ISEAS YUSOF ISHAK INSTITUTE

ISSUE: 2018 No. 80

ISSN 2335-6677

PERSPECTIVE

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Singapore |13 December 2018

Malaysia's Budget 2019: The New Government's Fiscal Priorities, Challenges and Opportunities

*Yeah Kim Leng**

EXECUTIVE SUMMARY

- Promulgated by the six-month-old government, the budget is set amid a more challenging external environment that is expected to prevail in 2019 along with higher downward risks. Institutional reforms take centre stage in the budget thrust to restore fiscal discipline, trust and transparency with a multitude of reform initiatives unveiled in the budget.

- The reform agenda to restore fiscal discipline and a clean, transparent and effective government is a necessary condition to avert a fiscal crisis in the longer term, but is not a sufficient condition to achieve higher and more inclusive economic growth.

- The budget reflects a gradual pace of fiscal consolidation with GDP growth for 2019 projected at a marginally higher 4.9 percent than in 2018 (4.8 percent), broadly in line with market expectations. However, tax and non-tax revenue projections may be optimistic especially if world oil price dips below USD70 a barrel.

- The elimination of the highly unpopular Goods and Services Tax (GST) and the reintroduction of the Sales and Service Tax (SST) have created a revenue shortfall amounting to roughly 2 percent of GDP. Revenue-enhancing measures introduced are projected to cover less than half the revenue foregone. The one-off tax refunds will be covered by a RM30 billion dividend payout from the national oil company, Petronas.

- While total expenditure allocation shows an increase of 8.3 percent, if we discount the one-off tax refunds, it is actually a more austere budget, with a less alarming widening of the fiscal deficit to 3.7 percent of GDP in 2018 and 3.4 percent in 2019. To avoid long-term debt distress, the ongoing review, postponement and cancellation of a number of mega infrastructure projects have reduced total liabilities to 74.5 percent at end June 2018 and this should fall further to 73.5 percent of GDP by end 2019.

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INTRODUCTION

Malaysia's momentous 14th general election in May 2018 saw the opposition coalition, Pakatan Harapan, wresting power from the Barisan Nasional coalition that had governed the country since independence in 1957. Six months later, the new government faced a crucial test in crafting the budget for 2019, not only because of the financial constraints in fulfilling its campaign promises but also in response to public calls for greater policy clarity and direction especially in the management of the economy.

The 2019 budget was unveiled on 2 November 2018 by the new finance minister, who for the first time since 1998[1] is not the Prime Minister. This departure from past practice forms part of the institutional reforms undertaken by the new government in the wake of numerous financial scandals and irregularities associated with the previous administration. The financial mismanagement and widespread corruption have had deleterious effects on the integrity and transparency regarding how the country's public finance and government spending had been administered, the restoration of which received topmost priority by the new government.

Besides the institutional reforms to restore public trust, the new government also abolished the Goods and Services Tax (GST) upon which much of the blame for the people's economic burden had been ascribed during the election campaign. The three-month tax holiday (August – October) prior to the re-introduction of the narrower Sales and Services Tax (SST) on 1 November resulted in a sizeable revenue shortfall and added to the revenue constraints in crafting the budget for 2019, with negative implications for longer term fiscal sustainability.

In saddling Budget 2019 with the theme "A Resurgent Malaysia, A Dynamic Economy, A Prosperous Society", the new government had to contend with numerous challenges as well as balance many competing needs. It has to ensure that economic growth is not negatively impacted as it cancels or puts on hold several mega infrastructure projects to rein in the mounting liabilities that had ballooned to over 80 percent of gross domestic product (GDP) under the previous administration. It has to ease the economic burden of the low and middle income groups that gave it the mandate to rule without imperilling fiscal sustainability and eliciting a sovereign rating downgrade. It has to instil fiscal discipline, good governance and transparency in the public administration without stymieing the day-to-day running of the government, especially in ongoing projects and services involving the private sector.

This article will assess the extent to which the new government has addressed these key issues and challenges through the 2019 budget, and synchronise its fiscal policy and strategy with the current macroeconomic context and outlook. The analysis sheds light on the rationale and feasibility of the budget to strike a judicious balance between sustaining growth, full employment and price stability on the one hand and fiscal discipline and rectitude on the other, not only in the year ahead but also in the medium to long term.

MACRO PERSPECTIVES OF BUDGET 2019

The budget was cast against the backdrop of the more challenging environment expected in 2019. Externally, following a synchronised rebound in 2017 the global economy has become more divergent in 2018 with less upside than downside risks that include US-China trade dispute escalation, quicker US interest rate normalisation pace, heightened financial market volatility, and a more pronounced economic slowdown in China.

On the domestic front, the Malaysian economy had moderated to 4.7 percent in the first three quarters of 2018 compared with 5.9 percent for the same period the previous year. Given the slightly below trend GDP growth and slower increase in exports and fixed investment, the official real GDP growth forecast has been lowered to 4.8 percent for 2018 while a marginal rise to 4.9 percent is anticipated in 2019. Consumer price inflation, which eased to 1.1 percent in the first 10 months of 2018 is projected to rise to between 2.5 and 3.5 percent on account of higher oil prices, planned floating of the fuel pump price, and minimum wage increase. The current account surplus (the equivalent of excess savings over investment) is expected to continue albeit to a smaller size at 2.2 percent of GDP (Table 1).

The assumptions and forecasts underlying Budget 2019 are broadly in line with market expectations amid uncertainty over the intensity and duration of the US-China tariff retaliation despite the three-month truce reached on the sidelines of the recent G20 meeting. Any escalation in global trade tension will further dampen growth and cause under performance of the economy, with negative implications for the tax revenue and fiscal balance forecasts.

Concomitant with the softer growth outlook, the government opted for a more gradual fiscal consolidation approach in formulating the budget for 2019. This is evident in the revision of the balanced budget objective by 2020 to a deficit of 3.0% of GDP, as specified in the mid-term review of the 11th Malaysia Plan (2015-2020) that was released two weeks before the budget announcement.

The new government shouldered the risk of a backlash from financial markets and credit rating agencies to a rise in fiscal deficit to 3.7% and 3.4% for 2018 and 2019 from the earlier expectation of 2.8% and 2.5% respectively (Table 1). Nonetheless, negative market reactions to the widening of the fiscal deficit have been muted in part due to the commitment of the new government to fiscal reforms, the economy’s resilience compared with other emerging countries and its comparatively deep financial markets supported by adequate domestic liquidity and savings. Concerns appear to linger over several fiscal sustainability risks as discussed in the following sections.

On spending, the estimated 10.4 percent rise in government operating expenditure for 2019 suggests an expansionary budget. However, excluding RM35.4 billion of tax refunds, the operating expenditure in 2019 would have contracted by an estimated 4.7 percent compared to the amount estimated for 2018. The refunds owed by the previous administration comprised RM19.4 billion for Goods and Services Tax (GST) and RM16 billion for income tax. The extent to which the sizeable refunds, akin to a fiscal stimulus of 2.4 percent of GDP, will provide a boost to the economy will depend on how they are utilised by the recipients. If invested in new ventures or plant expansion, the multiplier effect on the economy will be larger compared to the refunds being utilised for paying off debt, increasing working capital or boosting savings.

In biting the bullet to fully disburse the refunds owed to individuals and companies, the government has relied upon Petroliam Nasional Berhad (Petronas) to provide a special

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ISSN 2335-6677

dividend of RM30 billion in 2019. The special dividend again highlights the important role the national oil company continues to play in the country's financial and fiscal management.

Looking ahead, the fiscal reforms are expected to include a proposal to establish a stabiliser fund to which revenue will be channelled when the oil price exceeds a pre-determined threshold. The trade-off is that Petronas will see a reduction in accumulated earnings and consequently less funds available for capital investment. In the near term, diversifying revenue sources and broadening the tax base will continue to be key fiscal priorities as the new government embarks on a comprehensive fiscal reform agenda beginning with the setting up of the Tax Reform Committee in September 2018.

Table 1. Malaysia's Budget 2019: Key estimates, assumptions and forecasts

	Value (RM bn)				Annual change (%)			Share of GDP (%)		
	2016	**2017**	**2018e**	**2019f**	**2017**	**2018e**	**2019f**	**2017**	**2018e**	**2019f**
Revenue	212.4	220.4	236.5	261.8	3.8	7.3	10.7	16.3	16.5	17.1
Operating expenditure	210.2	217.7	235.5	259.9	3.6	8.2	10.4	16.1	16.4	17.0
Current balance	2.2	2.7	1.0	2.0				0.2	0.1	0.1
Net development expenditure	40.6	43.0	54.3	54.0	5.9	26.3	-0.5	3.2	3.8	3.5
Overall (fiscal) balance	-38.4	-40.3	-53.3	-52.1				-3.0	-3.7	-3.4
Less: Debt service charges	26.5	27.9	30.9	33.0	5.2	10.8	6.9	2.1	2.2	2.2
Primary balance	-11.9	-12.5	-22.4	-19.1				-0.9	-1.6	-1.2
Assumptions and forecasts										
Gross domestic product (GDP)										
Current prices	1,231.0	1,353.4	1,431.4	1,530.3	9.9	5.8	6.9			
Constant 2010 prices	1,108.9	1,174.3	1,230.3	1,290.7	5.9	4.8	4.9			
Current account balance	29.9	40.3	38.6	34.0	34.7	-4.2	-11.9	3.0	2.7	2.2
Gross exports	787.0	934.9	976.5	1,014.5	18.8	4.4	3.9	69.1	68.2	66.3
Consumer price index (2010=100)	115.2	119.45			3.7	1.5-2.5	2.5-3.5			
Unemployment ('000) (% of labour force)	504.1	502.6	511.1	514.0	-0.3	1.7	0.6	3.4	3.3	3.3

Source: Compiled from data published by Ministry of Finance, Malaysia

TAX STRUCTURE AND REVENUE RISKS

While the stabiliser fund will address the longer term revenue concerns, oil price volatility remains a key revenue risk in 2019. The Medium Term Fiscal Framework (MTFF) adopted by the government assumes world oil price to hover between USD60 and USD70 a barrel over the 2019-21 period. The 2019 budget's assumption of USD70 a barrel suggests key exposure to fluctuating world oil prices as demonstrated by the recent fall to around USD60 a barrel.

From a structural perspective, the abolishment of the GST has increased further the country's reliance on a narrow direct tax base and non-tax revenue, particularly dividends from Petronas and other government-linked companies. As shown in Chart 1, the indirect tax revenue from GST amounted to 4.6 percent of GDP in 2017. With its abolishment with effect from 1 August 2018 followed by the re-introduction of the Sales and Service Tax (SST) from 1 November 2018, the indirect tax share to GDP shows a drop to 2.9 percent in 2018 and 2.7 percent in 2019.

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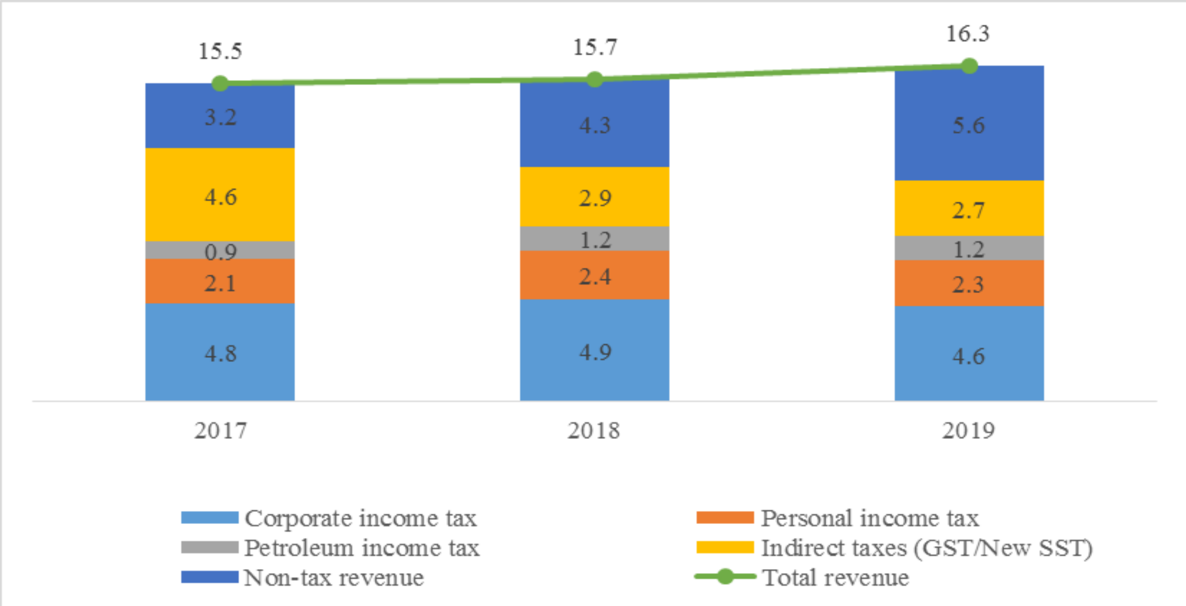
ISSN 2335-6677

Chart 1. Revenue structure (% share of GDP)



Source: Ministry of Finance, Malaysia

The estimated shortfall of RM22 billion in indirect tax revenue represents a reduction in tax burden for consumers but it saddles the government with the urgent need to seek new revenue sources. The revenue enhancing measures contained in Budget 2019 include the extension of service tax to imported services, introduction of digital tax from 1 January 2020, increase in casino duties to 35 percent of gross income, excise tax of 40 sen/liter on sugary beverage (soda tax), 1 percentage point increase to 4 percent stamp duty for transfer of properties above RM1 million, a doubling of real property gains tax to 10 percent for companies and foreigners and from 0 percent to 5 percent for Malaysians disposing property after 5 years and a rationalisation of tax incentives.

These measures are estimated to raise less than half the amount foregone in the reversion from GST to SST system, suggesting that further tax measures are likely in the coming years. The new taxes being broached include inheritance tax, wealth tax and higher personal income tax rates for the wealthy. Given that the tax gap, which is the difference between potential and actual tax collected, remains sizeable despite the absence of reliable estimates, the approach preferred by the new government is centred on strengthening tax administration, enhancing compliance and reducing tax evasion.

Toward to this end and to affirm its commitment to a clean and transparent government, the 2019 Budget contains a Special Voluntary Disclosure Scheme being offered to taxpayers from 3 November 2018 to 30 June 2019 to declare unreported income at special penalty rates.

SPENDING PRIORITIES AND TAX INCENTIVES

In crafting the 2019 Budget the new government adopted a 'Zero-based budgeting' approach to increase spending efficiency, effectiveness and cost savings. Under this approach, the allocation is based on the specified goal rather than the previous budget while all discretionary spending is planned from scratch. While this has resulted in an overall 8.3

percent rise in total allocation covering both operating and development expenditure, it is seen that except for the 21.7 percent increase in allocation for agricultural and rural development, the allocation for the other economic sectors have been reduced by between 12.8 percent and 23.7 percent (Table 2). Health and housing are the two economic sectors receiving higher budget while the allocation for education remains about the same. The education and training sector continues to receive the largest allocation of 20.4 percent share of the total budget, down slightly from 22.1 percent the previous year.

The share of operating budget, which increased by 10.4 percent to RM259.9 billion in 2019, inched up to 82.6 percent, highlighting the challenges of reducing non-discretionary expenditure. While the budgeted increase in 2019 is distorted by the grants to statutory funds and public corporations, the strong rise in operating expenditure in 2018 and 2019 reflects in part the sizeable emoluments (31.6 percent of total operating budget) attributed to the large size of the civil service.

Following a pick-up in the estimated share of development expenditure in 2018, it shows a deterioration in the 2019 budget to 17.4 percent of the total, way below the 27-30 percent in previous decades. To raise spending effectiveness in the coming years, there is a need to increase the share going to development expenditure.

Table 2. Total budget allocation by sector

	Amount (RM billion)			Annual change (%)			Share of total (%)		
	2017	2018e	2019B	2017	2018e	2019B	2017	2018e	2019B
Economic services	**41.06**	**50.98**	**44.73**	**-6.6**	**24.1**	**-12.3**	**15.6**	**17.6**	**14.2**
Agriculture, rural dev. & public utilities	4.79	5.90	7.18	-19.5	23.2	21.7	1.8	2.0	2.3
Trade & industry	6.96	10.39	8.67	-32.5	49.4	-16.6	2.6	3.6	2.8
Transport & communications	16.80	22.24	19.38	19.5	32.4	-12.8	6.4	7.7	6.2
Environment & others	8.04	8.20	6.26	-14.3	1.9	-23.7	3.1	2.8	2.0
Social services	**99.83**	**105.77**	**106.91**	**8.1**	**5.9**	**1.1**	**38.0**	**36.4**	**34.0**
Education & training	60.53	64.31	64.30	8.8	6.2	0.0	23.1	22.1	20.4
Health	25.52	27.69	28.99	10.4	8.5	4.7	9.7	9.5	9.2
Housing	1.50	1.18	1.66	-48.1	-21.3	40.9	0.6	0.4	0.5
Others	12.28	12.59	11.95	14.9	2.6	-5.1	4.7	4.3	3.8
Security	31.34	32.50	30.62	8.9	3.7	-5.8	11.9	11.2	9.7
Administration	**14.99**	**18.36**	**18.94**	**-13.7**	**22.5**	**3.2**	**5.7**	**6.3**	**6.0**
Others (debt services, etc)	**75.35**	**82.74**	**113.35**	**8.1**	**9.8**	**37.0**	**28.7**	**28.5**	**36.0**
Total (OE and DE)	**262.58**	**290.35**	**314.55**	**4.1**	**10.6**	**8.3**	**100.0**	**100.0**	**100.0**
Operating expenditure (OE)	**217.70**	**235.45**	**259.85**	**3.6**	**8.2**	**10.4**	**82.9**	**81.1**	**82.6**
Development expenditure (DE)	**44.88**	**54.90**	**54.70**	**6.9**	**22.3**	**-0.4**	**17.1**	**18.9**	**17.4**

Note: e - estimate; B - Budget

Source: Compiled from data published by the Ministry of Finance, Malaysia

Given that there are over 130 types of fiscal incentive schemes, a comprehensive review as proposed in the budget is timely for removing irrelevant and duplicative incentives. The streamlining of incentives will also contribute to narrowing the tax gap. Among the key incentives provided in the 2019 budget are tax incentives for green initiatives (Green Investment Tax Allowance) whereby qualifying assets have been increased from 9 to 40 assets.

Importantly, the budget highlights various incentives targeted at the adoption of Industry 4.0 or Industry4WRD ('Industry Forward' as coined in the budget). Incentives include tax deduction on readiness assessment expenses, double deduction on qualifying operating expenses incurred by anchor companies that develop the Industry4WRD Vendor development programme, and double deduction for scholarships, internship and training programmes to upgrade employees' technical skills in Industry 4.0 technology.

RESTORING FISCAL INTEGRITY AND ADDRESSING DEBT WOES

In the wake of the numerous financial scandals and irregularities plaguing the previous administration, it is not surprising that the topmost thrust of the budget is centred on institutional reforms aimed at restoring integrity, transparency and trust in the country's public finance and fiscal management. Key initiatives announced to strengthen fiscal administration include the adoption of Zero-based Budgeting, enactment of the Fiscal Responsibility Act by 2021 to prevent excessive debt-based spending, introduction of a new Government Procurement Act to ensure transparency and competition while punishing abuse of power, negligence and corruption, and a shift from cash-based to an accrual basis of accounting by 2021.

Another key budget emphasis is debt restructuring and rationalisation. The federal government's debt-to-GDP ratio has risen from 39.8 percent in 2008 to 50.7 percent in 2017 due largely to increased borrowing to finance the fiscal stimulus mounted to counter the economic downturn caused by the global financial crisis. More ominously, adding previously undisclosed liabilities, the country's total direct and indirect debt exposure has reached 80.3 percent of GDP in 2017 (Table 3). The ongoing review, postponement and cancellation of a number of mega infrastructure projects has reduced total liabilities to 74.5 percent at end June 2018 and this is projected to fall further to 73.5 percent of GDP by end 2019.

Table 3. Malaysia's total direct and indirect debts

	RM billion		Share of GDP (%)	
	End-2017	End-June 2018	End-2017	End-June 2018
Federal government debt	686.8	725.2	50.7	50.7
Committed government guarantees	102.1	117.5	7.5	8.2
1Malaysia Development Berhad (Net debt)	38.3	38.3	2.8	2.7
Other liabilities (PPP, PFI and PBLT)	260.1	184.9	19.2	12.9
Total	1,087.3	1,065.9	80.3	74.5

Source: Ministry of Finance, Malaysia

CONCLUDING OBSERVATIONS

The 2019 budget presented by the barely six-month-old government has set the country on the path to fiscal soundness. The reform agenda is a necessary condition to avert a fiscal crisis while pursuing a gradual pace of fiscal consolidation so that the well-being of the low income households (B40) is not adversely impacted by more targeted subsidies and welfare spending. The reforms per se however are not sufficient to ensure high and sustained economic growth. A strong positive response from the private sector especially in raising

ISSUE: 2018 No. 80
ISSN 2335-6677

productivity, skill and entrepreneurship levels, technological capability and investment is needed to complement the restoration of fiscal discipline and a clean, transparent and effective public administration.

There is hope that the fiscal restructuring and greater spending discipline and effectiveness envisaged in Budget 2019 will take root for greener shoots to sprout by 2020 and take the economy on a higher growth trajectory in the years beyond. In short, Budget 2019 is a well-constructed balancing act on a tight rope. The effectiveness and efficiency in which the budget thrusts and measures can be implemented remains the key to avoid falling off the fiscal cliff.

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[1] The current Prime Minister Tun Dr Mahathir Mohammad during his term as the country's 4th Prime Minister took over the finance portfolio when his deputy who was then the Finance Minister was sacked in 1998. Tun Daim bin Zainuddin was appointed Finance Minister from 1999-2001 before the then Prime Minister Tun Dr Mahathir bin Mohamad took back the portfolio prior to stepping down in 2003. The two subsequent Prime Ministers, Tun Abdullah Ahmad Badawi and Dato' Seri Najib Abdul Razak continued to hold the finance portfolio.

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