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Pre-Budget 2014: Speeding up fiscal reforms, alleviating burden on rakyat

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Economics Team

Nor Zahidi Alias
Chief Economist
+603 2082 2277
zahidi@marc.com.my

Nurhisham Hussein
Economist
+603 2082 2231
nurhisham@marc.com.my

Afiq Akmal Mohamad
Economic Analyst
+603 2082 2274
afiq@marc.com.my

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In a nutshell

- Budget 2014 will be tabled at a critical time when the Malaysian economy is at a crossroad of having to generate decent growth rates to ensure a smooth journey towards Vision 2020 and to address pertinent imbalances that may affect the future foundation of the economy. Being an open economy, Malaysia faces global uncertainties arising from the developments in the advanced and emerging economies. Although the overall economic climate has somewhat improved judging by the gradual upward momentum in the United States (US) and the mild recovery of the European economies after having been battered for almost three years, challenges have emerged from Asian economic giants, particularly China and India. Of concern is China's economic momentum in 2H2013 which will be critical for Malaysia's external sector performance as well as other Asian economies. Notwithstanding these, the strength of domestic pillars is quite intact, and judging by the pace of growth in private consumption and investment, we think that the overall economic performance in 2013 will be within Bank Negara Malaysia's (BNM) target of 4.5% - 5%. At the same time, the growth momentum in 2014 will likely be in line with Malaysia's long-term trajectory of 5.0%-5.5%.

- Some of the pertinent issues that the government will seek to address in Budget 2014 will include: (1) increasing pressure to speed up the improvement in the government's fiscal position due to the recent downgrade in the sovereign outlook by an international rating agency; (2) increasing burden on the middle-income group due to the narrow tax band and rising cost of living, especially in urban centers; and (3) persistent rise in property prices. While some of these concerns are currently being addressed by the government, we are of the view that more measures can be undertaken especially to ensure that the *rakyat* can cope with the rising cost of living in the urban centers. In addition, we look forward for more measures that can cushion the impact of subsidy rationalisation on the low income group.

- The pressure to speed up measures to improve the government's fiscal position has increased following the recent downgrade in Malaysia's sovereign rating outlook by Fitch Ratings. The relationship between budget deficits and sovereign rating provides a clear case for the government to be more aggressive in reducing the deficit in the years to come. As such, we think that there will be further measures announced to meet the government's commitment to trim the budget deficit and to balance it within a reasonable timeframe in order to alleviate some of the macro imbalances in the economy. However, as much as we think the government should be concerned about fiscal consolidation, we do not think that the views on its sovereign rating should be taken in the wrong context. A sovereign rating is merely an opinion of relative creditworthiness, i.e. the government's ability and willingness to service its debt fully and on time. It does not take into consideration socioeconomic factors and policy implications of deficit reductions for different aspects of the economy. It is not a report card of a country's economic performance, nor is it a seal of approval of a government's policy.

- We are of the view that the deficit could be reduced faster if the trend of higher-than-projected revenue received by the government in past years continues. This can be done by say, outlining a specific percentage of additional revenue that needs to be put aside to be used for deficit reduction in the future. This would lessen the tendency to spend the additional revenue collected unless the situation clearly warrants it. Similarly, the leakages commonly associated with the 'supplies and services' item under the operating expenses can be further contained through constant revisions of procurement guidelines. This is critical as the amount accounts for more than 17% of total operating expenditure and has increased by 184% since 2002.

- As we have continuously voiced out in our previous Budget reports, the burden on the middle-income group is, to some extent, related to the narrow tax band and the rising cost of living in urban centers in Malaysia. The narrowness of Malaysia's income tax band is clearly visible when a comparison is made to the personal income tax structure of another country like Singapore. What is clear is that Malaysian workers tend to be pushed to higher tax brackets even when they receive only small increments in their incomes. Again, we wish to reiterate our view that a revamp in the personal income tax structure will not only make a difference in terms of the disposable incomes of the *rakyat* but also serve as an incentive for Malaysian workers not to seek job opportunities in other countries.

- While we do not dispute the overall positive impact of the goods and services tax (GST) that the government is planning to introduce in the near future, we think the government should also highlight the possible negative effects, especially the tax burden on Malaysians, and clearly outline measures to mitigate them. The GST is regressive in nature, meaning that the tax burden on the lower-income group will be raised more proportionately than for the higher-income group (in terms of percentage). The possible impact on consumer prices also should not be underestimated and this should be highlighted. As such, there should be clear measures to offset these negative repercussions through, for instance, additional income assistance programmes such as 1Malaysia People's Aid (BR1M) and income tax cuts. At the same time, on the issue of BR1M, we still think that it should be given on conditional basis rather than through simple cash handouts as currently being practiced,for example, through shopping vouchers which people can use to purchase only basic necessities such as food. This is to prevent it from being misused by some groups who use their allocation for purchases of items like tobacco and alcohol.

- We think that more relief measures should be introduced to reduce the burden of the rising cost of living. For instance, we are still of the view that the combined relief of RM6,000 that is given for life insurance premium payments and Employees Provident Fund (EPF) contributions is insufficient. We think that the government should consider separating the EPF contributions and insurance premiums with relief of say, RM 5,000 and RM 3,000 respectively. This would offer twofold benefits: (1) to increase individuals' disposable incomes through reduction in their taxable income; (2) to encourage purchases of insurance policies which will serve as a safety net in future years.
- With regard to measures to avert further sharp increases in home prices, although some quarters might argue against it, we think that higher real property gains tax (RPGT) will to some extent bring down enthusiasm among speculators. As we argued in our Budget report last year, we think that the previous tax structure of a sliding scale in the RPGT (from 30% to 0%, depending on the number of years held) is preferable to the present scale to deter speculation in the property market. In addition, the government should discourage developers from offering certain financing packages such as Developer Interest Bearing Schemes (DIBS) that may encourage speculative activities which could lead to stronger increases in property prices. In addition, we think that an increase in stamp duty will help to mitigate the risk of higher home prices. In particular, purchases by foreign buyers can be imposed with higher processing fees like in Johor, where the fees are expected to be raised to approximately 4% or 5% of the property sales price starting next year. The minimum price of a property that can be bought by foreign buyers can also be raised to RM1 million from the current RM500,000 which we think is too low.
- We think the government should assist the *rakyat* to be more prepared for the increase in medical costs during their golden years by allowing withdrawals from EPF to purchase some kind of medical protection after they are no longer covered by their employers' medical benefits. This would enable Malaysians to save on medical costs during their golden years and at the same time help ease the government's increasing burden of high medical expenditures in the future. As we always argue, if the government can allow EPF withdrawals for investment in unit trusts (under the current ruling), we do not see any compelling reason why withdrawals are not allowed for the purpose of purchasing medical insurance which will undoubtedly benefit the *rakyat* and the government in the future. In addition, many medical coverage plans have investment elements attached to them (unit-linked insurance) which will provide some returns to policyholders.
- We are of the opinion that 'subsidy rationalisation' rather than 'subsidy reduction' should be the major focus of the government. Addressing the problem of redistribution of subsidies from the high income to the low income group is more critical than finding ways to make outright reduction in subsidies to the *rakyat*. This is not to say subsidies should not be reduced at all; however, considering that the present subsidy allocation is benefiting the high income group at the expense of the low income group, better mechanisms are required to ensure that subsidies can reach the targeted group. At the same time, measures to induce the high income group to sacrifice more to assist the needy is required.

Economic Conditions Surrounding Budget 2014

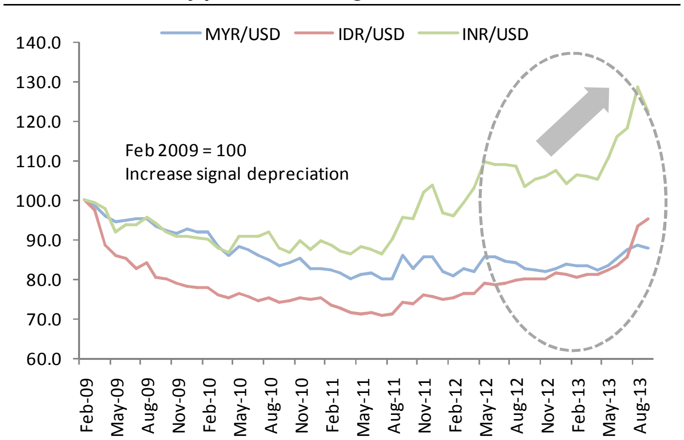
Budget 2014 will be tabled at a critical time when the Malaysian economy is at a crossroad of having to generate decent growth rates to ensure a smooth journey towards Vision 2020 and to address pertinent imbalances that may affect the future foundation of the economy.

While the global economic climate has somewhat improved judging by the gradual upward momentum in the world's largest economy – the US – and the ongoing revival of the European economies after having been battered for almost three years, challenges have emerged from Asian economic giants, particularly China and India.

China's economy continues to struggle after having to settle with a reasonably moderate growth of 7.5% in 2Q2013, down from the 7.7% expansion registered in the earlier quarter. This has increased the odds of China missing policymakers' growth target which has been lowered to 7.5%. The policy focus and direction under the new regime of Premier Li Keqiang seem to suggest that the Chinese government is serious in addressing economic imbalances, especially with regards to a credit implosion that is threatening both the household and the corporate sectors. With the increasing emphasis on measures to curb a property bubble as well as other measures to drain excessive liquidity in the economy, China will likely enter a longer period of deleveraging, causing growth to average circa 7% - 7.5% in the medium term.

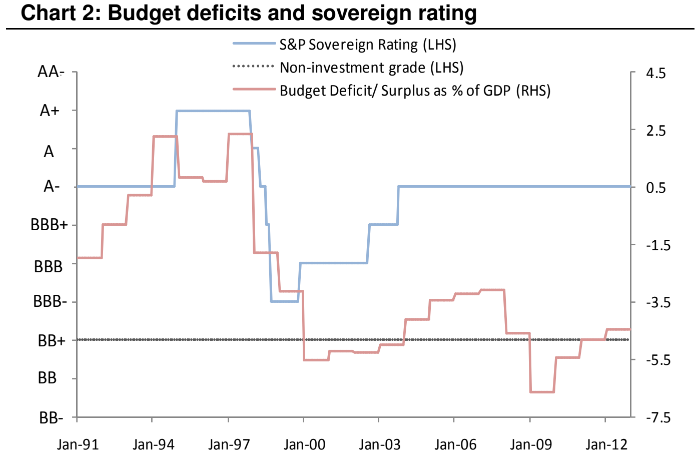
The recent turmoil in India and Indonesia is also affecting sentiment in Malaysia and other countries in the region. Their currencies were battered with the Indian rupee falling to almost INR70 per USD before recovering recently to INR62 per USD (12.2% depreciation from year-end 2012) while the rupiah slumped to almost IDR11,400 per USD at the end of September (14.1% depreciation from year-end 2012) as foreign investors fled following the widening of their deficits in both current account and government fiscal positions. As Malaysia is anticipated to go through challenging times following the revision in sovereign rating outlook by the Fitch Ratings as well as an expectation of a further decline in current account surplus, the ringgit's performance is also in the limelight among international investors. The ringgit has depreciated by 4.3% YTD.

Chart 1: Currency performance against USD



Source: Bloomberg, MARC Economic Research.

Chart 2: Budget deficits and sovereign rating



Source: CEIC, Bloomberg, MARC Economic Research.

Going forward, Malaysia's overall economic growth performance will hinge on the speed of recovery in the external sector as well as the sustainability of private consumption and private investment which are also showing signs of fatigue after a few years of robust performance. A recovery in commodity prices (palm oil and crude oil) is crucial for both external and domestic economies. For the government in general, a continuous reduction in the deficit will be the top priority due to the urgency of achieving greater fiscal health, and the increasing pressure from rating agencies will lead to more serious measures to contain expenditures and generate new sources of revenue. As far as *rakyat* are concerned, rising consumer prices and cost of living will remain as primary concerns. Measures will likely be targeted at the middle-income group which has been struggling due to lack of assistance compared with the low-income group.

Another important task is to address macroeconomic imbalances such as the overstretched household sector, rising home prices, rising government operating expenditure and insufficient innovative capacity and competitiveness, which will prove to be rather challenging at a time when the global economy remains fragile.

Critical issues facing the government and *rakyat*

- ***Increasing pressure to speed up improvement in federal government budgetary position***

The budget deficit has been a thorny issue for Malaysia since the Asian Financial Crisis, after the government introduced measures to pump prime the economy to get out of the recession. The latest global rout in 2009 also led to another round of stimulus measures which were meant to avert a deep crisis. The budget deficit as a percentage of gross domestic product (GDP) peaked at 6.7% in 2009 and has since slipped to 4.5% in 2012.

Although the general trend in budget deficits has been declining, the recent downgrade in outlook for Malaysia's sovereign rating by Fitch Ratings has led to a more serious focus on speeding up the reduction in deficits which have been lingering since 1998. The recent hike in fuel prices (RON 95 and diesel by 20 sen) – although seen as too small to affect the rating outlook – is a sign that the government is slowly reviving its efforts to reduce subsidies, which have increased to RM44.1bn in 2012.

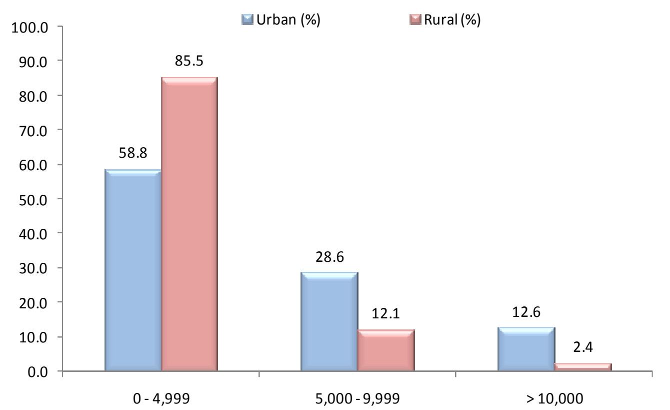
The close relationship between budget deficits and sovereign rating provides a clear case for the government to speed up deficit reductions. As such, more measures will likely be proposed to generate new sources of revenue and cut down excess expenditure. The establishment of the Fiscal Policy Committee (FPC) chaired by the Prime Minister is a manifestation of the government's serious commitment to tackling this issue.

- ***Increasing burden on middle-income group and narrow tax band***

The limited assistance received by the middle-income group has led to more concerns that those in the income group are hard pressed to cope with the rising cost of living, especially in urban areas. Statistics from the 2012 Household Income and Basic Amenities Survey indicate that about 60% of total urban households earned RM4,999 or less, which is barely sufficient to make ends meet in urban areas. This is compounded by the significant rise in cost of houses in places like Klang Valley, Selangor and Penang. In addition, the middle-income group is not eligible for the government assistance measures intended for the lower-income group. Malaysia's narrow tax band is another reason the middle-income group ends up paying higher income taxes when they jump to upper tax bands.

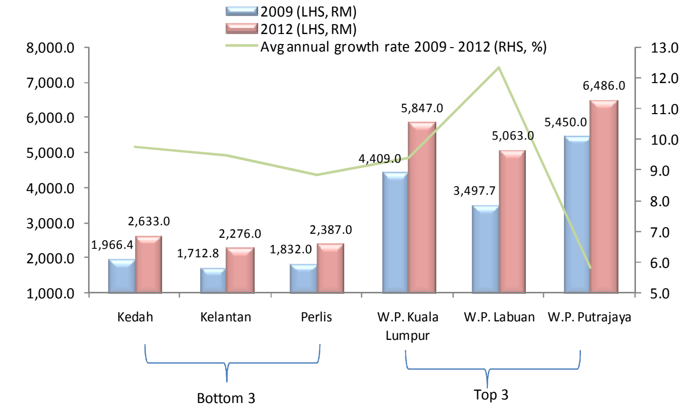
It is worth noting that income tax rates for Malaysians whose chargeable income of circa RM60,000 per annum are as high 19%. This is relatively hefty for people at this income level, especially when compared with another country like Singapore, which imposes a maximum income tax rate of 7% for those with chargeable incomes of less than SGD80,000. Similarly, in Malaysia, the highest tax rate (which is currently at 26%) is imposed on those whose chargeable income is above RM100,000 per annum whereas in Singapore, only those whose chargeable incomes are above SGD320,000 per annum fall in the top tax bracket.

Chart 3: Distribution of income share by location



Source: 2012 HIS, MARC Economic Research.

Chart 4: Top 3 and bottom 3 median income by states



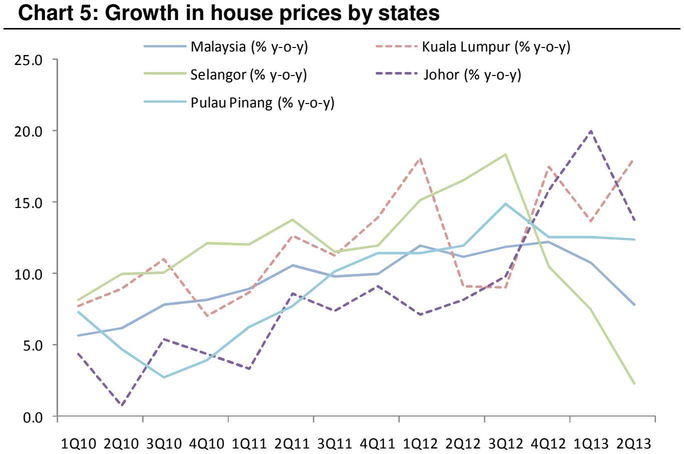
Source: 2012 HIS, MARC Economic Research.

- ***Rising cost of living in urban areas and elevated property prices***

Although the rising cost of living has been widely discussed, the main focus is the rising cost in urban areas which has led to what is termed as relative poverty among the population. Relating to this, the rising cost of housing has been one of the primary factors pinching the pockets of middle-income earners. Although recent statistics have shown that the pace of increase in overall home prices in Malaysia has softened to 7.8% year-on-year in 2Q2013, it has increased by 33% in the past three years. The average home price in Kuala Lumpur surged by 45%, while Selangor and Penang climbed by 36% each, respectively within the same period.

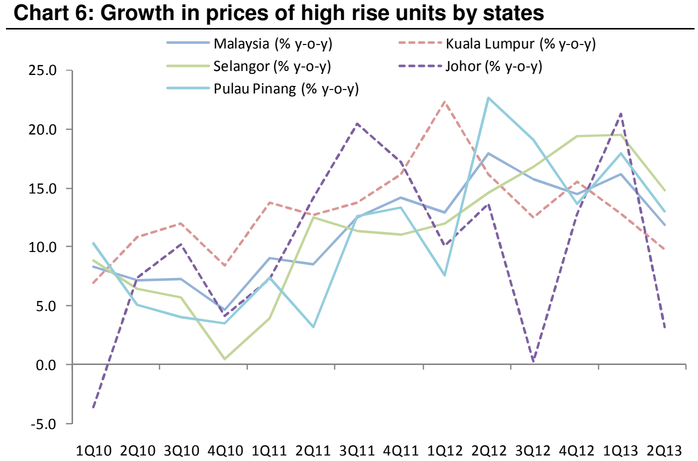
The average price for high-rise units (apartments and condominiums) has also surged as middle-income earners began to focus on cheaper alternatives to terraced houses. However, even for the high-rise units, the price has surged by 43% over the last three years. In Selangor and Kuala Lumpur, the average prices climbed significantly by 48% and 44% respectively, while in Penang, high-rise unit prices climbed by 43% over the same period.

Chart 5: Growth in house prices by states



Source: CEIC, MARC Economic Research.

Chart 6: Growth in prices of high rise units by states



Source: CEIC, MARC Economic Research.

The general cost of living is also expected to climb in the near term following the government's efforts to scale down subsidies to reduce the burden on the government's coffers. The government recently cut subsidies for fuel, resulting in a 20 sen hike in petrol and diesel prices. Other subsidies on goods such as sugar and cooking oil are anticipated to be slowly reduced in the future. A revision in electricity tariffs also cannot be ruled out as Petronas does not wish to continue subsidising gas prices.

Measures That May Be Considered

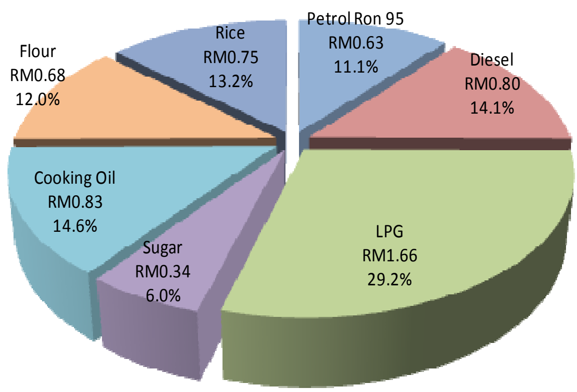
To ease the burden on the federal government coffers, the following measures can be considered:

- ***Further rationalisation of subsidies***

The recent upward revision in petrol prices (RON 95 and diesel) is the beginning of the long-term effort to wean Malaysians off their addiction to subsidies. According to Budget 2013, total subsidies will amount to circa RM38 billion in 2013 (about 19% of the federal government's total operating expenditure). Of this, about two-thirds or RM25 billion is from fuel and liquefied petroleum gas (LPG) subsidies. Due to the increasing amount and the general upward trend in oil prices, the price of RON 95 will likely be gradually adjusted according to the average monthly market prices. As such, the government may introduce a more systematic adjustment mechanism for RON 95 to reflect changes in market prices.

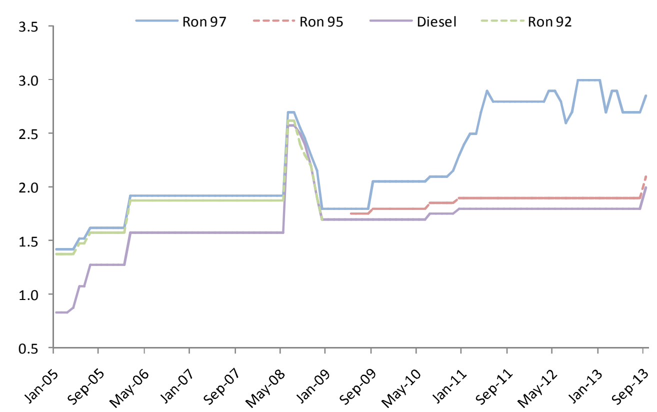
Other subsidies that are currently provided for items like sugar and LPG may be looked into and revised. Health reasons have been used to justify higher prices for sugar while Petronas' burden of subsidising gas prices is the rationale for higher LPG prices. Cooking oil and flour subsidies may also see gradual revisions as the percentage of subsidies currently allocated are relatively higher (14.6% and 12.0% respectively).

Chart 7: Composition of government subsidies for selected major items (Price/ kg,litre)



Source: KPDNKK, MARC Economic Research.

Chart 8: Petrol and diesel prices



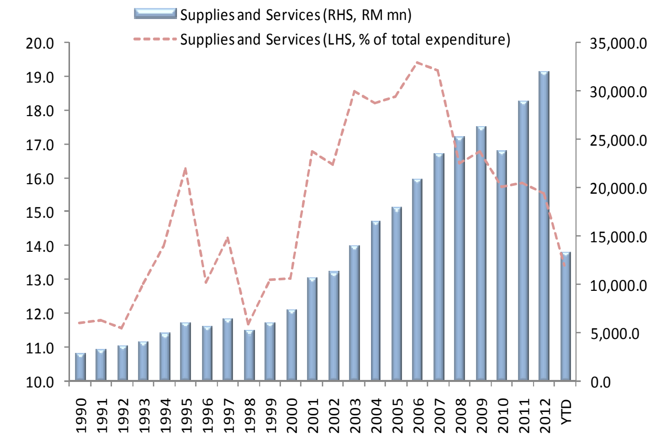
Source: KPDNKK, MARC Economic Research.

- ***Utilise additional revenue and contain leakages from the 'supplies and services'***

As we have emphasised previously, the government tends to underestimate its revenue in their annual projections. This can be seen from statistics in the past ten years (excluding the recessionary year of 2009) where the government collected RM91.5 billion more revenue than projected. Such a huge amount can be channeled to reduce the deficits if proper mechanisms exist. The Fiscal Policy Committee which was recently established may outline a specific percentage of additional revenue that needs to be put aside to be used for deficit reduction in the future. This will lessen the tendency to spend the additional revenue unless the situation clearly warrants it, for example, during periods of extremely weak economic growth or recession.

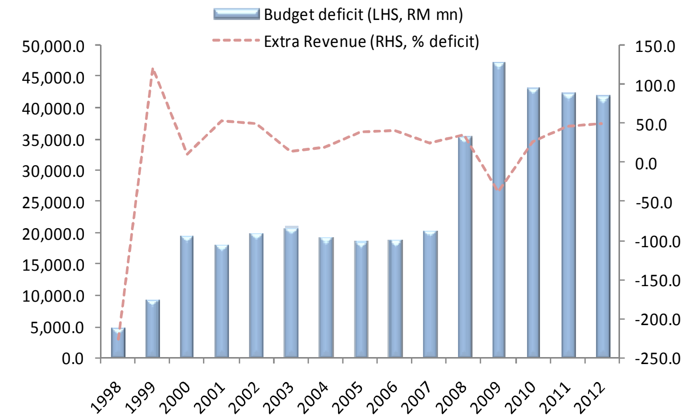
Similarly, the leakages commonly associated with the supplies and services item under the operating expenses can be further contained through constant revisions of procurement guidelines. This is critical as the amount accounts for more than 17% of total operating expenditure and has increased by 184% since 2002.

Chart 9: Total supplies and services and % of OPEX



Source: CEIC, MARC Economic Research.

Chart 10: Extra revenue as % of budget deficits



Source:CEIC, MARC Economic Research.

- ***Timing for the implementation of GST***

The timing for the implementation of GST is something which is highly anticipated in Budget 2014. As often argued, the implementation of GST will generally broaden Malaysia's tax base. Although this is a long-term measure (as the initial implementation may likely be revenue neutral with respect to sales and services tax, depending on the rate agreed by the government), the implementation of GST is expected to be generally positive for the economy by boosting exports and GDP growth. The positive impact on GDP growth will likely be driven by lower business costs as businesses will be refunded on taxes they paid for their inputs. The impact on government revenue stream is also expected to be positive even if the initial GST rates are 5% or 6%.

Of course, the government is aware of the regressive nature and the possible inflationary effect of GST. We think that the bulk of the consumer price index (CPI) items will be under standard rates while a smaller percentage would be zero rated. We are of the view that the impact on the CPI will not be too significant if the GST rate is 4%. However, at 5% and 6%, the effects on the CPI will likely be more than one percentage point. Due to the expected effects on consumer prices, we think that the government will provide some sort of compensation to lower-income consumers as well as a tax cut for middle-income earners. However, this compensation may only be provided in 2015.

To ensure the smooth implementation of GST, proper communication and enforcement issues will likely be addressed. These would probably include the continuation of subsidised training for small businesses and tax deductions for larger companies. In addition, measures to strengthen enforcement of the Price Control and Anti-Profiteering Act 2011 will likely be undertaken to prevent unscrupulous traders from raising prices unnecessarily, while programmes to increase awareness of the benefits of GST will be intensified.

To ease the burden of the middle-income group and to help *rakyat* cope with rising costs of living, the following measures can be considered by the government:

- ***Widen Malaysia's income tax band***

As mentioned in our previous Budget report in 2012, Malaysian tax payers in the lower income bracket are entitled to higher tax relief compared to workers in Singapore. However, as income increases, the effective tax rate tends to be higher for Malaysian workers than that of Singapore. The narrow income tax base in Malaysia has led to many workers falling into the higher tax brackets even if the increase in their pay is not significant. The narrow tax bracket is one of the reasons for the relatively small disposable income of Malaysian workers.

As such, we believe that the government will provide hints of the possible changes in the structure of personal income tax band so that workers do not fall into higher tax brackets as a result of small salary increments. Of course, the clear disadvantage would be the foregone revenue for the federal government. However, we opine that the impending implementation of the GST could partially offset the reduction in the government's revenue as a result of wider income tax bands.

- ***Higher eligibility for BR1M***

The possible impact of higher consumer prices after the implementation of GST expected in 2015 will likely call for compensations to lower-income groups as the tax burden under GST is slightly regressive in nature. As such, more income assistance programmes such as BR1M might be used to mitigate the initial impact on lower-income households. The government has announced that BR1M will be given more than once a year and that there is a high possibility that the amount allocated will be higher than the ones given out previously. In addition, we think that the eligibility of households for BR1M may be raised to ensure low-income households are compensated for higher prices. At the same time, tax cuts may be given to lessen the burden on the middle-income group who might not qualify for BR1M.

- ***Separate relief for EPF contributions and insurance premiums***

We are still of the view that a combined relief of RM6,000 that is given for life insurance premium payments and EPF contributions is insufficient. We think that the government should consider separating the EPF contributions and insurance premiums with relief of say, RM 5,000 and RM 3,000 respectively. This would offer twofold benefits: (1) increase individuals' disposable incomes through reduction in their taxable incomes; (2) encourage purchases of insurance policies which will serve as a safety net in the future years.

To alleviate upward pressure on home prices, the government may consider the following measures:

- ***Higher real property gains tax and higher price limit for foreign purchases***

The argument for higher RPGT has been widespread, although some quarters do not see it as a measure that will curb rising home prices. We respectfully disagree. We think that it will to some extent bring down the enthusiasm among speculators, although it may not totally alleviate the upward pressure on prices. We think that the previous tax structure of a sliding scale in the RPGT (from 30% to 0%, depending on the number of years held) is preferable to the present scale to deter speculation in the property market. In addition, the government may want discourage certain financing packages (i.e. those that include Developer Interest Bearing Scheme or DIBS) that may have caused property prices to climb more rapidly in recent years.

To complement the increase in RPGT, we also think that an increase in stamp duty will help to mitigate the risk of higher home prices. In particular, purchases by foreign buyers may be imposed with higher processing fees like in Johor where processing fees are expected to be raised to approximately 4% or 5% of the property sales price starting next year. In addition, the minimum price of a property that can be bought by foreigners may be raised to RM1 million from the current RM500,000.

- ***Speed up construction of homes under various government programmes***

Several programmes to assist the *rakyat* in buying affordable homes have been initiated by the government. The most popular is Perumahan Rakyat 1Malaysia (PR1MA), which focuses on the household income group of less than RM7,500 per month. There has recently been greater emphasis on providing assistance to the middle-income group as studies reveal that the median affordable house price for Malaysia is between RM120,000 and RM150,000.

There are of other programmes such as the My First Home Scheme (SRP) that was introduced in Budget 2011 to assist young adults earning RM3,000 per month or less to own their first home through a 100% financing scheme and the 1Malaysia People-Friendly Home (RMR1M) programme which was introduced in Budget 2012 with the intention of assisting those with household income of RM3,000 per month and below to purchase affordable homes.

However, as in other programmes, the speed of implementation is critical. More locations should be identified to ensure the *rakyat* can benefit from programmes like PR1MA. At the same time, the awareness of these programmes should be increased to ensure the public can fully benefit from the government assistance.

To encourage the *rakyat* to increase long-term investments and acquire financial safety nets, the following measure can be considered:

- ***Withdrawal from EPF to purchase medical insurance***

The importance of healthcare cannot be underestimated, especially when the government is highly subsidising the medical cost for the *rakyat*. The cost of healthcare is increasing every year and this will burden the *rakyat* especially after they are retired and are no longer covered by their employers' medical insurance.

We think the government should assist the *rakyat* to be more prepared for the increase in medical costs during their golden years by allowing withdrawals from EPF to purchase some kind of medical protection after they are no longer covered by their employers' medical benefits. This will enable Malaysians to save on medical costs during their golden years and at the same time help ease the government's increasing burden of high medical expenditure in the future years. As we always argue, if the government allows EPF withdrawals for investment in unit trusts (under the current ruling), we do not see any compelling reason why withdrawals are not allowed for the purpose of purchasing medical insurance which will undoubtedly benefit them and the government in their future years. In addition, many medical coverage plans have investment elements attached to them (unit-linked insurance) which will provide returns to policyholders.

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MALAYSIAN RATING CORPORATION BERHAD (Company No.: 364803-V)
5th Floor, Bangunan Malaysian Re, No. 17, Lorong Dungun, Damansara Heights, 50490 KUALA LUMPUR
Tel.: +603 2082 2200 Fax: +603 2094 9397 E-mail: marc@marc.com.my
Homepage: www.marc.com.my