EXECUTIVE SUMMARY

Compared to some of ASEAN member countries, Malaysia is considered as a developed country whose total primary energy consumption is estimated to increase by 2.9 percent annually from 2012 to 2035 (business-as-usual scenario). The share of its demand for oil and coal-based energy will remain the largest (59 percent) in 2035 (ERIA, 2015). This increasing energy demand is largely driven by the stable economic growth and the intentionally low energy prices due to the energy subsidy policy on electricity and transport fuel (gasoline and transport diesel) across the sector. Although the share of electricity and transport fuel subsidy is currently declining, the energy subsidy in Malaysia in 2010 accounted for 4.1 percent of the total GDP, with per-capita subsidy amounted to US$200 (IEA, 2015).

The petroleum subsidy alone was over RM20 billion, which corresponds to around 10 percent of the total government expenditure. Malaysia's fiscal deficit was 4.5 percent of the gross domestic product (GDP) in 2012, and the government aims to reduce it to 3 percent by 2015 and to 0 percent by 2020. The country has already started implementing policies to phase out the fuel subsidies. In December 2014, the government of Malaysia officially removed subsidy for fuels and introduced the "managed float system." The Special Industrial Tariff for electricity will also be abolished by 2020. If the subsidy in natural gas being sold to electricity companies is removed, electricity price could increase to almost double. However, the Automatic Price Mechanism on transport fuel, such as gasoline, has shifted to the flotation method per 1 December 2014. Currently, the retail price of gasoline and diesel are influenced by market price. Consequently, the price hike in transport fuel after the removal of energy subsidies turned out to be overestimated.

According to this study using the 2010 Malaysian Input-Output (I-O) Table, any increase prices in electricity and transport fuel leads to a serious price impacts to other sectors in Malaysia. Looking at other price changes historically, the rise of Production Price Index in Malaysia, such as wholesale price index and consumer price index was around 9 percent and 4.9 percent, respectively, from 2000 to 2012. When compared to these numbers, the price impact of a subsidy removal ranges from 5 percent to 6 percent is considered significant and hence mitigation measures such as phasing out subsidies particularly for the highly impacted sectors are increasingly important. Electricity price hikes largely affect the hotel and restaurant sector relative to other sectors. On the other hand, a transport fuel price hike affects several sectors widely.

Our study shows the overall effects of subsidy removal and accordingly we propose two options on the usage of the subsidy budget. First, the Malaysian government can use its energy subsidy budget to reduce the fiscal deficit. This option can lower GDP (1.5 percent lower compared with the reference case), with deficit improvement of 0.9 percentage.

Second, the government can also use the subsidy budget for expenditures on other sectors – for example, for investments in social infrastructure and education sectors. This option leads to higher GDP (0.7 percent) but lesser deficit improvement (0.3 percentage). This study

advocates this second option. However, both subsidy removal and higher prices could result in lower real private disposable income despite the higher GDP. The negative effect of subsidy removal will last for a couple of years. In this regard, we suggest the following strategies for further consideration:

1. Removing the inefficient energy subsidies could accelerate economic growth by reducing fiscal deficit. As both economic stability and fiscal reform are very important issues, Malaysian policymakers should strike a balance between these issues.
2. The Malaysian government can reallocate the subsidy budget to other areas such as social infrastructure, healthcare and education, which will bring future economic growth. This reallocation can help drive economic growth despite the increasing prices.
3. The government can phase out the energy subsidy gradually, enough for it to manage the negative impacts on real disposable income after the general price hikes. Appropriate subsidy reforms require careful explanation and foreseeable plan.