Chapter 3: An Overview of Public Expenditure Trend in Malaysia

This paper aims to explore the issue of public expenditure's ability to promote economic growth by focusing on the experience of a small open economy, namely the one of Malaysia. Malaysia proves to be an interesting case study as it experienced a major increase in public expenditure during the period 1970 to 2000, a phenomenon that is consistent with the proposition of Wagner's Law. The last three decades have witnessed a crucial role played by the Malaysia public sector; not only because of its increasing size and the employment opportunities it creates but also the degree of the government intervention in the economy (Salleh and Osman-Rani, 1991).

It will be useful to understand the historical background of Malaysia before we proceed to discuss about the public expenditure trend. Malaysia consists of two main territories, the East and West Malaysia, which is separated by the South China Sea. Not only they are geographically distinct units, but also there were also territorially based ethnic and historical differences. Malaysia is a middle-income economy of approximately 23 million populations, of whom 60% are indigenous (known as Bumiputera), mainly Malay and the remainder non-Malay (principally Chinese and Indian). Due to these differences, decisions on public policy tend to give priority for equality in wealth and distribution to avoid any unnecessary clashes of interests between the races.

At the time of independence in 1957, the economy was almost wholly dependent on rubber and tin mining exports. The government was quick to realize the need for diversification in the economy in order not to be over dependent on these agricultural commodities that is subjected to massive fluctuations in the global market. Main objective at that time was to branch out into the manufacturing sector hoping it could provide the impetus needed for rapid growth. Two major development strategies were the implementation of the import-substituting policy and subsequently export-oriented industrialization policy. The import-substituting policy was implemented in 1960s and focused on the consumer products that did not require high technology and capital. To enhance effectiveness of this policy, tariff protection or quantitative restrictions on imports were introduced to protect infant industries from foreign competition. Soon, the government realized that the import substituting policy could not ensure sustainable rapid growth of output and employment due to the near saturated domestic market.

Subsequently in 1968, the government introduced export promotion policy hoping it could provide sustainable growth in the manufacturing sector. Emphasis was put in labour-intensive industries such as electronics sector and creating considerable employment opportunities for the labour market. As a result, the manufacturing sector has been growing rapidly within the past few decades and has since garnered a substantial share in country's GDP. The structure of the economy had undergone major changes with the emergence of manufacturing sector as the new engine of growth. A better balance between agriculture, industry and the services sector has been achieved. Products of agriculture and mining such as the oil, gas, rubber, palm oil and others primary led the expansion in the initial phase of the manufacturing sector. Malaysia in its early period of rapid economic expansion was threatened by the world oil crisis and global recession in 1973. Compared to most oil-exporter countries, Malaysia was not badly hit but was only able to achieve a minimal growth rate of 0.8 percent in 1974 -75. Efforts to diversify the economy proved to be fruitful as Malaysia was not totally depended on crude oil as the main source of growth when the global recession occur. The transition of the structure of Malaysian economy can be seen in Table 1.

Table 1: Gross Domestic Product By Kind of Economic Activity at 1987 Constant Prices

Sector	1970	1980	1990	2000
Agriculture, Forestry and Fishing	32.06%	23.85%	16.22%	8.01%
Mining and Quarrying	5.72%	4.46%	9.34%	6.53%
Manufacturing	12.21%	18.58%	24.42%	31.65%
Construction	4.49%	4.61%	3.51%	3.17%
Services	45.53%	51.60%	46.50%	50.63%

Source: Bank Negara

The efforts contributed by private sector in diversifying the economy could hardly be refuted. Parallel to the efforts of the private sector, the government also has an active participation in the economy. The Malaysian Government is primarily involved in providing public goods and services, ensuring a suitable environment for the growth of private sector, regulating and managing the economy.

The degree of intervention of the public sector in the economy differs from period to period. Early period of post independence witnessed a more passive role of the government as embodied in the First Five-Year Development Plan (1956-1960), Second (1961-1965) Five-Year Development Plan and the First Malaysia Plan (1966-1970). This period basically adopted a laissez-faire development strategy that favoured minimum government intervention in the economy. Development in the commerce and industry was basically left in the hands of private enterprise. The Government focused mainly on providing essential services for ensuring internal security and restraining external threat, the establishment of general administrative machinery and basic infrastructures for the expansion of manufacturing sector. Public expenditure at this time was modest and the main objective of the public sector was to cultivate a comfortable commerce environment to complement the private sector. Although the government played a more reserve role, it also invested in projects that could generate revenues and employment opportunities.

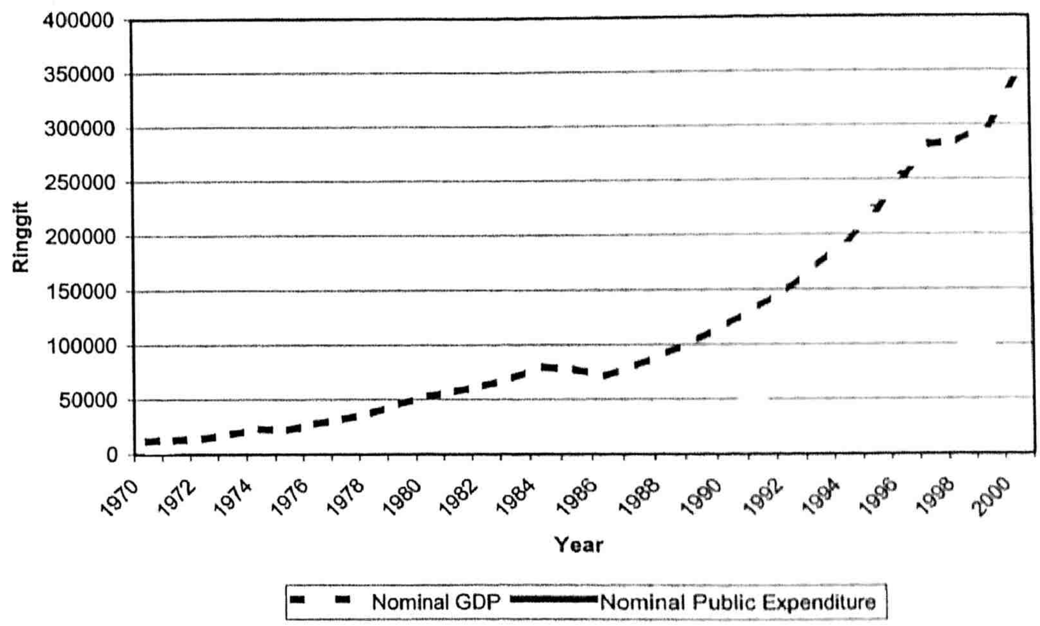
However, this laissez faire policy is partially abandoned after the suspension of parliament from May 1969 in the aftermath of the post-election racial riots as a result of discontentment of the dominance of Chinese community in the economy. Immediately, a special plan known as the First Outline Perspective Plan (OPP 1, 1971-1990) is drafted to correct ethnic economic imbalances. A new development strategy known as the New Economic Policy (NEP) is embodied in OPP1 involving an enlarged and more interventionalist role for the government. NEP has two main objectives. First is to reduce and subsequently eliminate poverty. Secondly, is to accelerate the process of restructuring of the society, particularly redistribution in equity ownership and employment. As a result, extensive use of public enterprises to overcome various socio-economic problems attributed to market failure and inequity suddenly became the new orthodoxy. This trend favouring a more enlarge public sector covers the period of Second (1670-75), Third (1976-80) and Fourth (1981-85) Malaysia Plans.

The government participated more directly by working with private sectors and making joint ventures through public agencies. Thus, the 1970s saw an accelerated increase in the public sector role in the economy as a result of a political turmoil. All these tasks are carried out through various government departments and public enterprises. Figure 1 reveals the time path of consolidated public expenditure and GDP in nominal values covering the period of 1970-2000.

Based on Figure 1, the size of public sector (measured as percentage of GDP) grew tremendously in the 70's and peaked at early 80's. In 1970, the ratio of public expenditure to GDP (in nominal values) was 28% and reached 54% in 1982. Growth in public expenditure was averaging around 3.9% per annum in 70s but declined in the 80s to around 0.8% per annum. Most importantly, the size of the public sector began to decrease in the 90s when it recorded average negative growth of 0.6% per annum. The rapid expansion of public sector in 1970s was mainly aimed to accelerate the achievements of NEP targets. The funding for this tremendous expansion of public sector was primarily from domestic sources, mainly from the forced savings of the

Employees Provident Fund (EPF). In addition to, the discovery and extraction of newly discovered petroleum reserves enhance the capability of government's expansion without dramatic increase in foreign borrowing. This situation persisted until Dr. Mahathir's Mohamad appointment as Malaysia's fourth Prime Minister in mid-1981. After 1983, public expenditure gradual decline and the size of public sector was only 34.5% in 2000.

Figure 1: Public Expenditure Trend In Malaysia (1970-2000)



With the announcement of the Privatisation Plan and Malaysia Incorporated Policy by Dr Mahathir in 1983, Malaysia was heading for a gradual cut down in the size of public sector. The Privatisation Plan aimed to gradually transforms ownerships of existing public agencies into private-owned companies. On the other hand, the Malaysia Incorporated Policy was to establish and strengthen cooperation between the private and public sectors, which will bring about strong and steady growth to the Malaysian economy. The aim was to increase efficiency in the provision of services in the country and at the same time reduce the size and role of the public sector. One reason for the cut back in public expenditure was due to the lacklustre performance of public enterprises. The public enterprises were already suffering from massive losses. Vaguely defined and contradictory objectives, coordination problems and the lack of supervision have hampered performance of public enterprises. Through privatisation, it was hoped that the financial burden of government could be reduced. These plans are widely perceived as a reversal of the earlier public sector expansion strategy adopted under the NEP.

It must be emphasized that although these policies were introduced in 1983, it was only until 1985 that both plans were strongly pursued. Federal government was obliged to cut down on its expenditure during this time. On contrary, public enterprises did not cut down on their spending instantly but instead increase their investment as a result of the implementation of heavy industrialisation strategy that aimed to accelerate growth in the industrial sector. The strategy emphasis was on heavy industries such as the steel, automobile, cement, motorcycles and other fields that required huge capital. Among the most prominent public agencies in the implementation of the heavy industry policy was Heavy Industries Corporation of Malaysia (HICOM). As the economy was still under the adverse influence of the international recession, much of the financing was raised through foreign borrowings, mainly from Japan. It must be stressed that the Malaysian Government was keen on decreasing the size of public sector but at the same time wanted to inject a much-needed impetus to the manufacturing sector. Involvements in the heavy industries were hoped to bring the growth of manufacturing sector to new heights. Eventually, the public expenditure recorded a net positive growth with the focus on heavy industries. Excess public expenditure soon led to fiscal deficits and accumulation of high foreign debt. Foreign debt, as percentage of GDP was 66% in 1986 compared with 9.5% in 1970.

Malaysia experienced another downturn in early 1980's that subsequently led to Malaysia's first recession in 1985. Real GDP in the 1985 recession declined to –1.1 percent but quickly rebounded in 1986. The Fifth (1986-90), Sixth (1991-95) and Seventh (1996-2000) Malaysia Plan period were aimed at encouraging private sector to lead the economy while government was obliged to play a complementary role. The accelerated process of privatisation contributed to a decline in the ratio of public to private investment that has been rising previously. Despite the vision of prudence fiscal and gradual reduce of the size of public sector in the Malaysia Plans, public investment expanded by 10.5 percent per annum under the OPP2 (1991-2000) as embodied in the Sixth Malaysia Plan. The public investment made was mainly directed to NFPEs, particularly Petroliam Nasional Berhad (Petronas), Tenaga Nasional Berhad (TNB) and Telekom Malaysia Berhad (TELEKOM) to finance their expansion and modernization programmes, especially during the first seven years of the OPP2 (OPP3: 40).

Public expenditure remained high after the outburst of the 1997 Asia financial crisis. The Government launched several fiscal stimulus packages to initiate economic recovery. Thus, the level of public expenditure was on the rise in the past recent few years in helping to the economy to face the economy turmoil created by the financial crisis. Various efforts were employed to get the economy back on track.

These measures include the introduction of capital control, restructuring of the banking system and enhancing corporate governance. Soon after the US suffered from recession after the terrorism attack on September 11, 2001 just when things were getting a little robust in Malaysia. Economic growth was hampered by US recession and recorded negative growth of -0.5% and –0.9% in the fourth and third quarter of 2001 respectively. Fiscal packages amounting to almost RM7.3 billion was spent to help revive the economy. These funds are used to finance development projects, training of retrenched workers, doubling the rates of current welfare payment and to intensify efforts to promote tourism. Malaysia projected a quick recovery when it recorded a growth of 1.1% in the first quarter of 2002 and 3.8% in the second quarter of 2002. Since then, the Malaysian Government has hinted to return to prudence fiscal measures and allowing private sector to lead the economy once again as the economy is set for recovery.

For the past few decades, generally we can see that the size of total public expenditure in Malaysia has grown considerably in absolute amount despite the prevailing government's policies to reduce the size of the public sector. Operating expenditure has been rising steadily, in a way similar to Wagner's proposition. The Malaysian Government is committed to the operating expenditure in the sense that it represents the amount need to spend to facilitate administrative purposes and the creation of jobs for civil servants. Developing expenditure is the only variable that can be exploited if the Government wants to cut its expenditure amount. This category of public expenditure has fluctuated frequently in line with the business cycles trend in Malaysia. Developing expenditure tends to be high during recessions and low when the economy outlook is bullish. Historically, developing expenditure is seen as an important fiscal tool used by the Malaysian Government to influence the economy, an action that closely follows the Keynesian doctrine. With the operating expenditure adhering to Wagner's Law and developing expenditure following Keynesian doctrine, it seems that both hypotheses has significant influence in the Malaysian economy. In order to determine the validity of these hypotheses, directions of causality between public expenditure and national income need to be tested.