

ECONOMICS MALAYSIA

THURSDAY, AUGUST 30, 2012

Mythbusting: Government Debt Edition Part II

Well, I'm back from my break and had a lovely time with family and friends – back to regularly blogging again.

Nevertheless, this wouldn't have been my chosen topic, but with the budget little more than a month away, I suppose its understandable.

In a column yesterday at the Malaysian Insider, Azrul Mohd Khalib repeats all the same old myths about Malaysia's government debt (excerpt; emphasis added):

Maxing out the national credit card

...Every national Budget over the past few years has had a deficit. When total national expenditure exceeds the revenue collected, a budget deficit then exists. The only way for the government to pay for this deficit is to borrow.

But like everything else in life and like you and me, contrary to what some people may believe, there is an actual limit as to how much debt that the Federal Government of Malaysia can accumulate...

*...For Malaysia, **the national legal limit is clearly stated under the 1983 Government Funding Act and the 1959 Loan (Local) Act and is 55 per cent of the country's gross domestic product (GDP).** Under these two Acts, the government cannot legally have debt beyond this ceiling.*

The 2011 economic report indicated that government debt had reached RM456 billion. This represented 54.3 per cent of the country's GDP, which was also 0.7 per cent under the limit permitted under the law. That was in 2011...

*...In 2011, **the government received tax revenue of RM185.4 billion.** But the original 2012 Budget was RM232.8 billion. So, the tax income alone is insufficient.*

Therefore, the government has borrowed. But Malaysia prides itself on not borrowing from international sources such as the International Monetary Fund or from other countries. Therefore, 90 per cent of debt is domestically funded; it is borrowed from us, from the Employees Provident Fund (EPF).

***Last year, the Ministry of Finance stated that the government had borrowed RM79.4 billion from the EPF. In fact, the government actually owes us more than RM240 billion.** Yes, that is how those bonuses, numerous cash hand-outs and special projects are being paid for. With your EPF money...*

...The same principle governs our debt ceiling of 55 per cent. The only way to increase it and legally allow the government to spend more than the limit is for

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ABOUT ME

HISHAMH

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An applied and practicing economist in the Malaysian financial sector.

The purpose of this blog was first to have a way to put down and present my ideas, work in progress, and thoughts on the Malaysian economy. The second reason was to hopefully attract critiques and feedback, that would help me improve on my own understanding of the way the world works, or at least, this little corner of it.

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Parliament to amend the two laws mentioned. As far as I know, we have not done so.

*If the government is spending more than the debt ceiling, then the spending is not legal. **Seeing how in 2011 government debt had already reached 54.3 per cent of the GDP and RM20.5 billion is needed each year to service the country's debt commitments, the question must be asked and answered: where are we today? Do we even care?***

Financial agencies are already warning of a possible downgrading of Malaysia's credit rating if the government doesn't rein in its debt.

Short of very optimistic economic growth rates, it is almost certain that the government's current spending levels have breached the debt ceiling this year. This could be a historical year. For the wrong reasons...

...The government has been adamant that there is sufficient revenue. Yet, it's borrowing like mad.

The Auditor-General's report is bound to reveal yet again the extent of wastage and mismanagement that is endemic in the system which cost taxpayers millions of ringgit. We will moan, groan and complain. And things will stay the same...

...The people responsible for today's debt will not be the ones paying for it. Instead it is our children and grandchildren who will be forced to pay.

They and we deserve better.

SIGH

My FAQ addresses all these issues and more and the original Mythbusting post adds further insights, but to save some time here are the key points in relation to the myths in this particular article:

1. The legal limit on debt

Neither the 1983 Government Funding Act nor the 1959 Loan (Local) Act actually mentions a limit, much less make a "clear statement" of it. The 1959 Act was amended in 2005, but the amendment does not mention a legal limit either. The limit is actually adjusted by government gazette with consent by the Agong. No parliamentary approval is required, nor is there any necessity to amend the acts themselves – ***the limits on debt are purely at the discretion of the Minister of Finance.***

This is totally unlike the US, where the mandate for changing the debt ceiling is specifically under Congress. If you want to sight the Acts and the relevant gazettes, I'd encourage dropping by satD's blog.

2. Calculating the 55% legal limit

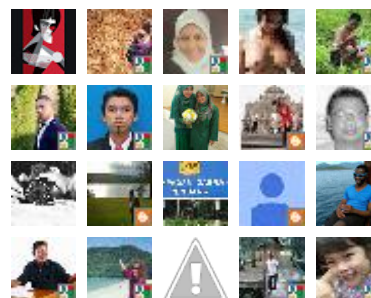
I've only just come to understand this myself. The 2005 (Amended) Act governs issuance of MGS, while the 1983 Act governs issuance of GII and Islamic Treasury Bills. There are actually two other laws that regulate government borrowing – the External Loan Act 1963 and the Treasury Bills (Local) Act 1946. The total current gazetted limits (reproduced from a Treasury presentation) are set out below:

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Legislation	Limit
External Loan Act 1963	RM35 billion
Treasury Bills (Local) Act 1946	RM10 billion
Government Funding Act 1983	Not more than 55% of GDP
Loan (Local) (Amended) Act 2005	Not more than 55% of GDP

The latter two are calculated in conjunction i.e. the calculated level is the sum of MGS, GII and Islamic Treasury Bills. Note the critical distinction here – **the 55% limit refers to MGS, GII and Islamic Treasury Bills alone**, and not total government debt collectively.

Far from approaching the 55% limit, the current aggregate outstanding issuance of MGS, GII and Islamic Treasury Bills is under 45% of GDP. The idea that Malaysia's government debt is approaching some kind of legal limit has no basis in fact.

3. Commitment to 55% total debt to GDP

While there's no danger of Malaysia breaching its legal debt limits, the government has made a commitment to keeping total debt below the 55% ceiling. **This however is an internal target and is not legally binding.**

4. The government is borrowing from EPF

Yes it is, but Azrul is mischaracterising this relationship. The Employees Provident Fund is a defined contribution pension fund for the benefit of private sector employees. As a pension fund, its primary mission is capital preservation, and as any fund manager worth his or her salt can tell you, the basis of any such investment portfolio is government securities because from a market risk perspective they are safer than anything else. **Any pension fund, here or elsewhere, will have the bulk of its portfolio in government securities i.e. "lending to the government".**

In fact, since we're talking about legal limits, Section 26a. of the EPF Act (Amended) 1991 specifically states the following (emphasis added):

*"Subject to any variation which the Minister may make under subsection (2), the Board shall invest or re-invest at least fifty per centum of the moneys belonging to the Fund and invested or reinvested during any one year, in securities issued by the Government of Malaysia, **provided that the total amount of moneys so invested in such securities at any one time shall not be less than seventy per centum of the Fund's total investments.**"*

If Azrul's numbers are correct, then the EPF is actually in breach of its own Act based on EPF's 2011 portfolio size of RM442 billion, which gives a ratio of about 54% – well below the 70% *minimum* level. Instead of asking why EPF is lending to the government, perhaps the more pertinent question would be why is EPF taking on more risks with our money by not "lending" as much to the government as it is required to.

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(Digression: in Singapore, they avoid questions like this by making it mandatory for the CPF to invest **all** member funds into government securities. EPF on the other hand is allowed considerably more discretion and leeway in where to invest member funds).

Another pertinent point here is that EPF's portfolio at the end of 2011 was about 1.56 times greater than the value of member funds i.e. it's not necessarily "our" money being lent to the government.

5. Where the money goes to

Another administrative (not legal) rule that the government tries to abide by is to fund all operational expenditure out of collected revenue, and only borrowing to fund development. In technical terms, what's being aimed for is that the operational budget should always be either in balance or in surplus, a principle that has been kept to all but three times in the last forty years. Borrowing is only utilised for development purposes (again technically, using the Development Fund under the government accounts).

In other words, civil servant bonuses, handouts etc, actually come out of tax and non-tax revenue, not out of borrowing.

6. Semantic issues

My nitpicking for the day. The government revenue quoted (RM185 billion) is actually total revenue and not tax revenue. Tax revenue for 2011 only amounted to RM135 billion.

7. RM20 billion for debt service

As an absolute number, it sounds like a lot; in relative terms it isn't. As a ratio to the operational budget – which remember, is supposed to be in balance – the government's interest payments for 2011 are actually the third lowest on record. In fact, the debt service ratio to operational expenditure the past four years has been at an all time low, averaging below 10%.

In 1990s when we were running a budget surplus, debt service averaged 23% of the operational budget, with the lowest level at 14.4% (1997).

8. Our children and grandchildren will be forced to pay for our debt

This is actually a tale of two hats, and the statement above comes from wearing only one of them. There's an important and vital reason why borrowing from domestic sources only is preferred because when you're able to do that, there's actually no inter-generational transfer of aggregate welfare. In Econo-english – the future burden on tax payers is offset by the future revenue stream from debt repayment.

Since debt liabilities are owed primarily to domestic institutions (such as EPF, insurance companies, banks and the like) who are in turn either tax payers or acting on behalf of taxpayers and citizens, debt repayment effectively goes back to the payers of tax. In other words, the monies aren't going anywhere, although there might be some

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redistribution of the proceeds.

If I wearing my taxpayers hat am liable for debt repayment of maturing debt incurred by my forebears, I wearing my EPF member, insurance policy owner, and unit trust investor hat *am also at the same time* the beneficiary of the government's current debt repayment. *And this is true at any given point in time, irrespective of when the debt is incurred.*

Given that there are less than 2 million individual taxpayers and over 12 million EPF members, there's also possibly a (small) transfer of wealth from the rich to the poor in the process.

The idea that government borrowing *now* is thus a net aggregate tax burden on *future* generations of citizens is mostly bunk. It would only be true if the borrowing is *external*, hence the reason why we try to keep government borrowing domestic and why external debt limits are far more stringent than the domestic limits.

Summing up

I suppose I'll be repeating these points again (and again) in the future, but I think its worth the effort to do so. There's so much misunderstanding of the unique position of government in an economy, and how significantly different governments are in economic terms from households. Imperfect understanding leads to skewed public discourse, which in turn leads to bad policy.

And we have enough problems as it is without having to invent fictitious ones that don't actually matter.

POSTED BY HISHAMH AT 10:00 AM 

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REACTIONS: Like (0) Don't understand (0) Boring (0)

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NadiaJ August 30, 2012 at 12:21 PM

Hi Hisham,

All excellent points. Was just wondering if we've been misreading the issue when it comes to government spending and revenue. In the long term, how sustainable is the reliance on oil-based revenues, and at which point should be worried about contingent liabilities given that the large amount of government-guaranteed debts to finance large-scale ETP-linked projects (the MRT, KLIFD) as well as corporate bond issuances (MAS, PLUS)?

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alberto August 30, 2012 at 1:48 PM

Thanks for the article Hisham.
Glad there is more than one side telling the story.

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