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The case for subsidy rationalisation

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In a nutshell

There are strong arguments for the government to embark on subsidy-rationalisation measures in Malaysia as across-the-board subsidies for products such as fuel and food items tend to benefit the richest segment of the population. Indeed, a recent study reveals that about 80 percent of gasoline subsidies in many countries benefit the richest 40 percent of the population. Subsidies also send wrong signals to the market and lead to misallocation of resources.

In Malaysia, the rising cost of global commodities has placed a significant burden on government coffers, presenting a compelling reason for the government to review its subsidy policies. While the government's budget deficit was mainly attributed to fiscal pump-priming measures during the global recession, sharp increases in the prices of oil and other commodities have exacerbated the government's revenue-expenditure gap.

Subsidy removals will undoubtedly affect consumer spending, especially if such measures lead to widespread increases in the prices of consumer goods. In Malaysia, where private consumption is a major pillar of the economy, a dent in consumer spending will adversely affect headline growth if such measures were to be implemented aggressively. This is compounded by the fact that a large number of workers have relatively low income levels, with 34 percent of them earning a mere RM700 and below per month according to the National Employment Return (NER) 2009. Approximately 70 percent of the sample surveyed earn less than RM1,500 per month, and even in a big city like Kuala Lumpur, 32 percent of workers earn less than RM1,500 per month.

While there have been many discussions on the possible measures to mitigate the impact of rising prices on the poorest group, the predicament of the middle-income group should also be highlighted. This group faces the issue of 'relative poverty' where their incomes are above the poverty level but are barely sufficient for them to cope with the high costs of living in big cities.

All in all, subsidy rationalisation makes sense if the underlying intention is to shift the benefits accrued to the mass population to targeted groups which are deeply affected by higher prices. However, subsidy rationalisation efforts would best be introduced initially for non-food products which have been highly subsidised across the board, such as fuel. The removal of subsidies for food items has to be done very gradually as it affects the poorest segment of the population. Across-the-board assistance such as fuel subsidies should be fine-tuned to curb overconsumption by the higher-income segments.

Subsidy rationalisation plans would ideally be accompanied by concise plans to protect the groups that will be most affected, i.e. the poorest and the middle-income segments who live in big cities. For instance, during the recent hike in the electricity tariff, the government clearly stated that those who use less than 300 kilowatt hours (kWh) of electricity per month will not be affected by the increase. Such information should ideally be made available when other subsidies are gradually removed in order to reduce anxiety levels in the community. Efforts to push prices closer to market-clearing levels should be accompanied by similar efforts to ensure upward adjustments to the price of labour (wages). Besides handing out direct compensation to the affected groups, disseminating information on the alternative places to shop from can help tide consumers over this period of high prices.

The government can also take this opportunity to demonstrate their commitment to improving transparency to achieve a two-pronged advantage: if subsidy-rationalisation efforts are transparently carried out, the rakyat can better appreciate the rationale behind this seemingly controversial move and perceptions of corruption could decline. Information on the amount of savings from subsidy-rationalisation efforts channeled towards compensating the rakyat should be constantly highlighted in much the same way the Performance Management and Delivery Unit (PEMANDU) did for investments. Certainly, regular and detailed information flows can help eliminate doubts among the rakyat on the government's intention to reduce the country's unsustainable dependency on subsidies without adversely detracting from the welfare of the rakyat.

The rationale for subsidy removal

Many discussions have centred on the government's efforts to rationalise subsidies that have become well-entrenched in the Malaysian way of life. A widely held argument is that subsidies distort the economy by sending the wrong signals to the market, leading to gross misallocation of resources. These are well-documented arguments that are widely embraced in the field of economics.

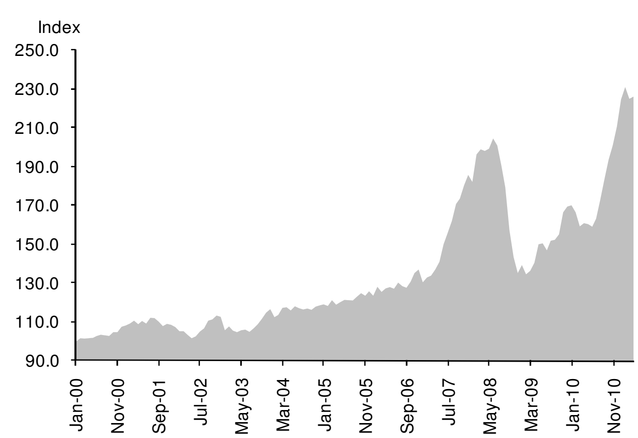
Ironically, this kind of distortion has been accepted throughout the world. For instance, agricultural subsidies in the western world, while constantly drawing flak from economists for their distortionary qualities, continue to figure prominently in these economies. As a case in point, farm programmes in US to subsidise grains, oilseeds, cotton, sugar, and dairy products have cost the US government a whopping USD20 billion per year in the government's budget outlays in recent years.

Why do countries continue to endure this type of distortion in their economies? Similar to free-trade arguments, removing any distortion would only yield positive results if, and only if, there is a level playing field. That is, if we were to remove a distortion but others do not follow suit, then the overall impact on the economy would be rather equivocal. In the same manner, lifting distortions in the goods market and not in the labour market will not bring about optimal results. Therefore, although subsidies are often derided, many countries will not remove subsidies completely because their policies go beyond the economic rationale.

Undoubtedly, there exist favourable arguments for subsidy rationalisation measures in Malaysia, as some subsidies have been implemented in an across-the-board fashion that benefit the rich, who already live comfortable lives, as well as the poor. The fuel subsidy is a prime example. In fact, a study conducted by the International Monetary Fund in 2010 (*Petroleum Product Subsidies: Costly, Inequitable, and Rising)* revealed that 80 percent of the benefits of gasoline subsidies in different countries went to the richest 40 percent of households. In view of this, the Malaysian government is taking rationalising efforts very seriously to ensure that subsidies benefit only the most needy groups, i.e. the low- and middle-income groups who are struggling in the wake of rising living costs.

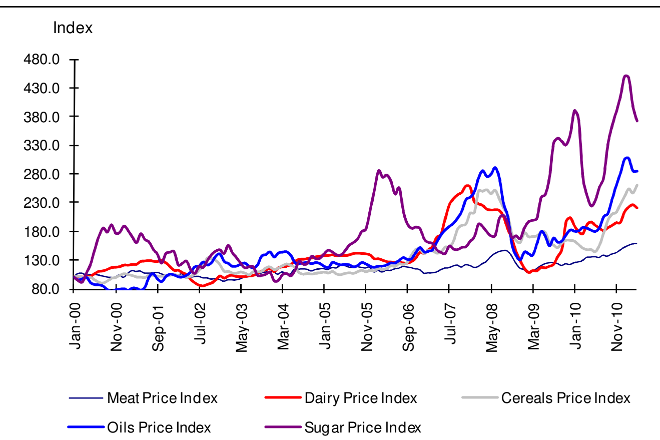
Rising global commodity costs have also placed additional burdens on government coffers, giving the government yet another compelling reason to review its subsidy policies. Government finances have been considerably strained by the astounding gain in the price of crude oil by 200 percent since hitting a low in December 2008 and the surge in other commodity prices – sugar by 273 percent, cereal by 160 percent, dairy products by 120 percent and meat by 58 percent since 2000 – due to tight supply following unfavourable global weather conditions and natural disasters. While a significant chunk of the government's budget deficit was attributed to fiscal pump-priming measures during the global recession, spikes in the prices of oil and other commodities have exacerbated the government's revenue-expenditure gap. As such, Malaysia's budgetary position, having been in the red for 12 years, is expected to continue languishing in deficit in the next several years and could add to the government's debt burden.

Chart 1: Food and Agriculture Organisation (FAO) Food Price Index (FPI) (rebased: Jan 2000=100)



Sources: FAO, MARC Economic Research

Chart 2: Breakdown of the FPI (rebased: Jan 2000=100)



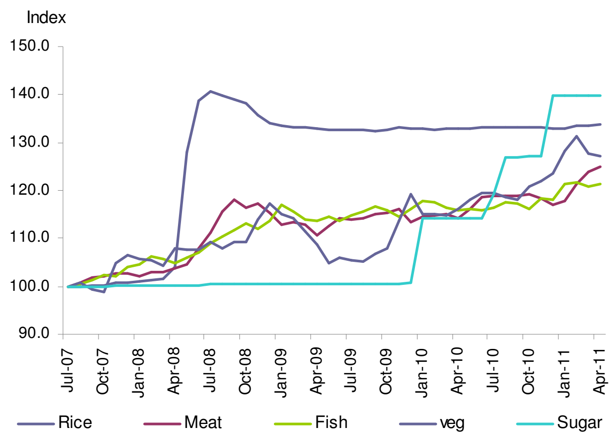
Sources: FAO, MARC Economic Research

Points to ponder

However, several factors have to be taken into consideration when taking steps to rationalise subsidies and move prices towards market-equilibrium levels if the government intends to achieve these levels.

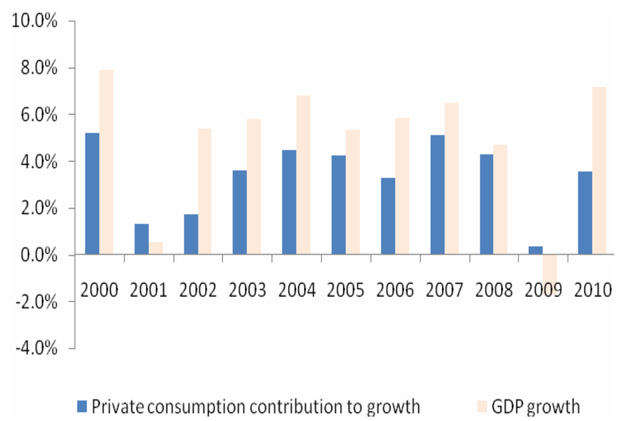
First, there should be a realisation that subsidy removals will undoubtedly affect consumer spending, especially if such measures lead to widespread increases in the prices of consumer goods. Consider the following case study: from July 2007, when civil servants last received pay hikes of between 7.5 percent and 35 percent, one can see that prices of major food items have generally increased between 20 percent and 40 percent within that period. A breakdown of the food component of the consumer price index (CPI) reveals that prices of meat, vegetables, rice and sugar have surged by 25 percent, 27 percent, 34 percent and 40 percent respectively. The salary hike for civil servants in 2007 was just enough to offset price increases within that period, and those who received less than, say, a 25 percent increase in their income since July 2007 would definitely feel the pinch from rising consumer prices.

Chart 3: Prices of food in Malaysia (rebased: Jul 2007=100)



Sources: CEIC & MARC Economic Research

Chart 4: Private consumption contribution to growth

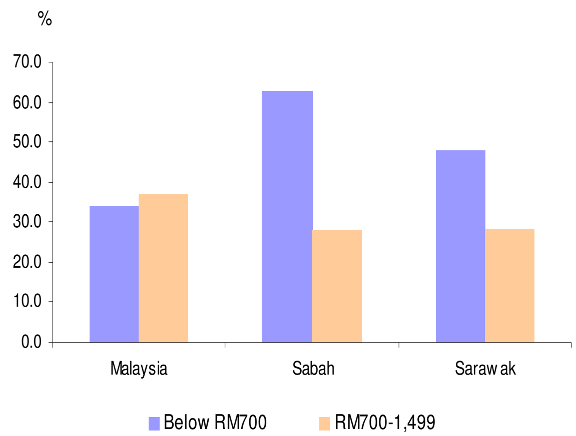


Sources: CEIC & MARC Economic Research

In Malaysia, where private consumption constitutes a major pillar of the economy, a dent in consumer spending will adversely affect headline growth. Indeed, private consumption in Malaysia contributed approximately 3.4 percentage points to headline growth (or 70 percent of the overall growth) between 2000 and 2010, of which a large part was driven by the strong labour market and easy credit provided by financial institutions to consumers. If, for some reason, labour market conditions deteriorate and credit lines to consumers are unplugged, private consumption will take a hit, dragging the economy's growth down. Therefore, if subsidy removal measures are strictly implemented according to schedule, the government must be prepared to accept a more benign growth profile in the next few years, although a continuous extension of easy credit can provide a buffer to some extent. However, should the government provide rebates to consumers in an across-the-board fashion upon detecting a softening in growth (as was the case after the sharp increase in pump prices in 2008), then its aims of shrinking its budget deficit and increasing subsidies' effectiveness may not be easily realised.

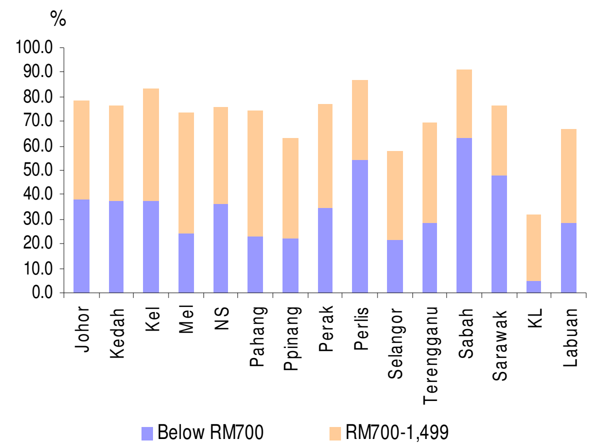
Consumer welfare should be given due attention as well. According to the NER 2009, a survey conducted in 2009 with a sample size of 1.3 million workers, approximately 34 percent of workers earned RM700 and below per month, while almost 70 percent earned less than RM1,500 per month. Even in a big city like Kuala Lumpur, 32 percent of the workers surveyed earned less than RM1,500 per month (see Charts 5 and 6).

Chart 5: Earnings of workers (overall)



Source: NER 2009

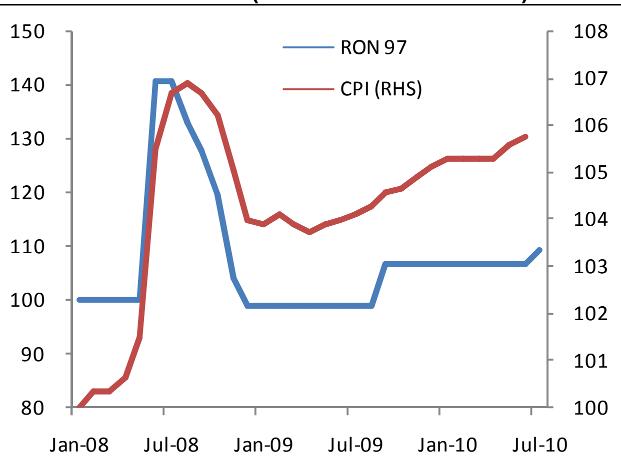
Chart 6: Earnings of workers (by state)



Source: NER 2009

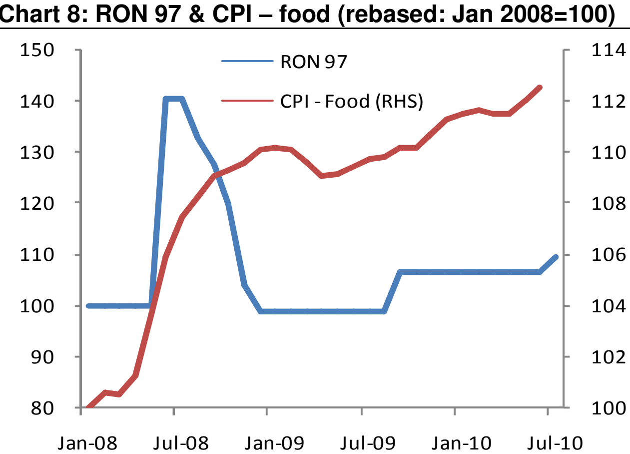
For these groups, food represents a bigger percentage of their monthly income than other groups. As such, sharp increases in major food items could dent their disposable incomes, causing them to hold back on other non-essential expenses. Compounding the problem is the fact that in Malaysia, food prices tend to be very sticky downward, i.e. after they rise following an event like a hike in pump prices, they will stay elevated even after fuel prices come down to the previous level or more. This can be seen from the experience in 2008 when pump prices were raised by up to 40 percent in June, pushing food prices up dramatically. Although fuel prices were reduced in the subsequent months, food prices remained on the uptrend (see Charts 7 and 8).

Chart 7: RON 97 & CPI (rebased: Jan 2008=100)



Source: CEIC

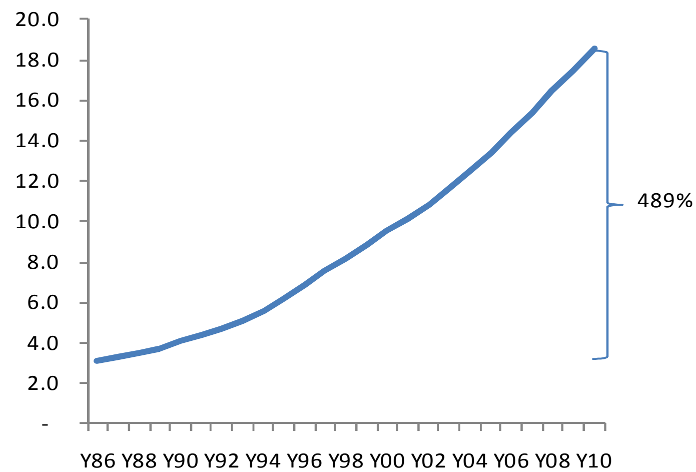
Chart 8: RON 97 & CPI – food (rebased: Jan 2008=100)



Source: CEIC

Another point to note is that while there has been a lot of discussion on the possible measures to mitigate the impact of rising prices on the poorest group, the predicament of the middle-income group should not be ignored. Contrary to popular belief, high petrol prices do not significantly affect the poorest group as they are more dependent on public transport. The middle-income group, on the other hand, faces the problem of 'relative poverty' where their incomes are above the poverty level but are barely sufficient for them to cope with the high cost of living in big cities. Significant chunks of their incomes go towards food, rent (or mortgages) and hire purchase (HP) loans. Since Malaysian banks have been providing easy access to HP loans in the past few years, the number of registered motor vehicles in Malaysia have grown exponentially since the 1990s (see Chart 9). As such, household expenses are heavily affected by pump prices.

Chart 9: Number of registered motor vehicles



Source: CEIC

Under these circumstances, subsidy-rationalisation efforts would best be introduced initially for non-food products which have been highly subsidised across the board, i.e. fuel. The removal of food items subsidies has to be done very gradually as it affects the poorest segment of the population. At the same time, readily available information on the plan to offset adverse impacts on the poorest group will be instrumental in reducing anxiety levels in the community. Efforts to push prices closer to market-clearing levels should be ideally accompanied by similar efforts to ensure upward adjustments to the price of labour (wages). In other words, while there is a clear plan to elevate prices of goods like sugar in stages within a predetermined period, there should also be a clear plan to raise labour compensation by a certain degree within the same period.

Understandably, it would be a challenge to induce private-sector employers to conduct periodical reviews of their remuneration packages as each firm would have different objectives and priorities. However, the public sector can draft a plan of salary increases for civil servants within certain periods which could encourage the private sector to follow suit. For instance, salary revisions similar to the one introduced in July 2007 (the first in 15 years) can be done more frequently for those who work in big cities to ensure that they can cope with the perpetually rising cost of living arising from lower (or eliminated) subsidies. While the government may incur additional costs on such measures, it can be offset by a reduction in the intake of workers in the future. In fact, measures such as redeployment of staff from overstaffed departments to ministries facing shortages in manpower can reduce further bloating of the civil service.

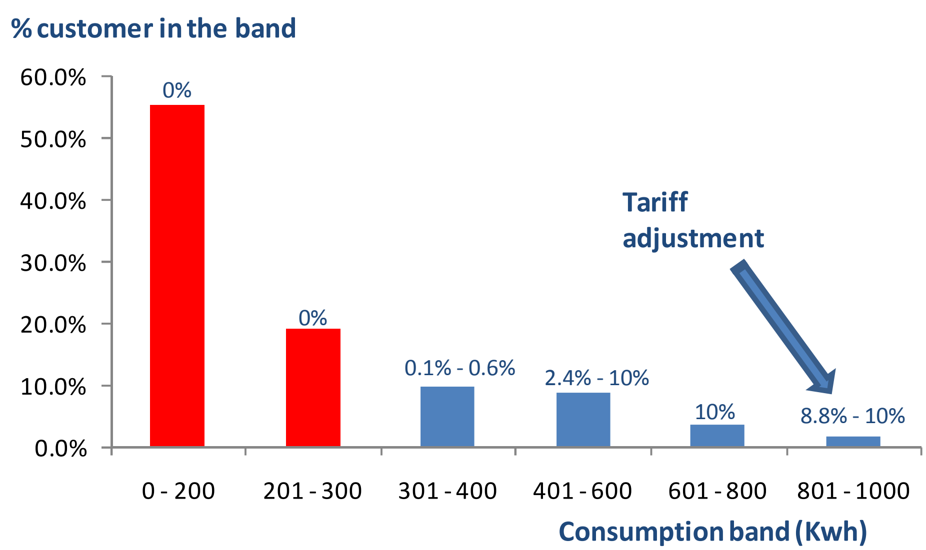
Besides handing out direct compensation to the affected groups, disseminating information on the alternative places to shop from can help tide consumers over this period of high prices. This is due to the fact that in some areas, consumers only have access to shopping outlets in limited places, preventing them from looking for best prices. Those who wish to go to hypermarkets have to travel far, and the greater cost of travelling reduces or negates the benefits of lower prices afforded by such retailers. On the other hand, in big cities, consumers can easily compare prices of goods being sold in competing hypermarkets located not too far away from each other.

The government can also take this opportunity to demonstrate their commitment to improving transparency to achieve a two-pronged advantage: if subsidy rationalisation efforts are transparently carried out, the *rakyat* can better appreciate the rationale behind this seemingly controversial move, and perceptions of corruption could decline. Information on the amount of savings from subsidy rationalisation efforts channeled towards compensating the *rakyat* should be constantly highlighted in much the same way PEMANDU did for investments. Regular and detailed information flows can help eliminate doubts among the *rakyat* on the government's intention to reduce the country's untenable dependency on subsidies without adversely detracting from the welfare of the *rakyat*.

Subsidy removals in other countries are commonly accompanied by some form of compensation to the affected groups to alleviate the initial pain associated with higher prices. In Indonesia, for instance, a temporary cash transfer programme was instituted to provide aid to approximately 19 million poor families in 2005 after petroleum prices were doubled. A similar measure was also implemented in 2008. In Jordan, the minimum wage was increased and greater wage increases were given to low-paid government employees after product prices soared by between 33 percent and 76 percent following the reductions in petroleum subsidies in 2005 and 2008.

In Malaysia, the recent hike in the electricity tariff provides a good example on how the government can reduce the country's unsustainable dependency on subsidies without adversely detracting from the welfare of the *rakyat* by clearly outlining a plan to protect the lowest income group. Such information should ideally be made available when other subsidies are gradually removed in order to reduce anxiety levels in the community.

Chart 10: The latest hike in domestic electricity tariff (starting June 1, 2011)



Source: TNB

All in all, subsidy rationalisation makes sense if the primary intention is to shift the benefits accrued to the mass population to targeted groups which are deeply affected by higher prices. Across-the-board assistance such as fuel subsidies should be fine-tuned to curb overconsumption by the higher-income segments. Subsidy-rationalisation plans are ideally accompanied by similar concise plans to protect the groups that will be highly affected, i.e. the poorest and the middle-income segments who live in big cities. A move towards market-clearing prices of goods should also be accompanied by efforts to bring labour-market compensation closer to the market equilibrium.

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