Rethinking the balanced budget timeframe

The Malaysian government is striving to reduce its budget deficit and to achieve a balanced budget. This sounds good. A balanced budget would ensure a strong public sector financial position, more confidence in the economy, a stable currency and a stable economy. It is expected that the government will reduce its deficit from 4.5% of gross domestic product (GDP) in 2004 to 3.8% in 2005. This process will involve a reduction of government gross development expenditure by about 9.0% in 2005.

Its worth noting that although the government's revenue from direct taxes may decline this year (-2.9%) due to a slower economic growth, the total government revenue for 2005 is expected to register a positive growth of around 2.2%, thanks to anticipated increases in other sources of revenue such as indirect taxes (an increase of 7 %) and non-tax revenue (an increase of 6.6%). However, to improve fiscal discipline and to strengthen the public financial position, the government chooses to pursue a balance budget approach.

Although, theoretically, a large budget deficit may lead to high inflation and a bubble economy, prudent spending and careful project selection will be able to neutralise this effect. Thus, the overriding principle is transparency and fiscal discipline in relation to project selection and budget allocation.

The actual size of a budget deficit will rest on the rate of economic growth. A lower rate of economic growth will widen the size of the deficit. Thus, to reduce the budget deficit, a proper project selection and financing is required. The budget should concentrate on income generating projects. Putting a ceiling on a budget by cutting some productive projects is not a good budget strategy as its will reduce economic growth potentials.

In reducing government expenditure, the government hopes that it can bring back the private sector on track as a major engine of growth for the economy. Although the policy is right, one wonders if the timing is suitable.

Certain investment figures are encouraging and reflect the readiness of the private sector to take over the role. For instance, foreign direct investment (FDI) inflows have actually improved in 2004. The net FDI inflows into Malaysia were registered at RM8.96 billion during Jan-Jun 2004, which was a significant improvement compared to an inflow of RM2.63 billion during Jan-Jun 2003. Another encouraging piece of news is that, according to the FDI Confidence Index 2004 compiled by A.T. Kearney, Malaysia's FDI outlook, based on a survey of global investors in 2004, has improved significantly to the 15th position in 2004 from the 23rd position in 2003. In Asia-Pacific, Malaysia is ranked the fifth most attractive investment destination after China, India, Australia and Hong Kong.

While there is basis for hoping that the FDI trend will continue, the data for private gross fixed capital formation (PGFC) is not all that encouraging. Although the (PGFC) had increased by 16.3% in 2004 and is expected to increase further by 12.9% in 2005, its value is still very low relative to the 1997 level. The PGFC dropped to RM44.0 billion in 1998 from RM89.6 billion in 1997. The PGFC is expected to increase to RM50.1 billion in 2005.

Furthermore, the world economic growth is projected to slow down to around 4.3% in 2005 (2004:5.0%), as the growth momentum in developed countries reverts to a moderate pace amid rising interest rates and high oil prices. The world economy is projected to decelerate further to a 4.1% growth in 2006.

The US economy is predicted to expand by 4.3% in 2004, before moderating to 3.5% in 2005. The economic signs in the Japanese economy are still mixed with a strong indication of slowing private consumption. In Europe, economic growth is improving only gradually and economic growth is expected to be sluggish. The European Central Bank trimmed its 2005 growth estimate for the Euro region to 1.95 from 2.3%, as announced by the ECB President Jean-Claude Trichet on 2 Dec 2004.

In line with the global trend, we expect that Malaysia’s economic growth will also be lower in 2005 and 2006. Theoretically, our fiscal policy should be expansionary to cushion the world slow-down effect.

Developed countries across the world are already making expansionary moves to reduce the anticipated slower economic growth. For instance, governments across Europe are cutting taxes on personal income and corporate profits by more than 18 billion euros ($24.6 billion) next year to boost consumer spending and investment and economic growth. In Germany, the region's biggest economy, retail sales have stagnated as unemployment rose to a six-year high of 10.8%. Germany and Italy, the third-biggest euro economies, are among countries cutting income taxes from 1 Jan 2005. Austria, Finland, Denmark and Greece are reducing corporate tax rates as they face increasing competition for investment from Eastern Europe, where the new Romanian government recently announced a flat tax rate of 16%.

The Malaysian economy is gearing itself for knowledge and technology driven growth. The transition to a knowledge-based economy has to start with capacity-building and, thus, requires large government expenditure. Moving towards this direction also requires a large improvement in the quality of human resources to meet the requirement for a work force that is skilled in science and technology (S&T). This will involve producing more S&T graduates from institutions of higher learning.

The Second National Science and Technology Policy has proposed that research and development (R&D) expenditure be increased to at least 1.5% of GDP by 2010 and called for a competent work force of at least 60 researchers per 10,000 labour force by 2010. Presently, R&D expenditure relative to GDP is fairly low. In 2000, R&D expenditure amounted to only 0.5% of Malaysia’s GDP, while the Republic of Korea (ROK) spent 2.9%, Japan 2.8% and the United States of America (USA) 2.5% of GDP.

The painful effect of deficit reduction is already being felt by the business community. This is evident especially for companies dependent on construction and infrastructure projects. Thus, a longer time-frame is needed for these companies to make the necessary changes.

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