

Wan Suhaimie
Economist
wansuhaimi@kenanga.com.my
Tel: 603-2161 9657

Malaysia Budget 2010 Preview

Focusing on managing the fiscal strain

HIGHLIGHTS

- The Government is facing a daunting task to keep in check its spending while ensuring the money is well spent to boost the economy. With economic recovery underway the focus is gradually shifting towards reducing the stress on its balance sheet. In tabling the budget 2010 proposal at the Parliament on Oct 23, **we expect the Government to tweak up its GDP growth target for 2009 to -2.0% to -3.0% from -4.0 to -5.0% while projecting the economy to rebound to around 4.0-5.0% next year.**
- The task of reducing the fiscal deficit amid maintaining a moderately high development spending will be tricky but not an impossible one. If it's serious about cutting the deficit it has to either tackle the soaring operating expenditure or boost revenue. The government's surprise move to raise the excise duty on tobacco by around 5.6% on Oct 1, ahead of the Budget demonstrated its resolve to boost revenue. Meanwhile, a big cut in operating expenditure may not be feasible and may disrupt administrative flow and logistics. Realistically, **we expect the operating expenditure to be reduced by no more than 5.0% largely by way of reducing or restructuring subsidies which had ballooned to about 22.0% of total operating expenditure from just 8.5% in 2007.**
- Since the Government has recently pledged to spend an extra RM1.0b every month till end of 2010 and the need to continue supporting the growth recovery, we expect it would still need to allocate nothing less than RM50b in development expenditure for 2010. **As the need to spend to support growth outweighs the need to rein its balance sheet, we project the deficit to remain relatively high at 7.2% of GDP in 2010 compared with the target of 7.6% in 2009.**
- **What to expect.** 1. Tax structure enhancement to alleviate burden of target group 2. Personal tax rate realignment 3. Removal or reduction on stamp duty for properties above RM250k 4. Removal or reduction in minimum brokerage fee. 5. Additional incentives to promote Malaysia as regional Islamic Finance Hub 6. Promoting FDIs by giving more incentives to various industries within regional development corridors. 7. Incentives to promote efficient fuel and related-technology.

Overview

A challenging task. Prime Minister Datuk Seri Najib Tun Abdul Razak will officially table his first scheduled budget on October 23 amidst the most challenging time in Malaysia's recent history. Unlike the previous two mini budgets or pump priming measures, this time the Government is facing a daunting task to keep in check its spending while ensuring the money is well spent to boost the economy. The PM also faces the challenge of regaining the confidence and support of the *Rakyat* and smoothly steer the economy out of a recession. With economic recovery underway the focus is gradually shifting towards reducing the stress on its balance sheet.

Running out of bullets. With the numerous announcement and counter cyclical measures to cushion the economy against the impact of the global economic downturn, it appears that the Government may have spent most of its ammo. Yet there is a strong indication that the upcoming Federal Budget may still “appear” expansionary and designed to win back public support by helping individuals and businesses cope with unprecedented rise in inflation and slowing demand.

Growth Outlook

A short term reprieve? The lethargic growth recovery of the US economy would continue to weigh on a strong growth comeback for Malaysia in 2H09. Though the US economy is stabilizing, the rising unemployment will remain a major impediment to a swift recovery. We estimate that 3Q09 manufacturing output contraction would be lesser at -5.8% from -10.9% in 2Q09 before projecting a rebound in 4Q09 at 3.3%. Coupled with improvement in domestic demand and the multiplier effect from the large fiscal spending, we expect the momentum would continue well into 2010. Hence, **we reaffirm our view that Malaysia’s GDP growth is projected to stage a rebound in 2H09 at 2.3% after declining by 5.1% in 1H09. For the whole of 2009 we maintain our GDP forecast of -1.3%.**

... a justification for growth revision. Consumption growth is likely to pick up gradually during the rest of the year owing to a firmer labour market and low inflation. However, the external sector is likely to remain a drag on the economy in 2009, while business sentiment, although likely to improve during the remainder of the year, will remain in negative territory due to excess capacity in the economy. Nonetheless, **we expect the Government to tweak up its GDP growth target for 2009 to -2.0% to -3.0% from -4.0 to -5.0%.**

A moderate improvement ahead. Malaysia's GDP to pick up gradually next year, underpinned by the government's fiscal stimulus measures and expected recovery in world trade and commodity prices. Domestic demand would also strengthen next year as improved labour market conditions spur higher private consumption. The main risk to these forecasts involves the nature and duration of the global recession. If global demand is weaker than assumed, prospects for Malaysia's exports and its economy will be eroded. **Given the uncertainty of the global economic recovery we foresee Malaysia’s GDP in 2010 to grow below its potential at between 3.0% and 4.0%.** Meanwhile the Government may project the economy to pick up speed to around 4.0-5.0% next year.

Government Spending

A tricky task. The job of reducing the fiscal deficit amid maintaining a moderately high development spending will be tricky but not an impossible one. If it's serious about cutting the deficit it has to either tackle the soaring operating expenditure or boost revenue. The government's surprise move to raise the excise duty on tobacco by around 5.6% on Oct 1, ahead of the Budget demonstrated its resolve to boost revenue. Meanwhile, a big cut in operating expenditure may not be feasible and may disrupt administrative flow and logistics. Realistically, **we expect the operating expenditure to be reduced by no more than 5.0% largely by way of reducing or restructuring subsidies which had ballooned to a record 22.6% or RM34.1b of total operating expenditure in 2008 from just 8.5% or RM10.5b in 2007.** Given that crude oil prices have subsided by more than half this year, we expect subsidies may have reduced to less than 20.0% of operating expenses.

Still in need of stimulus. Since the Government has recently pledged to spend an extra RM1.0b every month till end of 2010 and the need to continue supporting the growth recovery, we expect it would still need to allocate nothing less than RM50b in development expenditure for 2010 or still bigger than RM51.7b originally proposed for 2009. Plus it still has RM5.0b extra to spend in 2010 derived from the RM15.0b fiscal injection which is part of the RM60b mini budget package announced in March. Along with the expectation of a strengthening ringgit against the US dollar over the medium term, it may inevitably support the Government to be more flexible to cap its spending at RM60.0b for next year.

Balance Sheet Management

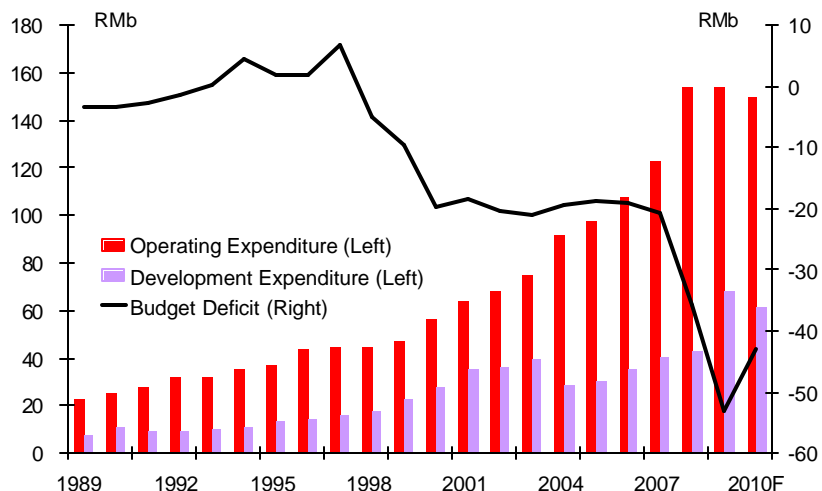
Managing the fiscal strain. Efforts are underway to rein in the burgeoning deficit amid a strengthening economic recovery. The Prime Minister's had recently pledged that the Government will be more "prudent" in its spending while hinting on cutting operating expenditure and finding ways to broaden its tax base. While we are not questioning his pragmatic approach, we reckon that reducing wastage and minimise leakages should also be made priority.

Need for alternative revenue generator. The over dependence of oil and gas revenue, which account for about 40.0% of total fiscal revenue, may have resulted a potential loss of about RM50.0b in tax collection in 2009 (given average crude price of more than US\$100/barrel versus average of about US\$70/barrel this year). This has prompted the International Monetary Fund to recently urge Malaysia to introduce the goods and services tax (GST). The argument goes that a tax like GST is based on consumption, and is more certain and stable source of revenue as oppose to income tax which is highly dependent on profitability and increase in earnings. Given the success of the implementation of GST in countries like Singapore and Australia and the fact that they are less susceptible to declining income during an economic downturn compared with countries with conventional tax regime, it is timely for Malaysia to rekindle its GST plans. **Hence, we expect the GST roll out to be part of the upcoming 10th Malaysia Plan (2011-2015).**

Fiscal sustainability remains intact. Ample liquidity and domestic resource surplus should continue to provide the capability and flexibility to the Government in implementing expansionary measures to support growth without crowding out private sector lending. **Public sector debt remains manageable, with total federal government debt over GDP of 48.6% as at end of 2Q09 which is below the globally acceptable benchmark of 60%.** Furthermore, a chunk of it is funded domestically with just 4.2% of total public debt raised abroad, making it less prone to foreign investors whims. In addition, domestic liquidity remains ample as reflected in the rise in foreign external reserves which currently stand at US\$96.0b as at end of September from the year's low of US\$88.3b in May.

Deficit to remain high. In spite of the plan to cut operating expenditure, we reiterate that the Government will continue its commitment to development spending amid the current uncertainty in the global economy in the upcoming year. **As the need to spend to support growth outweighs the need to rein its balance sheet, we project the budget shortfall to remain relatively high at 7.2% of GDP in 2010 compared with the target of 7.6% in 2009.**

Malaysia's Fiscal Deficit and Expenditure Trend (RM billion)




What to expect...

Addressing middle-income tax woes. To achieve the country's goal of transforming Malaysia into a high-income economy, the Government firstly need to relook into its current personal tax structure. In fact, Malaysia's effective tax rates system has been one of the major reasons for the brain drain. The middle to senior management (earning RM120,000 and above per annum) suffer the maximum tax rate of 27% and are often caught in the "middle-income trap" of high taxes and high cost of living. To address this issue, the Government is expected to propose tax efficient incentives that may give further enhancements to current equity and bonus income, pension, healthcare as well as retrenchment benefits.

Tax re-alignment. Realising that the upcoming budget would address the need to win the hearts of the people, the biggest impact would come from reducing personal income tax. The other justification for a tax cut would be the need to realign with the lower corporate tax which was reduced on a annual staggered basis of 1.0% each year for the past three years to 25.0% this year. **Since 1990, the personal income tax highest marginal rate has always been higher than corporate tax. Hence, it would make sense for the Government to further re-align both personal and corporate tax by way of shaving of another 1.0% of personal income tax.** Though it would cost the Government an estimated RM400m-RM500m for every 1.0% cut and put a strain on fiscal finance, it may nonetheless benefit the economy in general as it would raise household disposable income and boost consumer spending. Plus it would financially and mentally prepare the public for the eventual implementation of the GST in the future.

Personal tax relief. If proposed cuts on personal income tax is not enough, we believe that the resident **individual income relief may also be raised up to RM10,000 from the current RM8,000**. As opposed to cuts on income tax, the impact on raising personal income relief would put less strain on the current fiscal budget compared with a tax cut. This also would pave the way for an increase in the ceiling of income tax relief for life insurance premium, insurance premium for education or medical benefit, or mutual fund. In addition, the Government may consider, among others, raising the threshold of taxable income bracket from the current RM2,950 for an unmarried individual and RM3,200 for married individuals as well as extending and adding more personal relief.

Others goodies ... **1.** Removal or reduction on stamp duty for properties above RM250k **2.** Removal or reduction in minimum brokerage fee. **3.** Additional incentives to promote Malaysia as regional Islamic Finance Hub **4.** Promoting FDIs by giving more incentives to various industries within regional development corridors. **5.** Incentives to promote efficient fuel and related-technology. 

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KENANGA INVESTMENT BANK BERHAD (15678-H)
8th Floor, Kenanga International, Jalan Sultan Ismail, 50250 Kuala Lumpur, Malaysia
Telephone: (603) 2166 6822 Facsimile: (603) 2166 6823 Website: www.kenangaresearch.com


Yeonzon Yeow
Head of Research