Price Reforms: Motivation, Impact and Mitigating Measures

Introduction

In Malaysia and several other developing economies, subsidies and price controls have been an important feature of the policy toolkit. However, as economies become more developed, the costs of maintaining such policies increasingly outweigh their benefits. As a consequence, many developing economies have embarked on subsidy rationalisation and price reforms. This box article provides a background on price controls and subsidies, the importance of price reforms and the impact of such reforms. It also discusses the various mitigating measures that will be implemented to ensure that price reforms will lead to a more sustainable and inclusive growth for the Malaysian economy.

Background

One of the key aims of economic policy is to ensure sustainable and inclusive growth. An efficient allocation of resources is critical to the smooth functioning of a competitive economy, and this is often achieved through price signals[1]. However, markets by themselves will not guarantee inclusive growth where the benefits from growth and development are widely enjoyed by all levels of society. Market failures or inefficiencies could also arise when the price mechanism fails to account for the social costs and benefits of producing and consuming certain types of goods[2], especially public goods such as defence, education and healthcare. Therefore, government measures, such as the provision of subsidies and price controls[3], could in some cases be necessary for improving welfare and ensuring inclusiveness.

It has been conventionally argued that subsidies and price controls introduce distortions in the allocation of resources and have long-term adverse effects on economic efficiency. However, as with any economic policy, the costs must be weighed against the potential benefits. Where a substantial part of the population is living in poverty, especially in economies at early stages of development, widespread government measures such as price controls and subsidies ensure that the prices of key necessities remain stable and affordable for the intended target group[4]. Similarly, when most industries are at an infancy stage, subsidies and price controls provide the necessary initial support to compete, remain viable and grow into established industries. Hence, despite distortions to prices and resource allocation, these policies can enhance long-term sustainability and inclusiveness of economic growth.

As an economy develops, the costs of subsidies and price controls will steadily outweigh their benefits[5]. With growing incomes, more households would progress from low- to middle- or high-income brackets. Blanket subsidies or price controls would thus be subject to leakages, as those that do not belong in the vulnerable groups will continue to receive assistance. Artificially low prices also encourage wastage and overconsumption, and hence, a misallocation of resources. Importantly, as industries progress to a more mature stage, price distortions could inhibit the incentives to improve productivity, to innovate and achieve greater product sophistication, to adopt higher technological intensity and to move to higher value-added activities. Subsidies and price controls could thus pose an obstacle to economic development. Hence, as economies develop, the nature and rationale for subsidies and price controls often need to evolve toward more targeted and time-bound assistance, and less of a blanket subsidy.

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[1] In a market economy, scarce resources will command higher prices than abundant resources. As a result, producers and consumers will use scarce resources for only higher-valued purposes, ensuring an efficient allocation of these scarce resources.

[2] An example of such a market failure is pollution. As the costs of pollution are widespread, and not confined to the individuals directly involved, an absence of government intervention will result in excessive pollution.

[3] For the purpose of this box article, a subsidy is broadly defined as any government action that lowers either the cost of production or the price of consumption, while price control refers to any government regulation that establishes a maximum or a minimum price to be charged for specific goods and services.

[4] While it is economically and socially desirable to target subsidies to selected groups, the costly and complex task of identifying recipients and distributing the benefits could justify an initial widespread intervention (blanket subsidy) in economies at early stages of development.

[5] There are exceptions. It is widely accepted that subsidies and/or government involvement in areas where market failures exist is justifiable. For example, government measures to ensure adequate provision of education and healthcare are often necessary to reap their widespread benefits. A similar case can be made for public goods such as defence and infrastructure.

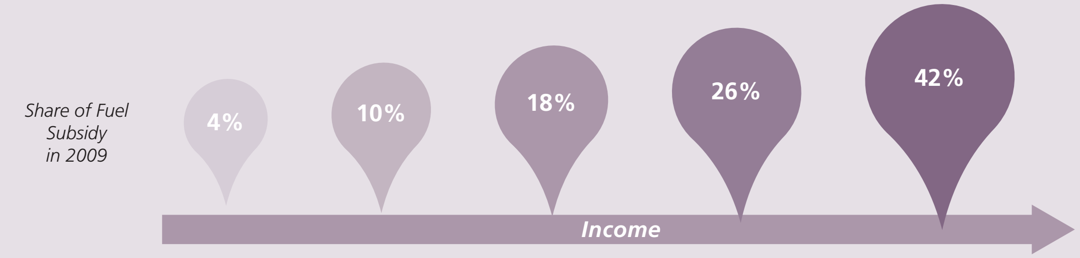
Subsidies and Price Controls: The Need for Reform

In Malaysia, subsidies and price controls have long been a feature of the economy. In 2009, subsidies and price controls were present in a range of products, including petrol, natural gas, electricity, cooking oil, sugar, toll charges and bus fares, which account for about a fifth of the CPI basket. At earlier stages of development, these policies helped to provide some degree of stability to the prices of domestic goods and supported the development of infant industries. Nevertheless, as Malaysia transitions to a high-income economy[6], the economic costs of subsidies and price controls far outweigh the benefits of such measures for a number of reasons.

First, most subsidies in Malaysia are blanket in nature, and hence, become more regressive as the economy develops. In a middle- or high-income economy, the benefits of most blanket subsidies will accrue more to the more affluent groups, especially if these groups consume larger quantities of the subsidised items. For example, in the case of the fuel subsidy in Malaysia, the benefits are enjoyed disproportionately by high-income households, who consume a larger amount of fuel as they are more likely to own multiple vehicles with larger engine capacities. It is estimated that the bottom 20% of households in Malaysia only receive 4% of the fuel subsidy, while the richest 20% receive 42% of the subsidy (Chart 1). Thus, the blanket subsidy has become a less effective tool in ensuring the benefits of low fuel prices are widespread and inclusive[7].

Chart 1

Share of Fuel Subsidy Received by Each Income Group



	Bottom 20%	Fourth 20%	Third 20%	Second 20%	Top 20%
Average Income in 2009 (in 2012)	RM1,050 (RM1,300)	RM1,900 (RM2,450)	RM2,800 (RM3,650)	RM4,450 (RM5,500)	RM9,950 (RM12,150)

Source: Household Expenditure Survey 2009/10 and Household Income and Basic Amenities Surveys 2009 and 2012, Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Second, subsidies and price controls result in price distortions by artificially depressing the prices of key goods and services in the economy. This could distort both consumption and production decisions in a number of ways, and hence, lead to a misallocation of resources in an economy. Key among these distortions is an overconsumption of the subsidised or price-controlled items by both households and firms. To illustrate, petrol consumption per capita in Malaysia has increased over the last decade and is higher than in other regional economies (Table 1)[8]. Coupled with a moderating trend in production (Chart 2), this has contributed to Malaysia becoming a net importer of crude oil and refined petroleum products in 2014.

From a structural perspective, subsidies and price controls could also hinder incentives to improve productivity and efficiency, thus holding back long-term development. Subsidies and price controls would result in an overreliance on cheap inputs by firms, which could lead firms to being trapped in

[6] Other developing economies that have undertaken price and subsidy reforms, in most cases for fuel and/or electricity, include Chile, Brazil, the Philippines, Turkey, India and Indonesia.
[7] The situation is worse if the impact of illegal fuel smuggling is considered.
[8] Overall petroleum product usage has grown at 3.0% annually on average over the last 10 years.

low-cost, energy-intensive sectors. This would reduce incentives to improve productivity, undertake research and development (R&D) or to innovate and move up the value chain, thereby impeding these firms' international competitiveness. Price reforms are thus needed to counter these effects. This is evidenced by findings from a survey by Bank Negara Malaysia that suggest that the majority of firms in Malaysia would adopt productivity-enhancing measures to manage rising costs following the upward fuel price adjustment in September 2013 (Chart 3).

Table 1

Road Sector Petrol Consumption Per Capita (2000-2011)

Country	Average 2000-2005	Average 2006-2011
	(kg of oil equivalent)	
United States	1,270	1,170
Japan	347	335
Malaysia	**279**	**294**
United Kingdom	340	259
Euro area	254	191
Singapore	163	173
Korea	151	155
Thailand	81	74
Indonesia	53	71
The People's Republic of China	31	46
Philippines	34	29
India	7	10

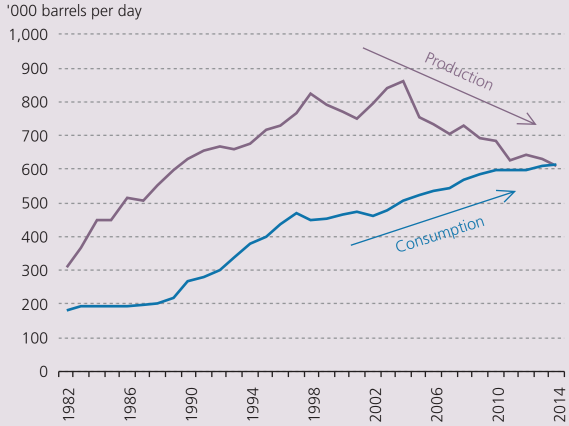
Source: World Development Indicators, World Bank

Specifically, for industries that are required to maintain low prices through price controls, they would become uncompetitive when costs rise and hence, would be less inclined to undertake quality enhancements. In extreme cases where prices are set at an artificially low level, revenue would be insufficient to incentivise firms to produce adequate output to meet demand. This could create shortages and black market transactions, as observed in the cement and steel industry in Malaysia in the past (Thillainathan, 2009). These effects are often reversed when industries are deregulated, underscoring the need for such reforms. For example, after the reforms of the electricity industry in Chile in the 1980s and 1990s, the industry experienced improved efficiency in generation and transmission, higher investment, more competitive prices and greater quality of services, particularly in rural areas (Pollitt, 2004).

In addition, maintaining subsidies and price controls also leads to challenges for public policy decision-making. Despite rising costs, it is often politically difficult to undertake upward adjustments of prices. As a result, prices of the controlled products are often left unchanged

Chart 2

Production* and Consumption of Oil in Malaysia

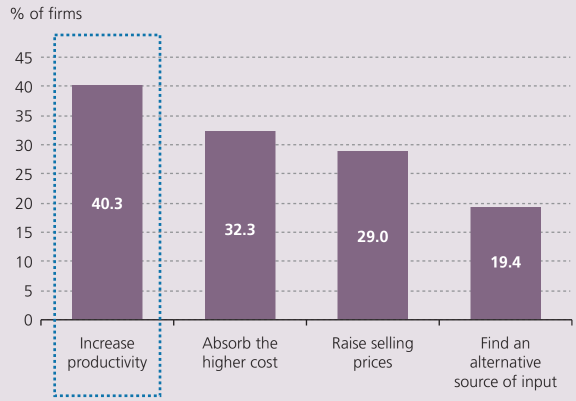


*Refers to crude oil and refinery gains

Source: US Energy Information Administration and PETRONAS

Chart 3

Survey Findings on Firms' Response to the Increase in Domestic Fuel Prices



Based on responses by 62 firms in the manufacturing and services sectors

Source: Bank Negara Malaysia Quarterly Survey 3Q 2013 for extended periods until significant increases in costs render these prices unsustainable. Eventually, this will result in large price hikes that would not only lead to large economic dislocation but also socioeconomic pressures[9].

Finally, subsidies and in certain cases price controls, also impose a burden on the government. Attempting to keep prices of resources low amid rising global market prices and overconsumption by households and firms will ultimately weigh on the fiscal position of the government. For Malaysia, subsidies on retail petrol alone accounted for RM23.5 billion[10] or 2.4% of GDP in 2013, higher than some regional economies[11]. This figure also does not account for the cost of implicit subsidies in terms of revenue foregone by public enterprises and the Government under price controls, such as the provision of natural gas below market prices to electricity generation companies to enable lower electricity tariffs. Ultimately, this reduces the funds available for the Government to spend on other key development areas that would significantly benefit the nation over the long term, such as infrastructure, health, education and social protection.

Thus, price reforms have the potential to benefit the Malaysian economy in the short and long term. For both households and firms, it is an important transition away from the regressive blanket assistance towards a more targeted support system. In the medium to long term, it not only reduces wastage but encourages productivity enhancements and further progress up the value chain, creating high-income knowledge-intensive jobs. It frees up resources for the Government to finance critical public spending on social protection, education, healthcare and infrastructure. A review of the literature by the IMF (2013) finds that subsidy reforms boost competitiveness over the long term by stimulating private investment, encouraging productivity-enhancing public spending and promoting efficient use of scarce resources. In summary, price reforms are a critical part of the overall strategy during the transition to a high productivity and high value-added economy, supporting the creation of more high-income jobs in Malaysia.

Price Reforms: Timing and Impact

It has been recognised that reforms have a higher chance of success if they are undertaken gradually and in an environment of growth and stability (IMF, 2013). Under such circumstances, households and firms are in a better position to adjust to higher prices and costs, and are able to undertake the necessary changes without creating large disruptions in economic activity. With this in mind, the Government has gradually lifted price controls and undertaken several price adjustments over the last several years[12]. More recently, the Government implemented additional price adjustments and introduced the managed float pricing mechanism for fuel, against a backdrop of steady growth prospects for the economy. The environment of lower global crude oil prices hence provided an opportune time to undertake this reform without the need for a price increase.

Nonetheless, it is acknowledged that price reforms have led to an increase in costs for households and firms. The challenges of managing these costs will continue, with movements in global commodity prices having a more direct effect on domestic cost conditions. While external price pressures are expected to remain subdued in 2015, the upward pressure on domestic costs could increase in the event of higher global commodity prices going forward. For households, in the absence of subsidies and price controls, an increase in the cost of living would have a disproportionate impact on vulnerable groups such as low-income groups, middle-income urban households, young working adults and senior citizens. These groups, particularly those with low savings, could face financial hardship. Firms, particularly small and medium enterprises, need to also cope with volatile costs and might find it difficult to pass on the additional costs to their customers

[9] These pressures have been observed in response to actual or attempted price adjustments in developing economies, such as Indonesia in 2012, India in 2010 and Jordan in the late 1980s and early 2000s (World Economic Forum, 2013).
[10] Based on the 2015 Budget speech.
[11] Based on the International Energy Agency statistics, total fuel subsidy in 2013, expressed as a percentage of GDP is 0.2% in PR China, 0.9% in Thailand, 2.5% in India and 3.3% in Indonesia.
[12] These include adjustments to the prices of fuel, electricity, sugar and other price-controlled items.

in order to remain competitive. Greater uncertainty on future costs and prices could also affect firms' investment and hiring decisions.

Therefore, a key policy thrust is to ensure that short- and long-term measures are earnestly implemented to partially mitigate the adverse effects of price reforms. The Government has undertaken targeted short-term measures, which include financial aid to support vulnerable households and firms in undertaking adjustments. Crucially, the Government has also enacted the Price Control and Anti-Profiteering Act 2011 to reduce profiteering[13] by businesses and firms. Efforts are currently geared towards strengthening enforcement of the Act to monitor and take action against errant parties. To this end, there have also been initiatives to promote awareness of consumer rights and of prices of goods through the media and online tools for price comparison. This will ensure that consumer activism can play a greater role in preventing excessive price hikes. Bank Negara Malaysia, through its monetary policy, remains vigilant on factors that could contribute to excessive inflationary pressures at the economy-wide level.

Price reforms must be complemented with measures to assist vulnerable groups, so as to achieve growth that is both sustainable and inclusive. To this end, a comprehensive social protection system[14] that covers social assistance, social insurance and human capital development programmes is being formulated to replace the regressive blanket assistance. The system will be targeted, sustainable and, most importantly, will help build the capacity of its recipients. This system will therefore not only provide short-term support to vulnerable households but would provide the opportunity to increase earnings by enhancing skills and capabilities. Such a system is a common feature in the advanced economies. For firms, specific incentives and grants will continue to be provided to encourage productivity improvements and innovation. Such assistance will support firms in adjusting to higher cost and facilitate the movement up the value chain into more sophisticated, technology-intensive and profitable ventures.

In addition, in a more deregulated pricing environment, the Government's role will evolve, from one that sets prices and provides subsidies to one that shapes regulations to foster a well-functioning and competitive market. Measures such as the introduction of the Competition Act 2010 and the establishment of Malaysian Competition Commission (MyCC) would promote effective competition and deter anti-competitive behaviour among firms. Well-developed regulation and enforcement can protect consumers and enable them to benefit from a wider range of better quality goods and services at affordable prices. These efforts to promote competition are consistent with the Strategic Reform Initiative (SRI) on Competition, Standards and Liberalisation[15], which has made considerable progress, contributing to improvements in Malaysia's business environment.

Taken together, these measures will enhance the ability of the economy to adjust to cost and price fluctuations, thus making it more resilient to shocks. As with all policies, the key success factor will be clear communication, consistent monitoring, effective implementation and enforcement, and continuous policy improvements.

Conclusion

Price reforms are a critical component of Malaysia's objective of achieving inclusive and sustainable growth as it evolves into a high-income economy. To support inclusiveness, the regressive blanket subsidies and price controls will be replaced by a more targeted social protection system that can provide sustainable support to households that are in need of such assistance. In enhancing growth sustainability, price reforms will incentivise firms to increase productivity, undertake innovation and

[13] Based on the Price Control and Anti-Profiteering Act 2011, profiteering refers to the act of making unreasonably high profit, after taking into consideration factors such as cost of production, supply and demand conditions and any tax imposition.

[14] Social assistance includes cash transfers, food stamps and targeted subsidies; social insurance includes insurance for disability, unemployment, health and other risks; human capital programmes include training and upskilling as well as public education and healthcare.

[15] Based on the Economic Transformation Programme Annual Report 2013.

move up the value chain, and avoid overreliance on cheap subsidised inputs. At the same time, the savings from the reforms create an opportunity for the Government to undertake more productive spending on infrastructure, healthcare and education. Consequently, Malaysia will benefit from a more productive and inclusive economy, more opportunities for the creation of high-skilled high-income jobs, greater access to higher quality goods and services, and an enhanced flexibility to manage shocks. Thus, while there are short-term challenges to manage, price reforms will ultimately place the economy on a more sustainable and inclusive growth path.

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