

SECTION 1:

FISCAL POLICY OVERVIEW

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SECTION 1: FISCAL POLICY OVERVIEW

Overview

A sound fiscal policy is a prerequisite to achieve macroeconomic stability and a sustainable national development agenda. The policy does not merely involve revenue and expenditure efficiency but also encompasses institutional and governance structure, transparent and quality reporting, credible and sustainable policy formulation, and effective risk management. Malaysia's fiscal policy is aimed at improving economic competitiveness and resilience, ensuring sustainable growth and enhancing the wellbeing of the people. Simultaneously, the Government needs to strengthen its finance by enhancing revenue base and optimising expenditure, thus creating fiscal space for countercyclical measures to stimulate the economy and ensure debt sustainability.

The Government is committed to bringing the state of public finance to a higher level based on three main principles, namely competency, accountability and transparency. In this regard, it is important to instill fiscal discipline and accountability to ensure prudent fiscal management. Based on the principles, the Government has initiated several measures in relation to financial disclosure, expenditure optimisation and revenue enhancement.

It has been the best global practice by developed countries to implement public investment project via off-budget approach through government

guarantee and public private partnership due to high capital requirement and long gestation period, particularly for public transportation. However, in order to provide a more transparent view of the fiscal position, the Government has recognised and disclosed several off-budget commitments which are not aligned with the best practice and have fiscal implications as part of its direct obligations. In addition, the debt servicing payment and development outlays of several government-linked companies that were under the off-budget arrangement are also accounted in the annual budget. This approach will ensure a more fiscally responsible decision making, in particular, those with significant and long-term financial implications.

The Government is undertaking a more rigorous expenditure optimisation exercise with the emphasis on avoiding wastages and leakages while at the same time ensuring programmes and projects continue to support growth. Among the top priority measures are streamlining functions of ministries and agencies; scaling down and ceasing of programmes and projects with low priority and low multiplier effect to the economy; and improving Government procurement policy, including a review of clause and term of contracts to enhance efficiency and effectiveness of contract management. Furthermore, in enhancing the fiscal conduct and ensuring effective implementation of various fiscal measures, the Government has established the Public Finance Committee chaired

**Table 1.1. Federal Government Financial Position
2017 – 2019**

	RM million			Change (%)			Share of GDP (%)		
	2017	2018 ¹	2019 ²	2017	2018 ¹	2019 ²	2017	2018 ¹	2019 ²
Revenue	220,406	236,460	261,814	3.8	7.3	10.7	16.3	16.5	17.1
Operating expenditure	217,695	235,450	259,850	3.6	8.2	10.4	16.1	16.4	17.0
Current balance	2,711	1,010	1,964				0.2	0.1	0.1
Gross development expenditure	44,884	54,900	54,700	6.9	22.3	-0.4	3.3	3.8	3.6
Less: Loan recovery	1,852	563	656	37.6	-69.6	16.5	0.1	0.0	0.0
Net development expenditure	43,032	54,337	54,044	5.9	26.3	-0.5	3.2	3.8	3.5
Overall balance	-40,321	-53,327	-52,080				-3.0	-3.7	-3.4
Less: Debt service charges	27,863	30,882	33,000	5.2	10.8	6.9	2.1	2.2	2.2
Primary balance	-12,458	-22,445	-19,080				-0.9	-1.6	-1.2

¹ Revised estimate.

² Budget estimate, excluding 2019 Budget measures.

Source: Ministry of Finance, Malaysia.

by the Minister of Finance which also consists of Minister of Economic Affairs, Governor of Bank Negara Malaysia and senior government officials. The committee will report its fiscal related findings and propose measures to the Fiscal Policy Committee (FPC) which is chaired by Prime Minister for further discussion particularly matters related to national development agenda.

On the revenue enhancement, the Government has set up the Tax Reform Committee to carry out a comprehensive review of the Malaysian tax system including tax incentives and exploring new sources of sustainable revenue. The main task of the Committee is to narrow the tax gap and improve tax efficiency in order to increase tax buoyancy. The Government has also reintroduced the Sales Tax and Service Tax (SST) to replace the Goods and Services Tax (GST) and increased the provision for a tax refund.

Overall, the Government will have to reset its fiscal consolidation path starting from 2018 to account for narrow revenue base, additional provision for off-budget items and tax refunds. Consequently, the fiscal deficit target for 2018 is revised upward. However, it is important to note that the revision is to accommodate the new policy direction while addressing short-term adjustments. As a commitment towards strengthening public finance, the Government will resume its fiscal

consolidation plan in 2019 and onwards. The strong economic fundamentals, stable and well-capitalised financial sector coupled with better fiscal governance will provide a solid platform to improve the Government finance.

Fiscal Stance

The Government's fiscal stance will continue to be expansionary, where the amount spent into the economy is higher than the revenue collected. The stance is appropriate considering the nation's high level of domestic savings. Due to high liquidity in the domestic financial market, there is ample room for private sector to increase their investment without the Government's borrowings crowding out the market. Furthermore, domestic investors will benefit from the Government's debt issuance by earning a stable return.

In managing Government finance in the immediate term, the Government has reviewed its public infrastructure investment policy particularly on mega projects such as East Coast Rail Link, High Speed Rail, Trans-Sabah Gas Pipeline and Multi-Product Pipeline. Other public infrastructure projects are still ongoing with their cost structures being reviewed. The reason is to balance the Government future commitment with its financial position and the

Feature Article

The Need for Fiscal Reforms

Introduction

In general, fiscal policy refers to the use of government spending and taxation to achieve desired macroeconomic objectives. For a developing country, fiscal policy tends to focus on promoting economic growth, creating employment opportunity and improving income distribution, amid the need to strike a balance between these objectives. Good conduct of fiscal policy is important in providing a conducive business environment, achieving socioeconomic wellbeing and creating fiscal space to implement countercyclical measures during the crisis.

Malaysia has achieved significant economic progress in terms of eradicating poverty, building world-class infrastructure and becoming a major trading nation. The GDP and GNI per capita have grown from RM5.1 billion and RM788 in 1957 to RM1,353.4 billion and RM41,128 in 2017, respectively. The achievement is partly contributed by the expansionary fiscal policy which supports the national development agenda. As a result, the Federal Government debt as at the end of 2017 stood at RM686.8 billion or 50.7% of GDP, while liabilities in the form of committed government guarantee, public private partnership and private finance initiatives obligations amounted to approximately RM400 billion or 30% of GDP. Overall, the total Federal Government debt and liabilities stood at RM1,087 billion or 80.3% of GDP.

In brief, the main factors which led to a high debt level of a government are the government's overspending, high tax evasion and excessive borrowing. High debt level may hamper economic growth because the government's commitment to serving the debt will reduce fiscal space for productive spending. The government will have less money to spend on socioeconomic development agenda as well as limited capacity to implement countercyclical measures during the economic crisis. Several European countries with high public debt level have experienced a prolonged economic recession after the global financial crisis in 2007 and 2008 (The Economist Intelligence Unit - EIU). Thus, the Government has embarked on the initiative to bring down its debt and liabilities to a more sustainable level while sustaining economic resilience and competitiveness. This objective requires the Government to conduct its current fiscal policy instrument in a more thorough and responsible manner besides undertaking comprehensive fiscal reforms.

Fiscal Reforms and Other Countries Experiences

Fiscal reform basically refers to the adjustment of government spending or tax revenue or a combination of both to achieve a better fiscal position in terms of deficit or debt level. Effective fiscal reforms lead to higher economic growth, and the incidence of higher growth is more likely to occur when the reforms include revenue and spending rather than only one aspect of the two elements (IMF, 2015). Consequently, higher economic growth will improve fiscal position through higher revenue.

Based on country experience worldwide, there is no one single standard framework of fiscal reforms. The reforms were undertaken to accommodate unique fiscal and economic profiles of each country. Some of the reforms covered expenditure side while others covered tax revenue. There were also cases which cover both expenditure and tax revenue simultaneously. The pace and success rate of the fiscal reforms also vary depending on factors such as the state of economic performance during reform and comprehensiveness of fiscal reforms (McDermott & Wescott, 1997).

Among fiscal reform measures undertaken by several European countries, especially post-global financial crisis are as follow:

- Rationalisation of public sector;
- New social security system;
- Tax mechanism reform to fight tax evasion;
- Improvement to business environment to encourage private investment; and
- Passing of laws to ensure transparency and control over regional government accounts.

However, some of the main lessons learnt based on previous fiscal reforms experiences (Kolev & Matthes, 2013), are as follow:

- Tax raise has been more detrimental to economic growth than expenditure cut;
- Reforms based on expenditure cut are more likely to succeed and long-lasting than reforms based on tax raise;
- Comprehensive expenditure review is needed to identify potential efficiency without jeopardising the effectiveness of government spending;
- Avoid cutting expenditure across the board as it can affect the long-term economic growth;
- Countries with sufficient fiscal space should aim for gradual fiscal adjustment;
- Economic growth and falling interest rate have positive effects on the success rate of reform;
- Social dialogue and public support for reform have been important factors for success; and
- Fiscal reform commitment must have the flexibility to allow for unforeseen circumstances, which require adjustment on fiscal reform.

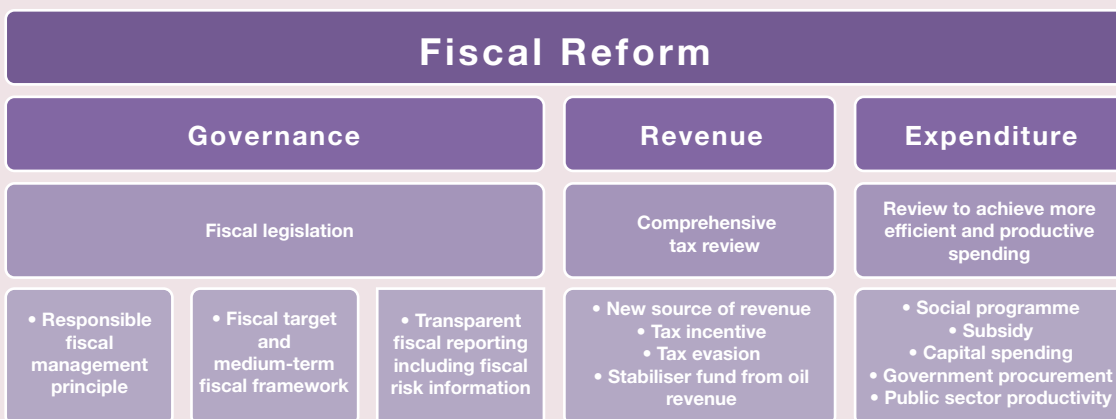
Malaysia Moving Forward – Fiscal Reform Initiatives

It is timely for the Government to undertake fiscal reforms proactively, given the magnitude of the adverse impact of the global crisis on countries with high debt levels. The experience on the conduct of fiscal policies and reforms of other countries provide a valuable reference for the Government in adopting and adapting best practices with regard to fiscal reform initiatives. The reforms will strengthen the Government's fiscal position thus creating fiscal space to build up economic resilience, particularly during a crisis.

The Government has implemented several fiscal reforms including rationalising subsidies, streamlining of government agencies and increasing transparency in government procurements. The reforms have enhanced government spending efficiency for instance by shifting from blanket subsidy to targeted subsidy. The subsidy rationalisation has reined in expenditure for subsidy and social assistance from RM39.7 billion in 2014 to RM22.3 billion in 2017. Nevertheless, the subsidy is only a small subset of fiscal policy levers, and there are other areas of fiscal policy that are worth revisiting for the purpose of fiscal reform.

Based on international experiences and studies by IMF as well as other agencies on fiscal reforms, three main areas of fiscal reforms are fiscal governance, revenue and expenditure. The Government needs to undertake comprehensive fiscal reforms strategically and take into account domestic and global economic performance and outlook. This is important for the Government to strengthen its fiscal position while sustaining economic growth.

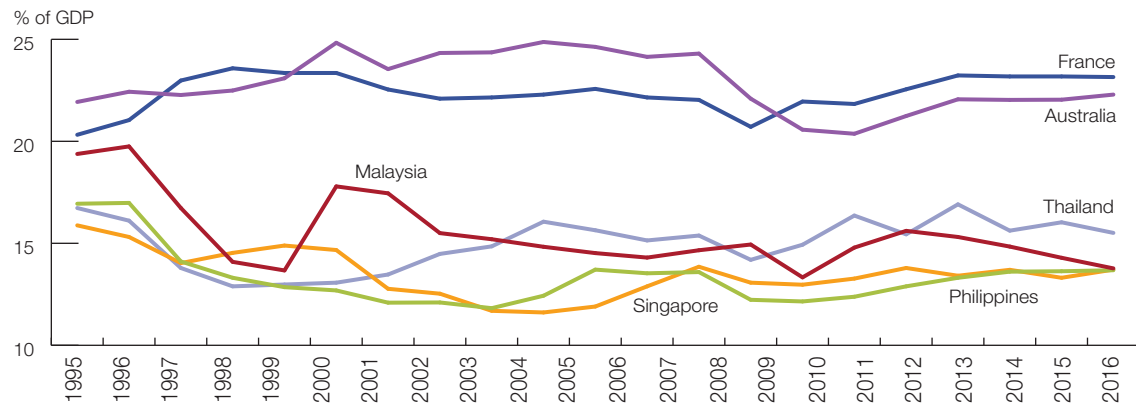
Areas of Fiscal Reforms



Fiscal governance is fundamental to fiscal reforms. Fiscal governance incorporates responsible fiscal principles, medium-term fiscal targets and high standards of fiscal reporting to give clarity to stakeholders on fiscal policy direction. A good fiscal governance framework needs to tailor to macroeconomic profiles and objectives of a nation. Fiscal governance in the form of legislation is more effective than administrative form, particularly in ensuring compliance.

Second key area of fiscal reform is to enhance the efficiency of revenue generation. This includes a comprehensive review of the tax system and collection. Malaysia's tax revenue as a share to GDP is about the same level as ASEAN countries. However, less than 20% of 14 million workforce and 1.1 million business establishments are paying income/corporate tax. In addition, there are more than 100 types of tax incentives mainly related to pioneer status, investment and reinvestment incentives (Bank Negara Malaysia, 2017) which limit tax revenue collection. In this regard, Tax Reform Committee was established on 1 September 2018 to rationalise tax policy and streamline massive tax incentives.

The setting of oil price threshold can also be considered for budget formulation. If the oil price breaches the threshold, any additional revenue must be put into a stabiliser fund within the Consolidated Fund. The reserves will provide fiscal space for the Government to mitigate

Tax Revenue as Share to GDP

Source: The World Bank, 2018.

adverse effects of economic crisis including cushioning revenue loss. The setting of threshold oil price could help the Government to be more prudent in determining the expenditure level.

The third key area of fiscal reform is aimed at increasing the efficiency and productivity of government spending by reviewing the implementation of programmes and projects. The reform focuses on public delivery system re-engineering, a more targeted subsidy and social assistance, needs-based development projects and improved cost structure. Therefore, Government services could be delivered at a lower cost due to savings generated by the increase in efficiency and productivity. In contrast, a mere expenditure cut with no improvement in efficiency and productivity level will jeopardise the government's service delivery. Comprehensive reviews of programmes and projects could identify the substantial amount of savings without deterring the achievement of the Government's objectives.

Conclusion

The Government is committed to restoring sound public finance by enhancing fiscal framework, particularly through institutional reforms, public expenditure review and tax policy reforms. Nonetheless, these reforms must be carried out in a comprehensive and inclusive manner, with full support from society. In this regard, effective engagement with all stakeholders is a key success factor. Overall, the Government has the responsibility to ensure fiscal sustainability while ensuring macroeconomic stability and wellbeing of the rakyat.

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urgency of the projects. However, the overall investment policy remains investor-friendly particularly towards private investment with high value-added activity. The Government will ensure that public investment will bring the desired socioeconomic benefit. Thus, emphasis will be given on the quality and outcome of spending rather than the quantity and output.

The Government is confident that the fiscal stance is appropriate to support the economic and development agenda of the nation. The Government will continue to strive for higher global competitiveness, economic resilience and improved wellbeing of the people. The initiatives undertaken will establish a solid foundation for healthier and sustainable government finance.

Performance 2018

In May 2018, the Government announced the withdrawal of GST resulting in an estimated revenue shortfall of RM21 billion. However, the reduction will be cushioned by additional revenue of RM14.5 billion, particularly from SST collection, dividend and oil-related revenue in line with higher crude oil prices. In addition, the Government has also managed to identify a net expenditure savings of RM6.3 billion, which could offset the decline in revenue. Thus, the Government has managed to maintain fiscal deficit target as announced in 2018 Budget.

In consonance with transparency and accountability principles, the Government has taken into account additional tax refunds (RM4 billion), the off-budget commitments and supplementary expenditure requirements. The additional expenditure of about RM16 billion includes special cash assistance for civil servants (RM2.7 billion), acquisition of Eastern Dispersal Link (EDL) highway (RM1.3 billion), Light Rail Transit Line 3 (LRT3) project and Electrified Double Track Project (EDTP) (RM2.4 billion), allocation for sewerage infrastructure, repairs and maintenance (RM9.5 billion). The Government is also expected to receive additional revenue of RM7 billion from PETRONAS dividend. This results in a net fiscal implication of around RM13 billion. Hence, fiscal deficit as a share to GDP for 2018 is revised upward from 2.8% to 3.7%.

With regard to primary balance, it is estimated to record a deficit of RM22.4 billion or 1.6% of GDP. Primary balance is the fiscal position which takes into account only the current year fiscal policy initiatives. The debt service charges, which is the result of past years fiscal policy is excluded as the charges are predetermined by the size of previous years' deficit.

Outlook 2019

In the adjustment period, fiscal position in 2019 will be set at a new base which will reset the new fiscal consolidation trajectory moving forward. With a narrow revenue base, there is a need for a more thorough expenditure review. In this regard, the Government has undertaken the zero-based budgeting¹ approach in formulating 2019 Budget to improve spending efficiency. Meanwhile, the Government has also decided to settle all the outstanding tax refunds estimated at RM37 billion of which RM18 billion dues from income taxes while RM19 billion from GST. To fulfil tax refunds obligation, the Government is expected to receive a one-off special dividend from PETRONAS amounting to RM30 billion, with the balance will be set-off by expenditure savings.

Total revenue excluding PETRONAS special dividend is expected to decline by RM4.6 billion to RM231.8 billion mainly due to lower interest and investment income, despite higher tax collection. In contrast, operating expenditure (OE) excluding tax refunds is estimated to decrease RM12.6 billion to RM222.9 billion in line with the new budgeting approach under zero-based budgeting. This involves savings from non-essential expenditure; postponing programmes and projects with less priority and urgency; improving the cost-efficiency of existing programmes and projects, which include scaling down of scopes; and subsidies rationalisations towards a more targeted mechanism. In addition, the Government has undertaken reclassification exercise from OE to development expenditure (DE) for the development related item to reflect a more accurate reporting. Meanwhile, DE is forecast to remain around RM55 billion. Hence, taking into accounts all the measures, the net savings is estimated at RM8.2 billion. After taking into account RM7 billion to partially finance the

¹ Refers to budget system which assumes a zero base at the beginning of budget cycle. Budgeting decisions are made as if all programmes and projects are completely new. Detailed review of budgeting could identify potential savings from existing programmes and projects.

refunds, the fiscal deficit is expected to reduce to RM52.1 billion or 3.4% of GDP, reflecting efforts to regain fiscal consolidation momentum during the adjustment period.

Medium-Term Fiscal Framework 2019 – 2021

Medium-Term Fiscal Framework (MTFF) is a multiyear projection of the Government's fiscal position. The MTFF provides fiscal guidance and outlines for three-year fiscal projection along with required key policy initiatives based on the medium-term macroeconomic assumptions. It sets a three-year optimal spending level taking into account the revenue generating capacity and the Government's commitments. The framework provides indicative expenditure ceilings for the Government during the period, which encourages proper planning of programmes and projects beyond the annual planning horizon to achieve specific desired goals in line with the fiscal consolidation path.

The medium-term period of 2019 – 2021 is the transition period for fiscal adjustment. Fiscal consolidation will resume in 2019 onwards with the outstanding issues including outstanding tax refund and off-budget commitment that is expected to be settled. In addition, the Government has started to undertake responsible and progressive fiscal reform initiatives in an orderly and transparent manner. Among the initiatives that will be explored is a review on related fiscal legislation and enhancing fiscal institutions and governance, including fiscal risk framework. In return, with the enhanced transparency and accountability, the nation's competitiveness and investors' confidence will improve, thus supporting productive investments and economic growth. The Government will accelerate its consolidation pace and is expected to further reduce its fiscal deficit level in the medium term.

Non-petroleum revenue is expected to remain as the largest revenue source representing 76% of total revenue while petroleum-related revenue contributes the remaining 24%. With the modest assumption of oil price ranging between USD60 – USD70 per barrel, total revenue during the MTFF period is prudently estimated at RM767.9 billion. The Government

will focus its effort to enhance tax compliance and efficiency through tax reform initiatives. Among the key initiatives are bridging the tax gap arising from tax leakages, enhancing existing legislation to ensure clarity and simplicity as well as reviewing the effectiveness of tax incentives.

Firm commitments to set an enveloped expenditure for the 3-year framework will enhance the Government's capacity to manage expenditure and implement reforms. The total indicative ceiling for OE will stand at RM754.9 billion for 2019 – 2021 while the allocation for DE is projected at RM164.7 billion. The ceiling indication under the MTFF will give guidance for each ministry to achieve an optimal level of spending towards the consolidation path.

The MTFF will serve as a strategic management tool to strike a balance between macroeconomic stability and fiscal sustainability. The MTFF portrays a realistic fiscal outlook and will be an indicator of the Government's fiscal discipline. This also provides clarity to the private sector, on the Government's fiscal policy in the medium-term.

Table 1.2. Medium-Term Fiscal Framework (MTFF) 2019 – 2021

	2019 – 2021	
	RM billion	Share of GDP (%)
Revenue	767.9	15.7
Non-petroleum	584.0	12.0
Petroleum-related	183.9	3.7
Operating expenditure	754.9	15.5
Current balance	13.0	0.2
Gross development expenditure	164.7	3.4
Less: Loan recovery	1.9	0.1
Net development expenditure	162.8	3.3
Overall balance	-149.8	-3.1
Underlying assumptions:		
Real GDP growth (%)	4.5 – 5.5	
Nominal GDP growth (%)	6.8 – 8.2	
Crude oil price (USD per barrel)	60 – 70	
Oil production (barrels per day)	600,000	

Note: MTFF estimate, excluding budget measures.
Source: Ministry of Finance, Malaysia.

Figure 1.1. Federal Government Overall and Primary Balance

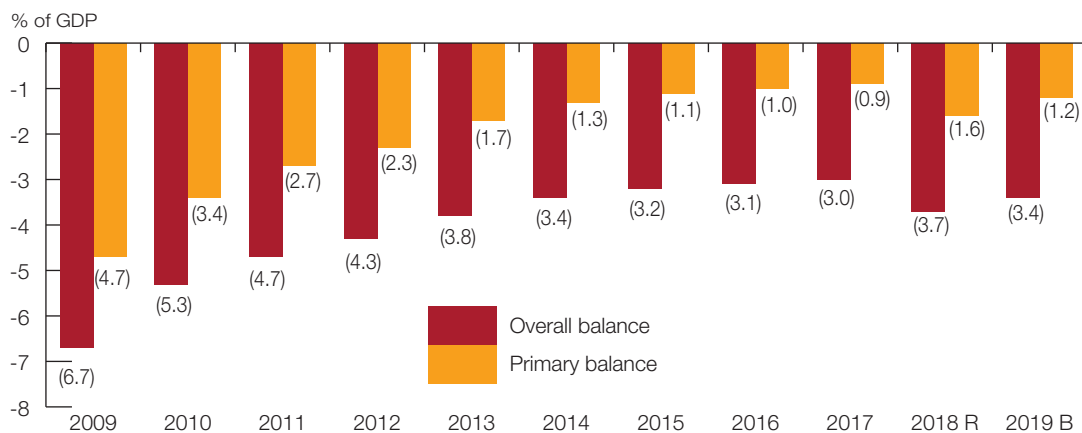


Figure 1.2. Federal Government Current Balance

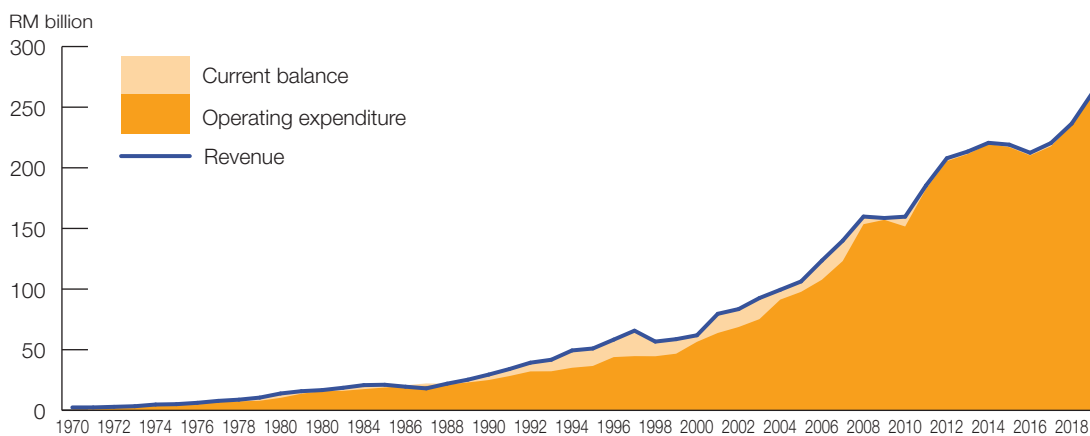
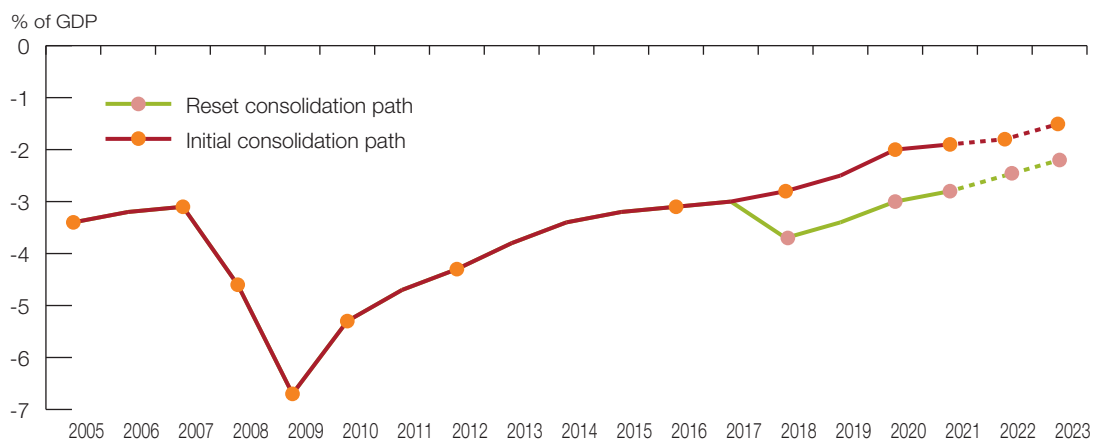


Figure 1.3. Federal Government MTF Overall Balance



Note: 2018: Revised estimate.
 2019: Budget estimate, excluding 2019 Budget measures.
 Source: Ministry of Finance, Malaysia.