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Malaysia's 2018 Budget: Balancing Short Term Needs and Long Term Imperatives

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EXECUTIVE SUMMARY

- Coinciding with the election cycle, Malaysia's Budget 2018 has been skilfully crafted with broad ranging reliefs, benefits and handouts to a broad spectrum of the voting population.
- The recent turnaround in the economic environment, led by an export surge and improving commodity prices, has provided a positive setting for the higher revenue projection to support the increased spending while keeping the budget within the targeted deficit reduction.
- Adjustments to the allocations for key sectors such as education, health and social welfare are instituted in the budget to ease the pain inflicted by spending cuts and subsidy rationalisation during the collapse of world oil prices in 2015.
- Spending on economic services is expanded to spur economic growth and investment as well as promote new thrusts in Industrial Revolution 4.0 and the Digital Economy.
- However, increased spending is concentrated on the operating expenditure side while development expenditure remains flat, leading to concerns over the 2018 budget's allocative efficiency as well as challenges for future budgets.

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The 2018 Budget for Malaysia was unveiled by the Prime Minister of Malaysia, Dato' Sri Mohd Najib bin Tun Abdul Razak, in Parliament on 27 October 2017. The budget was crafted with a clear sight on a general election that must be called by August 2018. Not surprisingly therefore the budget contains well-spread sweeteners for key constituencies, but not overly generous as to derail the medium term goal of achieving a balanced or near-balanced budget by 2020 through a gradual pace of fiscal consolidation.

While a more favourable external economic environment has provided the government with some respite from a tightening fiscal space, the government and the private sector should not be lulled into complacency in pursuing the necessary strategic reforms that are needed to tackle the country's socio-economic development challenges which the annual budget attempts to address with tax reliefs and stop-gap measures. The reform imperatives to strengthen the country's resilience take on a more urgent note given that the longer term threats may crystallised sooner rather than later amid lingering uncertainties and increased frequency of crises afflicting the global economy.

TURNAROUND IN MACROECONOMIC SETTING

Despite a plunge in oil prices by nearly 50 percent in 2015 the federal government's total spending was cut by only 0.5 percent amidst a slowing economy while enabling the fiscal deficit to be narrowed to -3.2 percent of gross domestic product (GDP) from -3.4 percent in the previous year. Besides cutting spending and subsidies, the shortfall in oil revenue was offset by the timely introduction of the goods and services tax (GST) in April that year.

In 2016, oil prices fell another 16 percent to USD44 per barrel necessitating the government to undertake a deeper 2.2 percent reduction in total spending. In spite of the economy weakening to its slowest pace of 4.2 percent since the 2009 recession, the continuing fiscal consolidation enabled the government to further narrow the fiscal deficit to -3.1 percent of GDP in 2016.

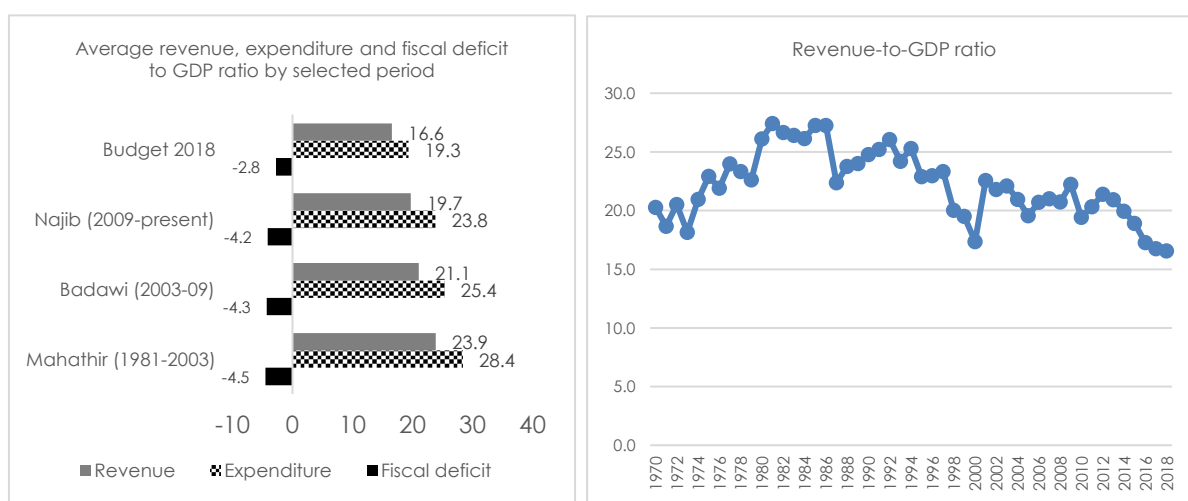
The purse string was loosened in 2017 on the back of the recovering oil prices and higher natural gas production that offset lower crude oil production. With the export-led turnaround since the beginning of 2017, the country's GDP growth has seen consecutive upward revisions as a consequence of better-than-expected performance in the first two quarters of 2017. The earlier official forecast of 4.8-5.3 percent for 2017 was revised to 5.2-5.7 percent in the economic report released in conjunction with the 2018 budget announcement. In 2018 the economy is projected to expand by 5.0-5.5 percent. The projected growth is within the range of forecasts by private sector and multilateral agencies although their forecasts are generally at the lower end of the range.

Given that the global economic growth is forecast by the International Monetary Fund to strengthen further from 3.6 percent in 2017 to 3.8 percent in 2018, the slight moderation in the projected growth of the Malaysian economy is largely due to the base effect arising from a stronger-than-anticipated growth that is likely in 2017 and capacity constraints faced by the country's export-oriented industries. The country's gross exports expanded by 21 percent in the first 9 months of 2017 compared to the corresponding period in the previous year. With the further strengthening of the global economy, exports which is a key driver of the country's current growth surge through its positive spill-over effects on domestic income, investment and employment, is likely to be sustained in 2018.

EXPANSIONARY BUDGET AND ITS IMPLICATIONS

A 5.4 percent rise in total operating and development expenditure to RM280 billion is budgeted for 2018, an increase similar to the 2017 budget. Operating expenditure will see a 6.5 percent rise to RM234 billion while development expenditure is increased by a mere 0.2 percent to RM46 billion. The budgeted expenditure amounts to an estimated 19.4 percent of the nominal GDP projected for 2018, a slight decline from 19.8 percent in the previous year. On the revenue side, an increase of 6.4 percent is projected for 2018, marginally higher than the estimated rise of 6.1 percent in 2017 but as a share of GDP, it shows a decline to 16.6 percent from an estimated 16.8 percent in 2017 and 17.3 percent in 2016.

The declining revenue-to-GDP trend is particularly noticeable since 2009. The average revenue-to-GDP share during the 2009-2017 period is 19.7 percent compared to 21.1 percent and 23.9 percent during two previous administrations respectively (Badawi, 2003-09, and Mahathir, 1983-2009), suggesting that the consecutive fiscal deficits since 1998 can be attributed not only to the sustained spending increases but also a decline in tax buoyancy. In the years preceding the 1998 Asian Financial Crisis, a 1 percent rise in GDP is associated with a 1.06 percent rise in tax revenue. In the period after 1998, the estimated revenue responsiveness fell to 0.92 percent for a 1 percent increase in GDP growth. The revenue growth of 6.4 percent assumed for 2018 is however consistent with the underlying tax buoyancy. The immediate revenue shortfall risk therefore emanates largely from the extent to which projected economic growth can be achieved which in turn is contingent upon the external environment. In the longer term, the government faces the challenge of raising the tax buoyancy which could have been impacted by generous fiscal incentive schemes given over the years to stimulate foreign and domestic investment.



Source: Ministry of Finance, Malaysia

Another creeping structural challenge that is evident in the 2018 budget is the estimated 6.5 percent increase in allocation for operational expenditure, raising its share to 83.6 percent of total expenditure budgeted in 2018 compared to an average of around 70 percent and 75 percent under the two previous administrations respectively. Given the larger economic multiplier associated with development spending, the meagre 0.1 percent increase in the development budget as well as its shrinking share of total government spending suggests a

decline in allocative efficiency. Subsequent budgets will have to address this structural issue where the non-discretionary operating expenditure items such as emoluments, retirement charges and debt service charges continue on an upward trajectory to account for a rising share of the total operating budget allocation.

A key mitigating factor to the revenue risk is the sizeable portion of non-tax revenue amounting to 20 percent of total revenue estimated for 2017 and 2018. The government retains some flexibility in achieving the non-tax revenue portion as it includes dividends from the national oil company and petroleum and gas royalties on account of higher gas production expected in 2018. Another revenue stabiliser is the GST collection which has so far exceeded albeit marginally the targets set for 2015 and 2016 despite a further widening of exempt items in the 2018 budget to address rising cost concerns and the regressive effects of the consumption tax on the low income households.

The higher budgeted spending is predicated on stronger revenue projection for public finance to remain on the fiscal consolidation trajectory that will see the overall fiscal deficit lowered to 2.8 percent of GDP in 2018 from an estimated 3.0 percent in 2017. With no new taxes introduced, the risk of a slippage remains high should economic growth wane. The government could mount a recalibration exercise as it did in early 2016 but given the firmer growth trajectory of both the global and domestic economy, the likelihood is lower for Budget 2018. Nonetheless, given that the budget coincides with the election cycle, the spending by the government is seen to be pro-cyclical rather than counter-cyclical in nature which is desirable to increase the country's fiscal flexibility.

ADJUSTMENTS IN BUDGET ALLOCATIONS AND THRUSTS

The effects of the budget cuts in 2015 and 2016 continued to be felt in 2017 and readjustments in the allocation for 2018 are evident to address the affected agencies and sectors. Modest increases are seen in the 2018 allocation for defence, security, health and education sectors following spending cuts undertaken in 2016. The cutback was particularly severe for the defence and internal security sector which saw a 10 percent reduction in total spending in 2016. Its allocation was increased moderately by 4.5 percent in 2017 and a further 4.0 rise in the 2018 budget to keep its share of total expenditure at a marginally lower 11.2 percent than in the previous two years.

Education and training remains the sector with the largest allocation amounting to 22 percent of the total. Its share is relatively unchanged over the past several years. After a relatively mild 1 percent decline in health spending in 2016, its allocation was raised by 9.1 percent in 2017 and a further 6.6% increase in the 2018 budget. Its share of total spending continues to chart an upward trajectory from 7 percent a decade ago to 9.6 percent projected for 2018.

Although the budget is an annual financial plan, its allocation and fiscal measures provide a glimpse of the prevailing socio-economic issues and priorities of the government of the day. Budget 2018 encapsulates 7 thrusts spanning economic development, including Industrial Revolution 4.0 and digital economy, social welfare, inclusivity and cultural transformation, education, skills training and talent development. Each thrust contains numerous measures and specific incentives.

For example, the first thrust is aimed at invigorating investment, trade and industry. It is broadly aligned to one of the 11th Malaysia Plan's (2016-20) strategic thrusts of re-engineering economic growth for greater prosperity. Under this budget thrust, specific incentives and funds are provided to promote high impact investment, strengthen small and medium-sized enterprises, accelerate exports, invigorate the agricultural sector, support micro-financing, promote tourism, healthcare tourism and logistics industries and strengthen the capital markets. In line with this thrust, the 2018 allocation for economic services is raised by 10.1 percent to RM46.8 billion or 16.7 percent of the total combined operating and development expenditure for 2018.

The budget's expansive coverage across sectors and stakeholders assures the widest possible impact of the budget. Key fiscal measures and instruments used cover the typical funding allocation (for example, financial assistance to paddy farmers, tourism infrastructure development fund), subsidised loans (Shariah-compliant SME loan and SME tourism fund with subsidy rate of 2 percent), government-guaranteed loans (SME automation financing), and tax incentives (investment tax allowance for medical tourism, double tax deduction on expenditure incurred for dental and ambulatory services). A noteworthy thrust is the support for Industrial Revolution 4.0 (IR4.0) and the Digital Economy with measures such as the provision of matching grants to enhance smart manufacturing facilities, tax incentives such as accelerated capital allowance on automation equipment, capital allowance incentive for information and communications technology (ICT) equipment and allocation for the construction of the first phase of the Digital Free Trade Zone.

Given the wide-ranging budget thrusts, there is a risk of lack of focus and scarce resources being spread too thinly across too many strategic initiatives. For instance, potential game-changers such as IR4.0 and green technology industry require large and sustained, multi-year funding to become fully embedded in the economy. There is merit for the government to avoid 'picking winners'. A critical success factor therefore lies in catalysing the private sector to take up the incentives and ensuring that the allocation are disbursed with proper governance and effective monitoring and evaluation mechanisms in place.

ELECTION BUDGET GOODIES GALORE

As an election year budget, the thrusts on inclusive growth and well-being of citizens contain a plethora of handouts aimed at maximising the 'feel good' factor. As a consequence, overall subsidies and social assistance is projected to rise by 15 percent to RM26.5 billion. Topping the list for the bottom 40 percent of the households is the cash transfer scheme with an increased allocation of RM6.8 billion that will benefit roughly 7 million recipients. Specific cash transfers are also directed to targeted groups such as oil-palm smallholders under Federal Land Development Agency (FELDA), fishermen, paddy farmers, civil servants, village heads, religious teachers, government retirees, senior citizens and children.

For middle income earners with annual income between RM20,000 and RM70,000 the individual income tax rates are reduced by 2 percentage points. The tax reduction is

projected to increase disposal income by between RM300 to RM1,000 while a total of 261,000 individuals will not have to pay tax.

A key vote base is women. The benefits provided under Budget 2018 include maternity leave extension from 60 days to 90 days, requirement of at least 30 percent participation in board of directors of government-linked companies and statutory bodies by end 2018 and individual income tax exemption on income earned within 12 months upon re-entry into the workforce.

Besides the income transfers to alleviate the rising cost-of-living concerns that was the most frequently expressed issue in pre-budget surveys, the budget also addresses the inadequate provision of affordable housing through the existing schemes. In a move to develop the rental market as a complementary strategy to alleviate the unaffordable house prices facing the low (B40) and middle income (M40) groups, a 50 percent income tax exemption for rental income was provided in the budget. This tax benefit is aimed at encouraging home owners to rent out their properties at a lower price.

While the rising cost of living afflicting the B40 and M40 households is being cushioned by tax reliefs and cash transfers, greater emphasis could have been given to the increasingly important issue of unemployed or under-employed youths, including a sizeable number of university graduates.

CONCLUSION

Malaysia's budget for 2018 is mildly expansionary with the higher spending projected to contribute an increase of 0.56 percent to the country's gross domestic product. With the external environment likely to remain positive through 2018, the GDP growth forecast of 5.0-5.5 percent is viewed to be reasonable to support the higher spending planned for 2018 while remaining on track to achieving a marginally lower fiscal deficit of 2.8 percent of GDP compared to an estimated 3.0 percent in 2017.

Nevertheless, with the economy exhibiting firm growth momentum due to favourable export performance, a greater restraint on spending would have been desirable to bolster the fiscal space and resilience to unexpected shocks to the economy. With the country's forthcoming general election that must be held by August 2018, a counter-cyclical budget is therefore out of sync with political realities besides the challenging task of cutting back on non-discretionary spending associated with the operating expenditure.

The positive macroeconomic environment that is expected to prevail through 2018 on the back of an improving global economy, provides the government and the private sector with a golden opportunity to undertake the more difficult but urgent reforms that are needed to set the economy more firmly on the path to high income as well as with more inclusive growth and environmental sustainability.

The 2018 budget has been comprehensively crafted to win public support, which is not unexpected in view of the impending general election. More concerted and sustained budget thrusts and complementary spending reviews and outcome assessment however are needed to spur growth, productivity increases, skills upgrading and high-wage employment creation. A well-designed budget is one that will accelerate the virtuous circle of growth, investment, productivity and income increases. That in turn will lead to higher tax revenue

to support a higher level of government spending. Malaysia's budget is seen to be striving in that direction except that the anticipated uplift to the economy in 2018 will stem largely from an external tail-wind that may reverse direction quickly.

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