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Malaysia: Outlook for Fiscal Policy, Countdown to 2020 (Abridged)

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Goals & Instruments of Policy

- Broad goals of government intervention : To stabilize economic activity, promote growth, optimize resource management & reduce inequality;
- Fiscal policy (FP), monetary policy, exchange rate policy & administrative measures are used to achieve above goals (which goals may not be achieved if conduct of policies are not optimal);

- Intervention can be at economy, industry or firm level;
- Our focus is on FP both with respect to its conduct & outlook;
- Both at Federal Government (FG) & Public Sector (PS) Levels;

FP Components & Implications

- Key components of FP: Expenditure policy, revenue policy (both wrt tax & non-tax revenue sources) & debt policy;
- Stance of FP not only affects cash flows and of the state of national finances but also of the stocks of liabilities (both explicit & implicit) of the FG & PS;

Constraints on Borrowing & Size

- In the conduct of FP, we note two constraints.
- FG has strived for a surplus in its operating account but not in its capital account. Why? Cannot borrow to support consumption but can borrow for development if resulting tax revenues are enough to service such debt;
- Target of debt policy: To keep total Federal debt (both domestic & external) at 55% of GDP to ensure FG's debt burden does not strain its debt servicing ability.
- A goal of this ppp: Examine FG's track record wrt these budgetary & debt constraints & their outlook.

Malaysia’s Deficit & Debt Lessons

- FG has always run a fiscal deficit since 1957 except for a few years in the 90s;
- In some years the deficit & debt was acute as in the 1H80s. Thus we were unable to aggressively use FP to revive the economy when it faced a crisis in the mid-80s.
- As we were in fiscal surplus in the 90s we were able to use FP to revive the economy, purge the banking system of its NPLs & recapitalize it by relying on massive govt borrowings.

Malaysia’s Current Experience With Deficit & Debt

- From 2000 (post-crisis AFC period) we have again run a persistent deficit in the fiscal account.
- They were the highest in the MM years & lowest in the DB years.
- But size of deficit a lot lower than in 1970 to 1987 period (at height of NEP) & a lot higher than in 1988-1997 period (post-NEP).

- Interestingly, deficit in NR years until 2014 was contained from getting out of hand (& barely) by reducing development expenditure (capex) of FG & reclassifying/relabeling such capex as capex of NFPEs & of larger Public Sector (PS).
- Akin to what happened in MM years of early & mid-80s. A window dressing of fiscal deficit took place then (& hence MM was the pioneer) via a reclassification of PS capex as capex of off-budget agencies (these were the NFPEs of the 80s).

Window dressing of Deficit & Debt

- The window dressing in post-2000 period via capex reclassification (leaving aside crisis years) has taken three forms.
- 1stly, use of window dressing can be seen from high or rising PS deficit which has gone hand in hand with high or falling FG deficit.
- This has been so under MM as well as NR though not so under DB.

Federal Govt’s Contingent Debt

- 2ndly window dressing has taken the form of a build up in FG’s contingent debt (which carries an explicit guarantee of the FG), which has pushed its debt load beyond the self-imposed threshold of 55% of GDP.
- (Note Contingent debt arising from FG’s guarantee of entities such as EPF & Tabung Haji, or from its obligations to step in to bail out debt holders when a privatized entity goes bust are not included here).

- During the MM years, the government guaranteed debt as a share of GNP rose from 5.2% in 1995 to 15.3% in 1999 before declining to 12.4% in 2003.
- Such GG debt as a share of GNP continued to decline during the DB era to 9% in 2008.
- There has been a reversal of the trend under the NR era with the GNP share of such debt rising to 16.1% in 2014.

Federal Govt’s Implicit Debt

- 3rdly, to keep down direct & contingent debt, some of the capex has been funded from borrowings that only carry the FG’s implicit liabilities. (Again note no account is taken here of FG’s implicit liabilities wrt its possible bailouts of corporates or banks).
- To account for FG’s total debt exposure, we only include FG’s implicit liabilities wrt borrowings of some entities linked to the government, as specified below).

- The practice of such off balance sheet borrowing which only carried the FG’s implicit liabilities started during the MM era & is continuing today.
- Under MM, RM30billion debt issued to develop Putrajaya by PHB itself amounted to 10% of nominal GNP then.
- Now known implicit liabilities of RM71.6b represent about 7% of current nominal GNP.

- The current known implicit liabilities of FG are as follows:
- 1MDB debt of RM37b (ie its total debt of 42b less FG guaranteed debt of 5b);
- Pembinaan PFI Sdn Bhd debt of RM26.6b;
- PDS financing of RM3.685b by SPVs of KDSB (PKFZ developer) (p4 of PwC Report 2009) &
- Putrajaya Holdings Bhd's debt outstanding of RM4.3b.

FG's Total Debt Exposure in Pre-Crisis Years: An Estimate

- There is no complete tally of the implicit debt of the Federal Govt.
- We have highlighted here only some of the debt issues which are undoubtedly the implicit liability of the FG.
- If implicit debt is taken into account, FG's debt load as a share of GNP exceeds 75%, which is at least 20% above its self-imposed debt threshold of 55%.

- In 1984, before outbreak of mid-80s crisis, FG’s debt load in terms of GNP was just under 70%. There was no case then of any contingent or implicit debt.
- In 1974, again before the outbreak of the mid-70s crisis, the FG’s debt load was only around 37% in GNP terms (again with no contingent or implicit debt to complicate matters).
- In 1997, the year before the full impact of AFC was felt, the FG’s overall debt load was only 48% of GNP, of which contingent & implicit debt was 7.8% & 10% respectively.

- In 2008, the year before GFC’s full impact was felt in Malaysia, the FG’s overall debt load was around 56%, of which contingent liability was 11.7% & implicit debt 7.5% (the latter no more than an estimate).
- Going by our estimates of FG’s total debt load in pre-crisis years, it appears that our current debt load is close to or in the danger zone. That being the case the NR administration’s big cut in subsidy & imposition of GST may have just come in time to avert a FG debt-induced crisis. But more needs to be done as will be clear from my subsequent slides.

Sources of Current Fiscal Problems

- During NR years fiscal problem caused/compounded by extraordinary & inequitable extent to which fuel was subsidized, thanks to MM's APM for fuel price control, which led to a fiscal nightmare for his successors after the escalation in oil price from 2008.
- This is key factor that wiped out surplus on fiscal current account. Thanks to persistently low oil price, there were only a few years when fuel subsidy was a problem during the MM era.

- Apart from consumption subsidy trap that we fell into, our fiscal position was made worse by lack of buoyancy of our tax system & over-reliance on oil as a revenue source.
- In post-2000 period, GNP share of tax revenue in fact fell by about 2% to about 16.5% caused by fall in indirect tax revenue.
- In intervening years fall was made even worse by underperformance of direct taxes from indiscriminate expansion of income tax breaks to promote investment.

- For much of this period non-tax revenue has boosted total revenue by 6% of GNP, made up substantially by dividends & royalty from Petronas.
- We are also over-dependent on Petronas for our total revenue. After touching a high of 40% in 2008 & 2009, it has come down in steps to 29% in 2014 and can be expected to fall much more with oil price at current level.

Fiscal Outlook

- Decision of NR administration to cut much of the fuel subsidy from late 2014 & impose GST wef 2Q2015 has greatly improved the country's fiscal outlook.
- With collapse in oil price from end 2014, these changes came just in the nick of time. If not the fiscal position would have been a lot worse.

What More Needs To Be Done?

- Decision to let pump price reflect world market price is sound. But adjusting price with a lag of one month is not satisfactory. Continued reliance on administrative action to adjust price may make it vulnerable to capture and reversal by populist forces. Best to let fuel price be set wholly by market as is case with price of all private goods & in almost all countries.
- Does not prevent govt from still fixing refining & dealer margin for fuel products. But again no good reason why fuel refiners & dealers should be treated differently.

- Continued reliance on fiscal incentives to promote investment is not satisfactory, except on a highly selective basis.
- A lower tax regime is better.
- Continued granting of generous tax breaks to corporates, despite massive cut in income tax rate from the mid-80s, has made for income taxes to be less buoyant.

Concluding Remarks

- No case for fuel subsidy as it primarily benefits top 50% of households. Cannot be justified on equity grounds.
- Brim is more need based. But given scarce resources & competing demands, there is no case for indiscriminate targeting of all bottom 40% of households.
- And tax breaks have to be targeted on a more selective basis. Only then will income taxes be more buoyant as it was in 2H70s & 1H80s. If not we have no choice but to increase GST to improve govt finances which may not be politically popular.