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Malaysia Strives for Fiscal Consolidation and Off-Balance Sheet Transformation

*By Cassey Lee**

EXECUTIVE SUMMARY

- A key aspect of the Malaysian 2015 Budget is fiscal consolidation to reduce the federal government deficit and debt level.
- The challenge faced by the Malaysian government is in providing support for targeted private-investments under its Economic Transformation Programme.
- It has overcome this fiscal constraint for growth policies by using an "off-balance sheet" approach involving the mobilization of government-linked corporations.
- A key future challenge for the Malaysian Government will therefore be to manage the performance and financial liabilities of these GLCs.

* ***Cassey Lee*** is Senior Fellow at ISEAS; e-mail: cassey_lee@iseas.edu.sg. *The author thanks Francis Hutchinson and Ooi Kee Beng for their comments and suggestions. The usual caveat applies.*

INTRODUCTION

The 2015 Budget for Malaysia was unveiled by Prime Minister Najib Razak on 10th October 2014. This is the sixth under the Najib Administration. Carrying the theme "The People's Economy", the budget's allocation at RM273.9 billion is relatively modest and is only four percent higher (in nominal terms) than that of the previous year.[1] This reflects one of the key strategies of the budget, namely, "enhancing fiscal governance", aimed at strengthening financial sustainability and reducing the fiscal deficit. This is not a new policy as fiscal consolidation has been implemented since 2013. The macroeconomic factors underlying this policy can be traced back to two pivotal economic policies that were launched in 2009. The first was the short-term fiscal stimulus implemented in the aftermath of the Global Financial Crisis (GFC) in 2008. The second was the long-term Economic Transformation Programme (ETP) introduced to transform Malaysia into a high-income economy by the year 2020.

A consequence of the fiscal stimulus in 2009 has been the fiscal deficit and rapid build-up of federal government debt to a level close to the self-imposed 55 percent limit (federal government debt as a percentage of GDP). This has necessitated fiscal consolidation,[2] which meant limited room for the federal government to directly support the ETP. Even though most of the investments in ETP are targeted to come from the private sector, significant state involvement is nevertheless needed. Herein lies the dilemma – how is the Malaysian government to provide financial support for investments when it has limited fiscal space to manoeuvre?

This essay discusses the approach undertaken by the Malaysia government to support private investment-driven growth via an "off-balance sheet approach" involving the use of government-linked corporations.

FISCAL ACTIVISM AND ITS CONSEQUENCES

The Najib Administration came to power in 2009 amidst great economic uncertainty following the Global Financial Crisis the preceding year. In 2009, the Malaysian economy contracted by some 1.5 percent – its first recession since the 1998 Asian Financial Crisis (*Figure 1*). The Malaysian government responded by implementing two fiscal stimulus packages amounting to RM67 billion

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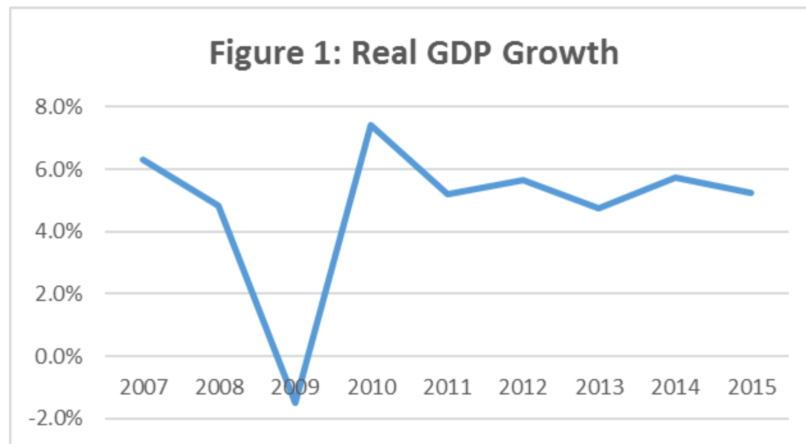
[1] Note that the inflation rate in the first and second quarters of 2014 were 3.4% and 3.3%, respectively.

[2] Malaysia's post-GFC fiscal consolidation experience is not unique. Many developed and developing countries are also currently undergoing fiscal consolidation after undertaking fiscal activism in the 2008-2009 period. See Sutherland et al. (2012) for further discussions.

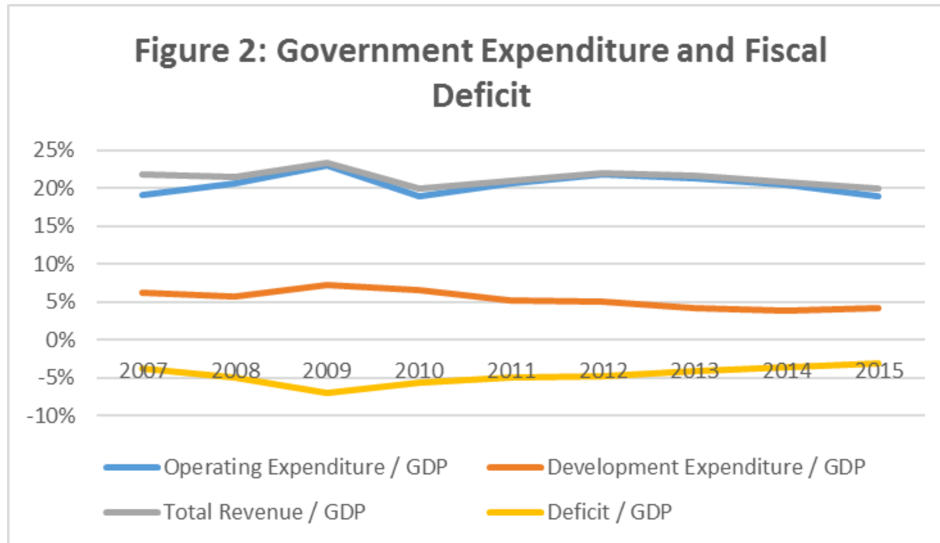
(9.9% of GDP) during the period 2009-2010. This included a direct fiscal injection of RM22 billion (3% of GDP). The impact of this stimulus programme was felt in 2010 when the economy rebounded strongly by growing at 7.4 percent in 2010. The Malaysian economy has since grown at a robust and moderate rate of about five percent annually since 2011 (*Figure 1*).



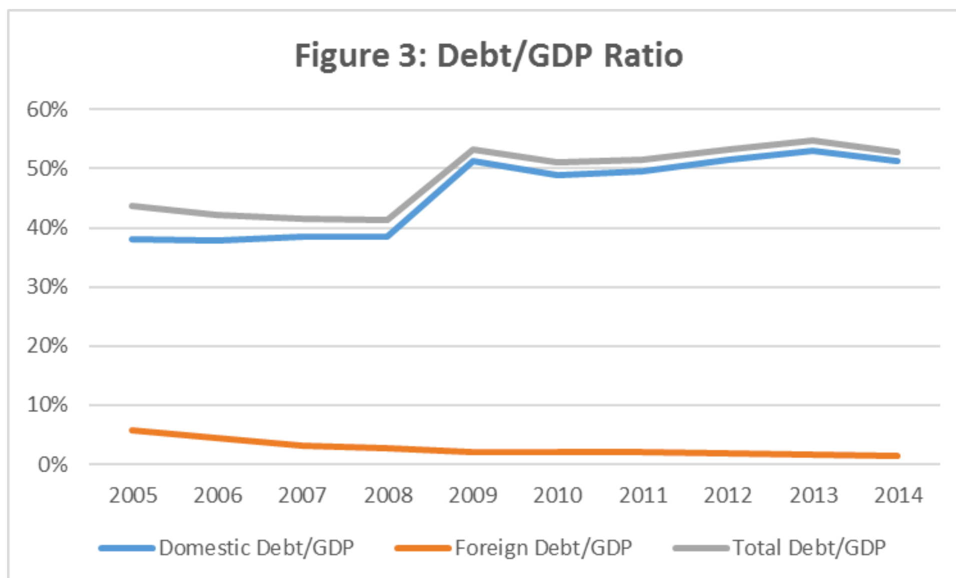
Source: Department of Statistics, Malaysia

One important consequence of the fiscal activism in 2009-2010 has been the rise in fiscal deficit and public debt. The fiscal deficit rose from five percent of GDP in 2008 to about seven percent in 2009 whilst public debt increased from 41 percent of GDP to 53 percent in the same period (*Figure 2*). Whilst the Malaysian government has been able to reduce government expenditures—thus reducing its fiscal deficits, it has been more challenging for it to reduce public debt. Public (federal government) debt as a ratio of GDP reached the self-imposed limit of 55 percent of GDP in 2013 and is expected to decline slightly to 53 percent in 2014 (*Figure 3*).[3] This implies that the federal government has limited space to borrow directly for its fiscal activities in the coming years. This problem has been compounded by the fact that the federal government's total revenue elasticity – which measures the responsiveness of tax revenues to GDP growth – has been declining since 2011 (*Figure 4*).

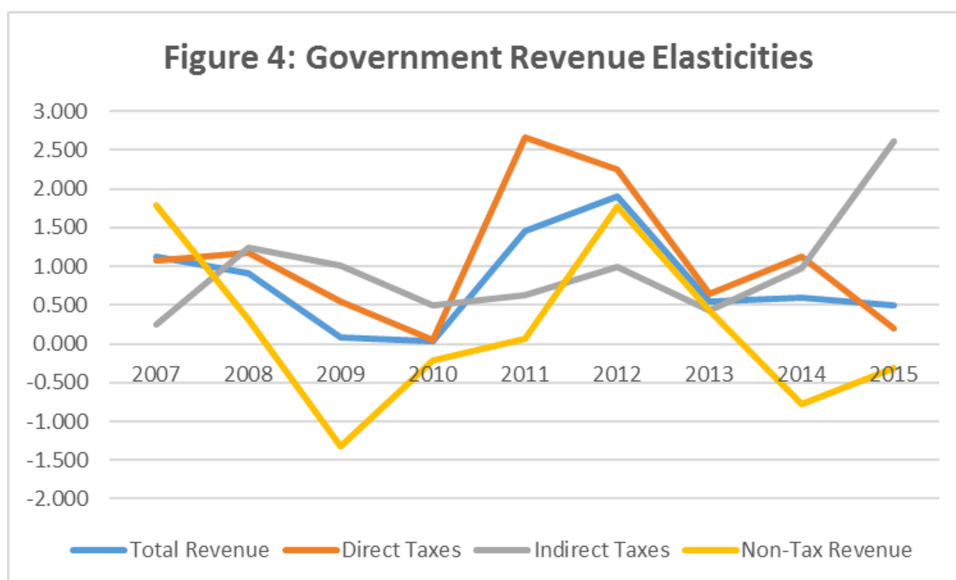
[3] Whilst the public debt carrying capacity of an economy may vary from country to country, it has been suggested that a prudent government debt target should be around 50 percent (Sutherland et al., 2012, p.9).



Source: Ministry of Finance, Malaysia



Source: Ministry of Finance, Malaysia



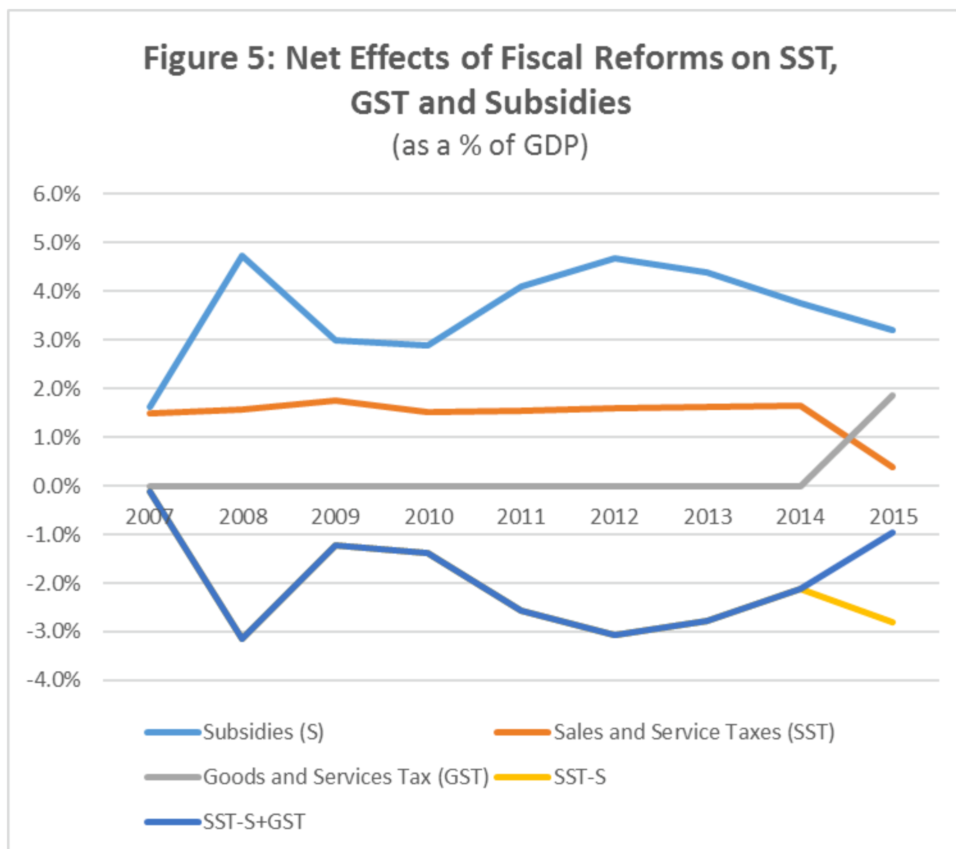
Source: Ministry of Finance, Malaysia

FISCAL REFORMS AND CONSOLIDATION

In light of the fiscal constraints confronting Malaysia, it is not surprising that fiscal reforms and consolidation continue to be key strategies in the 2015 Budget. Under the rubric "fiscal governance", the implementation of the goods and services tax (GST, replacing sales and services taxes, SST) in 2015 is likely to partially alleviate the fiscal constraint problem. In addition, subsidies will be further reduced by RM2.8 billion in 2015 (similar to the estimated quantum of subsidies reduction in 2014). The combined effects of GST and subsidy rationalization is expected to reduce expenditures (net of SST and GST) by one percent in 2015 (*Figure 5*).

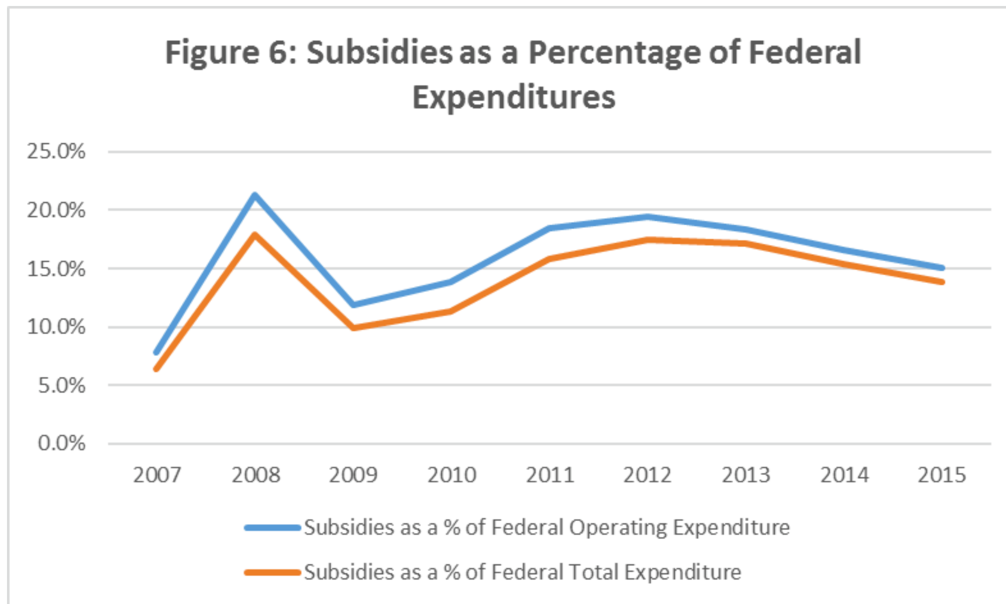
From a fiscal consolidation perspective, subsidies are likely to continue to be a drag on federal expenditures. The origin of high subsidies in Malaysia can be traced back to 2008 – the year of the 12th General Elections – during which federal expenditures on subsidies increased by 235 percent. Subsidy rationalization only began in 2013. Subsidies are estimated to account for some 15.1 percent of the federal government's operating expenditure in 2015 (*Figure 6*). The relatively modest rationalization of subsidies in the 2015 Budget is likely to be due to the implementation of GST in 2015. The government has been trying to soften the impact of fiscal consolidation via direct cash transfer payments under the "Bantuan Rakyat 1Malaysia" (BR1M) scheme which will

amount to RM4.9 billion in 2015 (compared to RM4.6 billion for 2014).[4] Thus, fiscal activism and consolidation in Malaysia are not only affected by the economic environment but also by political cycles as well. With the next elections not due until 2018, the Najib administration has three more years (2015-2017) to rein in subsidies.



Source: Ministry of Finance, Malaysia

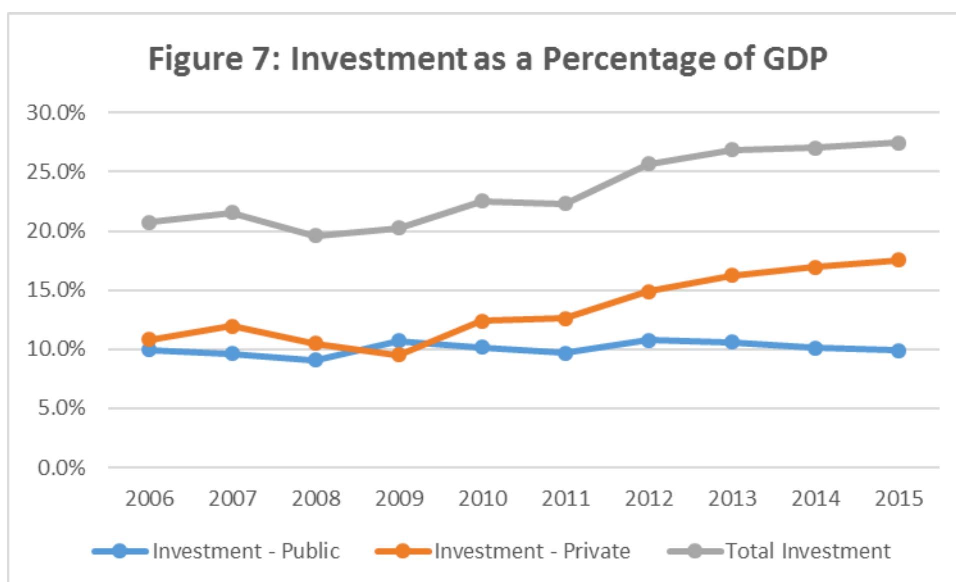
[4] The BR1M involves direct cash transfer to two types of households, namely, those with a monthly household income of (i) RM3,000 and below, and (ii) between RM3,000 and RM4,000. Launched in 2014, the BR1M payment will be increased from RM650 in 2014 to RM950 in 2015 for the first group, and from RM450 to RM750 for the second group. The estimated number of recipients is 7.9 million.



Source: Ministry of Finance, Malaysia

THE OFF-BALANCE SHEET TRANSFORMATION STRATEGY

Fiscal reforms and consolidation in post-recessionary periods can run into the risk of slowing down economic growth. With the Malaysian economy growing at a moderate and robust rate (of around five percent), the more challenging problem is likely to be sustaining medium to long-term growth while undertaking fiscal consolidation at the same time. This may seem odd to some, given that fiscal policies are more often regarded as macroeconomic stabilization tools. However, there has been increasing recognition that fiscal policies (via public expenditures and taxes) do have an impact on long-term economic growth through their effects on drivers of economic growth such as labour participation, human capital development, capital formation and technological change (Moreno-Dodson, 2013). In the case of Malaysia, from a growth accounting perspective, capital accumulation remains the most important source of growth. Capital accumulation accounted for close to 60 percent of growth during the 2011-2013 period (MPC, 2014, p.13). Private investment, in particular, has played an increasingly important role (*Figure 7*). Private investment as a percentage of GDP has risen from ten percent in 2006 to around 17 percent in 2014. Public investment has remained relatively stable at ten percent. Thus, the gap between private investment and public investment has widened since 2010.



Source: Ministry of Finance, Malaysia

The impressive recovery of private sector investment since 2009 raises new questions about the sources of economic growth. Interestingly, much of the recent recovery in private investment has taken place in the services sector (*Figure 8*). Within the services sector, much of these private investments have taken place in three industries, namely (i) finance, insurance, real estate and business services; (ii) transport, storage and communication; and (iii) other services (*Figure 9*).[5] Incidentally, these are also industries in which government-linked corporations (GLCs) have a heavy presence (*Table 1*). For example, GLCs account for 88.4 percent and 92.7 percent of total assets and operating revenues in the utilities industry. The growth in private investment in the manufacturing sector (where GLCs have less presence compared to services) has been less impressive. Thus, it is plausible that private investments especially in services may be mainly driven by GLCs.[6] This is related to the implementation of the Government's Economic Transformation Programme (ETP) covering the period 2011-2020.[7]

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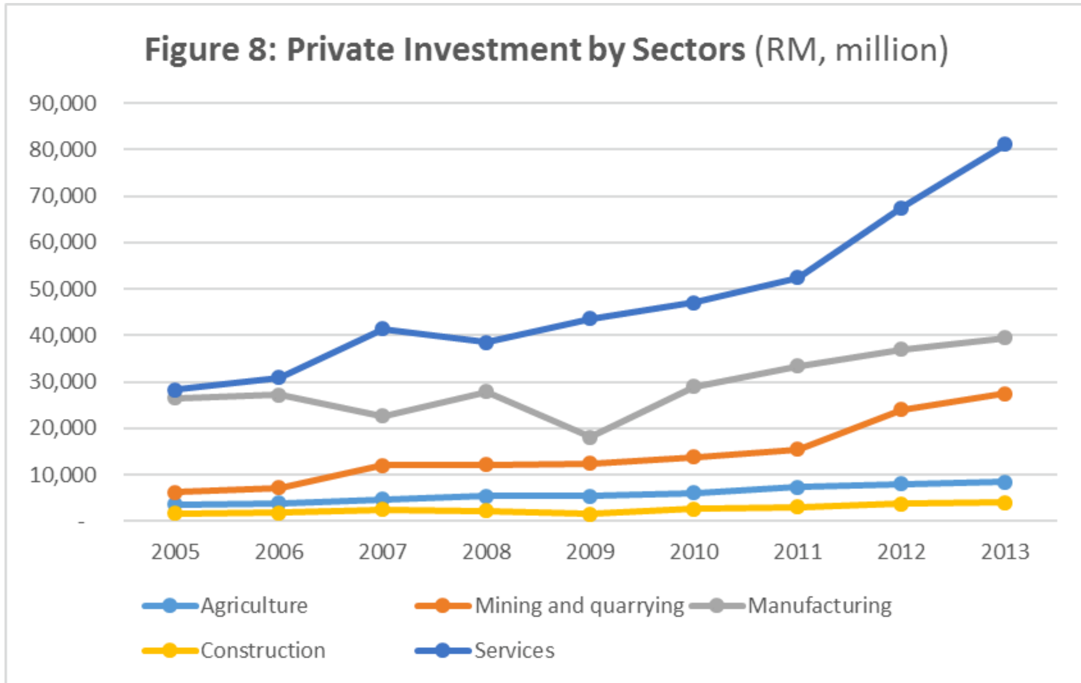
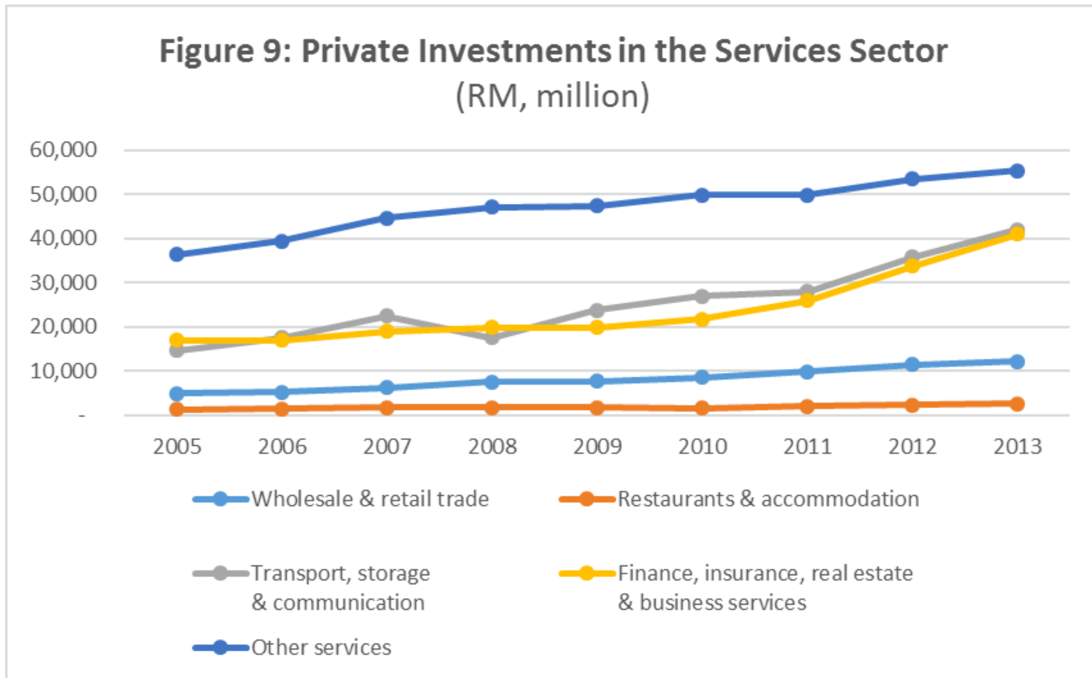
[5] Other services include electricity and gas, water, private health services, private education services and other private services.

[6] This remains a conjecture as detailed firm-level data on private investment are not publicly available. The counter-argument would be that private investments are not GLC-linked because the Department of Statistics defines private sector as comprising "all resident units operated by private enterprises except those controlled by government".

[7]The ETP identified 12 National Key Economic Areas as sources of growth: (1) Greater Kuala Lumpur/Klang Valley; (2) Oil, Gas and Energy; (3) Financial Services; (4) Wholesale and Retail; (5) Palm Oil; (6) Tourism; (7) Electronics and Electrical; (8) Business Services; (9) Communications Content and Infrastructure; (10) Education; (11) Agriculture; and (12) Healthcare.



Source: Department of Statistics, Malaysia



Source: Department of Statistics, Malaysia

Table 1: GLCs' Participation in the Services Sector, 2012

Industry	GLCs' Share of Total Assets (%)	GLCs' Share of Operating Revenues (%)
Banking	56.1	61.9
Beverage and Tobacco Product Manufacturing	5.1	9.8
Chemical Manufacturing	18.1	21.9
Food Manufacturing	2.3	1.1
Information (Communications)	67.1	55.8
Non-Metallic Mineral Product Manufacturing	2.4	2.5
Transport Equipment Manufacturing	28.0	52.4
Transportation and Warehousing	72.8	80.3
Utilities	88.4	92.7

Source: Menon and Thiam (2013)

The ETP was launched in 2010 as the Government's economic strategy to transform Malaysia into a high-income economy by the year 2020. The total investment requirements for the ETP are estimated to be RM1,419 billion, of which 92 percent (RM1,311 billion) will be sourced from the private sector (PEMANDU, 2010, p.85). Domestic sources will account for 73 percent (RM953 billion) of these private investments. The catalysts for these private investments are entry point projects (EPPs) – government-assisted investments that attract further private investments ("business opportunities" in ETP). About half of the private investments in EPPs will go to the services sector (*Table 2*).

Table 2: Investment Requirements under ETP, 2011-2020

NKEA	Total EPP Funding (RM, bil)	EPP Public Sector (RM, bil)	EPP Private Sector (RM, bil)	From Business Opportunities (RM, bil)
Greater Kuala Lumpur/Klang Valley	171.9	57.8	114.1	0
Oil, Gas and Energy	113.3	0.6	112.7	104.2
Financial Services	65.2	0.6	64.6	145.8
Wholesale and Retail	67.1	0.4	66.7	187.6
Palm Oil	59.7	2.9	56.8	64.5
Tourism	136.6	4.6	132.0	67.3
Electronics and Electrical	66.7	8.5	58.2	11.7
Business Services	33.1	3.1	30.0	8.1
Communications Content and Infrastructure	30.3	1.0	29.3	21.2
Education	19.86	10.27	9.58	0.09
Agriculture	18.9	8.2	10.7	2.9
Healthcare	11.9	0.3	11.6	5.3
	794.56	98.27	696.28	618.69

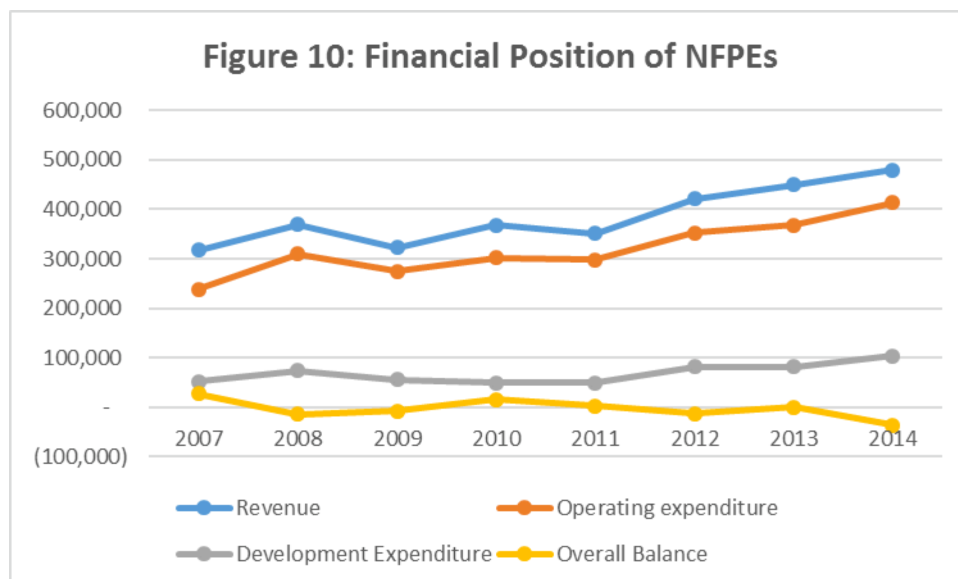
Source: PEMANDU (2010)

From a fiscal/budgetary perspective, even though these are private investments, significant government funding is likely to be required to support EPPs. It has be estimated that only 15 percent of the EPPs do not require specific government funding or policy support (ETP, p.93). Thus, since 2011, the federal government has begun allocating funds and providing incentives for the ETP programme.[8] However, as discussed earlier, the federal government has been constrained by fiscal consolidation.

[8] The funds for ETP have been and will be allocated in a series of tranches (ETP, p.120). The first tranche for 2011-2012 was approved by the Parliament in October 2010 (i.e. in the 2011 Budget). The second tranche for 2013-2015 was approved in 2012 while the third tranche for 2015-2018 should be approved in 2015 under the Eleventh Malaysia Plan. The last tranche for 2018-2020 will be approved in 2017.

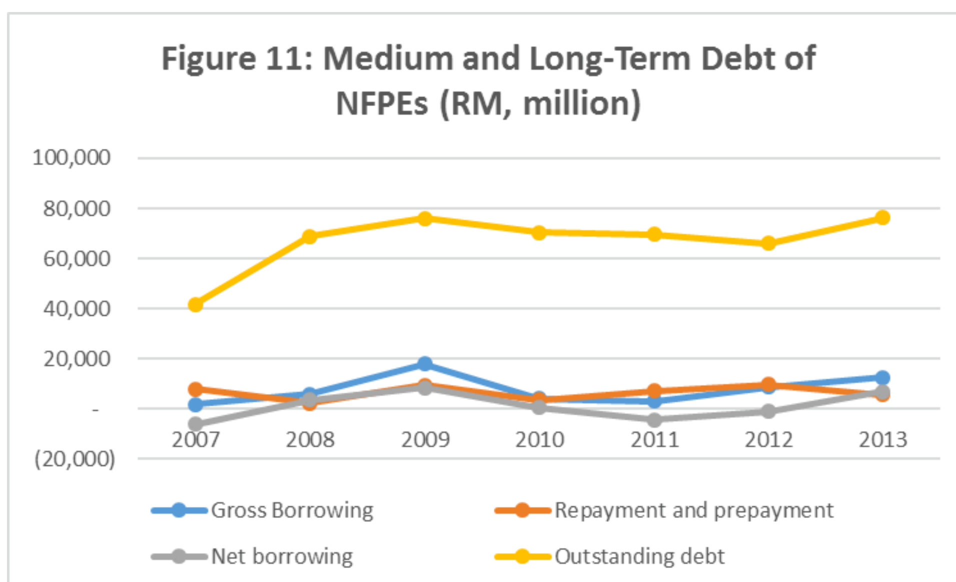
The solution to this dilemma has been to fund private investments indirectly via an "off-balance sheet approach" (as in not part of federal expenditure and debt). This approach entails investment by government-linked corporations (GLCs) that are either directly or indirectly controlled by the federal government. This approach is, in itself, not new. It involves the active participation of government-controlled enterprises officially classified as "non-financial public enterprises" (NFPEs) spending on development-oriented projects. The list of NFPEs include PETRONAS and many of the privatized state-owned enterprises such as Telekom Malaysia and Tenaga Nasional.[9] PETRONAS plays an important role in spearheading the EPPs in the oil and gas sector.

Overall, the revenues of NFPEs have risen in tandem with their operating costs – yielding a consistent net operating balance since 2007 (*Figure 10*). However, the total development expenditures of NFPEs have risen rapidly since 2012, probably due to their involvement in ETP-related projects. NFPEs' development expenditure rose from RM49 billion in 2011 to RM85 billion in 2012, RM81 billion in 2013 and RM103 billion in 2014. The overall financial deficit of NFPEs in 2014 was –RM36 billion. There are also indications that the NFPEs' debt levels have increased since 2012 (*Figure 11*). The outstanding debt of NFPEs increased from RM66 billion in 2012 to RM76 billion in 2013.



Source: Ministry of Finance, Malaysia

[9] See Appendix 1 for a full list of NFPEs.



Source: Bank Negara Malaysia

In addition to the NFPEs, the off-balance sheet approach also involves Khazanah Nasional and more recently, 1 Malaysia Development Berhad (1MDB). Khazanah Nasional, which was established in 1994, has significant equity holdings in some of the NFPEs. The portfolio of companies under its umbrella is very diverse. It includes companies in banking and finance, utilities and infrastructure, healthcare, property and construction.[10] Its role has changed since 2004 from that of a mere "custodian" to a more active investor to support the government's development strategies (Lai, 2012). This is reflected in its involvement as a major investor in the Iskandar Malaysia project in Johor.[11] The Iskandar Malaysia region has thus far attracted about RM130 billion in total cumulative committed investments, of which 64% are from domestic investors (MIDA, 2012, 2013).[12]

A more recent established GLC involved in the ETP is the 1 Malaysia Development Berhad (1MDB). The 1MDB is a strategic investment company established in 2009 and wholly-owned by

[10] As at 31 August 2014, these include such as UEM Group (100%), Axiata (38.8%), Telekom Malaysia (28.9%), Tenaga.Nasional (32.4%), SilTerra Malaysia (100%), Malaysia Airport (36.6%), MAS (69.4%) and Penerbangan Malaysia (100%). Source: Khazanah Nasional.

[11] The equity ownership of Iskandar Malaysia Berhad is distributed across three companies, namely, Khazanah National Berhad (60%), Employees Provident Fund (20%) and Kumpulan Prasarana Rakyat Johor (20%).

[12] The extent of Khazanah Nasional's financial investment in Iskandar Malaysia is unknown. See Hutchinson (2013, 2015) for discussions of the Iskandar Malaysia project.

the Ministry of Finance. Even though 1MDB is the smallest (in terms of total assets) amongst the three large GLCs involved in the ETP, it has grown the fastest in recent years (*Table 3*). The 1MDB is involved in two key sectors, namely energy (electricity generation) and the financial sector. Thus far, 1MDB has acquired three power plants at the cost of about RM13 billion and has won another RM8.1 billion greenfield power project (Project Track 3B). For the financial sector, 1MDB is involved in the building of a RM26 billion financial hub named the Tun Razak Exchange.

Table 3: Major GLCs Driving the ETP

GLC	Assets (RM, billion)	Industries
1Malaysia Development Berhad (1MDB)	51.4 @ 31/3/2014	Electricity Generation Finance Centre (TRX)
PETROLIAM Nasional Berhad (PETRONAS)	489.1 @31/12/2014	Oil & Gas
Khazanah Nasional Berhad (Khazanah Nasional)	135.1 @ 31/12/2013	Diversified – including banking and finance, utilities and infrastructure, healthcare, property, construction

Sources: 1MDB – The Star, "1MDB sinks into losses of RM665.3 million in FY2014," 6 November 2014; Petronas - Annual Report 2013; Khazanah Nasional – Khazanah Report 2013

FUTURE TRAJECTORIES

The Malaysian government is currently formulating the Malaysian National Development Strategy (MyNDS) as well as the 11th Malaysia Plan (2016-2020). Both are scheduled to be launched in May 2015. From a fiscal perspective, the federal government is likely to be constrained, and fiscal consolidation is likely to be continued in the medium term. This also implies that both the MyNDS and the 11th Malaysia Plan are likely to continue the strategies adopted in the Economic Transformation Programme (2011-2020). The size of the investment required is likely to necessitate a continued reliance of government-linked corporations as well as a more aggressive approach to attract investments, both domestically and especially from abroad. A key challenge will be to manage the performance and financial liabilities of the GLCs that have been mobilized to support private-sector driven investments in these development programmes.

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APPENDIX 1: List of Non-Financial Public Enterprises

Source: Ministry of Finance, Economic Report 2014/2015

1. Axiata Group Berhad,
2. Bintulu Port Holdings Berhad
3. Boustead Holdings Berhad
4. Cement Industries (Sabah) Sdn Bhd
5. Indah Water Konsortium Sdn. Bhd.
6. IJN Holdings Sdn Bhd,
7. Keretapi Tanah Melayu Berhad (KTM Berhad)
8. Kulim (Malaysia) Berhad
9. Malaysian Airline System Berhad (MAS)
10. Malaysia Airport Holdings Berhad
11. MIMOS Berhad
12. Multimedia Development Corporation Sdn Bhd
13. Penerbangan Malaysia Berhad
14. Percetakan Nasional Malaysia Berhad
15. PETROLIAM Nasional Berhad (PETRONAS)
16. PPES Works (Sarawak) Sdn Bhd
17. Rakyat Berjaya Sdn Bhd
18. Sabah Energy Corporation Sdn Bhd
19. Sabah Ports Sdn Bhd
20. Silterra Malaysia Sdn Bhd
21. Syarikat Perumahan Negara Berhad
22. Prasarana Malaysia Berhad
23. Syarikat Sesco Berhad
24. Telekom Malaysia Berhad
25. Tenaga Nasional Berhad
26. TH Plantation Berhad
27. UDA Holdings Berhad
28. UEM Goup Berhad
29. Mass Rapid Transit Corporation Sdn Bhd.

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Institute of Southeast Asian Studies
30, Heng Mui Keng Terrace
Pasir Panjang, Singapore 119614
Main Tel: (65) 6778 0955
Main Fax: (65) 6778 1735

Homepage: www.iseas.edu.sg

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