The Slump in the Price of Crude Oil: A Call to Review Malaysian Revenue Law and Fiscal Policies

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ABSTRACT

Global oil prices have fallen sharply, leading to significant revenue shortfalls in many energy exporting nations. It should be recalled that from 2010 until mid-2014, world oil prices had been fairly stable, at around US$110 a barrel. But since June last year, prices have more than halved. Stakeholders question the reason for the dip in oil prices. This paper looks at the potential long term solutions in a climate of persisting lower oil prices. The objectives of this paper are, first, to draw attention to the implications of the plunging oil prices in the way that it affects Malaysia, second, to show how Malaysia’s reliance on oil exports could become a drag on its economy and third, to analyse the implication and impact of lesser oil revenues on the economy which policy makers should address with a particular focus on the remedial measures potentially available to them through appropriate legal mechanisms, particularly tapping alternative sources of revenue. The methodology includes an examination of the laws and policies relating to income and expenditures and a consideration of mechanisms employed by other countries in raising revenue which are of relevance to Malaysia.

Keywords: Malaysian Economy, Declining Oil Revenue, Revenue Policies, Revenue Laws

INTRODUCTION

Macro economy is today dangerously adrift with its overwhelming impact too visible to ignore. Though it is not necessarily the main instrument to employ in assessing how well a government of a country is doing, macro economy has within it what it takes to influence the factors reasonable
people will use to measure government performance on the economy; and these include some outcome variables such as Income (Gross Domestic Product and growth rate), stability of prices (inflation and exchange rate), unemployment rate and poverty rate among others.

Gail Tverberg suggests in one of his works that the economy is a networked system of customers, businesses and governments which is tied together by a financial system and many laws and customs that have evolved over the years. Obviously, energy plays a key role in an economic system. In view of this, it can be argued an effective economy is tied to energy. Following this logical line of thought, it may also be held that as far as the economy of the modern world is concerned, the importance of stable oil price is not in doubt bearing in mind that oil, as a (natural resource) product, is the largest internationally traded goods or at least one of such goods.

Furthermore, it should be noted that the prices of energy-intensive goods and services are linked to energy prices, of which oil makes up the most substantial part with a capacity to impact the economy and hence, the claim in the above submission that energy as represented in oil holds the key to efficient and effective economic system. Thus, it may rightly be assumed that either upward or downward change in the price of oil is bound to have a wide-ranging effect for both oil importing and exporting countries, though the focus of this paper is on the latter based on the fact that Malaysia oil exporting country.

A Brief Overview of the Drop in the Price of Oil

In the second half of 2014, oil prices fell sharply ending a four-year period of stability. Brent crude oil, against which Malaysian oil is priced, peaked at US$115 a barrel in late 2013 but declined to about US$45 per barrel at the beginning of 2014 before bouncing back to US$60 per barrel in February 2015. That is more than 60% drop between June 2014 and January 2015 while the American (the United States’) benchmark West Texas Intermediate (WTI) fluctuated around the US$50 mark.

1Gail Tverberg is an actuary who is interested in Finite World Issues and he has written prolifically on oil depletion, water shortages and climate change.


In March 2015, the oil market seemed to have shown signs of stabilising but we could not hold onto it, as the global benchmark Brent crude oil fell below US$53 per barrel on 16 March 2015 but later rose to US$53.55 in the evening of the same day. It is worthy of note that the International Energy Agency had warned on 13 March 2015 that another sharp fall in oil prices was likely despite what appeared to be a rebound in early March and therefore, we were not caught unaware with the 3% fall on 16 March 2015 which at that time was a six-week low of US$52.50 per barrel. The falling price of oil places severe pressure on oil producing countries and test the flexibility of many of them, including Malaysia.

Impacts of Low Oil Price on the Malaysian Economy

The drop in the price of oil with a subsequent revenue shortfall has a significant impact on the economy of Malaysia. Understandably, the sources and implications of the falling crude oil prices have generated controversy but what is certain and obvious in the intensive debate is that if low oil prices persist for a lengthy period of time, it will not only reduce the revenue of oil producing countries but countries like Malaysia will be forced to make difficult economic, social and political adjustments.

Undoubtedly, the contribution of oil to fiscal revenue is substantial and hence, the severity of the shock reflected in the Ringgit (Ringgit Malaysia - RM) currency. The ringgit has been falling since the middle of 2014 as the oil price plunged, dropping to 3.58 against the US dollar on Friday, 16 January 2015 and by the following Tuesday, 20 January 2015, it fell to 3.59. It was on that day the government announced its budget revision. The steepest fall was at 3.71 (23/03/2015) standing at 3.51 on 2 May 2015. It should be pointed out here that ringgit was not the only victim, other regional currencies such as the Singapore dollar and the Indonesian rupiah had also fallen, but some economic analysts have argued that Malaysia’s reliance on oil income seems to have worsened the fall of the currency.

Malaysia’s current account surplus has been declining since peaking in 2008. Lower crude oil prices are putting pressure on Malaysia’s crude palm oil, a key source of export revenue. Crude palm oil exports to China, one of the major buyers of the product, fell to 22% on the year to 2.58 million tons in the January-November period of 2014. Malaysia was said to have recorded 20% year-on-year growth in its trade surplus over the same period, but some

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4See IEA, Oil Market Report for March, 2015 in which the watchdog that represents the world’s main oil-importing nations, says the recent stabilisation in oil prices is “precarious.” “Behind the facade of stability, the rebalancing triggered by the price collapse has yet to run its course,” it further observes in the report, released on Friday, 13/03/2015, see:https://www.iea.org/oilmarketreport/omrpublic/ and: http://uk.businessinsider.com/the-oil-crash-is-not-over-says-international-energy-agency-2015-3?r=US/iizzz3V1cm7i2h Accessed on Saturday, 21/03/2015.
analysts have attributed this to the boost in the electronics commodities with a warning of a potential deficit in the months ahead.

Falling oil prices have also hurt the state-owned energy firm – Petronas - which accounts for most of the government’s oil and gas revenue. The company warned in November 2014 that it would cut capital expenditure to take account of the added cost of exploring deep or difficult oil and gas prospects. It indicated that capital expenditure and operating expenditure would be cut by 15%-20% and 25-30% respectively this year.

Petronas pays the government an annual ‘dividend’ which is substantial, ranging of billions of ringgit but it is expected to try to negotiate this ‘dividend’ down with the government due to slump in oil prices. On December 2014, Petronas warned that its contribution to the government revenues in 2015 could drop to RM43 billion (US$12 billion) instead of the previously projected RM68 billion, if oil prices remain around US$75 per barrel.

According to MIDF Research (Malaysian Industrial Development Finance Berhad), total sales of Malaysian stocks by foreign investors topped US$2 billion in 2014, the highest figure since the 2008 financial crisis, and the sell-off appears to be continuing this year as investors flee the country. Bursa Malaysia, the country’s stock exchange, recorded a 5% year-on-year decline in average daily turnover to 2.037 billion in 2014.

It has also been reported that the gloomy market situation has triggered cold sentiment which seemed to have wrecked a planned merger of three banks as the talks ceased on 14 January 2015 between CIMB Group Holdings and two other local lenders to create Malaysia’s largest bank by assets. While the three banks were said to be convinced that their initial proposal to merge as announced in July 2014 was based on a sound logic, the changing economic landscape that followed the announcement had made the plan less attractive.

In an internal memo to his staff, the CIMB’s acting group chief executive said “the significant change in oil prices and currency exchange rates, as well as the challenging outlook for the financial services industry” were the main reasons why the merger deal fell through. If sustained, the oil price slump will have a huge impact on bondholders and banks with high dollar and energy exposures.

The CIMB Research had earlier last year envisaged and projected a loan growth of 10% in 2015 for the Malaysian banking sector which was the same level with that of 2014 as the growth in mortgages slowed down. Moreover, the brokerage expected banks to face other challenges such as the implementation of the goods and services tax.

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5See the official website of MIDF: http://www.midf.com.my/
tax that will be effective from this April (2015) and this is likely to reduce consumer spending.

A more expensive dollar from falling oil prices will mean more expensive imports for the merchants. The merchants must now pass on that added expense to the consumer to break even. Things generally become more expensive across the board when inflation sets in but because the nature of this type of inflation is predicated on the structure of the economy itself, it cannot therefore be controlled by monetary policy and manipulation by interest rates. Overtime, the government and domestic economy will eventually yield to the orchestration of the international market and helpless dependency on being an oil exporting country.

It took a while for the economic fall out to trickle down but it was gradually becoming discernible enough to notice and by the middle of 2015, with the declining oil prices and non improvement of oil exports, Malaysians citizens will discover a sudden and dramatic increase in food and transportation costs, among a host of other things.

As the title of this paper indicates, the challenge for the government is to review revenue laws and fiscal policies with a view to create incentives that will prevent the economy from collapsing anytime the price of oil falls. The policy adjustment will imply fiscal tightening, lower output and currency depreciation; the latter is harder to achieve under the fixed exchange rate regimes that characterise many oil exporters. If expectations of inflation are not well anchored, the depreciation may lead to higher inflation. A question may be raised as to what should be the appropriate policy response to falling oil prices in countries that export oil. Using Malaysia as a case study, in answering this question, it should be noted that while no two countries will experience the effect of plunging oil prices in the same way, they share common traits which may warrant some common policy response such as curtailing fiscal spending, removal of oil subsidies and depreciation of currency.

Malaysian Policy Response to Slump in Oil Prices

Malaysia is the third largest economy in Southeast Asia and one of Asia’s largest producers of petroleum-based products. About 30%-40% of its fiscal revenue comes from sales of oil and liquefied natural gas. In short, its economy relies heavily on oil and gas export revenues to maintain strong growth and control its debt. This is underscored in the way Malaysia overcame the last global economic problems.

The country was able to manage a quick recovery from the 2008 financial crisis and became one of the first major Asian countries to recover from that particular global economic crunch because at the time, its enormous oil revenue allowed the government to boost spending. However, the fall in oil prices had deprived the government of the means to help the economy make a similar response, which may have informed the abolition of fuel
subsides late 2013 and the imposition of sales tax in April 2015. It was obvious the country needed to find a new solution to address the economic challenges as the adverse turn in the oil market has put Malaysia’s current account balance under strain, and ruined budget projections.

In what may be described as acknowledging the global economic backdrop and its impact on Malaysia, on 20 January 2015, the Prime Minister, Najib Razak announced policy changes in a special address broadcast live nationwide in which he revealed measures his government would introduce with a view to easing the economically challenged situation.

The speech was generally seen as a Malaysian government position and indeed its policy response to the slump in the price of oil particularly when he said: “lately, there have been reports, concerns and queries on issues, such as crude oil prices and performance of the ringgit”.

At the news conference in Putrajaya, the Prime Minister proclaimed a revision to Budget 2015 to help Malaysian oil exporting economy adjust to the impact of plummeting global crude oil prices. One of the major aims of the budget revisions is to boost the value of the ringgit which had been sold down on the premise that the country revenue had fallen sharply along with slump in the oil prices. Malaysia’s currency traders have been selling down the ringgit which has fallen from RM3.14 against the US dollar on 28 August 2014 to around RM3.58 in January 2015. Najib Razak remarked that “the recent volatile capital flows and significant depreciation of the ringgit were also due to concerns over the impact of the sharp fall in oil prices on the Malaysian economy.” He further noted “being crude oil exporter [and with the oil prices plummeting recently], there was a perception that export receipts will also decline drastically and result in a current account deficit.”

He argued that “indeed, this perception is not correct. As a net crude oil exporter, we had a surplus of RM7.7 billion from January to November 2014. However, we are an importer of petroleum products with a net import bill of RM8.9 billion during the same period. If we include both crude oil and petroleum products, we are actually a net importer with a deficit of RM1.2 billion. Therefore, the perception that Malaysia is a large oil producer is also not true. However, if we factor in exports of crude oil, and net out petroleum products, then Malaysia is a net importer of petroleum. This does not include LNG, for which Malaysia is a net exporter”.

This argument or revelation (as described by some analysts) is in sharp contrast to the generally held belief that

7 See Najib Razak, Budget Revision: Full text of Prime Minister’s speech in the Star newspaper of Tuesday, January 20, 2015. Available on: http://www.thestar.com.my/News/Nation/2015/01/20/Budget-Rivision-Full-Speech/ the website was accessed on Tuesday, 17/03/2015
8 ibid
9 ibid
Malaysia is a net exporter of oil which implies lower government revenue as global oil prices fall. Conversely, in between claiming the lower crude oil prices benefit net oil importing countries like Malaysia, Datuk Najib Razak did acknowledge that falling crude oil prices would impact on government revenue. A wise and accurate approach is necessary to mitigate the effects of oil price slump on economic growth, national revenue and the value of the ringgit.\textsuperscript{10}

Among other steps outlined (in the broadcast) which the country would take is cutting 2\% from the RM273.9 billion in 2015’s budget. It must be noted that the budget was drafted in 2014 based on the benchmark assumption of oil price at the rate of US$100 to US$115 per barrel. The government had revised downwards its estimate for 2015 to the average baseline price of US$55 per barrel of oil to result in Malaysia facing a revenue shortfall of RM13.8 billion. If the revised figures are compared with the Budget 2015 as tabled in 2014, the outcome would show that despite the savings of RM10.7 billion from the implementation of the managed float mechanism for retail fuel prices, the government would face a revenue shortfall of RM8.3 billion to accommodate the measures outlined in the Budget. As a result, the higher projection made in October 2014 vis-a-vis the GDP ratio was given a downward review as the forecast for the GDP growth was adjusted to 4.5\%-5.5\%.

The Prime Minister noted that, “without any fiscal measure, the deficit will increase to 3.9\% of GDP against the target of 3\% for 2015. This requires government commitment on fiscal consolidation. Therefore, taking into account the revised estimates, we are revising the fiscal deficit target to 3.2\% of GDP in 2015. This is still lower than the fiscal deficit of 3.5\% of GDP in 2014.”\textsuperscript{11}

Following the recovery from the 2008 financial crisis as noted earlier, the GDP has been growing at a pace of more than 5\% on the brisk consumer spending and oil prices that were stable until June 2014.

Moreover, in lieu of the 3\% fiscal deficit envisaged earlier, the expectation now is that Malaysia will record fiscal deficit equal to 3.2\% of GDP. Abdul Wahid Omar, a Minister in the Prime Minister’s Department, had declared in 2014 that Malaysia would continue to run a current account surplus in both 2015 and 2016\textsuperscript{12} but as events turned out, this view was apparently meant to dispel speculation.

The Prime Minister also disclosed the RM5.5 billion would come from slashing government operating expenditures such as supplies and services, and grants allocated to state-owned companies. According to Najib

\textsuperscript{11} ibid

\textsuperscript{12} See TAN, CK (Nikkei staff writer), ‘Slumping crude starting to hit Malaysian economy,’ NIKKEI ASIAN REVIEW, January 22, 2015 edition, available on the following website address (accessed on Monday, 16/03/2015): http://asia.nikkei.com/Politics-Economiy/Economy/Slumping-crude-starting-to-hit-Malaysia-economy
Razak, these are “proactive initiatives to make the necessary adjustments following the challenging external developments”.

In addition to the measures announced by the Prime Minister, we feel the revenue system of the country needs restructuring. The imposition of a Goods and Sales Tax (GST) since April 1, 2015 is a positive step notwithstanding the teething problems encountered. Two obvious advantages of GST: it’s a) it is a comparatively more effective and efficient structure in yielding a reliable source of revenue b) it has a positive impact in controlling tax evaders. In addition to GST, we propose the implementation of a comprehensive system of capital gains tax and the reintroduction of inheritance tax.

The Rationale for a Capital Gains Tax in Malaysia

Although there is a very limited form of capital gains tax in Malaysia in the form of Real Property Gains Tax, the main objective of which is to control short term speculation in real property transactions, the authors are of the view that comprehensive capital gains tax system, notwithstanding its rationalisation on many grounds, would strengthen the fiscal system through its equity, efficiency and the revenue raising functions.

Revenue from taxes plays an important role in financing governments’ expenditures. It is in this spirit that a Capital gains tax (CGT) was first introduced in Norway in 1911 followed by the United States in 1913 as a means to cover the expenses resulting from the World War I. Following the example of these countries, CGT has been introduced in several other countries around the world although stressed on different motives. In developing countries such as Malaysia, the introduction of the tax was founded on the theory of taxing unearned increment, which stresses the fact that since the gains on real estate were not the result of the

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13 See OECD Tax Policy Studies Taxation of Capital Gains of Individuals Policy Considerations and Approaches 2006 at [61-65]: http://books.google.com.my/books/about/OECD_Tax_Policy_Studies_Taxation_of_Capi.html?id=x5Q5hBeWo7kC&redir_esc=y: where the capital gains tax is justified for securing tax revenues and efficiency considerations. It can also be justified by the search to attain horizontal and vertical equity considerations, to encourage savings and investment; and finally for simplicity, tax compliance and administrative considerations.

14 Grubel, H. G, Unlocking the Canadian Capital: The Case for Capital Gains Reform, the Fraser Institute, 2000 at 5.

15 The Finance Act 1965 in the United Kingdom (1965). In India, the tax was initially introduced in 1946 through the Income Tax and Excess Profits Tax (Amendment) Act (12 of 1947) to be applicable on transfers realised after the 31 March 1946. After being repealed, the tax was reintroduced from 1956 through Act (77 of 1956) which was approved on 21 December 1956 with effect from 1st April 1957. In Canada, See bill C-259 passed on June 18, 1971 with effect from 1972. The rationale for introducing CGT was justified by the need for financing growing cost of social security and the general government spending in Grubel, H. G, Unlocking the Canadian Capital: The Case for Capital Gains Reform, the Fraser Institute, 2000 at 6. In Australia, the introduction of the tax was to be effective on transfer made on or after 20 September 1985.
effort of the landowners but instead on social factors, taxing these gains was fair to finance community needs. It shows that in developing countries, the initial rationale of the tax was mainly founded on equity and fairness grounds in contrast to developed countries where besides its equity objective, the tax objective was also meant to reduce avoidance practices to ultimately generate revenue.

Given the strong economic growth of the country over the past decade resulting in marked appreciation of capital assets such as real property, shares listed on the KLSE and value of unit trusts, the authors feel that a comprehensive system of capital gains tax would fulfil the twin objectives of raising revenue for public expenditures and discharging the equity criterion of proportionate taxation.

**The Reintroduction of Inheritance Tax**

Inheritance tax or estate duty are called “death tax” by its opponents and is is a tax levied on the net value of the estate of a deceased person before its distribution to the heirs. It was introduced in Malaysia by the Finance (Estate Duty) Act 1971 but subsequently repealed by the Finance Act 1992. The rates before its repeal were 5% on estates worth between RM2 million and 4 million, and 10% if it exceeds RM4 million.

Currently, there is strong evidence in most parts of the world of an increase in the equity gap between the rich and the poor. For example, the one thousand richest families in Britain currently control £547bil which represents more money than the combined wealth of poorest 40% of the population. In Australia, the richest earn more than eight times the nation’s poorest and the Taxation Statistics for 2012-13 highlights the enormous pay gap between the rich and the poor. On a geographical basis, there is an average (mean) income difference of US$155,823 between the richest postcode (2027) and poorest postcode (2403)\(^\text{18}\). In USA, the average annual earnings in 2014 of a resident in five poorest states were US$24,999 or less in comparison to US$200,000, the average earnings of residents in the five richest states.\(^\text{19}\) Malaysia is no exception to this trend as confirmed by the Khazanah Research Institute Report published in November 2014. Although Malaysia is a high middle income country with a GDP of RM32,984 in 2013, 74% of

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\(^{17}\) See Sunday Times Rich List 2015: www.thesundaytimes.co.uk/sto/public/richlist


households have a monthly income of less than RM6,000. And the savings of the top 4% [17,061] EPF members is more than that of the lower 44% [2.85 million.]

The report also highlighted wealth inequality in the country: there are 38,000 Malaysian millionaires, wealthy Malaysians are buying million-ringgit houses and luxury cars, Malaysians were the fourth largest buyers (4%) of newly built property in London in 2012, and are the top buyers of homes in Singapore.

From the economic evidence on the disparity of wealth distribution, it is evident that a good number of rich Malaysians will leave estates of substantial value for distribution to their families. The authors fully concur with the call for the reintroduction of an inheritance tax which can be used to improve the economic standing of the poorer segment of the population. England implemented a probate duty in 1694 and as early as 1791, France adopted a universal estate tax. The US introduced it in its Federal tax code in 1916 and 19 members of the OECD countries impose varying rates of inheritance tax on their taxpayers.

Given that substantial wealth has been accumulated by a small minority of the population, the reintroduction of estate duty would be in consonance with one of Adam Smith’s canon of taxation that tax should be levied in proportion to wealth.

CONCLUSION
Notwithstanding its adverse effect on revenue, it must be stressed that low oil prices also provide an opportunity to reform energy subsidies and energy taxes. It is pertinent to note that the International Monetary Fund (IMF) has long advocated that government use the saving from the removal of energy subsidies toward more targeted transfers.

The removal of the subsidy since November 2014 has been accepted by the public as a necessary reform saving the Government a substantial sum [RM29 billion was used to subsidise petrol in 2013] which can now be channelled to other productive capital expenditures.

Malaysia and several other oil exporting countries need oil prices to be much higher than current levels to cover their spending but we can argue the

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23 http://taxfoundation.org/article/estate-and-inheritance-taxes-around-world

experience of another low in oil income offers a great opportunity for Malaysian leaders at both federal and state level to redraw our fiscal mentality.

Malaysia needs to redefine its expenditure priorities. What expenditure is necessary to stimulate economic growth and development? What expenditure will improve the quality of lives of Malaysians? And what expenditure will attract the necessary investments to open up other sectors of the economy?

In the event of a moderate oil price recovery, Malaysia would still require innovative funding and greater private sector involvement across the hydrocarbon value chain. Nevertheless, at high oil prices, we must maintain prudent and an incentive-based fiscal environment that will prevent the return of high cost of production currently experienced by industries in Malaysia. The government should be committed to ensuring clear and transparent fiscal rules of general application with appropriate incentives to investors and commensurate economic returns for the country.

Malaysia’s commitment to fiscal stability in its oil and gas sector remained unflinching especially as our historical antecedents clearly demonstrate this. The current market reality of low oil prices presents an opportunity for us to improve efficiency in our operations. Fiscal stability and predictability are as crucial as the reliable forecast of government revenues.

We consider the introduction of GST to generate revenue from the consumers of goods and services and its indirect effect of combating tax avoidance as a powerful fiscal tool. However, we believe that GST should be supplemented by the imposition of a comprehensive capital gains tax system and the reintroduction of an inheritance tax to levy taxes on the ‘uneared’ income of owners of capital assets and inheritors of substantial estates. These measures would provide a balancing effect in restructuring the fiscal system by subjecting the general public to GST and imposing additional taxes on ‘uneared’ income of the richer strata of society.

The measures suggested above have the potential to generate substantial revenues. However, the market economy, especially capital market and foreign exchange markets, foreign direct investment and other components of the economy operate best in liberal, business-friendly and corruption-free countries. It is therefore incumbent on the Government to root out corruption, curb protectionism and provide the right policies to nurture a free market economy. In such an environment, the strategy to restructure the revenue system to power the economy without over-reliance on petroleum income should be readily anticipated.

REFERENCES


