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RESEARCHERS AT SINGAPORE'S *INSTITUTE OF SOUTHEAST ASIAN STUDIES* SHARE THEIR UNDERSTANDING OF CURRENT EVENTS

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Malaysia Responds to Rating Agencies in Budget 2014

*By G. Sivalingam**

EXECUTIVE SUMMARY

- The recent 2014 Malaysian Budget unveiled several surprises such as the announcement of the long-delayed Goods and Services Tax, a significant increase from 15 per cent to 30 per cent in the Real Property Gains Tax, and the decision to abolish the sugar subsidy. In particular, the implementation of the Goods and Services Tax (GST) from April 2015 is expected to expand the tax base and increase revenue.

- The July downgrading of Malaysia's credit worthiness from positive to negative by Fitch Ratings was a clarion call to Prime Minister Najib Razak to avoid or lower the probability of rising debt levels and to implement budgetary reform. The decision to implement the GST can be seen as a result of immense pressure from international rating agencies.

- Prime Minister Najib Razak is likely to announce more cuts to subsidies as his administration tries to trim its budget deficit further. This follows a mention on budget day which stated that the government would gradually restructure the subsidy programme. This implies that it could still roll back subsidies post-budget.

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- There is concern over the inflationary impact of the GST, to be pegged at 6%, on the lower income groups. The Prime Minister has tried to soft pedal the introduction of the GST by drawing on the arguments of inflation, income increases and income transfers from the government to reduce resistance to the unpopular subsidy cuts.

- The Real Property Gains Tax has been increased drastically as a cooling measure to stabilize the housing market by bringing down housing prices and making housing more affordable. In addition, the removal of the Developers Interest Bearing Scheme is expected to stamp out bulk buying by foreigners.

INTRODUCTION

Malaysian Prime Minister Najib Razak presented the budget for the year 2014 in Parliament on 25 October 2013. The budget unveiled several surprises, including the announcement of the long-delayed Goods and Services Tax (GST) to be implemented in April 2015; a significant increase from 15 per cent to 30 per cent in the Real Property Gains Tax (RPGT); and the decision to abolish the sugar subsidy to fight the high diabetic rate among Malaysians under the age of 30. Although the GST has been touted as a possible remedy to boost Malaysia's tax revenues since 1998, there was still some surprise that the government had finally decided to "follow the crowd" in implementing it.

It is highly probable that the controversial GST is being implemented because of immense pressure from international rating agencies such as Fitch Ratings, and multilateral institutions such as the IMF and the World Bank. The Malaysian government is also fully confident that 17 months—between now and 15 April 2015—is sufficient time to make adequate preparations for a smooth implementation of the GST which promises to broaden the tax base. However, the 6 per cent GST was not as shocking as the 30 per cent RPGT to be imposed on capital gains on properties disposed of within 3 years of purchase for citizens and within 5 years of purchase for foreigners (The Star, October 26, 2013). While the GST will increase revenue and help narrow the fiscal deficit, the RPGT hopes not only to increase revenue but also to dampen speculative activities and Ponzi schemes in the property sector. Above all, the new measure is envisioned to make housing more affordable for citizens.

The government has thus acknowledged that there is a property or asset bubble and that many Malaysians have been priced out of the property market.

There are two important messages in the budget: to reduce the fiscal deficit as a percentage of GDP, and to cater to the basic needs of the population given that formal housing is a basic necessity. The latter is reminiscent of the federal government policy of low-cost housing to create a "property owning democracy" for the lower income group that was called for by the then Minister of Interior, Tun Dr. Ismail Abdul Rahman, in November 1961. This policy was reiterated when Tun Ismail—as Deputy Prime Minister in the aftermath of the 13 May 1969 general elections and the bloody racial riots—declared that the country should aspire to be a property owning democracy.

Prime Minister Najib, who is also Minister of Finance, is likely to announce more cuts to subsidies—the latest being the removal of the 34 sen subsidy per kilogramme for sugar—as his administration tries to trim its budget deficit further. This follows a mention in Budget 2014 which stated that the government would gradually restructure the subsidy programme, implying that it could still roll back subsidies post-budget, just like how it had cut fuel subsidies and raised the excise duty for cigarettes prior to the budget announcement. In particular, he said the 20 sen increase in gasoline prices in September 2013 was not a one-time measure and the

petrol subsidy would be reduced gradually and in stages over the fiscal year 2014. Najib also alluded that the subsidies would be rationalized over the year to ensure that foreigners did not benefit from the subsidies and there was no smuggling or illegal trading of subsidized goods—especially oil—across borders. On the other hand, the elimination of the sugar subsidy increased the price of sugar by more than 13 per cent and although the government claims it is not inflationary, it will have an effect on prices of prepared food, especially prepared food that has a high sugar content.

THE GOODS AND SERVICES TAX

The need to respond to the evaluations of international rating agencies was motivated by Malaysia's trade and investment links with the rest of the world. The July downgrading of Malaysia's credit worthiness from positive to negative by Fitch Ratings was a clarion call to Najib to avoid or lower the probability of the occurrence of a twin deficit. Fitch cited rising debt levels and a lack of budgetary reform when it cut the country's rating outlook. Moody's Investors Service also voiced concern last month that the deficit may exceed 4 percent of GDP this year, and warned that the government's fiscal targets may become "increasingly out of reach" without additional measures to contain it.

The downgrading of Malaysia's credit rating will make the country unattractive as an investment destination to foreign investors including foreign portfolio investors on whom the Malaysian economy has become dependent as a source of financing. Although short term in nature, the inflow and outflow of foreign portfolio investments (FPIs) is perceived to provide a stable source of funds—except in exceptional situations like the 1997-98 Asian Financial Crisis—and the effort to reduce the fiscal deficit will increase this source of financing. A heightened credit rating will also enhance Malaysia's ability and capacity to borrow in international financial markets or float Ringgit-denominated bonds. A strong credit rating will also ensure the long-term stability of the exchange value of the ringgit. The prospect of the ringgit appreciating against the US dollar with a balanced budget or a smaller fiscal deficit is also stronger.

Deputy Prime Minister Muhyiddin Yassin has stated that the introduction of the GST will "strengthen the economy … Malaysia's [economic] rating will be at a good level and will result in foreign investors having higher confidence in us" (*New Straits Times*, 26 October 2013, p.3). The positive aspects of the inflow of FPI on the Kuala Lumpur Stock Market or Bursa Malaysia has also been highlighted by the Prime Minister in his Budget 2014 speech. He pointed out that the composite index of Bursa Malaysia or FBMKLCI "reached 1818 points on 24 Oct 2013, with market capitalization of RM1.66 trillion, a new record high in terms of level and value … This underscores the increasing local and foreign investor confidence in the economy" (*New Straits Times*, 26 October 2013, p.15).

The budget announcement of a GST should appease rating agencies worried about the country's substantial sovereign debt, thus lowering the risk of a further ratings downgrade. At 53.3 per cent, the country's debt-to-GDP ratio is the highest among 13 emerging Asian markets. However, although a balanced budget or a fiscal surplus will have a positive effect on foreign capital inflows in the form of foreign direct investments and foreign portfolio investments, Najib's administration has not taken draconian measures to completely close the fiscal deficit. Adopting a gradual approach rather than a "big bang" approach (or shock therapy), the government has announced that it will reduce the budget deficit from 4 per cent in 2013 to 3.5 per cent in 2014. It will then try to turn the fiscal deficit around over the years. Although the government is comfortably in power after the recent elections, it is risk averse in terms of taxing citizens too much or eliminating subsidies at one go for fear of street demonstrations and civil disturbances or riots.

It bears remembering that Prime Minister Najib Razak returned to power earlier this year with the help of a spending spree that boosted consumption. Now voters are feeling the pinch with the latest efforts to appease the rating companies. The GST which was supposed to have been implemented since 1998 has been postponed several times over the last decade and a half because of fears that it would be inflationary and would be exploited by unscrupulous businesses and traders. In fact after the Budget 2014 was announced, the President of the largest federation of trade unions—the Malaysian Trade Union Congress (MTUC)—expressed concern over the impact of the GST on lower income groups. Mr. Mohd Khalid Atan, the MTUC President went on record to state that: "On the implementation of the GST … the government must get feedback from the lower income group before its 2015 deadline to prevent traders from taking advantage of the tax at their expense" (*New Straits Times* 26 October 2013, p.4). Other trade unions and consumers had also expressed concern that the GST could be inflationary. Najib has countered that the GST is being implemented in a low inflationary environment of 2 per cent. According to Najib "The government believes that this is the best time to implement GST as the inflation rate is low and contained" (*New Straits Times*, 26 October 2013, p.18).

The Prime Minister has tried to soft pedal the introduction of the GST by stating that it is not a new tax but a tax that consolidates two existing taxes, that is, (i) the Sales Tax and (ii) the Service Tax. He has also deduced from this that the consumer will pay less since he will be paying only one tax under the GST instead of two:

> As an example, if we were to buy a carbonated drink in a restaurant today, we would not notice that we are paying double taxes, which are sales and service tax. Put differently or explained in simple terms, with the GST system, consumers will only need to pay tax once and the prices of goods should be cheaper" (*New Straits Times*, 26 October 2013, p.7).

He has also justified introducing the GST by arguing that more than 160 countries have implemented the GST and "that GST is proven to be a transparent, effective and fair tax system. The vast majority of nations in the world would not have implemented GST if it was disadvantageous to the people and country" (*New Straits Times*, 26 October 2013, p.7).

To reduce resistance to the GST, the government has exempted a long list of goods and services from the tentacles of the GST. These include basic food items such as rice, sugar, salt flour, cooking oils, lentils, herbs and spices, salted fish, cencalok, budu, and belacan. GST will also not be imposed on piped water supply, the first 200 units of electricity per month for domestic consumers, transportation services such as bus, train, LRT, taxi, ferry, boat, highway tolls as well as education and health services are exempted from GST (*New Straits Times*, 26 October 2013, p.18).

To increase disposable income when the GST is implemented in 2015, the government plans to provide cash assistance; reduce the income tax of individuals and reduce the maximum tax rate for individuals. To gain the support of the corporate sector for the GST, the corporate income tax will be reduced by 1 per cent to 2 per cent in 2015 and by 1 per cent in 2016. This includes small and medium enterprises (SMEs). Tax deductions will also be given to corporations that provide training to their staff to facilitate the implementation of the GST. Cost of purchasing ICT equipment and secretarial fees and tax filing fee are allowed as tax deductions for the years of assessment 2014 and 2015.

THE REAL PROPERTY GAINS TAX

As noted earlier, an RPGT of 30 per cent will be levied if the property is disposed within 3 years of acquisition. However, if it is disposed within 4 years of acquisition, the RPGT is 20 per cent; and if it is disposed within 5 years of acquisition, it is 15 per cent. To dissuade foreigners from purchasing affordable housing, foreigners are only allowed to purchase property that is valued at RM1 million or more, whereas previously they could own property costing more than RM0.5 million. The question on many lips is whether the RPGT will be able to bring down property prices which in some areas has more than doubled in two years? The Malaysian National House Buyers Association (HBA) is hopeful that the RPGT will make housing affordable to common people again.

The National HBA has endorsed the RPGT as "an excellent mathematical formula" to curb speculation (*New Straits Times*, 26 October 2013 p.9). The National HBA Secretary General Chang Kim Loong has gone on record to state that "We have consistently called for government intervention to prevent a 'homeless generation' of young adult Malaysians from emerging, especially in urban and suburban areas whom, if not for wild speculation, would be able to buy their own houses" (*New*

Straits Times, 26 October 2013, p.9). In addition, the removal of the developers interest bearing scheme (DIBS)—which enabled buyers to pay a 5% or 10% down payment with mortgage payments kicking in only after the property is completed—would also stamp out bulk buying by foreigners.

The exemption of RPGT between 2007 and 2009 and the entry of DIBS in early 2009 created fertile ground for speculation. Home prices increased by between 20 per cent and 30 per cent annually in urban centres (The Star Online, 26 October 2013). It is likely that the RPGT—as well as the removal of the DIBS—may bring down property prices. If a person bought a property for speculation when the real property gains tax was minimal then by buying plenty of units he can create an artificial shortage. The demand will be there if the next purchaser thinks he can speculate and make money and not pay any taxes. However, with a very high RPGT, there will be a shortage of buyers—because new buyers are dissuaded or discouraged by the fact that they have to pay high taxes if they dispose of the property early—and demand will fall among speculators. Those holding onto units for speculative purposes will be caught out as a result of this fall in demand. In this way the RPGT can be considered a punitive measure targeted at those who are not genuine house buyers.

Foreign buyers may also be caught unawares especially if they have property that is valued at less than RM1 million because there will be no demand for these units of property from foreigners. Foreigners owning property valued at less than RM1 million will then have to depend on demand from the local population who may be able to force down the price of these properties as they may not have the ability or capacity to purchase the property at a price that is favourable to the foreign owner. It bears noting that there is a very limited supply of urban properties priced above RM500,000 outside Kuala Lumpur, Selangor, Penang and Johor Bahru, Properties which are priced above RM1 million outside the four states is almost non-existent.

The RPGT has drawn support from the Mentri Besar of Johor. The southern Malaysian state houses the Iskandar Development Region (IDR) where many foreigners have bought houses. According to Mohamed Khalid Nordin, the Mentri Besar or Chief Minister of Johor, “The rise in the real property gains tax will curb property speculation and ensure sufficient supply of houses in the market as well as correct the property purchase funding mechanism so that it will not burden the people” (*New Straits Times*, 26 October 2013, p.9).

CONCLUSION

The introduction of the GST is by no means a popular measure. But as the GST will only be implemented in 17 months from now, there may be a chance that the government may be persuaded to change its mind especially if there are increases in exports, rate of real GDP growth, current account balance of the balance of payments, oil prices and/or government revenues during this period. While the subsidy cuts on

basic essentials are also not popular, the staged approach adopted by Najib's administration–that harnesses the arguments of inflation, income increases and income transfers from the government–may very well reduce resistance to the unpopular subsidy cuts. The increase in the RPGT has already won a lot of popular support for the government from workers' unions and the public at large. The government seems to have addressed two of the basic concerns of the rating agencies– i.e. broadening the tax base by introducing the GST and cutting subsidies. Broadening the tax base will increase tax revenue and eliminating subsidies will decrease expenditure and hopefully turn the fiscal deficit into a surplus.

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