The need for fiscal reforms

Economics, Tax

The need for fiscal reforms Malaysia's fiscal policies have generally been expansionary, with 46 years of budget deficits, punctuated by only six years of budget surpluses, since Independence. While this does smack of a serious lack of fiscal discipline in an otherwise impressive macroeconomic management track record, there is no doubt that Malaysia has managed these deficits fairly well, with the notable exceptions in the early eighties when the deficits had ballooned warranting external financing. In the early eighties, budget deficits as percentage of gross domestic product (GDP) had swelled to unsustainable double-digit levels, rising to roughly 16 per cent of GDP in 1982. The economic crisis of the mid-eighties was a wake-up call, which led to fiscal deficits being progressively reduced and eventually reversed with five years of fiscal surplus (1993-97). In the wake of the Asian financial crisis, to contain the fallout, Malaysia reverted to budget deficit in 1998. To be sure, there is nothing wrong with that, as budget deficits during economic downturns are justifiable. However, the problem with Malaysia is that it gets addicted to deficits even after the bad times are over. Admittedly, Malaysia was not the only country in the region to run budget deficits in the late nineties, as all crisis-hit countries were at it. The difference, however, was that Malaysia has remained stuck in budget deficits, while South Korea and Thailand were able to return quickly to surplus budgets. Even Indonesia, the hardest hit, could keep its budget deficits at low levels, way below that of Malaysia, relative to GDP. This is not to suggest that Malaysian policymakers were unaware of the need to balance the books, and indeed there were serious efforts at reducing the deficit-GDP ratio progressively between 2002 and 2007. Since 2008, however, there has been a reversal with deficits rising again. Government spending under the two fiscal stimulus packages totaling RM22 billion is bound to raise fiscal deficits shortly. The chances are that this year's budget deficit will exceed the government target of 7. 6 per cent of GDP, as revenue growth is likely to fall short of expectations. The deficit problem is likely to worsen next year, with reduced revenue in the aftermath of this year's recession. The growing budget deficits cannot be blamed entirely on increased development expenditure under the five-year development plans or the anti-recessionary government spending. The problem appears to be structural rather than countercyclical. It is worrisome that government operating expenditure has been growing at a faster pace than government revenue so much so that there is a real danger of it exceeding revenue in the near term, if nothing is done to have these trends arrested. It is heartening to note that the Government plans to cut its operating expenditure by 15 per cent next year, although it sounds like a tall order. Fiscal reforms require major adjustments on the revenue side as well. The country's tax base has become increasingly narrow over the decades. It is precariously dependent on fewer sources than previously. For instance, oil and gas, which accounted for only 16 per cent of the total government revenue in 1995, now constitute 41 per cent of the total. Conversely, the share of personal income tax has fallen from 12 per cent to 9 per cent between 1995 and 2008, while that of corporate tax has remained somewhat constant at 23-24 per cent. The proportion of " other revenue" has nearly halved from 49 per cent to 26 per cent during this period. Overdependence on oil and gas for revenue is very dangerous and risky, not only because oil prices tend to be unstable but also because it is a depleting resource. A higher corporate tax rate is not an answer, as it would drive away investors to countries with lower tax rates. Unsurprisingly, Malaysia's corporate tax rates have been trimmed over the years down to the current level of 25 per cent, while personal income tax rate has been slashed to 27 per cent, and these are likely to fall further over the next few years. Higher income taxes are counterproductive, as they tend to penalise efforts to earn more. The Government has to find alternative sources of revenue. There is a need to take a serious look at the value-added tax (VAT) or the General Services Tax (GST), which represents a tax on consumption. In as sense, VAT/GST provides incentives for people to work harder and earn more so as to meet their consumption needs, although there will be a one-off inflationary impact. It is high time the Government made a firm commitment to GST with a clear timeframe for its implementation. The writer is the executive director of the Malaysian Institute of Economic Research