Economic Research

KDN No.: PP14787/11/2012(030811)

MALAYSIAN RATING CORPORATION BERHAD
(364803-V)

Vol.: ER/011/2017

Pre-Budget 2018: NegaraKu – Shaping the Future

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24 October 2017

In a nutshell

- Budget 2018 will be tabled at a time when global economic recovery of advanced economies is being clouded by patches of geopolitical uncertainties. In addition, while the global economy will likely continue to cruise on the back of stable economic growth of the United States (US) and China as well as accelerating European expansion, financial market risks are on the rise following a rapid increase in equity prices and geopolitical concerns especially in North Asia. Against this backdrop, MARC foresees that Malaysia's Budget 2018 will focus on both short-term and long-term measures to sustain economic resilience and steps to further embrace the shift towards a digital economy.
- Globally, prospects of the US economy remain encouraging. Continuing improvement in the labour market and a recovery in capital spending continue to spearhead the economy, which has led to a gradual increase in policy rate by the US Federal Reserve as well as a reduction in its balance sheet. In Europe, economic growth has surprised on the upside, on the back of stronger consumer spending while in China, economic deceleration has tapered off. Global trade volume for 2017 has been revised upward by the World Trade Organization (WTO) and trade is expected to remain vibrant in 2018. Commodity prices have generally recovered although the rise in crude oil prices has been capped by various factors that include rising inventories and improving shale drilling technology.
- As for Malaysia's Budget 2018, MARC expects the government's main focus to be on assisting the *rakyat* in dealing with the rising costs of living, enhancing non-oil revenue to strengthen Malaysia's fiscal position, as well as preparing Malaysia for its transformation to a digital economy. Long-term challenges such as the impact of an ageing population on the economy would also likely be discussed.
- At the macro level, MARC feels that Malaysia's economic growth will remain encouraging in 2018 but at a more normalised level of 5.2% (2017 forecast: 5.5%), on the back of decent global trade performance. The slight slowdown in the growth momentum will be in line with softer growth in commodity prices that we envisage in 2018. We anticipate the government to continue being extra cautious in its spending due to uncertainties in the global crude oil market. While it is true that the proportion of oil-related revenue to total revenue has declined in recent years, in our view, the level of crude oil prices will remain an important consideration in the eyes of policymakers in planning the country's expenditures.
- MARC expects budget deficits to slip marginally to circa 2.8% of gross domestic product (GDP) in 2018 as higher oil-related revenue and Goods and Services Tax (GST) add to the government's coffers while spending is rationalised. With private consumption likely to grow circa 6.7% in 2018, GST revenue will, in our view, be within the range of RM40 billion to RM45 billion, constituting about 20% of total revenue. MARC anticipates another year of positive growth in revenue in 2018 after two consecutive years of contraction in 2015 and 2016. We foresee development expenditure to be accelerated to support growth, while operating expenditures (OPEX) will be closely monitored to ensure minimal leakages. While we do not rule out further subsidy liberalisation efforts in the future, we do not think they will be introduced during this Budget.
- As Budget 2018 will be the last budget prior to the 14th General Election, some "*rakyat*-friendly" measures are to be expected. Measures to tackle the thorny issue of rising costs of living will be further enhanced. This could include, among others, a one-off personal tax relief for the middle-income group, albeit by a smaller quantum than the relief provided in Budget 2014 and the recalibrated Budget 2016. We do not foresee any outright reduction in the personal income tax for 2018 as the government remains cautious about its revenue growth in 2018 despite a slight recovery in crude oil prices in the past one year.
- MARC also expects allocations for the needy i.e. the amount of 1Malaysia People's Aid (BR1M) to be raised, albeit by a smaller amount. The lifestyle tax relief given in Budget 2017 could be reviewed upward as its total amount is currently capped at RM2,500, lower than the combined amount of reliefs given in prior years. In the long term, we think that there is a scope for further widening of the personal income tax band in order to ensure that people do not quickly fall into higher tax brackets when their incomes increase.
- The concerns over home affordability would likely continue to be addressed in the upcoming Budget as it remains a contentious issue among the *rakyat*. While the growth rates of house prices have moderated in recent quarters, prices remain too high for ordinary citizens. Demand and supply imbalances in the property market are clearly visible, especially in urban states. Measures by the government to address the problem through various schemes such as the 1Malaysia Housing Programme (PRIMA), People's Friendly Home

(RMR) and My First Home Scheme are commendable. However, the speed of implementation and updates on such housing schemes should be looked into more closely. MARC feels that it would be helpful to establish a single entity or agency to coordinate the various housing schemes in order to speed up the progress of all affordable housing projects in a timely manner. In addition, more incentives can be given to private developers, such as special tax deductions or reliefs for using the Industrialised Building System (IBS) technology in developing affordable homes, especially in urban centres.

- As for businesses, focus on strengthening small and medium enterprises (SMEs) will likely be continued despite the numerous incentives that have already been provided in Budget 2017. SMEs are the backbone of the economy, accounting for 98.5% of business establishments and contributing 36.6% of GDP. They also accounts for 65.3% of employment and 18.6% of total exports. MARC foresees additional measures to be proposed in Budget 2018 to assist SMEs in overcoming challenges relating to (1) obtaining financing; (2) enhancing capability in technology and research and development (R&D); (3) having low value-added products and lacking in competitiveness; and (4) having limited access to advisory services as well as limited marketing and promotion strategies. As for other business establishments, we maintain our view from last year that an extension for the Special Re-Investment Allowance (RA) should be considered. Although the extension would lead to slightly negative repercussions on the government's budgetary position, the measure will ensure that private investments will continue to grow at a decent pace in the years to come.

- In Budget 2018, MARC anticipates the government to highlight the importance of adapting to a digital economy for Malaysia's long-term growth potential. As efforts are drawn to ensure Malaysia is less dependent on a volatile exports sector, boosting other growth sources is essential in the medium- and long-term. In addition, possible revenue that can be derived from a digital economy could also be looked into. Such sources of income would supplement the revenue already generated from the GST which helped offset the decline in oil-related revenue since the collapse of oil prices in 2015. Revenue from the GST (amounting to roughly 20% of total revenue) will likely be boosted through better enforcement measures.

- As Malaysia is inspired to lay a strong foundation to face future challenges, Budget 2018 may touch on economic issues that will emerge in the years to come. In particular, high medical costs for the *rakyat* and large government allocations for health could be among them. News flow has indicated that the government is considering introducing a voluntary health insurance scheme in the near term to assist the *rakyat* in covering their medical expenses. MARC thinks that such a move is timely as this would lessen the burden of those who incur high medical costs. In the past, we have argued for withdrawals from the Employees' Provident Fund (EPF) to be allowed to pay for private medical insurance. If a voluntary national insurance scheme is introduced, MARC feels that EPF withdrawals should be allowed to pay for this health insurance scheme.

- As global crude oil prices remain uncertain, the government would likely continue to look for other revenue sources to ensure its fiscal consolidation efforts continue in the years to come. Several possible alternatives have been discussed in the media, i.e. taxes on foreign digital business providers. The recent proposal to amend the GST Act 2014 is aimed, among others, to incorporate a permanent establishment clause that would enable the tax authority to include foreign digital companies into the GST bracket. MARC opines that such an effort could bring in additional revenue, although it could slightly dampen business and consumer sentiment during its initial phase of implementation. In relation to this, MARC also feels that other tax measures such as capital gains on short-term financial transactions would bring additional revenue without significantly affecting market sentiment. Such a measure would also prevent excessive short-term speculations in the financial market.

- MARC continues to feel that there is a need to encourage investments in investment-grade bonds that are rated below AA. In order to develop a credible benchmark bond index, liquidity conditions in the secondary market must be improved, and the availability of such an index may help attract foreign investors to have greater exposure in the ringgit corporate bond market as an alternative to their existing exposure in the ringgit sovereign bond market. At the same time, we feel that there is a need for measures to foster a stronger and more resilient insurance industry in the future. Policyholders should be assured of the financial strength and claims-paying ability of their insurance carrier. As such, MARC thinks that financial strength ratings should be made mandatory.

Budget 2018 – Our expectations and wish list

Coping with rising costs of living

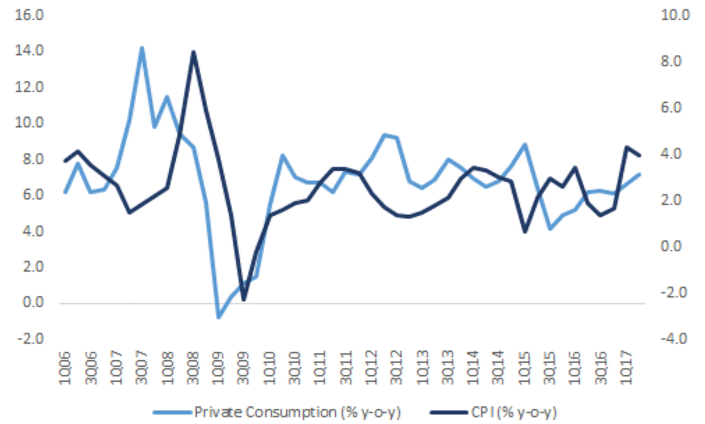
- As Budget 2018 will be the last budget before the next election, expectations of various handouts by the government are building up. However, we think that a critical reason for the government to provide some of these handouts is the need to sustain the uptrend momentum in consumer spending growth to support the overall economy going into 2018. This is in view of a possible moderation in global trade performance as uncertainties prevail due to geopolitical events and financial risks. Private consumption grew by an average of 6.9% in 1H2017, below the 7.4% pace recorded between 2011 and 2014.
- MARC anticipates government handouts to be given primarily to assist the *rakyat* in coping with the rising costs of living. This could include, among others, a one-off personal tax relief for the middle-income group, albeit by a smaller quantum than the reliefs provided in Budget 2014 and the recalibrated Budget 2016. The middle-income group was given a RM2,000 special tax relief for the assessment years of 2013 and 2015. For 2018, we see the possibility of a slightly lower tax relief for this group. As hinted by the Prime Minister, civil servants may also receive special handouts by the government as their contributions bring progress to the nation. In the past, civil servants had benefitted from salary increases (by 7% to 13%) in 2012 and minimum salary increases in 2016.
- MARC also expects allocations for the needy i.e. the amount of BR1M to be raised, albeit by a smaller amount. For the middle-income group, the lifestyle tax relief given in Budget 2017 could be reviewed upward as its total amount is currently capped at RM2,500, lower than the combined amount of reliefs given in prior years.
- We do not foresee any outright reduction in the personal income tax for 2018 as the government remains cautious about its revenue growth in 2018 despite a slight recovery in crude oil prices in the past one year. Government revenue had contracted for the past two consecutive years and in 1H2017, there was a deficit in operating balance of RM14.0 billion. MARC opines that measures such as the further widening of personal income tax bands would be a commendable long-term solution to ensure that workers do not quickly fall into higher tax bands once their incomes increase.

Table 1: Some of the measures related to living costs introduced in previous budgets

	Measures	*For Year Assesment (YA)*	*Amount or %*
1.	*Review of indvidual income tax rate*	*YA2013, YA2014, YA2015*	*±1%-3%*
2.	*Special tax relief on income up to RM8,000 per month*	*YA2013 & YA2015*	*RM2000*
3.	*Reduction in employees' contribution to EPF*	*YA2016 & YA2017*	*3%*
4.	*Introduction of parental care tax relief*	*YA2016 onwards*	*RM3000*
5.	*Lifestyle tax relief (replacing tax reliefs for the purchase of reading materials, personal computers, sports equipments and broadband subscription)*	*YA2017 onwards*	*RM2500*
6.	*Increase in tax relief for education fees*	*YA2016*	*RM2000*
7.	*Increase in ordinary child tax relief*	*YA2016*	*RM1000*
8.	*Increase in tax relief for unmaried child of 18 years and above in tertiary education*	*YA2016*	*RM2000*
9.	*Increase in tax relief for disable child*	*YA2015*	*RM1000*
10.	*Increase in tax relief for deffered annuity and private retirement scheme (PRS)*	*YA2016*	*RM2000*
11.	*Introduction of tax relief for SOCSO*	*YA2016 onwards*	*RM250*
12.	*Introduction of tax relief for child care centres and kindergartens*	*YA2017 onwards*	*RM1000*
13.	*Indroduction of tax relief for the purchase of breastfeeding equipment (once in two years)*	*YA2017 onwards*	*RM1000*

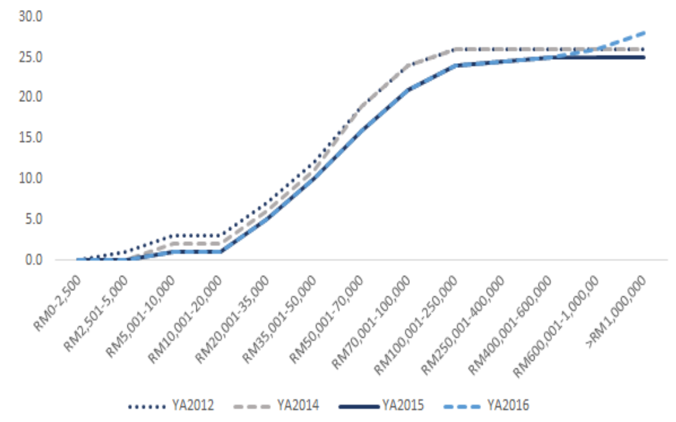
Source: Budget speeches from various years, IRB

Chart 1: Private consumption growth versus inflation rate



Source: CEIC, MARC Economic Research

Chart 2: Personal income tax rate structure

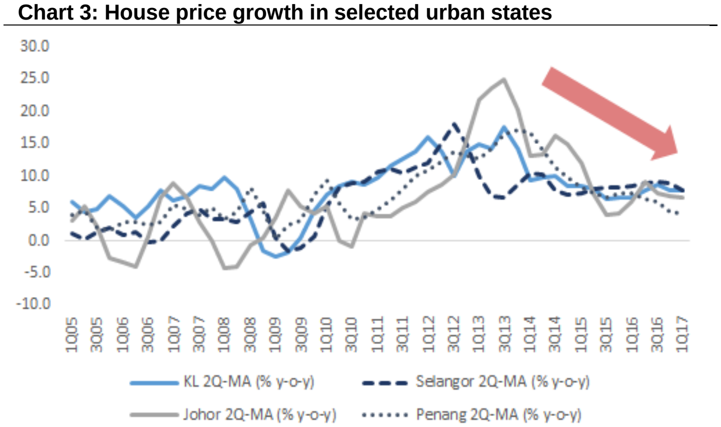


Source: IRB, MARC Economic Research

Addressing the issue of home affordability

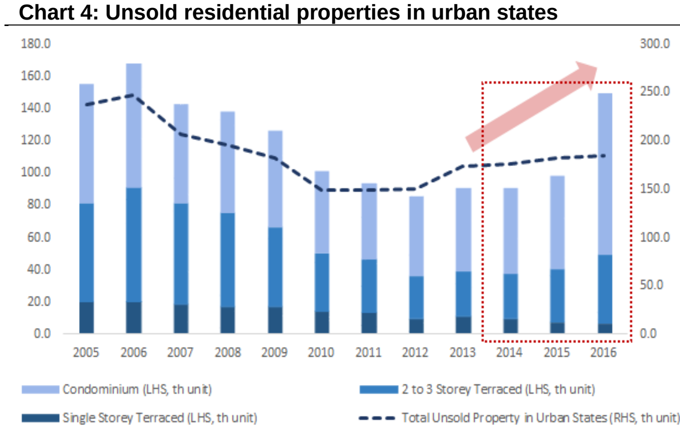
- Concerns over home affordability will likely continue to be addressed in the upcoming Budget 2018 as it remains a contentious issue among the *rakyat*. While the growth rates of house prices have moderated in recent quarters, prices remain too high for ordinary citizens. Demand and supply imbalances in the property market are clearly visible, especially in urban areas.
- The number of unsold residential properties, for instance, is on a rising trend. More than half of unsold units in urban states are from the high-end high-rise segment, such as condominiums. While both total incoming and planned supply of new residential properties have been declining every quarter since at least the latter half of 2015, the number of incoming and planned supply of high-end high-rise units has continued to rise since then. This has contributed to an acute oversupply in the high-end segment at a time when affordable properties are a scarcity.
- Measures by the government to address the problem through various schemes, such as PR1MA, RMR and My First Home Scheme, are commendable. However, MARC feels that the speed of implementation and updates on such housing schemes should be looked into more closely. As such, it would be helpful to establish a single entity or agency to coordinate the various housing schemes in order to speed up the progress of all affordable housing projects in a timely manner. In addition, more incentives can be given to private developers, such as special tax deductions or reliefs for using IBS technology in developing affordable homes, especially in urban centres. This could help lower the cost for developers and incentivise them to build more affordable houses in the future.

Chart 3: House price growth in selected urban states



Source: CEIC, MARC Economic Research

Chart 4: Unsold residential properties in urban states

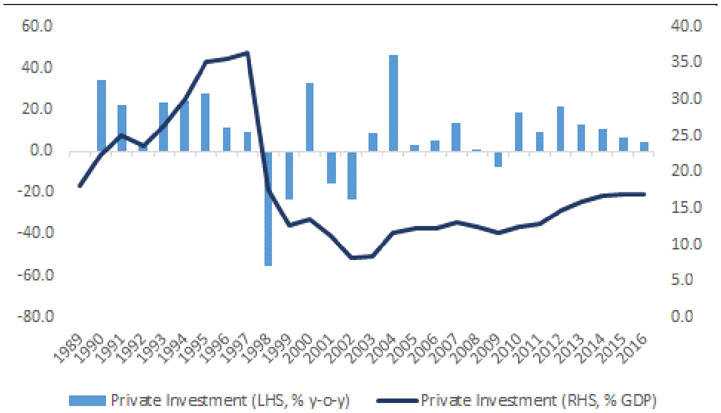


Source: CEIC, MARC Economic Research

Enhancing business capacity

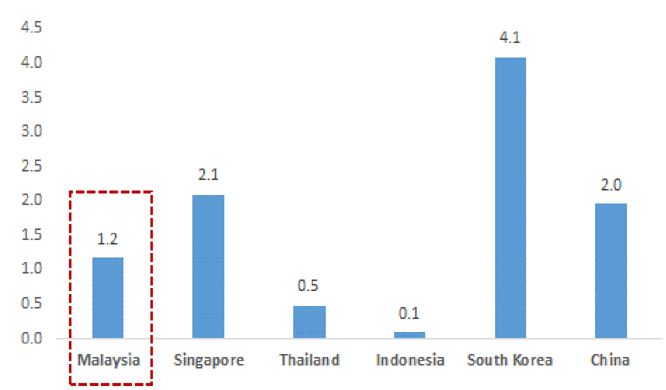
- As for businesses, the focus on strengthening SMEs will likely be continued despite the numerous incentives already provided since Budget 2017. SMEs are the backbone of the economy, accounting for 98.5% of business establishments and contributing 36.6% of GDP. They also account for 65.3% of employment and 18.6% of total exports. Among the incentives that were given to SMEs in 2017 were (1) a reduction in corporate tax rate to 18% for those with taxable income of up to RM500,000; (2) a 1-4 percentage point reduction in tax rates for those with a high increase in taxable income; (3) a 2% rebate on interest charged to SME borrowers; and (4) RM350 million worth of export promotion funds.
- MARC foresees additional measures to be proposed in Budget 2018 to assist SMEs in overcoming challenges relating to (1) obtaining financing; (2) enhancing capability in technology and R&D; (3) having low value-added products and lacking in competitiveness; and (4) having limited access to advisory services as well as limited marketing and promotion strategies.
- As for other business establishments, we maintain our view from last year that an extension for the Special RA should be considered. This is to further encourage reinvestments by companies that have exhausted their eligibility to qualify for RA. Under Budget 2016 it was proposed that a Special RA be made available in respect of reinvestments made in a period of only three years. Given that the RA was a highly utilised tax incentive according to Malaysian accounting firms, we feel that the Special RA should be extended for a few more years. While the extension would have slightly negative repercussions on the government's budgetary position, the measure will ensure that private investments will continue to grow at a decent pace in the years to come.

Chart 5: Private investment growth and as % of GDP



Source: CEIC, MARC Economic Research

Chart 6: R&D expenditure as % of GDP by selected Asian countries (five-year average)



Source: World Bank, MARC Economic Research

Adapting to a digital economy

- MARC opines that Budget 2018 would provide measures to further embrace the shift towards a digital economy. We think that the government will take important steps to prepare the country for structural changes that will take place in the economy in the next decade or so. These long-term challenges would include the readiness to embrace the fourth industrial revolution (IR-4) in order to enhance productivity and increase future capacity through automation and the interconnection of industrial production and the logistics chain. Accordingly, the government aims to raise the output of the economy up to the RM2 trillion mark within seven to eight years from the current RM1.2 trillion mark.
- The need to embrace digital automation, the Internet of Things (IoT) and data analytics is to ensure that the country will not lag behind in terms of competitiveness. The IR-4 will help reduce costs of doing business in the long term and hence enable businesses to compete effectively with global players. In this regard, upskilling of human resources is an essential step to ensure that organisations remain relevant in the IR-4 era. As such, MARC opines that in Budget 2018, more incentives will be provided to enhance human capital skills to cope

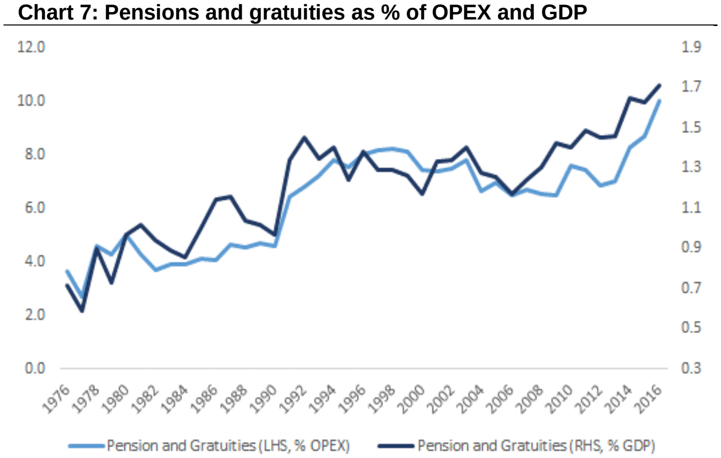
with the new era of the IR-4. These could include larger funds for training related to big data, cloud computing, IoT and cyber security. Collaborations through the Human Resources Development Fund (HRDF) with state-level skills development centres (i.e. Johor/Negeri Sembilan Skills Development Centres, Perak Human Capital Development Centre, etc) could be further promoted.

- Tax incentives could also be provided by the government to encourage Malaysian manufacturers to adapt to the IR-4. It was reported that while many manufacturers in the Malaysian food business are aware of the advantage of the IR-4 in lowering costs of production, only 30% have started to invest and leverage on this modern technology. Evidently, only big manufacturers can afford to embark on big investments and technological know-how acquisitions. Smaller players such as SMEs will likely need more assistance from the government to invest in similar new technologies.

Preparing for the impact of an ageing population

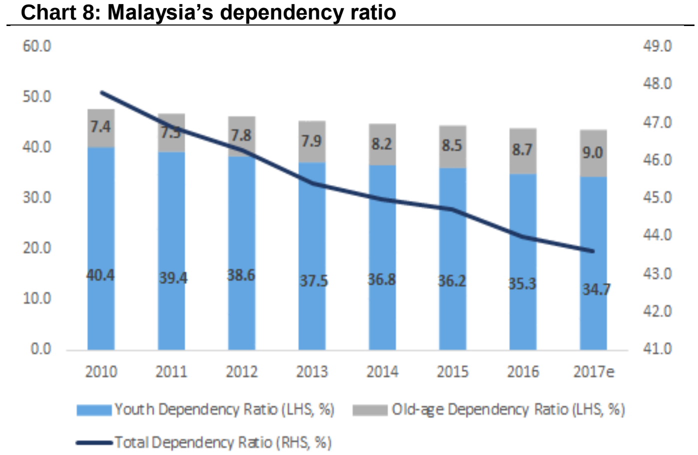
- In Budget 2018, the government might also take steps to address long-term economic issues such as an ageing population. This is despite the fact that the Malaysian population is not ageing as fast as other populations such as that of Singapore and South Korea. Among the important economic impacts of an ageing society are lower private consumption, higher social security costs (i.e. pensions and gratuities) as well as higher healthcare costs. In Malaysia, statistics show that while government spending for pensions and gratuities accounted for only 4.1% of total government OPEX in 1985, it represented 10% of total OPEX in 2016.
- Similarly, government health expenditure has risen by a compounded annual growth rate (CAGR) of 8.3% per annum in the past 10 years. Such an increase would put a burden on the population if proper measures are not taken by the government. In this regard, we view positively the recent news flow that suggests the government is considering introducing a voluntary health insurance scheme in the near term to assist the *rakyat* in covering their medical expenses. MARC thinks that such a move is timely as this would lessen the burden of those who incur high medical costs. In the past, we have argued for withdrawals from the EPF to be allowed to pay for private medical insurance. With recent developments, MARC feels that such withdrawals should be allowed to pay for this voluntary health insurance scheme. This will incentivise the *rakyat* to voluntarily pay for a medical scheme that would help them in times of need in the future.

Chart 7: Pensions and gratuities as % of OPEX and GDP



Source: CEIC, MARC Economic Research

Chart 8: Malaysia's dependency ratio

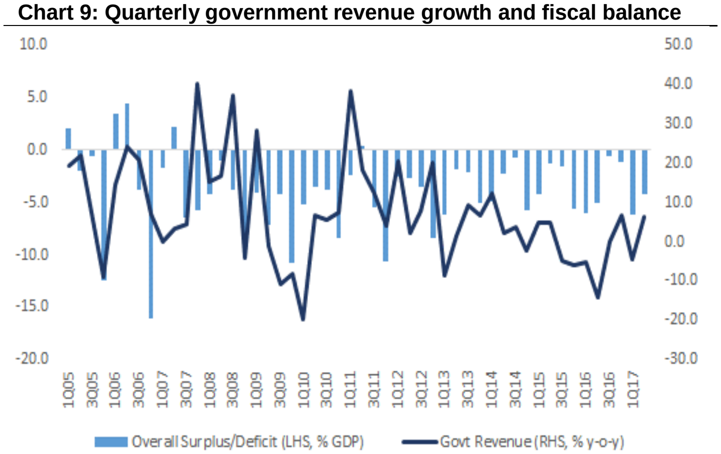


Source: DoSM, MARC Economic Research

Searching for alternative sources of revenue

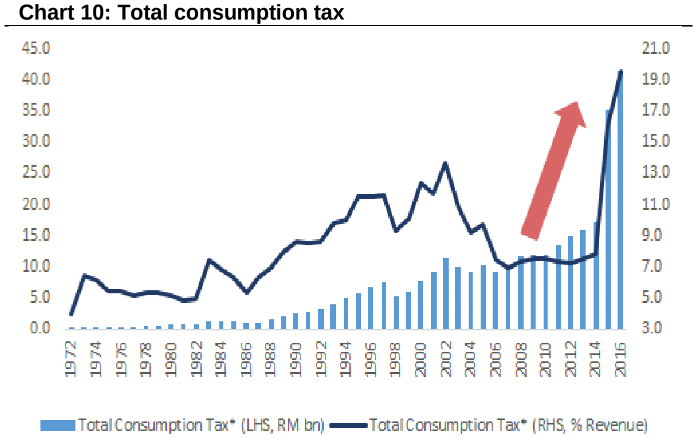
- As global crude oil prices remain uncertain, the government would likely continue to look for other revenue sources to ensure its fiscal consolidation efforts continue in the years to come. Several possible alternatives have been discussed in the media, i.e. taxes on foreign digital business providers. The recent proposal to amend the GST Act 2014 is aimed, among others, to incorporate a permanent establishment clause that would enable the tax authority to include foreign digital companies in the GST bracket. MARC opines that such an effort could bring in additional revenue, although it could slightly dampen business and consumer sentiment during its initial phase of implementation.
- We probably will not see higher taxes this year, including the GST, as the government wishes to keep up the "feel good" factor for the *rakyat*. While we do not rule out further subsidy liberalisation efforts in the future, we do not think they will be introduced during this Budget. In the near term, GST revenue will continue to be an important source of income for the government. We anticipate the revenue to be within the range of RM40 billion to RM45 billion in 2018. Going forward, MARC also feels that other tax measures such as capital gains on short-term financial transactions would bring additional revenue without significantly affecting market sentiment. Such a measure would also prevent excessive short-term speculations in the financial market.

Chart 9: Quarterly government revenue growth and fiscal balance



Source: CEIC, MARC Economic Research

Chart 10: Total consumption tax



Source: CEIC, MARC Economic Research
*Note: * = prior to 2015, consumption tax comprised only sales and services tax*

Improving market liquidity and transparency in the bond market

- For the financial market, MARC continues to feel that there is a need to encourage investments in investment-grade bonds that are rated below AA. The main benefit of having a liquid secondary market for this segment of financial instruments would be the mark-to-market value of portfolios that is more reflective of real and current valuations. This will help create benchmark prices that are based on actual transacted prices/yields rather than mathematically derived fair valuations. In order to develop a credible benchmark bond index, liquidity conditions in the secondary market must be improved, and the availability of such an index may help attract foreign investors to have greater exposure in the ringgit corporate bond market as an alternative to their existing exposure in the ringgit sovereign bond market.
- MARC also opines that there are measures that can be introduced to foster a stronger and more resilient insurance industry in the future. The financial strength of an insurer should be an important consideration in a potential policyholder's choice of insurance carrier, not just the affordability of premiums. Policyholders should be assured of the financial strength and claims-paying ability of their insurance carrier. In the advanced markets, insurer financial strength or claims-paying ability ratings are widely followed because they take into account company information that would not be accessible to the average individual. MARC believes that regulators could foster a stronger and more resilient insurance industry by making insurer financial strength ratings mandatory.

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