ISEAS perspective

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The Deficit Dilemma in Malaysia

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Malaysia's latest budget presented to the Malaysian Parliament on 28 September 2012 continues to be in deficit. The fiscal constraints on the government remain tight. The public debt in relation to GDP is growing, the subsidies cannot be reduced because of forthcoming elections and the budget is too dependent on petroleum revenue for its financing.

The deficit for 2013 will amount to 4% of GDP, down from 4.5% in 2012. The IMF's projection, on the other hand, puts the budget deficit at 4.8% in 2013 (IMF, 2012:6). The Prime Minister is at the same time targeting to reduce it to 3% over the next few years, to bring it into line with the Maastricht Principle on fiscal discipline.

The need for fiscal discipline is also being emphasized to influence international rating agencies to give the country a good credit rating. It should also be pointed out that Malaysia is not facing a fiscal crisis as government bonds are sought after by foreign investors who are confident that Malaysia has sufficient reserves of oil, gas and foreign currency to repay its debts. However, a further reduction of the fiscal deficit will nevertheless have a positive effect on Malaysia's international credit rating (Reuters, 2008).

Obviously the government does not think it is in a position to reduce the fiscal deficit because it is facing an election and there are competing demands by pressure groups on its limited resources. The student loans are a case in point as the opposition coalition had proposed to write them off and in response, the government gave a discount on student loans thus contributing to the larger-than-desired deficit. As a result of rising subsidies and increased expenditures Malaysia's public debt as a percentage of GDP has risen over the years from 43.2% in 2006 to 53.1% in 2012 (IMF, 2012:67) but still far below the Maastricht or European Union limit of 60% of GDP. There is also systematic empirical evidence to show "that the ruling coalition systematically increases federal government spending before elections" (Pepinsky, 2007:136).

The fiscal position or stance of the government can be evaluated in terms of its (i) fiscal discipline; (ii) pro-cyclical policies; and (iii) fiscal volatility. The Malaysian government cannot be easily accused of fiscal indiscipline as the deficit is not way off the target of 3% and is nowhere near the 6.7% recorded in 2009. However, the budget is expansionary especially in providing more subsidies and cash hand-outs. It is more counter-cyclical than pro-cyclical as the expansionary budget is to counteract the negative effects of the current drop in external demand for Malaysian exports.

DECLINING DEVELOPMENT EXPENDITURE

Fiscal variables have not been very volatile but there are some noticeable developments. For example during election years, the operating budget tends to increase by a large percentage. In the election year of 2004, the operating expenditure of the Malaysian Budget increased by more than 21%, whereas in the preceding three years it had increased by an average of only about 9.99% (Ministry of Finance, 2005). Similarly, in 2008, the operating budget increased by a surprising 24.70% whereas in the preceding three years it had increased by only about 10% per year (Ministry of Finance, 2010). In fact in 2007, it increased by 16.79% because the government had initially wanted to call for elections that year. Similarly in 2011, which was expected to be an election year the operating expenditure increased by 20.11%, whereas in the preceding year, it actually declined by more than 3%. In 2012, the operating budget increased by more than 10% (Ministry of Finance, 2012). There is some evidence then that the government increases the operating budget during an election year for political advantage.

The development expenditure however does not show a similar trend although it is discretionary when compared to the operating expenditure, which in many cases is mandatory in nature. Development expenditure declined in 2004 by more than 28%; increased by about 12% in 2008 but by only 3.55% in 2012. It is projected to fall by 0.42% in 2013.

Development expenditure is not expected to play an immediate role in influencing voter decisions as much as operating expenditure because the latter can be expanded immediately to meet voter demands.

Development expenditure has also been declining as a percentage of total expenditure over the period 2000 to 2012. As a percentage of total expenditure, it has fallen from 30.68% of total expenditure in 2000 to 18.80% in 2012. This is probably because operating expenditure has increased by more than 3.57 times whereas total expenditure rose by only 3.04 times between 2000 and 2012 (Ministry of Finance, 2012). Although development expenditure as a percentage of total expenditure has fallen, the government has been "spending on roads, rail and schools ahead of parliamentary elections. Though some of this extra spending is politically-motivated, it is also necessary to meet the needs of rising populations" (Business Times, 24.8.2012).

INCREASING SUBSIDIES

There are claims that the operating expenditure has increased manifold because of the uncontrolled increase in subsidies, which has helped build political support for the government. Subsidies as a percentage of operating expenditure have increased from 8.5% in 2000 to 20.9% in 2012. Some are claiming that subsidies are competing for prominence with emoluments in the operating budget. Although this is an exaggeration, subsidies accounted for nearly 21% of the operating budget whereas emoluments accounted for slightly more than 29% in 2012. Emoluments and subsidies were thus the main items in that year's operating budget.

International financial institutions and prominent local economists have been on the case of the government to reduce or eliminate the so-called wasteful subsidies. Obviously, elimination of these subsidies will create a positive surplus that can be utilized to generate growth rather than be kept idle as surpluses. No doubt, the government has been aware of the opportunity cost of subsidies but is also conscious of the political benefits of subsidies.

The subsidies to rice farmers are a case in point as their objective is to create food security. This is reminiscent of the rice shortages during the Second World War and the Japanese Occupation of Malaysia. However, the Malaysian government is not as obsessive as it was in the past in targeting 100% rice security. It is nowadays satisfied with 70%. The emphasis on food security is a crowd pleaser since food like education is a public good with positive externalities. For historical reasons the government is reluctant to be dependent on rice imports although the geo-political situation in Southeast Asia and East Asia is vastly different from what it was in the 1940s or the 1970s at the height of the Vietnam War.

The total subsidy to the rice sector in the most recent budget is RM 2.4 billion (Malaysia, 2012:12), which is nearly one percent or 0.95% of the budget, which incidentally total RM251.6 billion. The elimination of the rice subsidy will bring the fiscal deficit very close to the 3% target. However, it will raise questions regarding the Malay "way of life," culture, and what happens if there is a war! Furthermore, the thousands of farmers who have been locked into this labor intensive farming activity may have difficulty finding alternative employment. The reality is the government has not considered the alternatives to subsidizing rice cultivation especially since imported rice may cost less than domestically produced rice.

International financial institutions however point out that subsidies create market distortions and do not encourage innovations. Subsidies also create dependence on the government for handouts and freebies and discourage or inhibit innovations and technological adoptions and adaptations. In short, there is very little incentive to reduce the unit cost of production or to be efficient or competitive. Once a budget line is open for subsidies, it assumes a life of its own and it is quite difficult to remove it because of pressure from vested interest groups, who often have political clout.

The IMF has noted that in the cases of Malaysia, Indonesia, Iran, Sudan, and Yemen "the opportunity cost of subsidies is the revenue forgone by not charging international prices domestically" (Coady et al., 2010: 15). This is clearly a neoclassical analysis of the situation based on the belief that the market is an efficient allocator of resources. It is difficult to refute it though, as it seems intuitive to any rational person that prices should reflect the scarcity value of resources.

PETROLEUM AND FOOD SUBSIDIES

According to the OECD, the main reason for the increase in subsidies is "high global fuel and commodity prices, since the bulk of subsidies are linked to fuel and food prices. Moreover, subsidies in the current form are not very efficient. The majority of petrol subsidies benefit middle and high income groups, as well as foreigners and businesses. Such subsidies have also encouraged over-consumption of both fuel and sugar together with substantial smuggling activities" (OECD, 2012:98). The OECD also adds in a footnote that, "there are significant health costs attached to the artificially low price of sugar" (OECD, 2012:100).

The significant health costs associated with sugar consumption is however not well known to the poor and unskilled workers who depend on sugar for energy. Their breakfast comprising of "roti canai" and "ten tarikh" is usually over-dosed with sugar. Unless their incomes increase and their breakfast comprises of an American or Continental Breakfast it is hard to argue with them on the "white death" consequences of sugar. The poor are also dependent on sugar for their afternoon tea and cakes ("kuih") and dessert during dinner time. To reduce the subsidy on sugar involves providing a higher minimum wage and income for the poor.

However, despite the opportunity cost of petroleum subsidies, the government continues to subsidize energy prices for various reasons, including political stability. Abdullah Badawi's coalition fared very badly in the 2008 elections and lost its two-thirds majority in Parliament largely because the government listened to neoclassical economists from outside the country and allowed oil prices to increase to reflect their scarcity value. The government increased petroleum prices six times between 1 May 2004 and 5 June 2008 and this contributed towards nearly doubling the price of petroleum from RM1.37 on May 1, 2004 to RM2.70 on June 5, 2008. The price of diesel increased by about 3.3 times (see Table 1).

Abdullah Ahmad Badawi was thrown out of office largely because he allowed petrol prices to increase and in the process created economic distress for the lower and middle income classes. The argument that oil subsidies benefit middle and high income groups rather than the poor is also based on inexperience and lack of knowledge about the spiral effects of oil prices. Many small and medium enterprises that serve prepared food to the poor, for instance, are dependent on petroleum for fuel, and so, increases in fuel prices are passed on to consumers. Headline inflation, that is, increases in food and energy prices, hurt the lower classes who demonstrated during Badawi's regime and voted with their pocket to deprive his coalition a two-thirds majority in Parliament. As of 2009, 22 per cent of government expenditures in Malaysia for example were subsidies, with petrol subsidies alone taking up 12 per cent (Heidi and Foo, 2001:28, 36-37).

Table 1: Change in Petrol (RON 97) Prices (per litre)

Date	Petrol (RM)	Diesel (RM)
01/05/2004	1.37	0.78
10/10/2004	1.42	0.83
01/03/2005	1.42	0.88
01/05/2005	1.52	1.08
31/07/2005	1.62	1.28
28/02/2008	1.92	1.58
05/06/2008	2.70	2.58

Source: Loh, 2008; Narayanan, 2007:5.

The government has attempted to cut or reduce subsidies in its Budget 2013. The Prime Minister announced in his Budget Speech that effective from September 29, 2012, the subsidy on sugar will be reduced by RM0.20 per kilogram on the grounds that the government can no longer afford these subsidies, especially not with about 2.6 million Malaysians are suffering from diabetes. For fear that entrepreneurs will increase prices, the government has urged them to maintain prices by reducing the sugar content of their products (Malaysia, 2012:45) The government was keen to point out that it will continue to subsidize sugar consumption up to RM378 million in 2013; and its subsidy reduction efforts have ben supported by consumer advocacy groups and health organizations (Malaysia, 2012:45).

NEW SUBSIDY SCHEMES

However, the government has introduced new subsidy schemes including one to harmonize food prices between Peninsular Malaysia and East Malaysian states. The total subsidies to lower prices for transport and food amount to RM386 million in the latest budget and is no doubt targeted to mobilize the support of voters in the East Malaysian states which is critical to ensure for the ruling coalition. The subsidy will have an enormous impact as it promises to reduce the price of 14-kg gas cylinder by more than half from RM70 to RM 26.60 per cylinder (Malaysia 2012:46).

The government continues to subsidize flour, cooking oil, toll rates, electricity tariffs and gas prices.

In the 2013 budget the government also introduced schemes to subsidize interest rates for loans obtained by small and medium enterprises. These include (i) providing a 2% interest rate subsidy for SME efforts to develop IPR as collateral to obtain loans from financial institutions (Malaysia, 2012:23), (ii) offering soft loans up to RM100,000.00 to youth below 30 at an interest rate subsidy of 2% (Malaysia, 2012:39). Given its intangible nature, this type of financing can be used to political advantage by the government.

Other questionable subsidy schemes initiated in Budget 2013 are the interest rate subsidy and cash grants to motivate school bus operators to replace vehicles that are old and in dilapidated condition. According to Budget 2013, "the Government proposes school bus operators to be given, firstly, assistance of RM10,000 cash rebate and a 2% interest rate subsidy on full loans for the purchase of new buses to replace buses that have exceeded 25 years with new 12 to 18-seater buses" (Malaysia, 2012: 48). It might be to the advantage of society for the government to open this sector to competition rather than to continue to subsidize owners of inefficient private school buses.

DEPENDENCE ON PETROLEUM REVENUES

While the most contentious issue on the expenditure side has been subsidies, the most debated issue on the revenue side has been the growing dependence on the petroleum sector to finance the budget. According to Najib, more than 40% of the budget is financed by petroleum taxes and royalties and that it was the government's medium-term strategy to reduce its "over-dependence on oil as a finite resource" (CNBC, 3 October 2012).

The main sources of the government's revenue are (i) direct taxes which comprise income tax from companies, individuals and petroleum, co-operatives and others; (ii) indirect taxes which comprise of export duties, petroleum export duties, import duties, excise tax, sales tax and service tax and (iii) non-tax revenue, which includes petroleum royalties and gas cash payments (Ministry of Finance, 2012).

The contribution of non-tax revenue to total revenue has fluctuated between 19.24% and 33% in 2000-2012 (Ministry of Finance, 2012). However, in the latter period of 2010-2012, it fluctuated within a narrow band of 26.41% to 31.40%. Most of the non-tax revenue is probably from petroleum royalties. Total direct taxes have accounted for about half the total revenue and between 2010 and 2012 their contribution to total revenue fluctuated between 49.48% and 56.37% with the higher percentage being achieved in 2012. In 2012, income tax on petroleum accounted for more than 27% of total direct taxes and about 15% of total revenue. Indirect taxes as a proportion of total revenue have fallen from 29.12% in 2000 to about 15.59% in 2010.

However, in 2012, indirect taxes contributed more than 17% to total revenue. The reason for the decline in indirect taxes is because of the liberalization of the trade sector and the reduction of import duties as a result of membership of AFTA and the WTO. Most of the export duties collected from petroleum. The excise tax contributed the most among indirect taxes, making up about a third of such taxes in 2012. Also, the collection from excise taxes has risen because they have been substituting for import duties, which have been liberalized.

Given that petroleum income taxes in 2012 account for 15.42% of total revenue; petroleum export duties stood for 1.15% of total revenue and petroleum royalties; and gas payments made up almost 26.41% of total tax revenue, it is obvious that the contribution of the petroleum sector or Petronas to total revenue is about 42.98% in 2012. This has led to arguments that the budget is too dependent on oil revenues and there have been calls within and outside the government to reduce this dependence. This argument is also based on the fact that petroleum is a finite resource and the price of oil fluctuates quite a lot even in the short term.

FINANCING THE DEFICIT

To further broaden the tax and revenue base and reduce the dependence on petroleum, various groups including local and foreign economists, and tax consultants advise the introduction of the consumption-based Goods and Services Tax (GST). The government has been mulling over the idea since the early 1990s but has been hesitant because of the unknown effects on consumers. There is also fear that the GST may be inflationary, in which case it may not be a good idea to introduce it in an election year or just before an election year. The Prime Minister is reported to have said that, "I guess when the time is right, in the near future, probably after the next general election, we will introduce the GST. We need to explain this to the people and there is a growing acceptance that this is the way forward for Malaysia" (Malaysian Insider, 31.10.2012). In fact the Prime Minister spent almost a page of his budget speech on September 28, 2012 on why it was necessary to implement new taxes gradually after fully informing the Rakyat (people).

According to Najib, "the Government will give sufficient time to all parties to make necessary adjustments. Public acceptance of the new initiative will be solicited through information programs, education and extensive consultations" (Malaysia, 2012:26).

A large proportion of the domestic debt and the fiscal deficit have been financed by domestic borrowing, which is available to the government at low interest rates (Narayanan, 2007:7). The rates are low because those on savings are low, and Malaysia does have a high savings rate of about 33% of GNP (Ministry of Finance, 2012:92). The high savings rate has enabled the government to finance the deficit without difficulty but the burden of the financing is borne by the savers, who usually are from the lower income classes.

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