

The Tax-Spend Debate: Time Series Evidence from Sarawak Municipals, 1975-2003[†]

Muzafar Shah Habibullah* and AM Dayang-Affizzah**

This paper is concerned with the issue of the intertemporal relationship between revenues and expenditures and the way in which a State Government manages public deficits. In this study, different hypotheses are considered to examine such a problem. The so-called tax-spend hypothesis postulates that government raises tax revenues ahead of engaging in new expenditures (Buchanan and Wagner, 1978; and Friedman, 1978). The spend-tax hypothesis, on the other hand, predicts that government first spends and then increases tax revenues to finance their expenditures (Barro, 1974; and Peacock and Wiseman, 1979). There is also the fiscal synchronization hypothesis which suggests that government takes simultaneous decisions about revenues and expenditures (Musgrave, 1966; and Meltzer and Richard, 1981). Lastly, there is independence regarding the decisions to spend and raise revenues (Baghestani and McNown, 1994). Using the annual data on revenues and expenditures for the 22 municipals in Sarawak for the period 1975-2003, the cointegration and vector error correction model analyses suggest that the results are at best mixed.

Introduction

The discussion on the causal link between revenues and expenditures has been one of the most researched topics in macroeconomics. Establishing the direction of interdependence between the two macroeconomic variables—government expenditures and tax revenues would assist the policymakers in identifying the sources of any fiscal imbalances that might exist. Consequently, this would facilitate efforts to develop a suitable fiscal reform strategy.

The empirical testing of the relationship between government expenditures and tax revenues has resulted in several competing hypotheses. First, a unidirectional causality that runs from revenue to expenditure supports the so-called tax-and-spend hypothesis. The hypothesis indicates that, since government revenue causes changes in the government expenditure, the control of tax revenue should represent a good policy to control the government expenditure. Second, the spend-and-tax hypothesis implies that government expenditure leads to changes in tax revenue. In other words, the chain of causality runs from

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* Faculty Member, Department of Economics, Faculty of Economics and Management, Universiti Putra Malaysia, Selangor, Malaysia. E-mail: muzafar@econ.upm.edu.my

** Faculty Member, Department of Economics, Faculty of Economics and Business, Universiti Malaysia Sarawak, Sarawak, Malaysia. E-mail: amdassizah@feb.umimas.my