



**UNIVERSITI PUTRA MALAYSIA**

**AN ECONOMIC ANALYSIS OF GOVERNMENT  
FINANCING FOR DEVELOPMENT IN MALAYSIA**

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**AN ECONOMIC ANALYSIS OF GOVERNMENT FINANCING  
FOR DEVELOPMENT IN MALAYSIA**

**By**

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## TABLE OF CONTENTS

	Page
ACKNOWLEDGEMENTS	ii
LIST OF TABLES	ix
LIST OF FIGURES	xii
ABSTRACT	xiii
ABSTRAK	xvii
CHAPTER	
1 INTRODUCTION .....	1
The Role of Government in the Economy .....	1
Background to the Malaysian Economy .....	9
The Malaysian Economy .....	9
Constitutional Framework .....	16
Development Policies .....	18
Problem Statement .....	20
Objectives of the Study .....	25
Scope and Organisation of the Study .....	26
Sources of Data .....	30
Summary .....	31
2 GOVERNMENT EXPENDITURES IN MALAYSIA .....	32
Introduction .....	32
General Trends in Public Expenditure .....	33
Current Expenditure .....	35
Development Expenditure .....	39
Government Expenditure: Theory and Evidence ..	51
Theories of Government Expenditure .....	51



	Page
Growth of Government Expenditure in Malaysia .....	55
Government Consumption Expenditure and Taxation .....	63
Effects of Taxation on Savings and Expenditures in Malaysia .....	65
An Evaluation of Public Expenditure in Malaysia	68
Budgetary Trade-offs .....	68
General Administration .....	72
Expenditure Programmes for the Poor .....	73
Government Expenditure as a Stabilising Measure .....	74
Scope for Expenditure Restraint and Control .....	78
Conclusions .....	82
3 THE FISCAL SYSTEM OF MALAYSIA: TAXATION .....	85
Introduction .....	85
The Tax System in Malaysia .....	85
General Trends in Tax Structure .....	85
The Buoyancy and Elasticity of the Tax Structure .....	99
Application of Buoyancy and Elasticity Analysis to Malaysia .....	102
An Evaluation of the Malaysian Tax System ....	109
Revenue Productivity .....	110
Administrative Feasibility .....	116
Equity .....	118
Efficiency .....	121
Stability .....	122
Income Redistribution .....	122
Conclusions .....	124



	Page
<b>4 THE FINANCIAL SYSTEM .....</b>	<b>127</b>
Introduction .....	127
Financial Development and Economic Growth ....	127
Financial Intermediation .....	130
The Malaysian Financial System and Monetary Policy .....	131
Financial System and Development Finance .....	131
The Malaysian Financial Institutions .....	138
Monetary Policy and Economic Development .....	151
Models of Finance and Economic Development ...	156
Financial Savings and Economic Growth ...	156
Financial Repression Model .....	160
Market Forces vs. Regulation .....	169
Conclusions .....	172
<b>5 EXTERNAL PUBLIC BORROWING AND ECONOMIC GROWTH ..</b>	<b>175</b>
Introduction .....	175
Foreign Loans in Malaysia .....	175
Composition of Foreign Loans .....	175
Debt Service Payments .....	180
Factors Affecting the External Debt Situation .....	182
External Borrowing, Savings and Growth .....	188
Review of Previous Studies .....	188
The Empirical Evidence for Malaysia .....	194
Measures to Reduce the External Debt Problem ..	202



	Page
Trade versus Aid .....	207
Background .....	208
The Theoretical Debate .....	209
Net Foreign Borrowing, Exports and Savings in Malaysia .....	211
Constraints of the Export-Led Growth Strategy .....	214
Conclusions .....	215
 6 THE MACRO MODEL: THEORETICAL FRAMEWORK AND SPECIFICATION .....	 218
Introduction .....	218
Theoretical Considerations .....	220
Previous Malaysian Macroeconometric Studies ...	226
Theoretical Framework and Specification of the Model .....	229
An Overview of the Model .....	229
Private Demand Sector .....	233
Government Sector .....	246
External Sector .....	249
Monetary Sector .....	252
Capacity Utilisation, Prices, Wages, Unemployment and Output .....	261
 7 THE MACRO MODEL: EMPIRICAL RESULTS .....	 270
Estimation Procedure .....	270
Empirical Results .....	272
Summary of the Preferred Equations .....	290
Private Demand Sector .....	290
Government Sector .....	291
External Sector .....	292





	Page
Monetary Sector .....	292
Capacity Utilisation, Prices, Wages, Unemployment and Output .....	293
Validation of the Model as a System .....	294
Introduction .....	294
Historical Dynamic Simulation Tests .....	398
Outside Sample Forecasting .....	302
Historical Policy Simulations .....	306
Conclusions .....	313
8 CONCLUSIONS .....	316
Introduction .....	316
Summary of Findings .....	316
Policy Implications .....	320
Scope for Further Research .....	327
REFERENCES .....	328
APPENDIX	
A Dynamic Historical Simulation .....	350
B Dynamic Historical Simulation Results .....	360
C Ex-Post Forecasts .....	365
D Ex-Post Forecasts Results .....	375
E Relative Effectiveness of Alternative Policy Changes .....	379
F Within Sample Policy Simulations .....	385
VITA .....	392



## LIST OF TABLES

Table	Page
1 Central Government Expenditure as a Proportion of GDP .....	3
2 Various Indicators of the Public Sector .....	4
3 Federal Government Finance as a Proportion of Development Expenditure .....	7
4 Sources of Financing Overall Deficit .....	8
5 Major Economic Indicators for Malaysia .....	10
6 Gross Domestic Product by Sectoral Shares .....	11
7 Investment in Malaysia .....	15
8 Current and Development Expenditures in Malaysia ....	34
9 Federal Government Current Expenditure .....	36
10 Federal Government Development Expenditure .....	40
11 Employment by Race and Sector .....	42
12 GDP and Employment by Sector of Origin .....	43
13 Buoyancies of Government Expenditures and Tax Revenue in Relation to GNP .....	57
14 Buoyancy of Total Revenue and Expenditure .....	58
15 Estimates of Displacement Effects in Malaysia .....	61
16 Estimates of Effects of Taxation on Savings and Public Expenditure in Malaysia .....	66
17 Estimates of Trade-Offs Between Defence Expenditures and Economic and Social Expenditures in Malaysia ...	70
18 Major Components of Federal Government Revenue as a Proportion of Total Revenue .....	87



Table	Page
19 Components of Income Tax as a Proportion of Total Income Tax .....	91
20 Components of Indirect Taxes as a Proportion of Total Indirect Taxes .....	93
21 Components of Export Duties as a Proportion of Total Export Duties .....	94
22 Elasticity and Buoyancy of the Malaysian Tax Structure .....	104
23 Comparisons of Estimates of Tax Elasticities and Buoyancies .....	108
24 Domestic Debt .....	134
25 Assets of the Financial System .....	135
26 Deposits of the Major Financial Institutions ....	136
27 Assets, Loans and Investment of Major Financial Institutions .....	137
28 Securities Held by Insurance Companies as a Proportion of Total Assets .....	149
29 Commercial Bank Lending as a Proportion of Total Bank Loans .....	154
30 Federal Government Net Foreign Loans .....	177
31 Composition of Outstanding Market Loans .....	178
32 Composition of Outstanding Project Loans .....	179
33 External Debt Servicing Ratios in Selected ASEAN Countries .....	181
34 Public External Debt as a Proportion of GDP .....	185



Table	Page
35 Relationship between Net Foreign Borrowing, Government Expenditure and Taxation .....	197
36 Summary Measures of the Dynamic Simulation Error ...	300
37 Summary Measures of the Dynamic Simulation Error of Selected Models .....	301
38 Range of Absolute Proportionate Changes in Wages and Prices .....	312



LIST OF FIGURES

Figure	Page
1 Allocative Effect of Financial Intermediation .....	163
2 A Simplified General Structure of the Macroeconomic Model of Malaysia .....	230



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This study examines the ways and means of government spending and the consequent impacts on the economy. The scope for enhancing the efficiency of government spending and the utilisation of the various sources of revenue are identified so as to maximise the net benefit of government involvement in the economy. The main sources of financing government expenditure include taxes, domestic and foreign borrowing and credit creation. Trends of both the spending and financing aspects of the government



budget are also discussed within the context of several related theoretical and empirical debates. Initially, the level of analysis is partial in nature, using single equation estimates, although cross references are made to link the various sources of government financing and spending. A simple macroeconomic model within the context of a simultaneous equation system is later developed to identify the impact of changes in several sources of government finance on main macro variables such as GNP, employment, prices, wages and private investment. This is done through several simulation exercises involving changes in policy variables such as taxes, the supply of money and public borrowing.

The empirical evidence reveals the greater responsiveness of changes in government spending compared to that of taxes, in relation to changes in Gross National Product (GNP). Increase in tax revenue is accompanied by a more than proportionate increase in government spending. Discretionary efforts to raise the revenue productivity of the tax system are outweighed by non-revenue generating objectives which include equity and administrative feasibility. Empirical estimates support the hypothesis that increasing the deposit rate of interest will attract more savings and thus facilitate a more effective role for the financial intermediaries in mobilising scarce financial



resources from the surplus to deficit spenders for productive investment purposes. The negative impact of the growth in net foreign borrowing on economic growth is reinforced by the negative relationship between net foreign borrowing and savings.

The simultaneous system approach of the macroeconomic analysis of government spending reveals several trade-offs between the different sources of government finance. A sustained increase in net credit operations of the private sector leads to the greatest expansionary impact on GNP and private investment which, however, are accompanied by greatest inflationary pressures. At the other end of the spectrum, tax and debt financing have the least expansionary impact on the economy. Nevertheless, they are also the least inflationary source of government finance.

Hence several issues which emerge from this study can be summarised. Firstly, it is important to ensure efficient utilisation of government expenditures for achieving the objectives of development policies especially within the context of increasing resource constraints. Secondly, both the benefits and costs of alternatives sources of finance must be taken into account so as to minimise the costs to the economy.





Finally, the increase in government deficit within some reasonable limits need not be counterproductive or inflationary.



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**ANALISIS EKONOMI PEMBIAYAAN KERAJAAN BAGI PEMBANGUNAN  
DI MALAYSIA**

Kajian ini menganalisis cara dan sumber perbelanjaan kerajaan serta kesan berikutannya ke atas ekonomi. Skop bagi melicinkan kecekapan perbelanjaan kerajaan serta kegunaan beberapa punca hasil dikenalpasti bagi memaksimumkan faedah bersih penglibatan kerajaan dalam ekonomi. Punca-punca utama bagi pembiayaan perbelanjaan kerajaan termasuk cukai, pinjaman dalam dan luar negeri, serta penciptaan kredit. Arah aliran kedua-dua aspek perbelanjaan dan pembiayaan bagi belanjawan kerajaan juga dibincangkan dalam konteks beberapa perbahasan berteori dan empirik yang berkaitan. Peringkat analisis pada permulaan adalah separa, dengan menggunakan anggaran persamaan tunggal. Beberapa rujukan silang dibuat bagi mengaitkan berbagai sumber pembiayaan dan perbelanjaan kerajaan. Sebuah model makroekonomi yang mudah dibina dalam konteks sistem persamaan serentak bagi mengenalpasti kesan perubahan beberapa sumber kewangan kerajaan terhadap angkubah-angkubah makro yang utama, termasuk Keluaran Negara Kasar (KNK), gunatenaga, harga-harga, upah dan pelaburan swasta. Pengenalpastian ini dilakukan



melalui beberapa simulasi yang melibatkan perubahan dalam angkubah-angkubah dasar seperti cukai, penawaran wang dan pinjaman awam.

Bukti empirik menyatakan gerak balas yang lebih bagi perbelanjaan kerajaan, berbanding dengan cukai, terhadap perubahan dalam KNK. Pertambahan dalam hasil cukai disertai oleh pertambahan yang lebih dari seimbang dalam perbelanjaan kerajaan. Tindakan budi bicara bagi meningkatkan daya pengeluaran hasil sistem cukai ditindih oleh objektif-objektif lain seperti keadilan dan kebolehlaksanaan pentadbiran. Anggaran empirik menyokong hipotesis bahawa pertambahan kadar faedah deposit akan menggalakkan lebih tabungan. Ini akan memudahkan peranan yang lebih berkesan bagi pengantaraan kewangan dalam menggerakkan sumber kewangan yang kekurangan dari pembelanja lebihan ke pembelanja defisit untuk pelaburan yang berdaya keluaran. Kesan negatif pertumbuhan pinjaman asing bersih keatas pertumbuhan ekonomi ditekankan oleh hubungan negatif antara pinjaman asing bersih dengan tabungan.

Pendekatan sistem serentak analisis makroekonomi bagi perbelanjaan kerajaan menyatakan beberapa "trade-off" antara sumber-sumber kewangan kerajaan. Pertambahan terjamin dalam operasi kredit bersih bagi sektor swasta membawa kepada kesan

pengembangan yang terbesar ke atas KNK dan pelaburan swasta. Ini pula disertai oleh tekanan inflasi yang terbesar juga. Pembiayaan melalui cukai dan hutang mempunyai kesan pengembangan yang kecil terhadap ekonomi tetapi juga merupakan punca kewangan kerajaan yang mempunyai tekanan inflasi yang rendah.

Beberapa kesimpulan boleh dibuat dari isu-isu utama yang timbul dari kajian ini. Pertama, kegunaan perbelanjaan kerajaan yang cekap perlu dipastikan bagi pencapaian objektif-objektif dasar pembangunan, terutama dalam konteks kekangan sumber yang bertambah. Kedua, faedah dan kos sumber-sumber kewangan alternatif mesti diambil kira agar meminimumkan kos keatas ekonomi. Akhir sekali, pertambahan defisit kerajaan dalam had yang munasabah tidak semestinya mempunyai kesan daya keluaran yang negatif dan juga tekanan inflasi.

## CHAPTER 1

### INTRODUCTION

#### **The Role of Government in the Economy**

Increased government involvement in the economy today has grown both in size and complexity to an unprecedented extent. This is not surprising since the increasingly complex and technologically advanced economy creates greater demands for government intervention to handle problems that did not exist in simpler times. There are many justifications for government involvement in the economy. Any review of the factors leading to the growth of government involvement in an economy traces one or more of the following general roles of government: namely allocation, distribution and stabilisation (see Chapters 2 and 3). While market failures have been commonly used, directly or indirectly, to justify such involvements, they do not in themselves justify all activities which governments actually carry out and the manner in which they are performed (Stiglitz, 1986; Tanzi, 1987). Governmental activities, for example, may benefit small groups at the expense of society as a whole, or that some government enterprises may be less efficiently managed than private concerns (see Chapters 2 and 5).



The government wields considerable power in influencing the level and type of economic activities. The extent of the government's influence on economic growth depends on the size and nature of its public expenditure. However, the amount the government can expend is dependent on the revenue it can raise, the loans it can obtain, and the assets that it owns. Thus, the way in which the funds are mobilised and used will also have an impact on the growth potential of the economy (Khan and Knight, 1981). Critics contend that the "heavy hand" of government has replaced the "invisible hand" of market competition in allocating resources and determining prices and incomes. The extent and form of government involvement have become hotly debated issues. The central question is not whether government involvement is good or bad, but whether the ultimate gains from such involvement outweigh the costs imposed upon society.

This thesis deals with the various ways and means of financing government expenditures and their consequences within the context of the Malaysian economy during the 1966-85 period. The scope of analysis is limited to that of the Federal Government. A comparison of the proportion of central government expenditure to Gross Domestic Product (GDP) with other countries as in Table 1 reveals that the figure for Malaysia is the highest among ASEAN countries. In fact, it is comparable to the ratios for developed countries.

**Table 1**  
**Central Government Expenditure as a Proportion of GDP**

	1970-75	1976-80	1981-85
Malaysia	34	35	40
Philippines	11	10	9
Thailand	15	19	21
Indonesia	20	22	23
Singapore	25	23	29
Industrial Countries	42	41	44
United States	35	34	37
United Kingdom	44	46	47
Federal Republic of Germany	43	48	50
World	39	38	42

Source:

IMF, Government Finance Statistics, various issues.

Several indicators of the scope of the public sector are illustrated in Table 2 where the variables are in nominal terms. Federal Government total revenue and expenditure accounted for an increasing proportion of GNP during the 1966-85 period. This is because the growth of both total revenue and expenditure at an average annual rate of 14.7 per cent have surpassed the corresponding growth rate of GNP of 11.8 per cent.

Table 2

## Various Indicators of the Public Sector

	1966-70	1971-75	1976-80	1981-85	1966-85
	a				
Growth Rate of GNP	5.8	14.0	19.0	7.1	11.8
Growth Rate of Total Revenue	9.6	17.1	22.3	8.8	14.7
Growth Rate of Tax Revenue	10.9	18.9	23.1	7.2	15.2
Growth Rate of Total Expenditure	6.3	20.1	25.2	5.7	14.7
Tax Revenue ----- GNP	15.5	18.3	22.3	24.1	20.1
Total Expenditure ----- GNP	24.4	28.9	34.1	43.0	32.6
Public Sector Deficit ----- GNP	5.1	7.8	9.3	14.0	9.1
Public Gross Capital Formation -----	39.6	32.3	36.3	48.7	39.2
Total Gross Capital Formation					

## Source:

Bank Negara Quarterly Bulletin, various issues.

## Notes:

a

all figures are in percentages.

1966-70 First Malaysia Plan.

1971-85 Second Malaysia Plan.

1976-80 Third Malaysia Plan.

1981-85 Fourth Malaysia Plan.

The public sector is limited to the Federal Government only.



The rapid growth of the public sector especially since the 1970s was mainly the result of its expanded role in the economy (Malaysia, 1986). Specifically, the rapid growth of the public sector in Malaysia reflects a shift from the limited use of the fiscal system to provide a congenial framework for the regulation and expansion of the government to the use of the fiscal system, or specifically the budget, as an instrument of allocation, growth, distribution and stabilisation. In other words, the role of the public sector, which in the 1960s concentrated on providing basic services, had shifted towards greater and more direct participation across most sectors of the economy (Malaysia, 1981).

The proportion of Federal Government total expenditure to GNP rose from 24.4 per cent (1966-70) to 43 per cent (1981-85). Federal Government tax revenue as a proportion of GNP has also increased, namely from 15.5 per cent (1966-70) to 24.1 per cent (1981-85). Since 1980, and especially with the negative-GDP-growth year, in 1985, steps have been taken to reduce the predominance of the public sector through cuts in government expenditure and through privatisation. Nevertheless, the public sector still accounts for a very significant proportion of total gross capital formation ranging between a 5-year average of 32.3 per cent to 48.7 per cent during the 1966-85 period.

