BULLETIN PERSATUAN EKONOMI MALAYSIA
EKONOMIKA
Vol. 1 No. 1 JANUARY-MARCH 2009

Missing the Point: Malaysia's Debate on Fuel Price Subsidies

by
Cheong Kee Cheok

MUCH has been aired about the government's decision to raise petrol prices. With much to gain and lose, the political establishment has been the center of the debate. The government, directly and through the think tanks it sponsors, defends that decision, while the Opposition, embracing populist sentiment, argues for continued subsidization and lower petrol price.[1] Many of those affected by this increase, especially the educated middle class, have been particularly vocal (e.g. Netto 2008) in condemning this move, calling minority voices speaking in favor of the increase 'academic' (as in removed from reality) or apologists for the government, and citing 'evidence' from other countries or situations (e.g. Loke 2008).

The debate misses the point, or, even worse, is deeply flawed. This failure stems from ignoring the basics about subsidies and from the abuse of statistics, unwitting or deliberate.

The Basics of Subsidies

Subsidies play an important role in many governments' social policy, but represent only one form of transfer. Unlike social welfare payments to the poor or unemployment benefits which are direct payments to a target group, they are an indirect form of transfer since only those who utilize the goods or services subsidized benefit from them.

Subsidies may be explicit, for which monetary payment is made, or implicit subsidies for which no payment is involved. They may be untargeted, available to the public at large, or targeted at specific intended beneficiaries. Even if the poor have access to what is subsidized, and the benefit from the subsidy represents a larger share of their budget, the absolute quantum of benefits goes disproportionately to the better-off simply because the latter use more of it. For good or evil, subsidies distort the allocation of resources in favor of the good or service subsidized.

The Reality of Subsidies in Malaysia

The history of government subsidies in Malaysia goes all the way back to independence. It was originally associated with the government's rural development program and the bulk was subsidies to production. If opaque and subject to leakages, these production subsidies – for double cropping of padi, land development, education at all levels, and specific areas of manufacturing and tourism – were modest and could at least be justified in terms of poverty alleviation, human capital investment and growth promotion (Thillainathan 2008). The amounts were also modest. This changed under the Mahathir administration with the establishment of the Approved Price Mechanism for petroleum products in 1982. This mechanism maintained the consumer price of petroleum products but ensured producers received the market price through variation in the tax payable by them. As long as the market price remained below the fixed retail price, the government derived revenue from the sale of petroleum products. However, as prices of petroleum products rose, this tax was transformed into a subsidy. Thus, Malaysia had been subsidizing liquefied natural gas (LNG) since January 1990, diesel since October 1999, and petrol since June 2005 (Ariff 2008). Until the June 2008 increase in prices, Malaysia has one of the largest fuel subsidy bills in the world (Economist 2008).

In the recent run-up in world oil prices, this subsidy payable by government to producers became a serious burden on government.[2] Ariff (2008) noted the government's 2007 fuel price subsidy was RM8.77 billion when oil price averaged $79 per barrel, and would have been just over RM18 billion if oil price reached $105.[3] Not surprisingly,

[1] *Their respective positions are captured in the public debate between Anwar as Opposition leader and Information Minister Shabery Cheek on July 15, 2008 (Malaysiakini 2008).*
[2] *Thillainathan (2008) noted a second form of subsidy necessitated by high oil prices – that of natural gas to utility companies. This implicit subsidy is not our focus here.*
[3] *This did not include tax revenue foregone.*

INSIDE: A Critical Review of Price Control & Subsidies >**P5** ■ Challenges of the Ninth Malaysian Plan >**P8**
■ Some Thoughts on the Fuel Subsidy Issue > **P10**

Ekonomika invites comments/ contributions from readers. Please write with address and contact details to:
Honorary Editor, Ekonomika
Persatuan Ekonomi Malaysia,
c/o Faculty of Economics and Administration,
Universiti Malaya,
50603 Kuala Lumpur, Malaysia
or
e-mail: gunaa7@yahoo.com

For further information on past issues as well as other publications of the Persatuan Ekonomi Malaysia, please check our website at:
http://www.pem.org.my
or
Contact our Secretariat at: Persatuan Ekonomi Malaysia, c/o Faculty of Economics & Administration (New Block), Universiti Malaya, 50603 Kuala Lumpur.
Tel: 03-7967-3647 / 7956-0075,
Fax: 03-7956-3139
e-mail: mgt@pem.org.my

Table 1: Energy Efficiency Indicators

Country	GDP / unit of Energy Used	Energy Used per capita	
	In 2004	% Change 1999-2004	2005
Malaysia	4.1	-0.1	2,389
US	4.6	0.3	7,893
Japan	6.4	—	4,152
Germany	6.2	0.3	4,180
United Kingdom	7.3	0.2	3,884
Korea	4.2	-0.1	4,426
China	4.4	1.1	1,316
India	4.5	0.4	491
Indonesia	4.1	—	814
Thailand	4.9	-0.1	n.a.
Vietnam	4.2	0.3	617
UAE	2.2	0.2	11,436
Saudi Arabia	2.2	-0.3	6,068
Venezuela	2.6	—	2,293

Note: Energy used is measured in kg. of oil equivalent; GDP is measured in year 2000 Purchasing Power Parity Dollars.
Source: World Bank: World Development Indicators 2007, 2008

the government's decision on June 5, 2008 to raise the retail price of petrol from RM1.92 to a still subsidized RM2.70, with an even larger percentage increase for diesel was framed in terms of fiscal unsustainability.

The Malaysian Fuel Subsidy Debate

The Malaysian debate on fuel subsidies revolves around several arguments. These may be summarized as follows:

- The subsidy as oil prices continued to escalate is unsustainable.
- The subsidy can be maintained simply by managing government finances better, and/or by using the increased oil revenues from Petronas to pay for the subsidy.
- Reducing the subsidy erodes citizens' standard of living, hurting everybody.
- Other oil producing countries maintain levels of subsidies at least as high or higher than in Malaysia.
- There is no evidence that subsidies lead to wasteful energy use.

The first view is the government's rationale for increasing fuel prices 41 percent on June 5, 2008. Superficially, the argument of unsustainability cannot be disputed. A weakened fiscal position also constrains the government's ability to stimulate the economy at a very time growth is slowing. Yet this argument misses the real issue, which is whether fuel subsidies which are general price subsidies can be justified in the first place. The answer has to be no. Far from being good for the public and the country, Malaysian fuel subsidies are a suboptimal means of providing social protection to the lower income classes and achieving economic growth. Even as subsidies go, they represent the least desirable form of subsidy in terms of social protection. Indeed the need to reduce subsidies has been stressed by economists and others both in and outside government (Ariff 2008, Lee 2008, Mahani 2008, Thillainathan 2008).[4]

[4] *In a hard-hitting essay, Randhawa (2008) appropriately refers to oil subsidies as 'socialism for the rich, capitalism for the poor'.*

The Opposition, however, took the populist line, making two main arguments. First, the reduction in fuel subsidies has adversely affected the public's standard of living. And second, this impact can be avoided because the existing level of subsidies can be sustained. This line of reasoning finds support from the middle class who populate the increasing number of blogs.

The first argument is easily refuted, since the 'public' who benefited from these subsidies were the middle and upper classes.[5] The lower income classes do not primarily benefit because they either do not own vehicles or drive the least expensive vehicles that also consume the least petrol. To the extent that they are hurt by the price hike resulting from the reduction of fuel price subsidization, specific relief targeting them is indeed needed. But these measures do not include reverting to the old subsidy formula.[6]

The second argument is even more wrong-headed. To argue that subsidies should be maintained because the government could afford it is to argue in favor of perpetuating the damage these subsidies inflict on the economy, damage which worsened as the subsidies escalated. Linking the elimination of government waste to continued subsidization is logically flawed. While the former is clearly a desired outcome, using the savings thus achieved to subsidize the middle class only compounds the problem.

Just what damage might high fuel subsidies cause? Subverting the market by keeping prices low encourages fuel consumption and vehicle travel, with associated costs such as traffic and parking congestion, higher risk of traffic accidents, heightened emissions leading to air pollution and productive time lost. In that sense, subsidies, by encouraging consumption, actually contribute to the upward pressure on fuel prices.

Is there evidence of this in Malaysia? Table 1 shows international comparisons of energy efficiency, measured by value of output generated per unit of energy consumed. Malaysia's energy efficiency compares unfavorably with that in developed countries, including gas-guzzling USA. More tellingly, it also did poorly against the likes of China and India, as well as its neighbors in Southeast Asia. The countries which subsidize fuel even more than Malaysia did fared even worse. In addition, while the developed countries as well as China and India improved their energy efficiency between 1999 and 2004, Malaysia showed no improvement. If we look at energy consumption, Malaysia, with GDP a fourth or less of that of the advanced countries, consumes about half their energy in per capita terms. Malaysia consumes a lot of energy for a country at its present level of economic development, this energy is not particularly efficiently used, and it shows no sign of doing better.

Just what damage might high fuel subsidies cause? Subverting the market by keeping prices low encourages fuel consumption and vehicle travel, with associated costs such as traffic and parking congestion, higher risk of traffic accidents, heightened emissions leading to air pollution and productive time lost.

On the negative side, the fuel price increase elevates the general level of prices and threatens to derail growth, raising the specter of stagflation in a country that is a net importer of oil.

The Impact of Eliminating Fuel Subsidies

The consequences of eliminating fuel subsidies and allowing fuel prices to rise are both positive and negative. On the positive side, there is ample evidence that the demand for fuel will fall (Hiro 2008). Over time better energy efficiency is achieved as consumers seek to contain total fuel costs by switching to more fuel-efficient vehicles and reducing per capita vehicle travel, the two other components of fuel costs other than price (Littman 2008, p. 6, Wagner 2008). Malaysian evidence of this switch is the strong sales of vehicles like the Perodua Viva in a slowing economy.

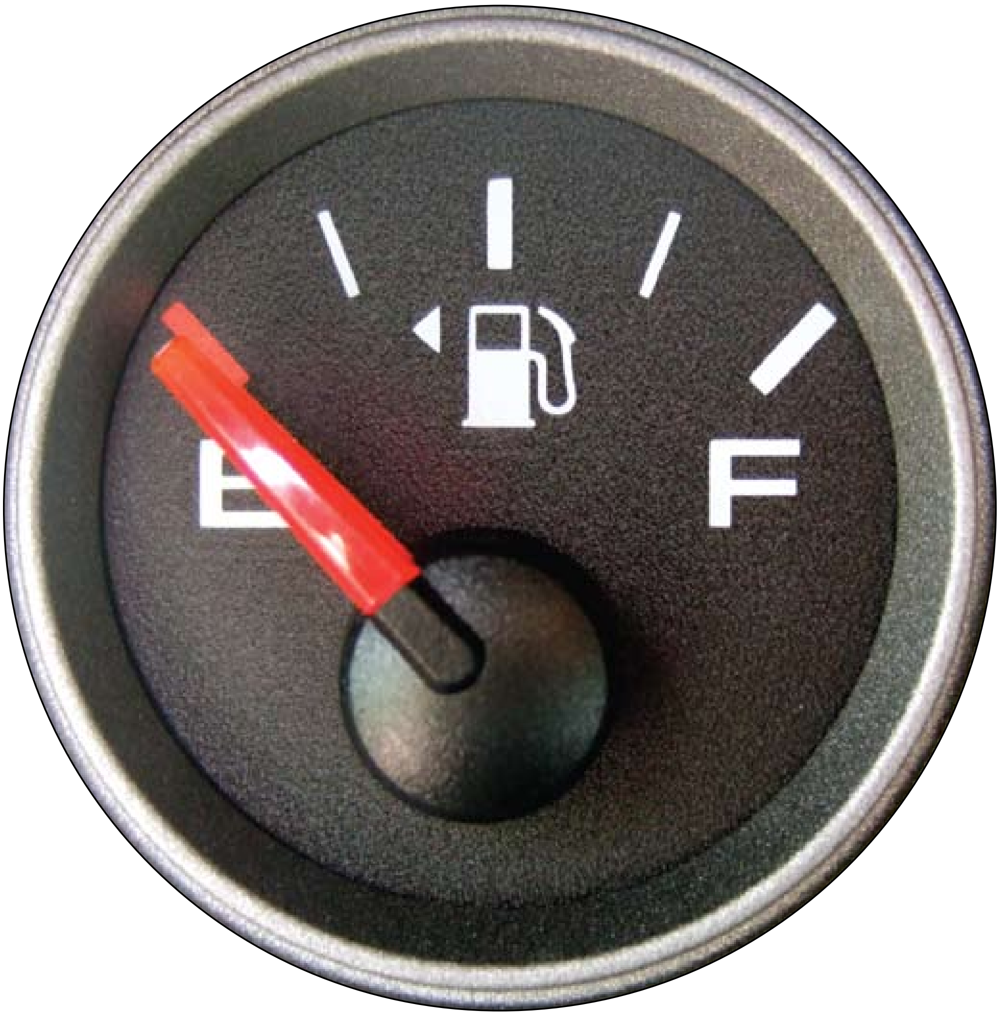
On the negative side, the fuel price increase elevates the general level of prices and threatens to derail growth, raising the specter of stagflation in a country that is a net importer of oil. This has occurred in the US and was the cause of global recession in the last three decades (Roubini and Setser 2004). For the global economy, escalating fuel prices are just one of what has been termed 'the three F's' – fuel, food and finance – hobbling economic activity. For Malaysia, a net oil exporter (if only barely), stagflation poses a real threat because of its external dependence, especially on American prosperity.

Malaysia's modest inflation, the lowest in Asia, has subsidies to thank for, but the price Malaysians paid has been high. At a time of dwindling growth and tepid FDI inflow[7], that amount

[5]Thillainathan (2008) estimated that 76 percent of the 2006 fuel subsidy (excluding tax foregone) to have been captured by vehicle owners and operators.

[6]In this connection, the government's decision to dole out RM625 to every car owner can at most be viewed as an attempt to soften the impact, but not really helpful to the lower income classes. Similarly, the policy of maintaining a 30 sen subsidy runs the risk of entrenching this subsidy as a citizen's right.

could have been much better used to promote growth. Indeed, the prospect of stagflation strengthens rather than diminishes the case for ending these subsidies.



The Appropriate Response to Fuel Price Increase: Learning from Japan

Unpopular though this will be, there is no question that fuel subsidies should be removed, although in a phased manner to cushion the impact. The equally important question is what should the government be doing with the resources saved? It should be adopting a two-pronged approach of protecting the most vulnerable and of promoting greater energy efficiency.

Protecting the vulnerable from the inevitable overall price increase can be achieved through targeted direct resource transfers to them. A variety of tools exists, from targeted conditional or unconditional cash transfers to the poor, as has been attempted in Indonesia (Widianto 2007), food related assistance, social funds to public works or investment in infrastructure that creates employment and promotes future growth (ADB 2008).[8]

There is no shortage of initiatives for promoting energy efficiency both among producers and consumers. Ranging from incentives to increase energy efficiency and regulating energy efficiency standards to measures like lower speed limits, encouraging car pooling and the use of public transport, these measures have long been implemented in Japan, Western Europe and the US. Given the sorry state of our 'modern' transport system and the even sorrier state of our civil society, clearly not all these are applicable to Malaysia, but many are, with appropriate adaptation.

The important point to note however is not specific measures but the existence of a consistent long-term energy policy and plan. For this, there is no better example than for us to truly 'look east' and learn from Japan (Box 1). Thanks to such a policy, Japan increased its energy efficiency by 40 percent between 1973, when the first oil shock hit, to 2003. Its steel production is a third more energy efficient (or less energy intensive) than China and 15 percent better than the US (Hombu 2006).

Unfortunately, far from discussing such a plan, the debate has centered around whether a bad policy should be maintained. Having made a politically brave decision, the government remains mired in the old paradigm of subsidization. At the same time, knee-jerk policy responses like the windfall tax on independent power producers speaks to the absence of a coherent strategic response and will do more damage to the economy than having no plan at all. Among the Opposition, populism has reared its ugly head, and scoring political points has taken priority over good economic judgment. Finally, some among the middle class, the most vocal segment of civil society, have shown they cannot or will not countenance what is ultimately in their long-term interest, preferring instead short-sighted instant gratification. How sad for Malaysia.

■ *A graduate of the University of Malaya and the London School of Economics, where he obtained his Ph.D, Cheong Kee Cheok is Adjunct Professor and formerly Dean at the Faculty of Economics and Administration, University of Malaya. He spent sixteen years at the World Bank as senior economist and then Coordinator for China and Vietnam in its Economic Development Institute, now the World Bank Institute. After returning to Malaysia in 1997, he continued to consult for the Bank and UN agencies. His work has taken him to China , Vietnam , Cambodia , Laos , Mongolia and North Korea , among other Asian countries. His research interests include, and he has written on, economic development, econometric modeling, transition economies, regional development, employment and poverty. His book Asia Resurgent: Transformation, Growth and Integration was published by the University of Malaya Press in 2006.*

---

[7]*For all the government hype, FDI into Malaysia is now less than half of what Vietnam attracts.*
[8]*For a description of each type of social safety net, see http://www1.worldbank.org/sp/safetynets/index1.asp.*

A Critical Review of Price Control & Subsidies

by
R. Thillainathan

HISTORICALLY, the economic and financial management of Malaysia has been generally prudent. Reliance on subsidies and price control have been limited and very selective. However, former prime minister Tun Dr Mahathir Mohamad was more radical with his price control experiment — distorting resource allocation, making for inequity and threatening to undermine the country's sacred legacy of fiscal prudence.

Before Mahathir's premiership, subsidies were aimed at production and investment, not consumption. A more serious problem with subsidies then, was that they were implicit and opaque, and not explicit or transparent. Therefore, it was less amenable to public scrutiny. This made it more difficult to question the government on its subsidy programme.

Investment activities that were subsidised heavily but implicitly are as follows:

- Double cropping of padi (with irrigation provided free of charge);
- Land development and resettlement (with the administrative costs of the scheme not recovered from the settlers);
- Education (where fees charged were small relative to cost, and more so for Higher education);and
- Key areas of manufacturing and tourism (where profits earned were exempted from tax).

As padi farmers and settlers were amongst the poorest in the country, the subsidies extended to them were not wholly inequitable. University graduates and businessmen (in non-traditional areas), singled out for subsidies, were less deserving, no doubt. But in the first few decades of independence, it may have been justifiable to subsidise graduates and businessmen, given the high rate of unemployment and the critical importance of knowledge workers for development.

Mahathir greatly widened fiscal incentives (to cover agriculture and information technology services) and expanded the size of implicit subsidies (by exempting profits earned over a longer period).

Prime Minister Datuk Seri Abdullah Ahmad Badawi has also aggravated inequities. Firstly, by widening the class of exempt investors, which covers even those engaged in real estate development; and secondly, by withdrawing the tax-exempt status of equity investments for workers with the Employees Provident Fund and of retail investors with Permodalan Nasional Bhd, and the like — by replacing the imputed system of taxation of dividends with a single tier system of taxation.

Let us now look at explicit subsidies. Their coverage and size were always limited until Mahathir's premiership. The handouts under the school food and nutrition programme are the only items of consumption that were subsidised, and strictly in a limited way. Production inputs subsidised were fertilisers, as well as (to an extent) credit in padi farming and textbooks for schooling. The payment of a guaranteed price to local padi farmers has been, until recently, more in the nature of a production, and not a consumption, subsidy. Now with the run-up in the world prices of rice, and a nearly unchanged guaranteed price, the padi farmers are likely to be the real losers and the licensed traders/importers the big winners.

Mahathir's consumption subsidy time bomb took the form of the approved price mechanism (APM). He implemented this back in 1982 for petroleum products. The mechanism maintained the price payable by the consumer to the government's fixed (or controlled) price. To ensure that the producer received the market price, it adjusted the tax payable by oil companies or the subsidy payable to them.

Mahathir was lucky. During his long premiership, to maintain the fuel price (paid by consumers), only the tax rate had to be adjusted, and little or no subsidy was payable. Abdullah was not so lucky. Since he became prime minister, oil price has escalated — thanks, in part, to the easy money policy of the US.

In 2008, assuming an oil price of US$100-US$120 per barrel, the fuel subsidy is estimated to be RM18 billion, and the tax forgone, RM7 billion. Therefore, the total consumption subsidy for motor vehicle owners, the well-off in Malaysia, is a colossal RM25 billion. In 2006, when oil price averaged US$70 per barrel, the total subsidy paid was RM10 billion. Of this, RM7.6 billion was captured by motor vehicle owners and operators. This excludes the tax revenue forgone of RM7.3 billion.

In 2002, during Mahathir's last full year in office, when oil price averaged US$25.50 per barrel, the total subsidy paid was only RM3.7 billion, of which fuel subsidy was probably RM2 billion.

With respect to price control and the resulting consumption subsidy, it was not confined only to controlling the price payable by the consumers (to an arbitrary price it had fixed). It also extended to a second type of price control — one aimed at regulating profit of utilities with monopoly power. A utility was permitted to increase its price provided the return on its capital was below the prescribed threshold return. However, under the Mahathir administration, the maintenance of the price of a utility (at an unchanged level) was accepted as an end in itself. This applied not only to the utilities such as water, electricity and telecommunications but also to gas.

Petronas, which is a producer and distributor of gas in Malaysia, is required to sell it at a controlled price to electricity generators at a price well below its international price. The government had decided to control the price of gas because it was also controlling the price of electricity. This led to cross-subsidisation of not only electricity generators but also electricity users.

This also interferes with the smooth operation of the market mechanism and distorts resource allocation. This is to the extent that the subsidy becomes an off-budget financing arrangement, which makes it more opaque and makes meaningful analysis of such arrangements more difficult. For the oil price of US$100 to US$120 per barrel, the implicit subsidy from the control of gas price is estimated to be at RM20 billion.

It is staggering to note that now the consumption subsidy, and just for fuel, will far outstrip the development expenditure of the public sector. The fuel subsidy in 2008 is estimated to be RM45 billion versus the projected total development expenditure of RM40 billion. Interestingly, the RM200 billion Ninth Malaysia Plan development expenditure target was itself a record. The size had worried many economists on its likely inflationary or crowding-out effects.

The APM is not an inspired insight, rather it was a monumental folly. Stabilising the fuel price through an adjustment in duty — which offered, in any case, only a limited cushion — or through a subsidy only leads to the squandering of a scarce resource. As this is a depleting resource, the government failed to take into account the real risk of a continued rise or a sudden jump in price, as had certainly been the case from 2004. And once the public gets used to a fixed price, the government will find it very costly (except in a crisis) to raise the price.

The massive subsidy for fuel is enjoyed by motor vehicle owners and operators, the better-off segment of society. There is no case for the granting of this subsidy. No such subsidy is being granted to non-vehicle owners and operators, the worse-off segment of society. Only some users of public transport may deserve the subsidy but there are less indiscriminate and inequitable ways of addressing their needs.

The removal of the fuel subsidy will no doubt greatly increase the cost of owning and operating motor vehicles and force the less well-off amongst them to use public transport. As the coverage and frequency of public transport services is not satisfactory, this will greatly inconvenience the group. Therefore, the removal of the subsidy has to be accompanied by a corresponding improvement in public transport, both bus as well as mass rail transit, including an effective system of feeder buses to support it.

The removal of the subsidy will also impose a painful readjustment on energy-intensive industries or force them to become more fuel-efficient.

Given the bad state of traffic congestion encountered by road users in getting to their workplace and back, priority should also be given to the introduction of urban congestion charge on road users. There is a strong case for the revenue collected from this to be spent on cross-subsidising public transport. Of course, the imposition of the congestion charge will immediately reduce the number of motor vehicles getting into the city. Public bus transport can be stepped up concurrently (which is not very difficult) to cope with the increased demand (with mini buses reintroduced to service commuters in the suburbs).

The removal of the subsidy will also impose a painful readjustment on energy-intensive industries or force them to become more fuel-efficient. This is something to be welcomed in the interest of building a more competitive and resilient economy.

In passing, it is also instructive to refer to a third type of price control — reliance on which was greatly increased by Mahathir as a means to achieve his so-called zero inflation target. This form of price control was aimed at price maintenance as an end in itself, and applied to industries dealing in so-called essential goods such as sugar, cement, steel, motor vehicles and even chicken. To make price control more palatable to businessmen, the authorities protected their profits by strictly regulating competitive imports or entry into these industries, and by allowing the businessmen to seek a price review based on changes in their cost of operations.

This type of price control activity, with import or entry restriction, can expose the regulator to capture by the regulated. It can enable businessmen to charge a higher price or to short-change on quality, thereby, undermining the welfare of consumers or the competitive position of other businessmen, who are end users of the controlled products. Where the authorities have been slow in allowing price adjustments in the face of major shifts in supply or demand conditions, such price control activities have led to shortages and black marketeering. This has been found to be the case, from time to time, in the cement and steel industries.

Where government controls have taken the form of a severe restriction on imports, regulated through the issue of import permits with a nominal regulation of prices, as in the case with the import of motor vehicles, this has led to abnormal profits in such distributive trades and intense competition amongst rent-seekers to capture such profits. Rent-seekers are always on the lookout for opportunities to create contrived scarcities to earn monopoly rents. To eliminate such incentives and opportunities, the government has to make a firm commitment to competition in all its economic pursuits.

After the general election of March 2004, the government under Abdullah started raising the prices of petroleum products. But it halted this process in 2007, partly because of some public disquiet, and also in order to not prejudice its prospects in the subsequent general election, which it called in March 2008. Now that the election is over, it has no choice but to raise the fuel price and eliminate the unprecedented and massive subsidisation of consumption for the country's legacy of fiscal prudence to be restored.

In 2004, the total government revenue was around RM100 billion. But only RM8.8 billion was generated from taxes on motor vehicles. However, petroleum products were enjoying a subsidy of RM4.2 billion. Less the subsidy, net taxes on motor vehicles was only RM4.2 billion. In 2008, motor vehicle owners are likely to end up enjoying a subsidy, on a net basis, of around RM10 billion.

There is no case for motor vehicle owners, certainly a very well-off group, to enjoy such subsidies. There is also a strong case for the government to subject the consumption of petroleum products to sales tax. The level of the sales tax on petroleum products in Malaysia is a lot lower than in most countries, including those in the region.

At the current level of oil prices, the duty has to be waived. In fact, the government has to provide a substantial subsidy, in addition to keeping prices at the current level. Even if Malaysian consumers pay prices which reflect market prices, which include full duty, the prices paid will still be lower than overseas. Therefore, in the interest of fiscal prudence, as well as equity, the government should let prices rise to the desired level, at least on a phased basis.

Collecting taxes on motor vehicles through a duty on petroleum products is also more efficient as the duty payable will be related to usage. Therefore, it will create the right incentive for users to be less wasteful and to economise when prices are higher.

Road tax as well as import and excise duties on motor vehicles are a less efficient form of tax. They cannot be justified as a wealth or luxury tax, as other forms of wealth or luxury consumption are not subject to such taxes. If the purpose is to regulate the car population, it is best to require a certificate of entitlement (COE) to own a car (as in Singapore) or to operate the car (as can be done for driving in Kuala Lumpur's central business district, or CBD). The certificates can, then, be auctioned off amongst the higher bidders.

The government is now better placed to make this policy shift, with the sizeable investment it has made on mass rail transit. The additional investment required to improve this form of public transport will be a lot less than that those required on flyovers and elevated highways. The massive investments for an improved road network, in any case, can alleviate traffic congestion only on a temporary basis.

The government continues to build more flyovers and elevated highways in the Klang Valley instead of improving the interface between the different mass rail transit systems, extending their coverage, reintroducing a mini-bus feeder system within each suburb and by ensuring a more effective enforcement of traffic rules.

Price controls and price subsidies have been on the rise in Malaysia since Mahathir's early years as prime minister. There is no sign of it changing under the present administration.

Improvements in public transport, including better bus services, combined with a road pricing system for entry into KL's CBD, the revenue generated from COEs and the road pricing system to cross-subsidise public transport can easily be justified, as users of public transport do not impose any external costs on other road users. These improvements will greatly reduce the multi-billion losses the economy is currently suffering from the time lost in commuting within the Klang Valley and from the enormous stress traffic congestion imposes on commuters.

Price controls and price subsidies have been on the rise in Malaysia since Mahathir's early years as prime minister. There is no sign of it changing under the present administration.

Price control is inefficient for attaining economic or welfare goals for several reasons. Firstly, it distorts resource allocation. Secondly, it dispenses with the services of the price mechanism, which provides a costless way of coordinating economic activities that are, by their very nature, extremely complex and involved.

Thirdly, beneficiaries cannot be targeted and, thus, end up benefiting those who do not deserve any assistance. Often those who deserve the assistance are only a small minority and there are other more efficient and less inequitable ways, such as income transfers. Finally, price control encourages illegal and immoral activities, including bribery, corruption, smuggling, as well as illicit manufacture.

The size of the consumption subsidy, almost entirely due to the control of fuel price, has gone almost completely out of control. Ineptitude and opportunism, or lack of grit, are now threatening the integrity of the government's finances, as well as the very fabric of the economy.

The production subsidies accorded to businessmen through a system of fiscal incentives (or tax breaks) have been increasing from the early years of Mahathir's administration. Many corporations, including the multinationals have, thus, not paid taxes for many, many years running. More importantly, under the current full employment environment, investments generated by fiscal incentives create no additional jobs and, in fact, reduces tax revenue. Why is this so? With full employment, the new investment displaces an existing investment which is currently paying taxes. And hence, the country ends up collecting less tax revenue.

The alternative to a system of fiscal incentives is to rely on a lower tax regime to promote investment. A lower tax regime can make for more investment, higher profits and, hence, more taxes. This happened in Malaysia in spite of the big reduction in tax rates during the mid and late 1980s. If there are no tax breaks, there will be more corporate taxpayers. The resulting gains on tax revenue from the removal of fiscal incentives will far outweigh any likely losses in tax revenue from the reduction in the tax rate. These reforms will also make for less distortion in resource allocation.

■ ***Dr R Thillainathan is a past president of the Malaysian Economic Association.***

Challenges of the Ninth Malaysian Plan

by
Amirsham A. Aziz

ON the global front, firstly, the Mid-Term Review of the Ninth Malaysia Plan has been launched during an extremely testing environment where world economic growth is expected to slow down as a result of a standstill in the growth of the US economy, and its pass-through effects on western Europe and the emerging and developing economies. The World Economic Outlook 2008 published by the IMF described the situation as one where 'the world economy has entered a new and precarious territory' and expects the effect on the rest of the world to be significant. In addition, the effects of the US subprime mortgage market collapse is still unfolding and there is a strong possibility that it could turn into a full blown global credit crunch and cause further strain on the global financial market. The actual impact of these developments is still uncertain. We however have to remain alert so that we can respond with appropriate measure in a timely manner to cushion its impact on the economy.

Secondly, inflationary pressures mainly arising from higher prices for food and energy adds further risk to an already uncertain global environment. The upward pressure on food and energy prices is expected to be prolonged due to slow supply response from producer countries, strong and growing demand for these commodities by emerging economies such China and India as well as geopolitical factors. The impact of the higher prices will be most felt by middle income economies including Malaysia as these commodities constitute a significant share of their disposable income. The high prices and shortage of these commodities have sparked labour unrest, riots and political instability in several nations. We have to use a mix of policy instruments – fiscal, monetary and direct to effectively manage the problem so that it does not derail development plans. Most importantly measures must continue to be introduced to minimise its impact on the middle and low income group.

The upward pressure on food and energy prices is expected to be prolonged due to slow supply response from producer countries, strong and growing demand for these commodities by emerging economies such China and India as well as geopolitical factors.

Thirdly, we must be cognisant of the increasingly competitive global environment particularly in the context of being able to continuously attract quality foreign direct investment (FDI). FDI is important to complement domestic investment so as to achieve the targeted rate of economic growth, to venture into high technology and knowledge-intensive industries as well as to open up new markets. Although Malaysia recorded a substantial increase in the inflow of FDI, about 53% in 2006, the highest level since the Asian financial crisis, the emerging economies of China and India as well as Singapore won majority of the investments into the East Asian region. According to the World Investment Report 2007, the largest inflows among developing economies went to China, Hong Kong, India and Singapore and to the transition economies of the Russian Federation. FDI inflows into Africa also doubled due to increased interest in natural resources, improved prospects of corporate profits and more favourable business climate.

The competition for FDI is expected to intensify with more developing economies transforming themselves to provide a stable and conducive business environment. In particular, within the region besides China and India, Indonesia and Thailand are expected to pose keen competition. We must also be aware that there are several risks in the global economic landscape such as the current account imbalance, exchange rate shifts, volatile oil prices and stress on financial markets that could have implications for FDI flows in the medium term. Malaysia will therefore have to respond appropriately to enhance its position as an attractive destination for FDI. It must be noted that reliance on incentives to attract FDI is unsustainable in the long run and several studies and experience have shown that economy-wide efficiency, versatile labour force, quality infrastructure, consistency in policy, stable political environment, comfortable living conditions and public safety are more important considerations for foreign investors. Preliminary findings of a survey undertaken by the EPU in collaboration with the World Bank covering 1,418 firms recently, shows that the perception of crime, theft and disorder as a constraint to doing business has worsened significantly and stands out as the most serious cause for concern.

The greatest challenge on the domestic front is with respect to addressing the skills and talent gap. The survey of firms undertaken by the EPU with the World Bank also indicates that firms perceive skills shortages as one the biggest problem. The survey also shows that while the problem of skills shortages in the manufacturing sector has improved slightly, the problem is more acute in the services sector. The problem of skills shortages has become more pressing as we venture into more high technology and knowledge-intensive activities. While the Ninth Plan allocates almost a quarter of its development expenditure towards education and skills development, more short term measures will need to be introduced to address this issue. In this context, the brain gain programme to attract talented Malaysian overseas as well as expatriates has to be revisited to make it more attractive and effective. In addition, the private sector must assume a greater role in terms of continuous skills upgrading of their employees.

Domestically, the second challenge is to increase private sector participation to spearhead economic growth. During the first two years of the Ninth Plan, private investment grew by 8.6% on average and amounted to RM135.6 billion. The Mid-Term Review of the Ninth Malaysia Plan targets for private investment to increase at an average rate of 10.6% during the next three years equivalent to RM305.8 billion.

During the first two years of the Ninth Plan, private investment grew by 8.6% on average and amounted to RM135.6 billion. The Mid-Term Review of the Ninth Malaysia Plan targets for private investment to increase at an average rate of 10.6% during the next three years equivalent to RM305.8 billion.

Potential investors must be made to understand that the current political scenario in fact offers greater scope for improving accountability and transparency and affords greater check and balance on the Government. It also allows for greater debate on important policies and engages a wider spectrum of stakeholders. The nature of relationship between the Federal and State governments as provided for in the Constitution also ensures consistency in key policies.

Therefore, a stronger showing by the private sector is necessary to achieve the set target and ultimately achieve the 6% real GDP growth rate. This is certainly going to be a colossal task but I don't think it is impossible. The private sector must be more forthcoming to invest particularly in the new growth areas in the agriculture, manufacturing and services sectors as well as knowledge-intensive and high technology activities. They must be less risk adverse. The Government on its part will continue to further improve the business climate including further deregulating and liberalising the economy.

Yet, another challenge relates to the corporate sector. In the immediate term, companies need to make internal adjustments in the light of increasing prices of building materials, energy and other commodities to remain competitive and sustainable. In the medium term, companies must brace themselves to higher wages of its employees. Rising wages is inevitable as they move into higher end, high technology and knowledge-intensive activities as they will require better qualified and talented employees. Companies must be prepared to accept that a larger proportion of cost will go towards paying wages.

In addition, the corporate sector must also introduce measures to become more competitive and achieve greater global presence. For this purpose, subsidies will need to be gradually reduced to enable companies to compete in the open market and become more resilient. To achieve global presence, the quality of products and services must also be continuously upgraded to meet international standards and changing consumer taste and needs. In this respect, companies should pay greater attention towards undertaking R&D as well as innovation. Entrepreneurial capability will also need to be enhanced.

Last but not least, I consider managing perception with regards to the changing political landscape in the country as an important challenge. The ruling Government's lack of two third majority in the Dewan Rakyat should not be perceived as a case of political uncertainty or instability but rather a case of political maturity of the people. Potential investors must be made to understand that the current political scenario in fact offers greater scope for improving accountability and transparency and affords greater check and balance on the Government. It also allows for greater debate on important policies and engages a wider spectrum of stakeholders. The nature of relationship between the Federal and State governments as provided for in the Constitution also ensures consistency in key policies. The current political scenario therefore offers a healthy and more vibrant landscape for investment.

■ ***Amirsham A Aziz is Minister in the Prime Minister's Department. This speech delivered at the Seminar on the Mid-Term Review of the Ninth Malaysia Plan organized by the Malaysian Economics Association (MEA) on 30 June 2008.***

Some Thoughts on the Fuel Subsidy Issue

by
Tan Eu Chye

THE surprised fuel subsidy cut that entailed raising the retail prices of petrol and diesel by some 40 per cent and 63 per cent respectively would have highly inflationary consequences. Even though business, particularly commercial vehicle operators, have no cause to increase prices given their continued and perhaps enhanced access to fuel subsidies, they would still attempt to find justifications in the rising cost of non-fuel inputs. Moreover, the business community would seek every opportunity to defend their real earnings by passing not only their higher cost of production but also their higher cost of living to helpless consumers. Thus a spike in the inflation rate and a period of high inflation can be expected following this move, compounded by the already rising food prices and the upcoming hike in electricity tariffs.

Of course, the public cannot altogether be deemed as insensitive to the need of scaling down the fuel subsidy simply by their protests. The need to have an efficient public transport system has long been overlooked, akin to our past neglect of the agriculture sector. They have to expend a great deal on fuel especially with their daily encounters with traffic jams and on vehicle maintenance. There is very limited substitutability between private transport and public transport in the wake of the fuel price hike as the infrastructure for public transport cannot simply be developed over night. Thus, switching to public transport is not an immediately viable option to most. Even the savings from the subsidy cut to be channeled towards greater subsidization for essential food items and the provision of fuel rebates to private vehicle owners may not be placating enough. And what makes the subsidy cut more objectionable to the public is their perception, rightly or wrongly, that the government has been extravagant. The sentiment is also worsened by the rapid erosion of the purchasing power of their savings amid a high inflation-low interest rate environment.

Given that the country's economic growth has been driven in recent years by domestic private and public consumption spending, the dampening effect of higher inflation on domestic spending could also retard the growth momentum. Barring any unforeseen circumstances, the national economy is not likely to experience a recession. However, the lingering effect of the subprime crisis in the advanced economies and escalating oil prices that adversely affect economies worldwide have heightened the risk of stagflation in the global economy.

The public cannot altogether be deemed as insensitive to the need of scaling down the fuel subsidy simply by their protests.

Nevertheless, the subsidy cut is not bereft of any economic justification. Short of an internationally coordinated action to stabilize or bring down the oil price like the coordinated intervention in the foreign exchange market witnessed occasionally amongst industrialized economies, it may be more prudent to allow market forces to effect the adjustment of the economy to the oil price shock. Given that speculative forces might have been partly responsible for the oil price spiral, such forces may be countered by a concerted action amongst countries to reduce or even remove subsidies on oil consumption. Otherwise, the continued granting of subsidies would merely serve to accommodate the speculative forces as the demand for oil would then go unabated.

Moreover, the artificially low price of oil made possible by generous subsidy provisions merely results in inefficient fuel consumption that intensifies global warming through the greenhouse effect. The adoption and maintenance of a more energy-saving attitude and thus a more environmentally friendly lifestyle would be deferred. This bears semblance to the argument that maintenance of low wages via liberal access to foreign labor would merely discourage industrial automation. Hence, the high oil price may eventually turn be a blessing in disguise as it could possibly constitute a mechanism for averting some future environmental and thus economic catastrophe, much more disastrous than the current high oil price spell.

Raising wages and the cost of living allowance (COLA) to cope with the rising cost of living would merely compound the inflationary problem as wage-push inflation could then set in. This in turn could undermine the nation's external competitiveness. Generally, there should not be any undue attempt to put more money into the pockets of consumers to ease their burden as it could have the unintended effect of accommodating the demands for higher prices amongst traders. Similarly, price controls need to be exercised cautiously as they have the tendency to create shortage of goods that could be real rather than artificial. Inflation may also be more successfully tamed by raising interest rates instead.

■ ***Professor Dr. Tan Eu Chye teaches at the Faculty of Economics & Administration, University of Malaya.***