

SECTION 1:

FISCAL POLICY OVERVIEW

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SECTION 1: FISCAL POLICY OVERVIEW

Overview

Fiscal policy plays an important role in assuring macroeconomic stability and sound public finances. An effective fiscal policy through adjustments in public spending and tax measures is expected to sustain the growth momentum and enhance the potential output of the economy, while strengthening Government finances. As an open economy, Malaysia is exposed to external uncertainties such as global economic and trade vulnerabilities, geopolitical tensions as well as volatility in commodity prices and financial markets. These remain the key challenges in managing the country's economy and public finances. Therefore, it is essential to formulate sound fiscal policies in ensuring the economy is resilient and capable of providing countercyclical measures in addressing external shocks with the overall objective of safeguarding the national development agenda.

The Government has been consistently introducing fiscal measures and initiatives to strengthen further its public finances, diversify the economy and improve the well-being of the people. In supporting the fiscal consolidation effort, the Government's fiscal stance is anchored on two main pillars, namely enhancing its revenue base and ensuring public spending on programmes and projects with high multiplier

impact on the economy. The pro-growth fiscal policy is aimed towards promoting investment, enhancing competitiveness, improving public infrastructures and increasing inclusivity. Through prudent and disciplined fiscal policy, the Government will ensure the socioeconomic agenda remains its top priority in steering the nation towards realising the Shared Prosperity Vision 2030.

Strengthening Fiscal Institutions

The Government is committed to institutional reforms, particularly in areas related to public finances and governance. The establishment of Parliament Special Select Committee on Budget is one of the significant moves to strengthen fiscal institutions. The Committee has been tasked to scrutinise and oversee matters related to the Federal budget. In July 2019, the Committee tabled a report on debt and liabilities position to Parliament that outlines eight recommendations to improve debt and liabilities management. Among the recommendations are to regularly update report on the Government's debt and liabilities to Parliament; assess the sustainability of government guarantees (GG) and possibility of capping the GG; carry out comparison

**Table 1.1. Federal Government Financial Position
2018 – 2020**

	RM million			Change (%)			Share of GDP (%)		
	2018	2019 ²	2020 ⁵	2018	2019 ²	2020 ⁵	2018	2019 ²	2020 ⁵
Revenue	232,882	263,300 ³	244,530	5.7	13.1	-7.1	16.1	17.4	15.2
Operating expenditure	230,960	262,260 ⁴	241,020	6.1	13.6	-8.1	16.0	17.3	14.9
Current balance	1,922	1,040	3,510				0.1	0.1	0.3
Gross development expenditure	56,095	53,700	56,000	25.0	-4.3	4.3	3.9	3.5	3.5
Less: Loan recovery	788	900	766	-57.5	14.2	-14.9	0.1	0.0	0.0
Net development expenditure	55,307	52,800	55,234	28.5	-4.5	4.6	3.8	3.5	3.5
Overall balance	-53,385	-51,760	-51,724				-3.7	-3.4	-3.2
Primary balance¹	-22,838	-18,760	-16,779				-1.6	-1.2	-1.0

¹ Excluding debt service charges.

² Revised estimate.

³ Revenue estimates, including a one-off PETRONAS special dividend of RM30 billion.

⁴ Operating expenditure estimates, including a one-off allocation for outstanding tax refunds of RM37 billion.

⁵ Budget estimate, excluding 2020 Budget measures.

analysis on the Government's debt with peer countries; review Public Private Partnership and Private Finance Initiative reporting; and introduce specific coding for other financial commitments in the annual budget document. These initiatives are expected to enhance further the Government's accountability and transparency in managing public finances as well as debt and liabilities.

In ensuring more prudent debt management as well as reducing debt and liability to a manageable level, the Government has also established the Debt Management Committee (DMC) in May 2019. The DMC is responsible for formulating medium- and long-term debt management strategy and framework, as well as recommending policy direction to address risks associated with fiscal and debt position. In addition, the DMC is tasked to facilitate the implementation of best practices on sustainable and transparent debt management.

The Government will uphold its self-imposed guiding principles on fiscal management in supporting fiscal consolidation path towards a balanced budget. The main principles are to maintain an operating surplus where operating expenditure (OE) is only to be funded by revenue collection, while borrowings are

only for development expenditure (DE). In addition, the Government will adhere to the self-imposed debt limit of 55% of GDP and ensure debt service charges do not exceed 15% of revenue. Furthermore, the role of the Fiscal Policy Committee is fundamental in formulating and steering the adoption of fiscal principles and reform initiatives. The principles will be institutionalised through the introduction of Fiscal Responsibility Act (FRA) in 2021 as announced in the 2019 Budget.

In this regard, the formulation of FRA reflects the Government's commitment to restore its fiscal discipline and transparency amid a challenging external environment. This initiative is imperative in strengthening the Government's finances and ensuring long-term fiscal sustainability. The Government is also formulating the Government Procurement Act (GPA) to further enhance good governance in public procurement towards achieving best value for money, efficient spending and greater transparency. The GPA is expected to be tabled in Parliament in 2020. Furthermore, the implementation of fiscal reform initiatives will further strengthen the financial position and provide fiscal flexibility as well as enhance accountability and adopt best practices in managing public finances.

Feature Article

Fiscal Responsibility Legislation

Introduction

In the 2019 Budget, the Government has announced several reform initiatives to strengthen its fiscal administration. One of the initiatives is the introduction of the Fiscal Responsibility Act, which is expected to be tabled in Parliament in 2021. The introduction of the Act reinforces the Government's commitment to strengthen public finances through enhancement of fiscal discipline, spending effectiveness and transparency.

Fiscal Responsibility Legislations (FRL) are legal documents which consist of legal standards, rules and procedures relating to fiscal and budget management. The main purpose of the law is to secure sound public finance while ensuring medium- and long-term fiscal sustainability. An effective FRL contributes to fiscal stability, transparency, accountability and orderly budget process. These can be achieved by incorporating a good fiscal rule framework which focuses on principles, procedures, numerical rules, or any of the combination based on a country's needs.

Fiscal Rules

FRL contains fiscal rules which govern the conduct of fiscal policy through numerical targets or ceilings on budgetary aggregates. Generally, there are four main types of fiscal rules, namely budget balance, debt, expenditure and revenue rules for national or sub-national governments.

Budget balance or structural budget balance rule constrains the size of the budget deficit, thus controlling the evolution of the debt ratio. Meanwhile, debt rules set an explicit limit on the stock of public debt in relation to GDP. Expenditure rules impose a ceiling on the total, primary or operating spending in terms of growth rate or ratio to GDP. Revenue rules set ceilings or floors on revenues to ensure revenue collection is sustainable and sufficient to finance expenditures. A single fiscal rule is insufficient to address concerns related to fiscal sustainability. Therefore, a combination of the four fiscal rules with flexible provisions could be a better option to develop a good fiscal framework. Moreover, each of the fiscal rules has its own strengths and weaknesses.

Table 1: Properties of Different Types of Fiscal Rules

Type of Rule	Pros	Cons
Budget balance rule	▪ Clear operational guidance ▪ Close link to debt sustainability ▪ Easy to communicate and monitor	▪ No economic stabilisation feature (can be pro-cyclical) ▪ Headline balance could be affected by developments outside the control of the government (e.g. a major economic downturn)
Structural budget balance rule	▪ Relatively clear operational guidance ▪ Close link to debt sustainability ▪ Economic stabilisation function (i.e. accounts for economic shocks) ▪ Allows to account for other one-off and temporary factors	▪ Correction for the cycle is complicated, especially for countries undergoing structural changes ▪ Need to pre-define one-off and temporary factors to avoid their discretionary use ▪ Complexity makes it more difficult to communicate and monitor
Debt rule	▪ Direct link to debt sustainability ▪ Easy to communicate and monitor	▪ No clear operational guidance in the short-run as policy impact on debt ratio is not immediate and limited ▪ No economic stabilisation feature (can be pro-cyclical) ▪ The rule could be met via temporary measures (e.g. below-the-line transactions) ▪ Debt could be affected by developments outside the control of the government
Expenditure rule	▪ Clear operational guidance ▪ Allows for economic stabilisation ▪ Steers the size of government ▪ Relatively easy to communicate and monitor	▪ Not directly linked to debt sustainability since no constraint on the revenue side ▪ Could lead to unwanted changes in the distribution of spending if, to meet the ceiling, shift to spending categories occurs that are not covered by the rule

(continued)

Table 1: Properties of Different Types of Fiscal Rules (continued)

Type of Rule	Pros	Cons
Revenue rule	- Steers the size of government - Can improve revenue policy and administration - Can prevent pro-cyclical spending (rules constraining the use of windfall revenue)	- Not directly linked to debt sustainability since there is no constraint on the expenditure side (except rules constraining the use of windfall revenue) - No economic stabilisation feature (can be pro-cyclical)

Source: Fiscal Rules in Response to the Crisis-Toward the "Next-Generation" Rules. A New Dataset, IMF.

Components of FRL

In formulating the FRL, a government can consider various essential and optional components to be included in the law. Medium-term fiscal policy strategy is one of the essential components of the law which provides fiscal guidance, projections and key policy initiatives, normally for three years. In addition, an annual budget policy strategy is another important component of FRL which complements the medium-term fiscal objectives. Other vital components include the regular publication of reports on the performance of fiscal policies and audited financial statements to ensure accuracy and reliability of the information.

Several optional components can be included in the law to enhance the credibility and transparency of fiscal policy management. A government may be required to quantify the impact of new revenue or expenditure measures compared with existing policies and provide justification to support the desired fiscal targets. In addition, fiscal risk, including contingent liabilities is another popular optional component of the law. This component may arise and cause fiscal outcomes to deviate from initial plans. Other optional components may include quantifying tax expenditures, numerical fiscal rules, debt sustainability analysis and other various scenarios of long-term projections such as pension and health expenditures.

Table 2: Components of FRL

Essential	Optional
- Medium-term path - Annual budget policy strategy - Regular reports - Audited financial statement	- New versus existing policies - Numerical fiscal rules - Debt sustainability analysis - Fiscal risks including contingent liabilities - Tax expenditures - Various scenarios of long-term projections

Source: Ministry of Finance, Malaysia.

Country Experience

Many advanced and emerging countries have adopted FRL to strengthen their fiscal institutions, as well as to promote a more responsible and transparent fiscal management. The rules and principles of the law are either embedded in their constitutions, budget system laws and international treaties or enacted as a separate law to govern public finances. Countries such as Chile, Ireland, New Zealand and Thailand have adopted FRL as a separate law because of its advantages. The advantages, among others, cover other layers of government, focus on fiscal process rather than the budget process, and enhance political commitment for fiscal reforms.

Table 3: Key FRL Features of Selected Countries

New Zealand (Fiscal Responsibility Act, 1994) ▪ Fiscal Rule: Operating surplus ▪ Focused on fiscal sustainability and prudent debt levels ▪ Maintained levels of total net worth ▪ Required governments to set out specific fiscal targets for medium-term ▪ Improved fiscal reporting of fiscal risks ▪ The Act was repealed and incorporated into Public Finance Act as Part 2 in 2013	Chile (Fiscal Responsibility Law, 2006) ▪ Fiscal Rule: Structural balance ▪ Established independent committees and a fiscal council ▪ Established pension fund, as well as economic and social stabilisation fund ▪ Improved fiscal reporting of fiscal risks and contingent liabilities
Ireland (Fiscal Responsibility Act, 2012) ▪ Fiscal Rule: General budget balance ▪ Introduced debt rules ▪ Consistent with Stability and Growth Pact agreement under EU ▪ Set out medium-term budgetary objectives ▪ Established a fiscal advisory council ▪ Improved fiscal reporting and assessment on fiscal policy and performance	Thailand (Fiscal Responsibility Act, 2018) ▪ Fiscal Rule: Expenditure rules ▪ Introduced debt rules ▪ Targeted public investment ▪ Set numerical limits on contingency fund and debt repayment ▪ Required a medium-term fiscal framework ▪ Set up the National Fiscal Policy Board ▪ Improved fiscal reporting of fiscal risks

Source: Government of Ireland, New Zealand Institute of Economic Research, UNESCAP dan Inter-American Development Bank.

Conclusion

Several governments have adopted fiscal responsibility legislations to enhance fiscal policy management, accountability and transparency. A good FRL should include rules that are flexible, simple, transparent and orderly. Fiscal rules need to be monitored and reported regularly to avoid deviation from fiscal policy. In addition, a strong political commitment can ensure smooth adoption of FRL, especially in a dynamic global economic environment.

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Fiscal Position in 2019

In 2019, revenue performance is expected to remain favourable amid global economic challenges. The revised total revenue is expected to increase RM1.5 billion to RM263.3 billion compared to original estimates, constituting 17.4% of GDP. Tax revenue is expected to rise 3.4% to RM180 billion or 11.9% of GDP due to higher collection of sales tax and service tax, while non-tax revenue is projected at RM83.3 billion or 5.5% of GDP.

Meanwhile, total expenditure is expected to increase RM1.4 billion to RM316 billion or 20.8% of GDP as compared to the budget estimates. OE is estimated to expand by RM2.4 billion to RM262.3 billion or 17.3% of GDP, mainly due to higher fuel subsidies requirement following the rescheduling of the targeted fuel subsidy programme. In contrast, DE is expected to decline to RM53.7 billion on account of revision and timeline readjustment of several projects. The increase in expenditure is not expected to affect the fiscal deficit target, which is cushioned by higher revenue projection. Overall, the Federal Government's fiscal deficit is expected to remain at 3.4% of GDP as originally targeted in the 2019 Budget.

Consequently, excluding debt service charges, primary balance is expected to record a lower deficit of 1.2% of GDP (2018: -1.6%).

Outlook for 2020

Fiscal policy will continue to emphasise on sustainable economic growth, revenue enhancement and prudent spending. The Government will continue with its fiscal institutional reforms, particularly tax reform initiatives to improve tax administration, strengthen auditing and investigation as well as narrow tax gap. Furthermore, the Government will continue to adopt zero-based budgeting in its expenditure management to ensure efficient and effective spending as well as reprioritise and focus on high-multiplier impact projects. In addition, efforts will be intensified to consolidate a more comprehensive reporting on assets and liabilities position.

The Federal Government revenue is expected to register RM244.5 billion or 15.2% of GDP in 2020. The collection in tax revenue is higher at RM189.9 billion, while non-tax revenue at RM54.6 billion. Total expenditure is forecast at RM297 billion or 18.4% of GDP, of which OE is RM241 billion and DE is RM56 billion. While fiscal policy continues to support economic

growth and maintain the resilience of the economy, the Government remains committed towards fiscal consolidation efforts to strengthen the country's financial position.

The 2020 deficit target of 3.2% of GDP is slightly higher than the 3% originally announced in the 2019 Budget, but remains on a consolidation path. This is due to the Government's strategic decision to strengthen domestic economic activities as pre-emptive measures to provide immediate support and sustain the growth momentum in light of slower global growth forecast. Thus, the Government will allocate an additional injection of 0.2% of GDP through DE to revitalise public investment via capital formation in strengthening long-term potential of the economy. The allocation will be mainly channelled to accelerate the implementation of the impactful transportation and connectivity projects such as the construction of Pan Borneo Highway, Mass Rapid Transit 2 and Gemas-Johor Bahru Electrified Double Track Project. Small-scale developmental projects will also be implemented such as upgrading of dilapidated schools, clinics, water treatment plant and sewerage facilities as well as suburban broadband infrastructure. These projects are expected to generate high-multiplier impact on the economy towards achieving inclusive development.

In addition, allocation is provided for implementation of the rationalisation plan of Federal Land Development Authority (FELDA) and Lembaga Tabung Haji as well as higher debt servicing commitment for SRC International Sdn. Bhd. The Government will also focus on programmes which create more employment opportunities and income generation, thus improving the well-being of the people. Given the pre-emptive measures, the overall deficit in 2020 is expected to be lower at 3.2% of GDP (2019: -3.4%), with fiscal consolidation remaining on its trajectory and the debt position at a manageable level.

Medium-Term Fiscal Framework 2020 – 2022

The Government has adopted the Medium Term Fiscal Framework (MTFF) as a tool for medium-term fiscal planning. The framework

provides macro-fiscal projections for a three-year period by setting targets and ceilings for revenue, expenditure as well as the overall deficit. The projections will be revised annually on a rolling basis to reflect the latest medium-term forecasts for revenue and expenditure as well as macroeconomic assumptions. Thus, the adoption of MTFF is essential to ensure fiscal consolidation remains on track by enhancing fiscal discipline, optimising the allocation of resources and ensuring budget predictability.

The 2019-2021 MTFF has been revised based on the latest macroeconomic assumptions after taking into account the current global environment and lower crude oil prices. In this regard, for the period 2020-2022, the MTFF underlying assumptions are based on the projection of real GDP growth in the range of 4.5% to 5% (nominal GDP growth: 5.5%-6%), crude oil prices between USD60 to USD65 per barrel and crude oil production of 600,000 barrels per day. These assumptions provide conservative estimates of revenue to match with prudent expenditure allocation during the fiscal year.

Under the 2020-2022 MTFF, based on current tax policies, total revenue is forecast at RM764.9 billion or 15% of GDP. Non-petroleum revenue continues to be the primary source of revenue which is expected to contribute RM615.7 billion or 12.1% of GDP. In addition, petroleum-related revenue is projected at RM149.2 billion or 2.9% of GDP. The Government will continue its efforts to improve revenue collection through initiatives to broaden the tax base, reduce leakages and explore new sources of revenue.

On the expenditure side, the total indicative ceiling is estimated at RM910.4 billion or 17.8% of GDP for 2020-2022. OE will be allocated a sum of RM751.4 billion or 14.7% of GDP while DE a total of RM159 billion or 3.1% of GDP. The total indicative ceiling provides a threshold for ministries and agencies to plan their programmes and activities, thus making the budget planning process more efficient. The expenditure ceilings which are based on resources and spending capacity will ensure more prudent and efficient fiscal management. This will be a key controlling mechanism to keep fiscal consolidation on track in the

**Table 1.2. Medium-Term Fiscal Framework (MTFF)
2020 – 2022**

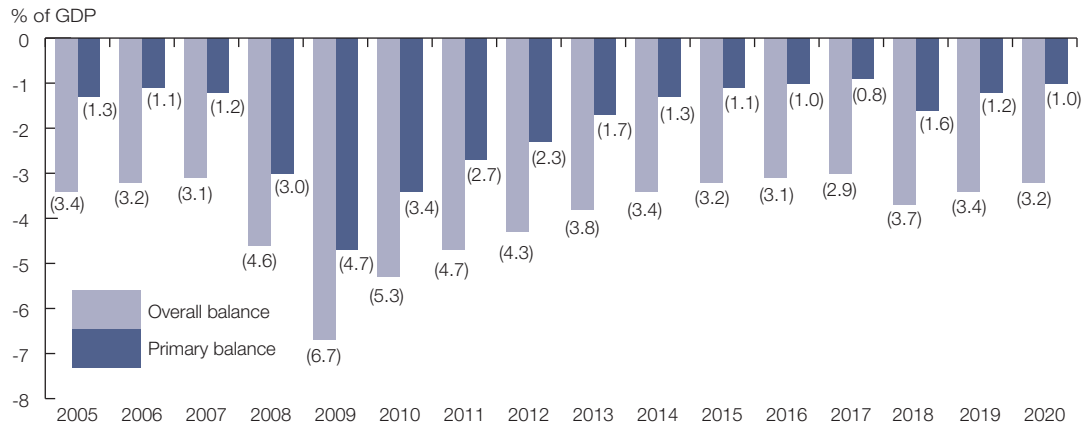
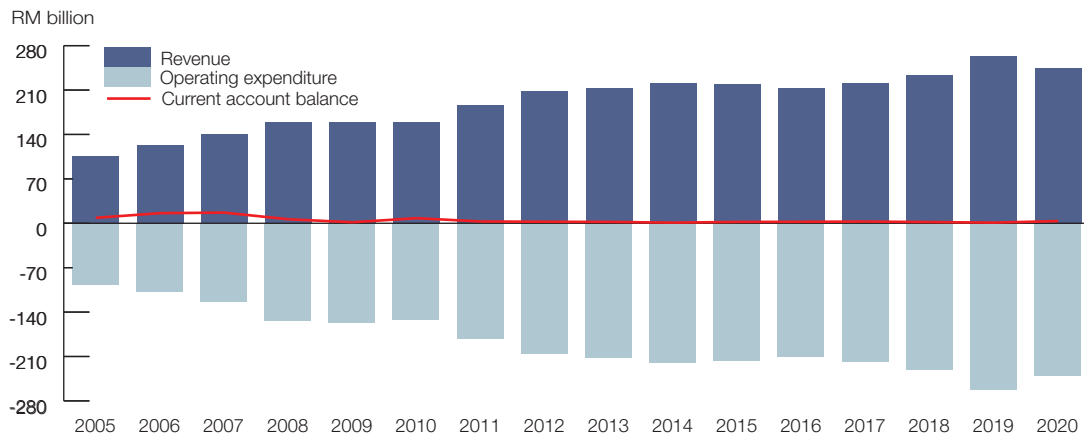
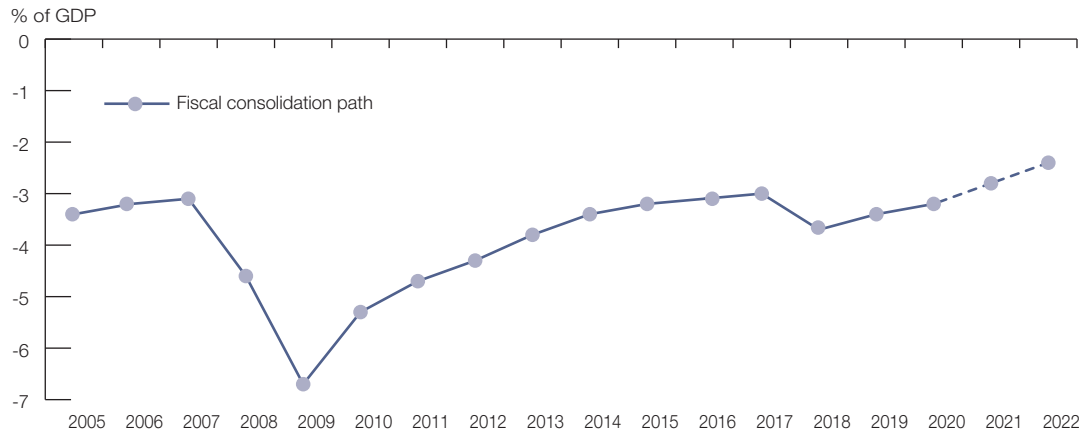
	2020 – 2022	
	RM billion	Share of GDP (%)
Revenue	764.9	15.0
Non-petroleum	615.7	12.1
Petroleum-related	149.2	2.9
Operating expenditure	751.4	14.7
Current balance	13.5	0.3
Gross development expenditure	159.0	3.1
Less: Loan recovery	1.8	0.0
Net development expenditure	157.2	3.1
Overall balance	-143.7	-2.8
Primary balance	-31.9	-0.6
Underlying assumptions:		
Real GDP growth (%)	4.5 - 5.0	
Nominal GDP growth (%)	5.5 - 6.0	
Crude oil price (USD per barrel)	60 - 65	
Oil production (barrels per day)	600,000	

Note: MTFF estimate, excluding budget measures.
Source: Ministry of Finance, Malaysia.

medium term and strengthen further the Government's finances. As a result, the fiscal deficit is targeted to average 2.8% of GDP for the three-year period. The lower deficit will provide more flexibility and capacity for the Government to create fiscal space and respond to any uncertainties in the event of economic crisis.

Conclusion

The Government will continue to strengthen its finances despite the current external headwinds, particularly trade tensions and volatility in commodity prices. The ongoing fiscal reform initiatives will further enhance the accountability and transparency of the Government as well as contribute to fiscal sustainability. In 2020, the fiscal deficit is anticipated to reduce to 3.2% of GDP and decline further to an average of 2.8% in the medium term, while the primary deficit is forecast to be lower at 1% of GDP and an average of 0.6%, respectively.

Figure 1.1. Federal Government Overall and Primary Balance**Figure 1.2. Federal Government Revenue, Operating Expenditure and Current Balance****Figure 1.3. Federal Government MTFF Overall Balance**

Note: 2019: Revised estimate.

2020: Budget estimate, excluding 2020 Budget measures.

Source: Ministry of Finance, Malaysia.

