

Keynote Speech:
Sustainability of Fiscal Policy in Malaysia
Ucaptama: Kemampuan Dasar Fiskal di Malaysia

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ABSTRACT

This keynote speech was delivered at the International Conference on Interdisciplinary and Strategic Studies (ICRIS) on August 12, 2021. It shed light on the sustainability of fiscal policy especially during the COVID-19 pandemic and call for re-structuring fiscal reform to achieve more sustainable fiscal policy. The proposed reform covers enhancing the efficiency of revenue generation, increasing the efficiency and productivity of government spending, improving the enforcement against the black market as well as utilising Islamic financial instruments namely zakat and waqf to finance fiscal policy.

KEYWORDS

*Fiscal policy,
sustainability,
Malaysia,
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ABSTRAK

Ucapan ini disampaikan di Persidangan Antarabangsa dalam Kajian Rentas Disiplin dan Strategik (ICRIS) pada 12 Ogos 2021. Ia menerangkan tentang kemampuan dasar fiskal terutamanya dalam menghadapi pandemik COVID-19 dan menekankan keperluan menstrukturkan semula pembaharuan fiskal bagi mencapai dasar fiskal yang lebih mampan. Pembaharuan tersebut termasuk meningkatkan kecekapan penjana pendapatan, meningkatkan kecekapan dan produktiviti perbelanjaan kerajaan, menambah baik penguatkuasaan terhadap pasaran gelap serta memanfaatkan instrumen kewangan Islam iaitu zakat dan wakaf untuk membiayai dasar fiskal.

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Dasar fiskal, Kemampuan, Malaysia, COVID-19

1.0 Introduction

Thank you to the organiser, IRIS Institute for inviting me to discuss a very important topic especially in the face of economic crisis in this COVID-19 pandemic. I will discuss about good governance of fiscal policy and what need to be done to ensure that our fiscal policy is sustainable. Fiscal policy is the use of government spending and taxation to influence economic conditions. There are two main aspects in managing fiscal policy namely revenue and spending. A balance between revenue and spending is very important to ensure that we do not have prolonged budget deficit.

2.0 Sustainable Fiscal Policy

Sustainable fiscal is a situation in which the ratio of federal debt to national income is stable or moving down over the long term. This goal can be attained by bringing spending, excluding interest payments, roughly in line with revenues, or in other words, by approximately balancing the primary budget. Ensuring long-term fiscal sustainability requires that governments engage in continual strategic forecasting of future revenues and liabilities, environmental factors, and socio-economic trends in order to adapt financial planning accordingly. Ben Bernanke, the ex-Chairman Board of Governors of the Federal Reserve mentioned in his speech at the Annual Conference of the Committee for a Responsible Federal Budget in 2011 that "fiscal sustainability is a long-run concept. Achieving fiscal sustainability, therefore, requires a long-run plan, one that reduces deficits over an extended period and that, to the fullest extent possible, is credible, practical, and enforceable".

A good fiscal policy must have good revenue generation. In other words, the government needs to be effective in collecting revenue such as tax revenue, indirect or direct taxes, as well as other revenues that come from government's investments, operation and other resources. The debate about which revenue is better has been going on for a long time. Is it better to collect tax or other revenues? Generally, economists are of the view that the best is when the government can increase tax collection, not depending on the dividend from existing resources. For example, the revenue management of The Gulf Cooperation Council (GCC) countries is considered not good because they rely too much on petroleum. That is why, in Saudi Arabia for instance, I am involved to some extent in looking at their budget, they have their Vision 2030. Their goal is to reduce government revenue's reliance on petroleum. That is why they are opening up their economy to various other economic activities. Diversifying economic activities will help the economy to grow and generate more income from taxes and so forth, not just relying on petroleum-based source of revenue.

A good fiscal policy is not only about how to make money but also how to spend. It is important to strike a balance in revenue base as well as optimise expenditure. How can government spending multiply the economy effect? When we spend RM10, how much can we bring back in our income generation? The

problem in certain countries or bad management of the economy is the spending does not bring back anything in return. This will bring trouble later. A good fiscal policy is when government expenditure is directed more towards development rather than operating expenditure.

A good fiscal policy can have high debt. High debt to gross domestic product (GDP) ratio can be good or bad. High and increasing debt levels are harmful to governments' fiscal positions and can cause a vicious cycle of growing debt, reducing the potential for economic growth as funds are diverted away from productive investments. However, the debt is a good debt when it is used for investments and generate higher income for the country. For instance, many developed countries have very high debt to GDP ratio such as Singapore (109%), Japan (234%) and the US (106%) compared to Malaysia (around 60%). So, high debt is not necessarily bad for the country. We have to look at how the debt is used to generate more revenue for the country.

A good fiscal policy also means a holistic budget. It should not only cater to a certain spectrum of the society. Not just the B40, M40 and T20 groups but a bigger picture of the society. The budget should not put too much pressure on the T20 at the same time not giving too much facilities to the B40 without a proper target. A targeted subsidy is better than a general subsidy because the general subsidy can end up giving the benefit to the unintended people.

2.1 Islamic approach

The Islamic approach to fiscal policy and budget is different from the conventional approach. The purpose is the same for both approaches which is for the good of mankind. However, the differentiation between the Islamic approach and the conventional approach is the definition of human wellbeing. The principles of sustainable fiscal policy have long been embedded in Islamic teachings that we refer to as the balance between this world (dunya) and the hereafter (akhirah). Allah reminds us in the Quran:

وَابْتَغِ فِيمَا آتَاكَ اللَّهُ الدَّارَ الْآخِرَةَ وَلَا تَنْسَ نَصِيبَكَ مِنَ الدُّنْيَا

“Seek the reward of the Hereafter by means of what Allah has granted you, without forgetting your share of this world” (Al-Qur'an, Al-Qasas: 77)

Islam teaches us to remember the hereafter but not neglecting this world. In Islam, prosperous life is not solely about the material aspect. Islamic principles about fiscal policy and budget aims to develop a society that is based on the balanced distribution of wealth by putting the values of material and spiritual at the same level (Abdul Mannan, 1997). Thus, the fiscal policy is designed by taking into consideration the material aspect as well as the spiritual aspect of development.

On the other hand, non-Islamic approach only focus on the material aspect. Whatever that is considered to be good and bring materialistic benefit then that is considered as a good economy. That is obviously not the case. So, this is why a lot of Scandinavian countries are now talking about happy economy which not only considers the material aspect but also other aspects of wellbeing.

3.0 Is Malaysia's fiscal policy sustainable?

The big question is, is Malaysia's fiscal policy sustainable? Can we survive this pandemic? Figure 1 shows that Malaysia's revenue was RM314.55 billion with borrowing about 16.8% in 2019. That is quite a lot of debt revenue. Meanwhile, 68.3% of our revenue came from tax. Not so bad compared to many other countries but we need to have higher tax revenue as the main source of income. Higher tax revenue is a reflection of the businesses on the ground doing well. When companies are doing well,

they pay higher tax and salaries. The employees who receive high salaries also pay tax to the government. Thus, the government gain a lot of tax revenue. In contrast, government tax revenue will decrease when companies are not doing well.

Ibn Khaldun discussed in his book, Muqaddimah how the government can gain higher tax revenue. He argued that the government should not increase the rate but make sure the tax rate is reasonable. The government should facilitate businesses to grow then collect tax. In other words, the government should increase the volume of taxpayers instead of the tax rate. I think Ibn Khaldun's idea is more advanced than the Keynesian's theory of public economic policy.

In 2019, 83% of government expenditure was for operating expenditure whereas 17% for development expenditure. Most of the government expenditure were operational expenditure such as emoluments and debt service charges. The development expenditure was very small compared to operational expenditure. A sustainable fiscal policy would see a huge proportion of income from tax and strike a balance between development expenditure and operating expenditure.

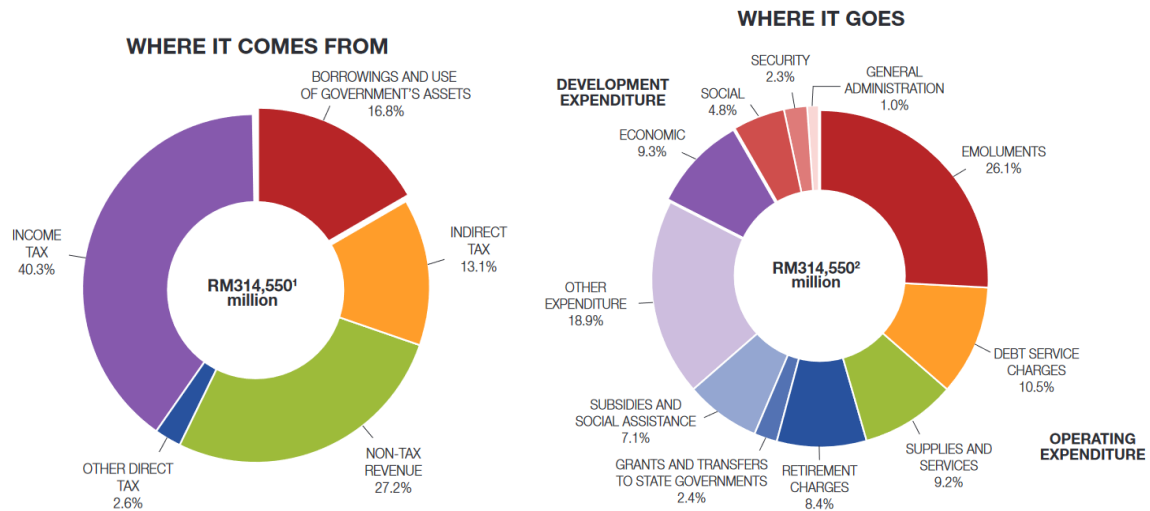


Figure 1. The 2019 Federal Government Budget: Revenues and Expenditures (Ministry of Finance, 2018a)

Our country has been having prolonged budget deficit since 1998 as shown in Figure 2. We never experience surplus since 1998. In other words, we have been spending more than we earn every year since 1998. There were from time to time we fluctuated in terms of reduction of the deficit but all the way starting from 1998 till now, our government has been operating on deficit budget. In comparison, Thailand and the Philippines have surplus at certain times, but we have been continuously operating on budget deficit since 1998. And of course, with this COVID-19 pandemic, this deficit problem will be exacerbated.

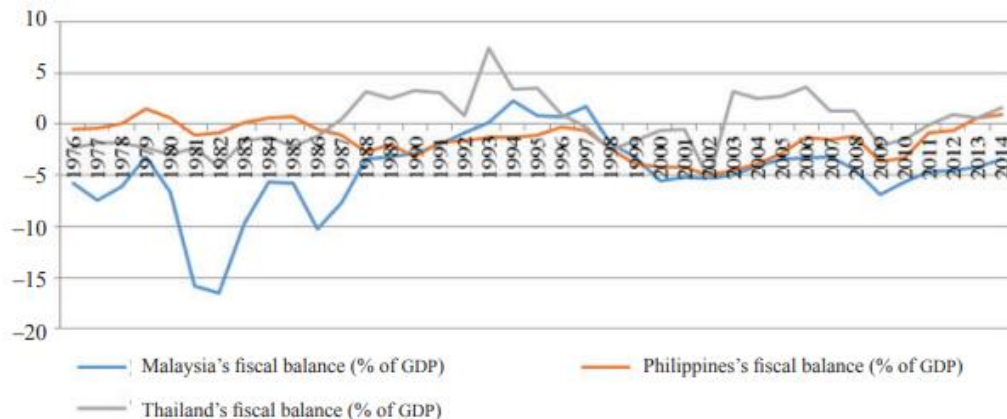


Figure 2: Fiscal balances (% of GDP) in Malaysia, Thailand and the Philippines, 1976-2014 (Lau & Syn-Yee, 2018)

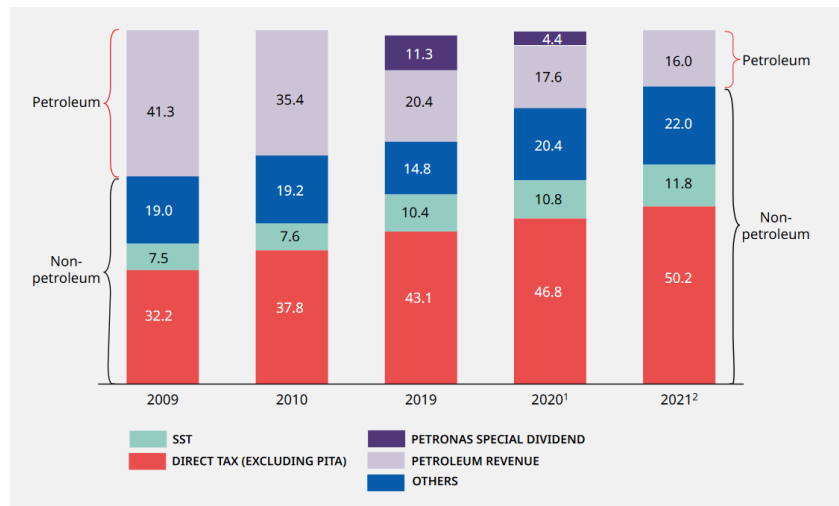
Our prolonged fiscal deficit is not necessarily a problem. Lau and Syn-Yee (2018) argue that even though we have a prolonged fiscal deficit, we never have a problem to serve our debts. This is because, for every RM100 debt, we can generate some cents of profit to repay the debt. Sometimes, the government need to take a huge amount of loan to stimulate the economy in order to ensure economic growth or when the economy contracts, the government has to spend to revive the economy. However, in a normal situation, we should not allow the economy to be in prolonged deficit because it will lead to higher debt to GDP ratio. In my opinion, according to Ibn Khaldun's simple concept, the government should look into having a surplus without jeopardising spending at all times. Ibn Khaldun suggested that government should be operating on surplus but not by contracting the economy or by not spending because government spending is very important in the economy.

The Covid-19 pandemic will further exacerbate our prolonged fiscal deficit and increase our debt to GDP ratio. For instance, in March 2021, our debt was about RM879 billion which was about 62% of our GDP (Ministry of Finance, 2021). However, the government needs to spend even more during this unusual or unintended event as the COVID-19 pandemic causes health and economic crisis. The people cannot work and lose their income. Then, the government need to support them which in turn further increase our fiscal deficit and debt because the government's source of revenue such as tax also become limited. Thus, the government needs to speed up economic recovery for instance by making sure that our vaccination programme is a success. High and fast vaccination rate will allow the economic sector to reopen, all the essential and non-essential economic sectors, which in turn speed up our economic recovery.

Malaysia has good economic growth prospect despite the pandemic. IMF predicted Malaysia's economic growth in 2021 at 6.5% (Bernama, 2021) while the World Bank expected Malaysia's economic growth at 6.7% (World Bank, 2020). On the other hand, the Fitch rating is a bit more conservative and predicted Malaysia's GDP growth to be about 4.5% in 2021. However, based on our vaccination programme track record, they expected Malaysia's economy will grow at 6.3% in 2022 (Fitch Ratings, 2021). If we can manage the pandemic well and reopen the economy, God willing we can recover the deficit that has been accumulated especially during the pandemic.

4.0 Towards sustainable fiscal policy

We can achieve more sustainable fiscal policy by reviewing our revenue generation and spending. Malaysia needs to have a variety source of income and reduce our dependence on petroleum-related revenue. Figure 3 shows that we have been reducing our reliance on petroleum-related revenue but in 2019 and 2020, the government asked Petronas to pay more to the government in terms of tax, dividend and others. This is not a good practice. Petronas should determine how much dividend to pay based on their financial performance and position. The government needs to focus on generating more tax income rather than non-tax revenue like this.



**Figure 3. Petroleum-Related and Non-Petroleum Revenue (% of total revenue)
(Ministry of Finance, 2020)**

In addition, we need to have a good balance of operating and development expenditure. Currently, our operating expenditure is about 83% of our budget. We should increase development expenditure that will generate more income. The government needs to be efficient and effective in its spending while enhancing transparency and good practices in public expenditure. It should focus on projects with high-multiplier impact and people-centric, as well as based on necessity and capacity to spend, without affecting public service delivery. This is aligned with measures to enhance spending optimisation and value for money, thus ensuring sound public finances that support sustainable economic growth.

The government should not be too involved in business. According to Ibn Khaldun, the government should facilitate businesses not running the business. The government should not *tuzahim* (تُزَاهِم) or be involved in doing business because it will reduce competition and so on. However, in a certain condition such as the country's strategic economic area, the government may need to intervene for national interest.

4.1 Re-structuring Fiscal Reform

There is a good book published in 2013 entitled "The Body Economic: Why Austerity Kills?" which studies about economic depression and economic regression. In such situations, should the government act in the form of austerity or stimulus? The book examines financial crises from the Great Depression in the US in the 1930s to Russia and Indonesia in the 1990s to contemporary Greece, Britain, Spain and the US in the 2000s and 2010s. The conclusion of the study is, at all times, when there is economic contraction due to economic depression and so forth, the government shall not adopt austerity policy. Austerity policy does not help the economy to grow but instead will cause the economy to shrink.

This theory has been discussed by Ibn Khaldun in his book, *Muqaddimah*. According to Ibn Khaldun, the government needs to put in effort to maintain budget surplus without affecting government spending because government spending is crucial in maintaining economic growth. Thus, the government need to increase income by facilitating businesses to prosper and increase the wealth of the people. In return, greater income tax, corporate tax and others will increase government revenue and allow high government spending. At the same time, avoiding prolonged fiscal deficit. This has been mentioned by Ibn Khaldun long before people talk about Adam Smith, Keynesian economics and so on. A lot of current economic theories has been brought up by Ibn Khaldun as he studied the structure and economic development during the time of the Islamic Caliphate.

The government needs to enhance the efficiency of tax revenue collection. Tax evasion rate is very high in our country. There is less than 20% of our 14 million workforce and 1.1 million business establishments paying tax (Ministry of Finance, 2018b). In addition, we have more than 100 type of tax incentives which limit tax revenue collection (Bank Negara Malaysia, 2017). In this regard, Tax Reform Committee was established on the 1st September of 2018 to rationalise tax policy and streamline massive tax incentives. Suggestions of the Tax Reform Committee include:

1. Reduce the tax gap, mainly informal and hard-to-tax sectors as well as widening the tax base through digitalisation and effective enforcement activities;
2. Reduce tax leakages by reviewing existing tax incentives and legislations;
3. Explore new sources of sustainable tax revenue such as digital and environmental tax; and
4. Enhance tax administration by reviewing the legislation and simplifying administrative processes and procedures towards improving compliance.

The government needs to increase the efficiency and productivity of government spending by reviewing the implementation of programmes and projects. Government services could be delivered at a lower cost due to savings generated by the increase in efficiency and productivity. 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. The government should focus on public delivery system re-engineering, a more targeted subsidy and social assistance, needs-based development projects and improved cost structure.

Enforcement against the black market also needs to be stepped up. The black market is also called underground economy or shadow economy, covering all illegal economic activities, unreported income and often associated with crime and corrupt practices. Figure 4 shows the huge size of black market in Malaysia and Figure 5 indicates that our enforcement against the black market is very weak compared to other countries.

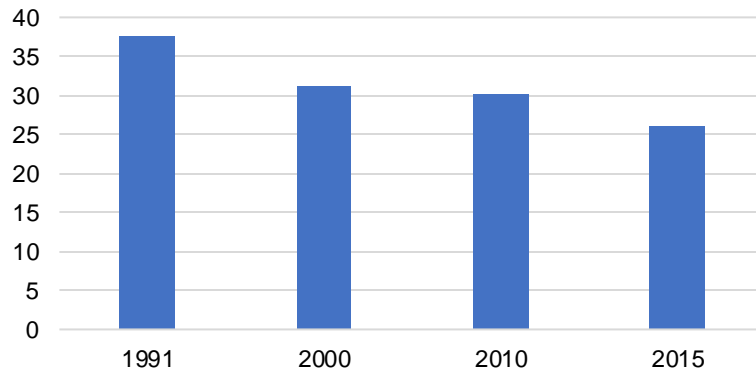


Figure 4: Size of Shadow Economy in Malaysia (% Of GDP), 1991-2015 (Medina & Schneider, 2018)

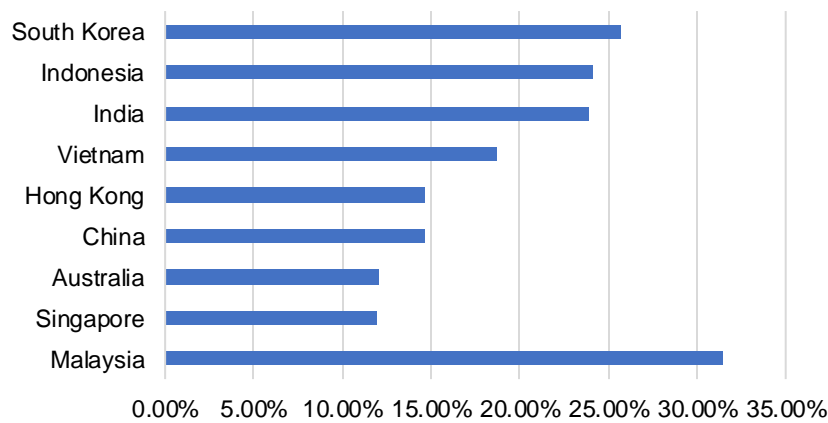


Figure 5: Average Size of Shadow Economy in Malaysia and selected countries, 1991-2015 (Medina & Schneider, 2018)

Government spending must cater for the wide spectrum of people. For me, our fiscal policy needs to consider the Bumiputera without neglecting others. Why? If we look at our demography, Bumiputera forms the largest group of people and this group keeps on growing bigger and bigger. Emphasizing on the Bumiputera will ensure the stability of our country. We have to ensure the distribution of wealth is inclusive.

Moving forward, after the pandemic, the government has to focus on recovering the budget. We cannot prolong the pandemic. We have to manage it well so that the economy can work again and generate income from the essential as well as non-essential sectors. That way we may be able to recover some of the budget deficit accumulated since a long time ago.

There must also be a benchmark to measure the needs of government economic intervention depending on the progression of economy. There is no country where the government does not intervene at all or intervene in everything. Even China, a socialist country, open their economy for a lot of private initiatives and businesses. The US, a capitalist country also has some degree of government intervention. There is no hard and fast rule of how much government intervention is necessary in the economy. Therefore, we need to develop a benchmark for Malaysia to measure how much government intervention is necessary for our economic growth and activities.

The government should utilise Islamic financial instruments to finance fiscal policy. Zakat could be used as a counter-cyclical policy through the discretionary and non-discretionary fiscal policy. The discretionary fiscal policy is carried out by varying the disbursement of Zakat to the recipients. During the expansion phase of the business cycle the government reduces Zakat expenditure to close the inflationary gap. This action helps increase the Zakat surplus in the Baitul-Mal. The Zakat expenditure could be increased, by using the Zakat surplus accumulated during the boom periods, when the economy is in the downswing to spur aggregate spending and economic activities. Therefore, government spending and taxation could complement Zakat as stabilization policy.

Waqf can also be incorporated in our fiscal policy. In Malaysia, we tend to view waqf as a small matter but it is actually an investment instrument that can be a catalyst for national economic growth. For instance, it is said that no less than 40% of the government spending came from waqf during the Ottoman times. We need to view waqf in its broader and larger form. It can benefit everyone, Muslims as well as non-Muslims in this country. By the existence of underlying assets in waqf, the economy activities will reflect the real economic activity. The implications of this condition will increase the primary surplus in the government budget and in the long term will create the fiscal sustainability and inclusiveness.

5.0 Conclusion

It is very important to maintain a sustainable fiscal policy. For me, our budget is still quite sustainable, but some areas need a lot of improvements. Our fiscal policy needs improvement especially in the areas of revenue generation particularly tax collection and tax incentives. The efficiency and productivity of government spending must also be reviewed. Our national resources should be exploited to improve revenue generation and at the same time improve the wellbeing of the people. Our prolonged budget deficit and increase in debt to GDP ratio is inevitable in the current COVID-19 pandemic situation. Nevertheless, as we start to recover from this pandemic and reopen the economy, government intervention is crucial to improve our fiscal sustainability.

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