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Recalibration of Budget 2016

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The recalibration and its rationale

- The Prime Minister (PM) on January 28, 2016 unveiled the recalibrated Budget 2016. The recalibration comes on the heels of Moody's recent downgrade of Malaysia's sovereign credit rating outlook to stable from positive.
- According to the PM, the recalibrated budget plan is based on two thrusts: ensuring continued economic growth and preserving the *rakyat*'s welfare.
- In the recalibrated plan, the real gross domestic product (GDP) growth outlook has been trimmed down to 4.0%-4.5% from 4.0%-5.0% originally.
- The average Brent crude oil price is assumed to hover between USD30 to USD35 per barrel during the plan period, down from the USD48 per barrel assumption in the original budget plan.
- The recalibrated plan will enable savings of RM9 billion and keep the fiscal deficit target for 2016 at 3.1% of nominal GDP.

Primary measures

- The recalibrated budget plan sees the addition of restructured and recalibrated measures that include the following:
  - Reduction in employees' contribution to the Employees' Provident Fund (EPF) by three percentage points from March 2016 to December 2017, with employers' contribution remaining unchanged.
  - Provision of a special tax relief of RM2,000 to individual taxpayers with monthly incomes of RM8,000 or below for the year of assessment 2015.
  - Reduction in the cost of daily basic necessities by the implementation of, among other things, liberalisation of the control on import quotas or Approved Permits (AP) on eight agricultural produce for a temporary period to ensure consistent supply.
  - Limitation of sales of all houses priced up to RM300,000 in all new housing projects to first-time house buyers only with immediate effect.
  - As announced in the 2016 Budget, 30% from the levy contribution to the Human Resources Development Fund (HRDF) amounting to RM200 million will be provided to enhance the competency and skills of employees through reskilling and upskilling, including retrenched workers.
  - To enhance the efficiency and amount of tax collection, compliance and auditing efforts will be doubled, and taxpayer penalty relaxed to encourage taxpayers to declare their past years' incomes.
  - Streamline the management of the foreign workers system.
  - More prudent government spending, particularly on supplies and services, and continued efforts to rationalise the provision of grants to Government Trust Funds, federal statutory bodies and government-linked companies (GLC).
  - With regards to development expenditure, focus will be given to projects and programmes that are *rakyat*-centric, as well as those with high multiplier effect and low import content, while non-physical projects and projects still under study will be rescheduled.
  - Development financial institutions (DFI) and government-owned venture capital (VC) funds will increase their financing funds by RM6 billion to provide financing to small and medium enterprises (SME) and startup companies.
  - GLCs to implement initiatives to narrow the income gap between higher management and employees gradually.

Our take

- The recalibration of Budget 2016 was inevitable given the dramatic fall in crude oil prices. To ensure it remains on a stable fiscal consolidation path, the government needs to increase revenues and/or decrease expenditures. To increase revenues, the government, as announced, will: (1) enhance tax collection efficiency and effectiveness; and, (2) undertake a redistribution and bidding process which will optimise revenue from the telecommunication spectrum. To reduce expenditures, it plans to: (1) reschedule the implementation of non-physical projects and projects that are still under study, which could trim cash flow commitments by up to RM5 billion; and, (2) further reduce expenditure in the supplies and services category.

- Overall, we see the recalibration exercise helping to soften the impact of slower economic growth and higher cost of living on the *rakyat*, especially the lower income group, and to keep Malaysia on its fiscal consolidation path. The recalibration does take into account issues related to cost of living, unemployment rate, private sector boost and commodities, especially oil prices, issues brought up by the Prime Minister in an earlier speech.

- From a macro perspective, we are of the view that the new real GDP growth target is more realistic and in line with our forecast that we penciled in at the beginning of 2016 (MoF: 4%-4.5%; MARC: 4.4%). The global economic scenario is not supportive of Malaysia's external sector at this juncture and a more pronounced slowdown in private consumption is anticipated in 1H2016 due to slower spending as a result of higher prices and the base factor. In addition, the labour market outlook is likely going to deteriorate slightly, as suggested by news flows.

- In the recalibrated budget plan, revenues are lower by between about RM7 billion and RM9 billion and expenditures are lower because of savings of about RM9 billion. As the government is keeping its budget deficit target unchanged at 3.1% of GDP, our calculations suggest that the government did not revise its nominal GDP growth forecast (at 6.8% for 2016) despite having revised its real GDP growth forecast. We respectfully differ on this. We think that even if the projected amount of deficit remains almost unchanged because of the recalibration (around RM38 billion), nominal GDP growth will likely be lower this year due to the moderation in overall economic activity.

- We had expected nominal GDP growth to be revised down as real GDP growth forecast was lowered. Technically speaking, unchanged nominal GDP growth and lower real GDP expansion can only happen if the growth in the 'implicit GDP deflator' – which is a broad measure of inflation – accelerates to circa 2.4% in 2016 from -0.1% in 2015. This suggests that inflation in the economy is expected to increase quite rapidly in 2016. We think this is unlikely to happen as slower economic growth is normally accompanied by slower growth in prices unless prices are pushed up by cost factors (cost push). The last time the implicit GDP deflator surpassed 3% was in 2011 when the economy was growing by 5.3%. We are maintaining our nominal GDP growth target at 4.5% to 5.5% as mentioned in our Economic Outlook 2016 published in late December 2015.

- It is notable that without the recalibration and assuming that total revenue declines by approximately 3.5% (or RM8 billion, the mid-point between RM7 billion and RM9 billion) as projected by the government, the budget deficit could, according to our calculations, climb to circa 3.8%-3.9% of GDP. With the recalibration, such a drop in revenue will mean actual expenditures will have to be reduced by at least RM8.5 billion in order to maintain the budget deficit at 3.1% of GDP. In order to achieve this, the government plans to reduce both operating and development expenditures. Whether this is achievable or not will largely depend on its implementation. We have noted that underutilisation of development expenditure in the past (by an average 7%) had "saved" the government approximately RM3 billion to RM4 billion per annum. As such, it would seem that it would not be difficult for the government to save RM5 billion from development expenditure in 2016. Notwithstanding this, a possible side effect of this measure is slower economic growth.

- Looking from another angle – assuming that the government is successful in cutting its expenditures by RM9 billion as planned – in order to keep the budget deficit target at 3.1% of GDP, total revenue will have to decline by less than RM8.5 billion in 2016 as a larger drop in revenue will cause the budget deficit ratio to GDP to breach its 3.1% target. Based on our base case scenario, an average crude oil price of USD30-USD35 per barrel will trim revenue by circa RM10 billion. As such, we are of the view that it is possible for the budget deficit ratio to climb to 3.2%-3.3% of GDP if nominal GDP grows within the range of our forecast of 4.5-5.5%. Having said this, we believe that a slight increase in budget deficits will not result in any revision in Malaysia's sovereign ratings at this juncture.

- Overall, as a result of developments in the global economic environment, the fiscal space for policy makers to respond to materialising downside risks is becoming narrower. Notwithstanding this, the measures to support private consumption through a reduction in employees' contribution to EPF and tax relief for middle- and lower-income earners may result in higher-than-expected revenue from goods and services tax (GST) that could help cushion against a sharp deterioration in the government's financial position.

Table 1: Fiscal deficit as % of GDP, assuming government expenditure unchanged from the budgeted level.

Fiscal deficit in 2016 (%GDP)		Change in government revenue from 2016's budgeted level (%)						
		-5.5	-5.0	-4.5	-4.0	-3.5	-3.0	-2.5
2016's Nominal GDP growth (%)	3.5	-4.3	-4.2	-4.1	-4.0	-3.9	-3.8	-3.7
	4.0	-4.2	-4.1	-4.1	-4.0	-3.9	-3.8	-3.7
	4.5	-4.2	-4.1	-4.0	**-3.9**	**-3.8**	-3.8	-3.7
	5.0	-4.2	-4.1	-4.0	**-3.9**	**-3.8**	-3.7	-3.6
	5.5	-4.2	-4.1	-4.0	**-3.9**	**-3.8**	-3.7	-3.6
	6.0	-4.2	-4.1	-4.0	-3.9	-3.8	-3.7	-3.6
	6.5	-4.1	-4.0	-4.0	-3.9	-3.8	-3.7	-3.6

Source: MoF, MARC Economic Research

Table 2: Fiscal deficit as % of GDP, assuming government revenue decline by RM8 billion from the budgeted level.

Fiscal deficit in 2016 (%GDP)		Change in government expenditure from 2016's budgeted level (%)						
		-3.5	-3.4	-3.3	-3.2	-3.1	-3.0	-2.9
2016's Nominal GDP growth (%)	3.5	**-3.1**	**-3.1**	-3.2	-3.2	-3.2	-3.2	-3.3
	4.0	**-3.1**	**-3.1**	-3.2	-3.2	-3.2	-3.2	-3.2
	4.5	**-3.1**	**-3.1**	**-3.1**	-3.2	-3.2	-3.2	-3.2
	5.0	**-3.1**	**-3.1**	**-3.1**	**-3.1**	-3.2	-3.2	-3.2
	5.5	**-3.1**	**-3.1**	**-3.1**	**-3.1**	**-3.1**	-3.2	-3.2
	6.0	-3.0	**-3.1**	**-3.1**	**-3.1**	**-3.1**	-3.2	-3.2
	6.5	-3.0	**-3.1**	**-3.1**	**-3.1**	**-3.1**	**-3.1**	-3.2

Source: MoF, MARC Economic Research

Table 3: Fiscal deficit as % of GDP, assuming government expenditure will be reduced by RM9 billion from the budgeted level.

Fiscal deficit in 2016 (%GDP)		Change in government revenue from 2016's budgeted level (%)						
		-4.0	-3.8	-3.6	-3.4	-3.2	-3.0	-2.8
2016's Nominal GDP growth (%)	3.5	-3.2	-3.2	-3.2	**-3.1**	**-3.1**	-3.0	-3.0
	4.0	-3.2	-3.2	**-3.1**	**-3.1**	**-3.1**	-3.0	-3.0
	4.5	-3.2	-3.2	**-3.1**	**-3.1**	-3.0	-3.0	-3.0
	5.0	-3.2	**-3.1**	**-3.1**	**-3.1**	-3.0	-3.0	-3.0
	5.5	-3.2	**-3.1**	**-3.1**	**-3.1**	-3.0	-3.0	-2.9
	6.0	-3.2	**-3.1**	**-3.1**	-3.0	-3.0	-3.0	-2.9
	6.5	**-3.1**	**-3.1**	**-3.1**	-3.0	-3.0	-3.0	-2.9

Source: MoF, MARC Economic Research

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