Fiscal Prudence's the Answer

There is a vicious rumour in town that the government has run out of money to spend. To dispel such unfounded talk, we take a look at how the government budgets its money.

RECENTLY, I had dinner with a group of senior news and business editors from the local media organisations, hosted by Tan Sri G Gnanalingam, the executive chairman of Westport. It was a fruitful session. Besides getting direct feedback and listening to their views on various national and international issues, I was able to share with them my thoughts on certain aspects of our economy. A chief news editor of a major daily wanted to know the impact of a prolonged budget deficit on the economy. Another business editor asked why was it that we were so conservative and could not borrow more to finance new infrastructure and other projects.

These are important questions, especially when we know that there are people who have been spreading malicious rumours that the government is running out of money, and that we are very conservative in our fiscal stance by putting a tight rein on expenditure. These people are irresponsible. While they represent a very insignificant minority, I feel we must clear the air.

Yes, the government has money. It comes from direct taxes and non-tax revenue, including royalties and dividends from Petronas. This year, the Federal Government expects to collect about RM100 billion in revenue from all sources. If there is a shortfall in revenue to finance operating and development expenditure, the government borrows.

In Malaysia's case, this borrowing comes mainly from domestic sources. The government has money to pay its bills and all the expenditure which has been budgeted for. Of course, if someone comes with a project proposal and there is no provision in the Budget, we cannot spend that money. To some people, this indicates that the government has no money. This is misplaced.

There are not many governments in the world which can finance all their expenditure through revenue. Even the supposedly rich countries such as the United States, Japan and many Western European states have to borrow to finance government expenditure.

In some ways, government finance is no different from personal finance. If and when we do not have cash to pay for our houses or buy cars or furniture, we borrow. Usually, from banks or on credit. Borrowing is not a problem. What is important is that we service the loans, pay our debts and have enough to meet our daily expenses.

The same is true with the government. We have been borrowing, but what is important is that we can service the debt. The principle we follow is that debt repayment, including interest payment, should not take too much of our revenue. If the interest payment takes up more than 20% of operating expenditure, for example, this will be a heavy burden on the government. We will then have less money to spend on other purposes. So, we avoid being in such a situation. At present, our debt servicing accounts for about 12% of total operating expenditure.

In a number of developed economies, the budget deficit is a major issue. It is a big issue in some European countries. The US is also facing a serious deficit problem. The US is estimated to be in the red by almost half a trillion dollars next year. Running up a budget deficit of around US$ 400 billion in 2004 and at about 4% of gross domestic product (GDP), it is the largest in US history in absolute terms and as a percentage of GDP, since 1993. The US budget deficit is now almost one-fifth of the total federal spending, and around 40% of the total receipts from federal income taxes. These deficits will gradually harm the future income of Americans, as these borrowings have to be serviced and ultimately repaid.

Many economists agree that this is not good for the US and world economy. Obviously, a large and prolonged budget deficit can result in adverse consequences: a fundamental shift in market expectations and a related loss of confidence both at home and abroad. A sharp rise in interest rates can hurt the stock market and reduce private consumption and investment.

In Malaysia, we are striving to reduce our budget deficit. A few years ago, we said we wanted to achieve budget balance – meaning expenditure equals revenue – by 2006. We realise that this is not going to be achieved in the short term. Our objective now is to control and gradually reduce the deficit towards an appropriate balance in the medium term. If we allow the deficit to keep on increasing, it could affect our credibility and credit rating. This means that the government and the private sector will have to pay more in terms of debt servicing for its borrowings.

The deficit we have been experiencing since 1998 has been due to a slow growth in revenue, following the Asian financial crisis as well as the need to pump-prime the economy. During the period between 2001 and 2003, a lot of money went into infrastructure projects, including rural infrastructure. Our infrastructure is now first class. In fact, we suffer the danger now of not fully utilising some of our infrastructure. Hence, to implement more large infrastructure projects while the deficit is at current levels cannot be justified. We are fortunate to have an international airport like the KL International Airport and the administrative capital of Putrajaya, but we do not need more of these at present.

A continuous deficit in the annual budget carries much risk for the economy and the future. Deficit spending simply means spending borrowed money today in the hope that you will realise sufficient revenue in the future to pay off the debt.

Economists differentiate between cyclical and structural deficits. Cyclical deficits are caused by recessions and economic slowdowns, which can impact tax revenues and government outlays. Cyclical deficits normally disappear with the passage of time and following an improvement in the general economic condition. A structural deficit, on the other hand, is the occurrence of a government deficit despite the economy already being at its full employment level. A structural deficit may be worsened by an economic slowdown and it need not reduce or go away when the economic environment improves. Prolonged deficit spending during downturns may lead to a more permanent structural deficit, which may be harder to overcome.

As I have mentioned earlier, we are striving to control and reduce the budget deficit. We need to instill fiscal discipline at all levels. A prolonged deficit cannot be sustained, for one day our children will have to pay for it. We may be enjoying excellent facilities now, but if more of these are being built from borrowings, then our children, and perhaps their children, will have to suffer later and bear the burden. We expect to reduce our budget deficit from 4.3% of GDP in 2004 to 3.8% this year.

The argument among economists about the effects of persistent government deficits is varied, but all budget deficits have to be financed. Economists agree that when the government borrows, say from the central bank, to finance its deficits, it engages in inflationary financing. And when the government finances its deficits by borrowing from the public, it engages in debt financing.

Both methods lead to inflationary pressures on the economy because funds in the economy are limited. But in Malaysia, borrowing has never been inflationary. Our deficit has been funded mainly by non-inflationary sources such as by the Employees' Provident Fund board.

Deficits are also a postponed tax liability because the government has no other choice but to pay off its debts from future tax collections. And the interest paid on the debt is an added cost of postponing this liability. Deficits also affect the economy through their short-run stabilising or destabilising effects. This is why for future development plans, including the Ninth Malaysia Plan, we must take into consideration the amount of government debt and plan expenditure accordingly.

When the government takes up a lot of funds, there will be that much less available for other productive uses, especially by the private sector. Hence, bank interest rates will go up, which will push prices up. This is the crowding-out effect.

An important point to note is the fact that higher interest rates will cause an increase in the interest burden on the government to service its own debts and make it more difficult to reduce deficit and debt. It is a vicious cycle. Persistent government deficits will strain the capacity of revenues to finance the growing interest bill. Thus, future generations of tax-payers will be burdened by today's deficits.

It may be worse if government deficits are financed by external debt. Initially, external borrowing increases the purchasing power of domestic residents when the borrowing occurs. But when there is repayment of principal and interest, it is a transfer back to foreign residents. Again, if government deficits are persistent and they incur an element of foreign debt financing, it means that future tax-payers are being burdened with debt to foreigners to repay today's government spending. This is a problem faced by many developing countries in Africa and South America.

At the end of the day, the best rule to follow is that we should spend within our means. Whether it is the government incurring debt or the individual consumer embarking on a credit card spending spree, we must know that we cannot get away from repaying our debts. Our debts will ultimately catch up with us. Discipline and prudent fiscal management are, therefore, vital for the government in managing its finances.

While we can continue to incur a high fiscal ratio of deficit to the gross national product in the short run, this cannot be sustained in the medium term. We also need to look for new revenue sources to strengthen our financial position. In the medium term, we need to further reduce the deficit and possibly have a budget surplus. In times of need, the budget surplus will come in handy and can provide some cushion for sudden shocks and volatility. It is important, therefore, to continue consolidating our budget and strengthen our financial position.

Equally important will be the pursuit of measures to reinvigorate domestic private investment as well as attract foreign direct investment that will fill in the gap arising from the process of fiscal consolidation. Creating a conducive environment for private investment growth and removal of rules and regulations that are impeding private investment growth will bring about more long-lasting benefits than would continued deficit government spending. mb

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