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## **Fiscal decision and fiscal performance: the case of Kelantan and Penang**

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### **Abstract**

This paper attempts to shed some lights on the relationship between the fiscal balance of state governments in Malaysia and their decision concerning their revenue and expenditure. In particular, the paper seeks to examine whether the fiscal situation of the Malaysian state governments can be explained by the way decision process regarding expenditure and revenue collection is made. For the purpose of this study, we choose to focus on two states governments namely Penang and Kelantan. The choice of these two states was made based on the significant difference in term of their fiscal situation. This study employs ARDL or bound test procedure proposed by Pesaran and Shin (1996), Pesaran and Pesaran (1997) and Pesaran et al (2001) to test for the cointegration relationships. Our results show that in the short- run, the causality seems to run from state government expenditure to state government revenue of Kelantan. This finding is consistent with the spend-and-tax hypothesis. In other words, the state government of Kelantan decides on its expenditure first before it decides on its revenue. As for Penang, the finding seems to point to an institutional separation as no causality is found between its revenue and its expenditure in the short run. In the case of long- run causality, Kelantan is found to have a negative sign of error correction model (ECM) in the revenue equation.

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## **1. Introduction**

The Malaysian government has recently launched the Government Transformation Plan (GTP) in its bid to increase the efficiency of the public service delivery. The plan is also aimed at reducing public deficit by rationalizing subsidies and minimizing wastages. However, for the plan to succeed, a proper consideration needs to be given to the fiscal landscape of the state governments. Even though the state governments constitute only a small portion of the total government revenue and expenditures, poor fiscal management at the subnational level could still negatively impact the overall fiscal performance of the country as a whole. There are at least two explanations for the close relationship of the fiscal situation of these two levels of government.

Firstly, the state government borrowing capacity is curbed by a regulation in the Constitution. As such, any deficit at the state government level would at the end be borne by the federal government either through a higher level of federal transfers or an increase in federal borrowings. Secondly, the administrative and political system of the country is organized in such a way that the decision making process of the federal government is subject to lobbying and gerrymandering by the state governments and their representatives in the Parliament. Therefore, when a state government is in financial difficulties, it can always count on the federal government to offer it a lending hand. Together, these two points show the needs for the GTP to include measures that are aimed towards a better fiscal management system at the state governments', failing which the achievement of the objectives listed under the plan may be jeopardized. On the other hand before any such measures can be implemented, it is equally important to have a better understanding of how the fiscal system is managed at the state level.

It is the objective of this paper to analyze the fiscal management system of the state governments in Malaysia. More specifically, the paper seeks to examine whether the fiscal situation of a state government can be explained by the way decision process regarding expenditure and revenue collection is made. Do decisions about expenditures and revenues are being made together or independently? If they were made together, do the state decides on their expenditure first and revenue second (tax-spend hypothesis) or vice versa (spend-tax hypothesis)? And more important, how would these decisions translate into the state government's fiscal performance?

For the purpose of this study, we choose to focus on two states governments namely Penang and Kelantan.

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