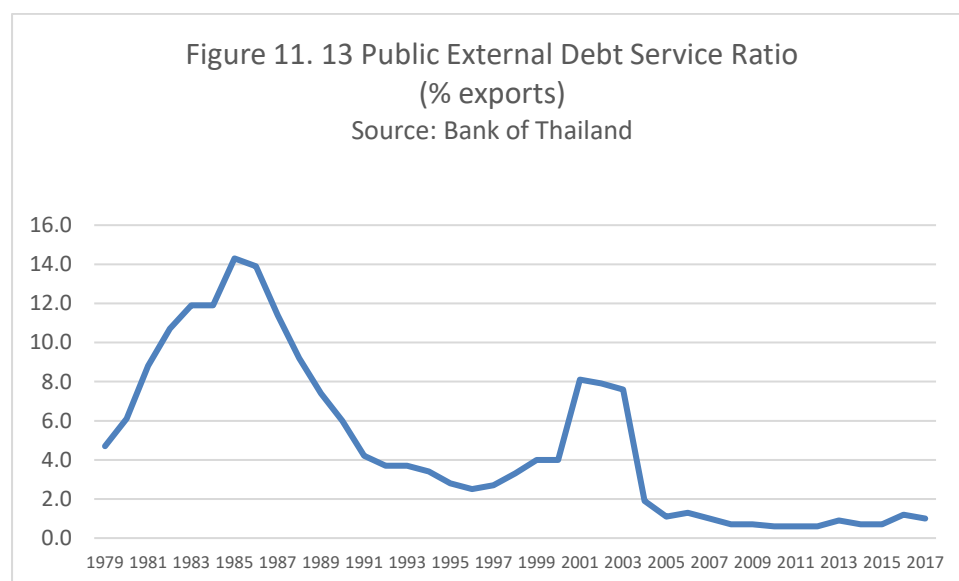
The ceiling on the Debt/GDP ratio was reduced from 60% to 50 % in 2004, reflecting the conservative economic ideology. However, the fear of a global recession caused by the financial crisis prompted the government to raise the ceiling back to 60 percent again in 2009 (Figure 11.12). Nevertheless, Thailand's actual Debt/GDP ratio has never hit the debt ceiling. There is a need to recognize that some types of public spending can be self-financed because if the public debt can generate strong growth in GDP in the medium term, the Debt/GDP ratio will tend to be lower as the economy is driven by quality public spending.

The gap between the ceiling and the actual level of Debt/GDP ratio indicates fiscal space, which allows the government to pursue the debt-financing budget deficit to spur growth. By early 2018, public debt was only at 41% of GDP, the level which is a far cry from the public debt in advanced economies. There has been ample fiscal space for the Thai government to embark on public infrastructure spending.



Since high debt causes a rapid rise in interest payments, another rule of fiscal sustainability has been institutionalized by imposing a ceiling on debt service as a percentage of total budget. The ceiling was made more stringent after 2003 by lowering the maximum debt service from 16% to 15 % of the total budget. The Thai government was able to control the debt service within the ceiling without difficulty. The high liquidity in the money market during the economic downturn enabled the government to borrow at the meager rate of interests.

As far as foreign borrowing is concerned, there is also a ceiling on foreign debt service to exports at 5%. Foreign borrowing declined while exports grew rapidly in the last decade. Therefore, there has been no problem in keeping the debt-service to exports ratio within the permissible range (Figure 11.13).



There is another prudential fiscal rule to make sure that fiscal policy fosters long-term growth, which is the only sustainability condition that Thailand has failed miserably. The structure of government spending matters for long-term growth. If a large part of government spending is current rather than capital expenditure, it would be challenging for the government to curtail total spending as it would affect those who used to receive such benefits. On the other hand, if a large portion of expenditures falls into capital goods, it would be relatively more straightforward to cut down the budget deficit in the future. In other words, fiscal flexibility will be impaired with a higher proportion of current expenditure in the total budget. Political consideration involves when the government has to choose between capital goods and consumption goods which include military hardware.

Public investment in infrastructure projects can increase productivity in the private sector and raise the economy's long-term growth path. In particular, public investment in transportation and communication has a supernatural high rate of return to the economy. Such kind of investment is complementary to private investment. Therefore, increased public investment has a crowding-in-effect. In contrast, high public consumption relative to public investment can retard growth. Empirical evidence of cross-country investigation indicates that growth can be jeopardized if public consumption increases faster than public investment.

Thailand's rule of fiscal sustainability is also concerned with the structure of fiscal expenditure. It imposes a minimum level of public investment, requiring that it must not fall below 25 percent of the total budget. Since 2008 the budget allocated to public investment has fallen below the required level. The share of capital spending was 35 percent in 1997,

declining steadily to 9 percent in 2013. With the depreciation of existing public capital stock, the net public investment would not sufficiently raise public capital stock.

Consequently, the long-term growth of the Thai economy has been adversely affected by the declining share of public investment. In the short-run, we will not see the impact of a slowdown in public investment. However, in the longer term, the tradeoff between output and future consumption will become clear terms of sluggish growth, low productivity, and deteriorating international competitiveness.

Using data on 42 developing countries from 1975 to 2001, Vergne (2009) finds the evidence that election-year public spending shifts towards more visible current expenditures, in particular wages and subsidies, and away from capital expenditures. Ehrhart (2013) investigated panel data from 56 developing countries over the 1980-2006 and concluded that indirect tax revenue in election years is estimated to be lower by 0.3 percent of GDP than in other years. His result supports the opportunistic political budget model.

In conclusion, fiscal variables are affected by political and economic factors. Fiscal sustainability is ensured if rules and regulations are strictly observed. Time inconsistency problem can occur in conducting monetary and fiscal policy. The government and people who are receiving benefits of present consumption through populism programs are happy in the short run, but in the long-run fiscal policy that departs from the rule of adequate capital spending will retard growth.

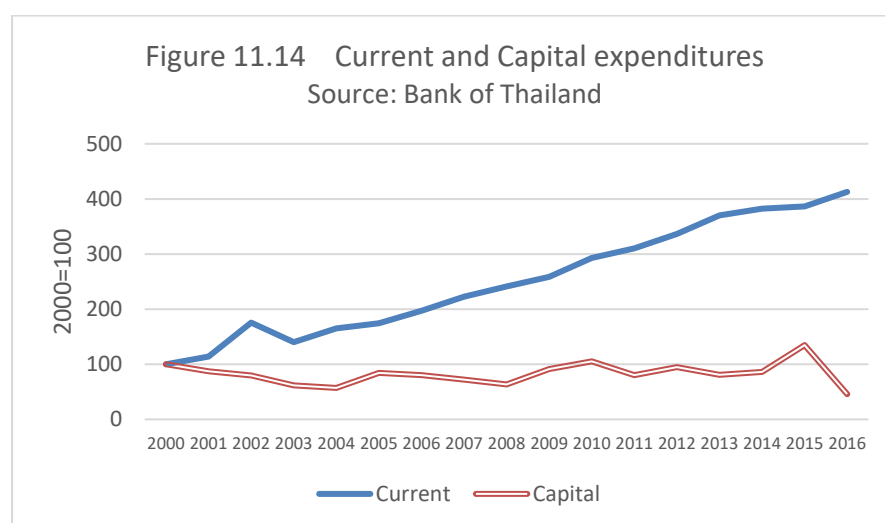


Figure 11.14 suggests a rise in the current/capital spending ratio. It will be difficult to cut down current spending let alone maintain its level. The current spending kept on rising and quadrupled by 2016, while capital spending was maintained at the same level as in 2000, which is the benchmark year. It even declined in 2016. The fiscal spending structure has changed in such a way that the long-term growth path has been compromised. The rise in current expenditure relative to capital spending is related to political economy and the economics of the coups.

For Thailand, there was no specific election year, which varies according to the years of military coups and the length of time spent on drafting a new constitution. However, it can be observed that current expenditures, in particular, defense spending, increase after the military coups. Yakovlev (2007) provides empirical evidence that increased defense budget at the expense of budget for other development goals can be detrimental to economic growth. Similarly, Hou and Chen (2013) applied the Augmented Solow Growth Model to examine the influence of military expenditure on economic growth for 35 developing countries throughout 1975–2009. The empirical results from the system of Generalized Method of Moments (GMM) estimators indicate that defense has a negative and significant effect on economic growth. In 2014, Thailand's military government proposed the purchase of submarines for protecting natural resources and preventing human trafficking in the Gulf of Thailand. The detrimental impact of increased defense spending on long-term growth is imminent when the share of public expenditure on economic services declines as it happened after the 2006 military coup (Nidhiprabha, 2009).

Expansionary fiscal policy through a tax cut and increase spending can effectively increase output, but its impact on inflationary pressure cannot be ignored. The timing of the policy implementation is essential. If the fiscal stimulus is carried out during the period of oil price decline and exchange rate appreciation, the inflationary impact of running a budget deficit can be mitigated. Carrere and de Melo (2012) analyzed data from 140 countries over 1972–2005 and concluded that the probability of occurrence of growth in the years following a fiscal stimulus is higher the lower the level of fiscal deficit. The success of a growth-oriented fiscal expenditure reform is associated with a stabilized macroeconomic environment.

Vera (2009) points out that the conventional arguments against fiscal activism are based on simple monetarism assumptions, ignoring developing countries' economic structure and causation mechanisms. The expansionary impact on output of a fiscal stimulus suggests that the Thai economy could have returned to the pre-shock growth path had fiscal stimulus been earnestly implemented. The fear of excessive budget deficit inhibits output stabilization and incurs the opportunity cost of high growth in the long run.

7. Concluding remarks

This chapter provides evidence that Thailand's fiscal policy can be employed to stabilize short-term fluctuations of output and maintain price stability. There are several lessons from Thailand's fiscal experience. Sufficient fiscal space is needed to carry out an expansionary fiscal policy to stimulate growth in the aftermath of the global recession. If rules of fiscal sustainability are observed, available fiscal space permits effective fiscal stimulus.

Fiscal stimulus must not be applied too late and too little after the collapse of exports and domestic demand. The empirical evidence from this paper points out that fiscal policy instruments are useful tools when the economy experiences external and internal shocks. With ample fiscal space, the discretionary fiscal policy can be undertaken to achieve long-term

growth. Unwarranted fear of unsustainable public debt and ultra-conservative fiscal policy has cost the country an opportunity for achieving long-term growth.

After the military coups in 2006 and 2014, the Thai economy experienced the lowest economic growth in the ASEAN region. More importantly, the budget spent on economic services were diverted into current spendings such as defense and income transfer payments. The opportunistic political budget models predict fiscal spending before an election to gain votes by incumbent governments. However, in the case of Thailand, such kind of opportunistic spending comes after military coups, akin to military business cycle spending.

Expansionary fiscal policy employed to counteract short-term fluctuations must be withdrawn after the economy is on its recovery path. If not, it can be a burden to the government and result in adverse impact on the economy, as people gradually become addicted to populism policy, such as proving cash handouts to rice farmers and rubber tree growers when the world commodity prices are declining. The political risk and adverse consequences of the withdrawal of fiscal spending consequences must be considered before implementing the fiscal expansion in response to insufficient aggregate demand.

Tax revenue increases faster than expenditure during economic upturns, mitigating the inflationary pressure through enlarging budget surplus. During economic downturns, tax revenue declines faster than public expenditure, leading to budget deficit to reduce the deflationary gap. When the economy experiences rising price levels, public spending tends to increase faster than public revenue. When formulating countercyclical fiscal policy measures, the role of automatic stabilizer must be taken into account. Any new measures of the fiscal policy applied in response to economic slowdown must consider the impact of such policy on affecting the working process of automatic stabilizers. For example, the tax exemption for high-income taxpayers in through long-term savings in the forms of investment in capital markets as LTF (Long Term Funds) and RMF (Retirement Fund) has eroded the effectiveness of automatic stabilizers and created income inequality.

Income tax-allowances schemes intended to spur private consumption expenditures up to 15,000 baht before the year ends for a brief period, three years in a row from 2016 to 2017, are prime examples of short-termism. Because of its temporary nature, it has no permanent effect on the economy. At worst, it is a program which raises vertical inequity, because only those who pay income tax receive that kind of tax benefits. Stimulus fiscal packages should focus on capital spending, rather than current spending to maintain fiscal flexibility of spending and to promote long-term growth.

If public spending goes to infrastructure rather than wages hike in the public sector, the economy's output capacity can be enhanced. Thus, raising the share of capital expenditure in total budget is vital to promote long-term growth with price stability. It is imperative that

current spending is curtailed once the economy regains its pre-shock growth path. Since 1997, the share of capital spending has declined so much that it reduces long-term growth rate.

The expansionary impact of increased public spending and tax cuts would not be sufficient during the period of political turmoil and uncertainty. Counter-cyclical policy can lead to output expansion provided that the government can maintain consumer confidence and restore business sentiment.

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