UNDERSTANDING COSTS BEHIND PRODUCTION AND DOING BUSINESS

By Samirul Ariff Othman

Many participate in the debate surrounding costs underlying production and doing business, either supporting the economic reforms initiated by the present Government in our march to transform our economy, or attacking it. To the opponents, reforms are seen as an obstacle and hindrance for businesses to thrive. Their perception is largely shaped by media reports of businesses winding down their local operations and usually relocating to our neighbors or retrenchment of employees. Anecdotal evidence seems to suggest that there is an overall increase in costs associated with reform initiatives. However, is this really the case or is there more than meets the eye?

To set the record straight, we must be clear about what we are discussing about, one ought to say what they mean and mean what they say, otherwise any further discussions will only result in a futile academic exercise. To begin with, Strategic Reform Initiatives (SRIs), the second critical component of the Economic Transformation Programme (ETP) is much maligned and unappreciated by many. Let us examine several of the least popular SRIs and subject them to scrutiny –namely the Goods and Services Tax (GST), implementation of Minimum Wages, subsidy reforms and rationalization and finally the implementation of the Competition Act.

However, at this juncture, we also need to understand what Cost of doing business (CODB) is and appreciate that CODB is different from production cost. CODB is an aggregate measure gauging the economic competitiveness of a country. In order for a country to remain competitive, CODB must be reduced, in other words CODB is a reciprocal of competitiveness. Indeed, SRIs were introduced to reduce CODB and certainly CODB could be reduced, although it may take time for the desired outcome to be achieved. The adjustment period is the time taken for the desired outcome to be realized and the outcome is permanent.

The relationship between CODB and cost of production is as follows, when CODB is reduced, production costs will also go down. However, during the adjustment period, various changes will occur and this is actually part of the "planned changes." Various quarters maybe unhappy with these changes, however these changes are overarching, unrelenting and will weed out undesirable aspects to create a better economic environment. What is undeniable is though, the short term effect of the initiative to reduce the CODB may increase production costs, however this feature is only temporary and transient in nature. While CODB is an indicator of the economy at large, cost of production is an indicator at the individual firm level, and this may explain why the readings of the two indicators maybe disconnected at times.

The first of the four SRIs mentioned earlier is a broad-based consumption tax, the GST is levied on “value-added activities” along the delivery chain. However, most basic products and services such as rice, raw meat, fresh fish, vegetables, domestic public transportation and healthcare services are tax exempt or zero-rated. This value added tax is to be paid by consumers. GST is a bitter pill necessary to improve revenue of the government, it is certainly more transparent, efficient, effective and business friendly, in short more superior to the Sales and Services Tax (SST). Improved government revenue will enable more allocation to be given to the Federal Government‘s Development Expenditure. This will translate into better infrastructure, increased technological efficiency and ultimately improved CODB.

Minimum wages were introduced to help address many of the Labour Market’s imperfections. Empirical evidence suggest that wages were not determined freely by supply and demand, but instead employers are in the dominant position when determining wage rates, aggravated by a rate of unionization less than 10%. In addition there exists a somewhat big productivity-wage gap. We ought to bear in mind that labour market is an integral component of the economic machinery and signs of imperfection should be given due attention.

There are two ways to remain competitive –by keeping costs low or by focusing on quality. In the long run, the cost advantage option may not be viable as firms shift their operations to countries with a lower cost advantage in Southeast Asia. An economy can remain competitive by focusing on quality, innovation and adding value. For that matter, our economy will be able to attract both domestic and foreign FDIs in high value added activities if we are competitive.

Among the most compelling reason as to why subsidies should be managed properly is that inefficient allocation of subsidies will encourage wastage. Furthermore, if not managed properly the subsidies will not reach the intended recipients. Subsidies should be targeted and transferred to the right group. Adjustment might be painful in the short term but what results in the long-term is improved efficiency and reduced CODB, or in short an optimal allocation of expenditure.

A near perfect competition in the Labour Market will not be possible should there be numerous distortions and inefficiency. Protecting certain industries will result in the emergence of a few dominant players. These privileged players will tend to use their dominant position to prevent the entry of new players in the market and hence suppress free and fair competition. More often than not they in collusion with one another. It is precisely for this reason that the Competition Act was put in place to ensure that the playing field will be level for all.

Thus it can be seen that the SRIs will induce changes through adjustments. It maybe painful to some and may increase the cost of production (but not CODB). However, this weeding out process will cause inefficient industries to close shop while at the same time attract and hatch new high value added industries. In a nutshell, what emerges is a structural change of the emergence of high value added industries. In relation to this, steps must be take to mitigate those affected –for example employees made redundant must be retrained.

In the final analysis, the government must facilitate the transition of our industries to be lean and mean. Failure to do so will be costly to us in the long run.

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