Finding Funding

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Malaysia's Budget 2022 to stay expansionary despite limited revenue uptick

- Malaysia's government will be tabling its Budget 2022 on Oct 29th – the first under PM Ismail Sabri. Coming on the back of a grand 5-year spending plan under the 12MP, the new budget is likely to stay expansionary, in part due to the political considerations ahead of a potential general election next year.
- We see deficit coming in at 5.0-5.5% of GDP. This should allow for a narrative of fiscal consolidation from what is likely to be a shortfall of 7.0% of GDP this year. If recent years are any guide, it will also allow room for some stimulus should the economy face unforeseen headwinds once again.
- When the budget is announced, there will inevitably be much fanfare about how much is to be spent where. To us, however, it is a lot more important to focus on how it will all be funded. With GST re-introduction being too 'hot' to carry out in the near term, the government has few alternative avenues for revenue. This would make leaning on Petronas – a tried-and-tested way before – rather tempting, especially given the recent oil price uptick.

The Easy Part

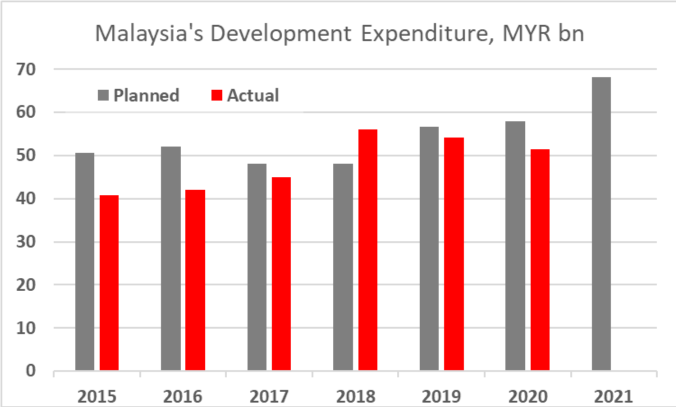
Before we delve into the tough part of how the Malaysian government could try to raise its revenue, let's first zoom in on the relatively easier part about where it would focus its expenditure on.

To that end, the 12MP five-year plan that it announced in late September should provide a fairly comprehensive roadmap that guides the broad strokes of expenditure focus in Budget 2022.

From that document, we garnered a heavy uptick in development spending, especially. Over the period of 2021-25, the 12MP envisages a hefty 53.8% increase in development expenditure compared to the 11MP of half a decade before, to as much as MYR400bn.

To decipher how much development expenditure will be budgeted for 2022, it helps to know that 2021 figure was slated to be MYR68.2bn, leaving an average of MYR83bn worth of annual spending for 2022-25. Hence, if the government is keen to showcase its seriousness about hewing close to the 12MP's visions, it would likely ramp up to the tune of MYR80bn, if not more – at least initially.

Recall, for instance, that when it was first budgeted in late 2020, the development expenditure for 2021 was supposed to be MYR69bn, but it had to be revised down due to the reality of fiscal stringency imposed by the Covid-19 pandemic resurgence. Historically speaking, there is a broad tendency for actual spending to fall short of the plan, as well.



Source: OCBC, CEIC.

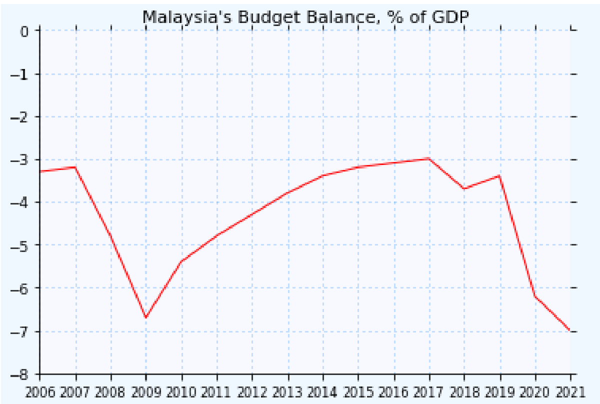
Still, we expect a significant focus on development expenditure to help growth, especially for big-ticket projects such as the East Coast Rail Link to connect the less developed eastern coast area of the Peninsular Malaysia to the economic epicentre of Klang Valley, for instance.

Indeed, the geographic aspect of the budget allocation is a perennial feature in Malaysia, with areas that are less developed receiving more attention. It does not hurt that states such as Kelantan, Terengganu, Sabah, and Sarawak are crucial election battlegrounds.

The harder part

When it comes to how to fund all these worthwhile projects, however, there has been relatively less clarity. At the broad level, the 12MP envisions a considerable decline in fiscal deficit to 3.0-3.5% of GDP by 2025 – effectively halving the shortfall from what is likely to be close to 7.0% of GDP this year. As clearly as it shows the market where the end-destination will be, the plan is a lot less explicit about the path it has in mind to get there, however.

As we detailed in our Sep 28th report, the path towards such a steep cut in deficit may be even more arduous given the large increase in development expenditure – and entail a similarly big uptick in incoming revenues.



Source: OCBC, Bloomberg.

To some extent, the pre-budget statement that the MOF laid out on Aug 31st did mention a few means of increasing expenditure, such as the introduction of Special Voluntary Disclosure Program for those who have failed to pay indirect taxes such as customs duties, and the requirement for furnishing Tax Compliance Certificate for firms that want to participate in government tenders. However, even though they are helpful, they are unlikely to move the needle in a major and sustainable way in raising revenues.

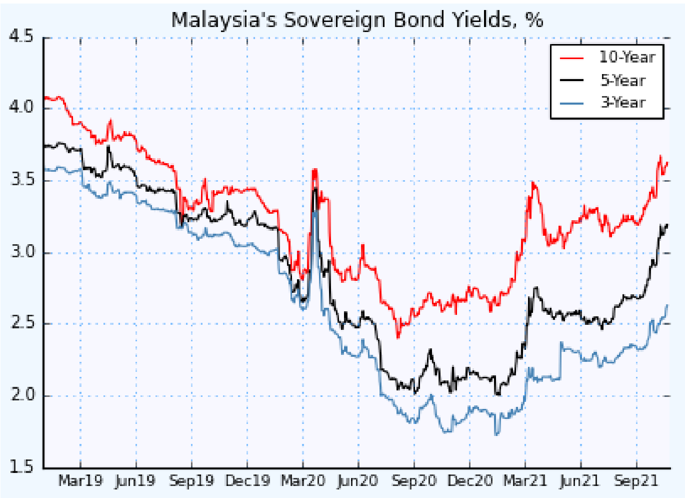
Hence, the potential lingering revenue gap would remain a considerable one, leaving us to assume a baseline of fiscal deficit of 5.0-5.5% of GDP, in line with the 5.4% deficit that the Budget 2021 laid out at the first instance of its introduction in late 2020, before subsequently climbing up to the official 6.5-7.0% ratio after various episodes of fiscal stimulus packages this year.

While there is an off-chance that the deficit might well be wider than that, we believe that the government will be keen to leave itself some wiggle room should there be a need to come up with stimulus packages again.

Even as the Covid-19 pandemic bout has come under control and the economic reopening is happening in earnest – with talks of border reopening in November, for instance – the situation will remain an unpredictable one for a while.

Hence, even as the recent increase in debt ceiling from 60% to 65% of GDP would technically allow for deficit to be at a higher level in 2022, we are of the view that the government will act with some restraint.

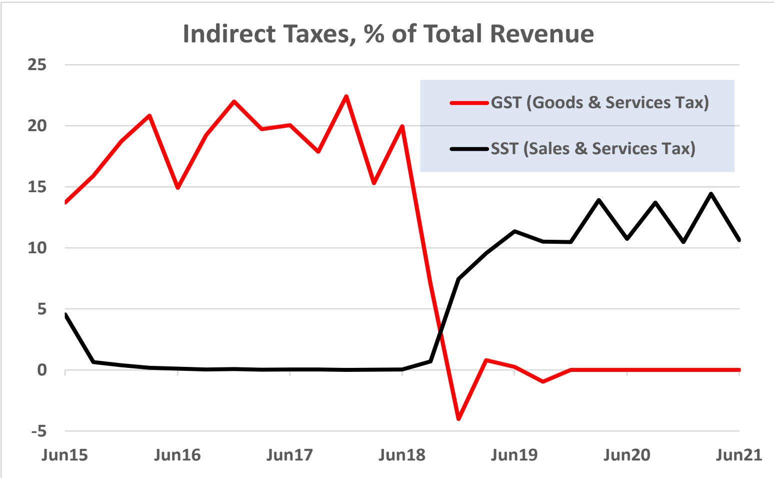
For one, potential action by ratings agencies continues to form a natural constraint, with S&P retaining a negative outlook on Malaysia's sovereign rating, for instance. The recent uptick in MGS yields – while occurring at a time of some upward shift in global yields – may also be indicative of bond supply concerns by market players.



Source: OCBC, Bloomberg.

In the long run

Looking beyond Budget 2022, for Malaysia's fiscal consolidation path to materialize more concretely, resolving the issue of revenue shortfall is inevitable. To that end, purely from the economics angle, the re-introduction of GST remains the most viable option.



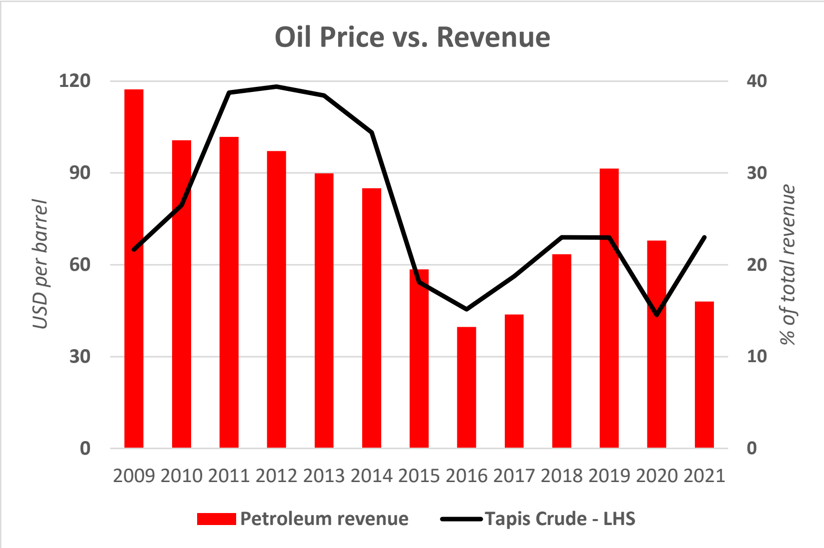
Source: OCBC, CEIC. Note: Negative GST receipts denote periods when the government had to pay out a backlog of GST refunds.

First introduced in 2015 by the Najib administration, GST came to contribute as much as 22.4% of total revenue by 2017. When it was discontinued in 2018 by the Pakatan Harapan government, it was supposed to be replaced by a return of Sales and Services Tax. However, the replacement tax regime has not contributed as much to the government coffers since.

The issue of GST reintroduction remains a politically loaded one, given that its widespread unpopularity. The fact that the GST refunds were not properly implemented the first-time round, resulting in a backlog of MYR19.4bn refunds that the PH government had to clear, has also left a bad taste. Moreover, to bring it back at a time when the economy is still bearing deep battle scars of the fight against the pandemic impact would be akin to adding salt to the wound, as well.

However, despite such constraints, the government has not dismissed such an idea altogether. As recently as Aug 12th, the Economy Minister Datuk Seri Mustapa Mohamed said that the authorities should consider the suggestion by OECD's recommendation to bring back GST as part of Malaysia's medium-term fiscal strategy, for instance.

To us, it remains a matter of when, rather than if, that the GST would make a comeback. It has to await the end of election cycle and also a firmer footing of economic recovery, nonetheless, which means that it is unlikely to take place before mid-2023 at the earliest.



Source: OCBC, CEIC, MOF. Note: 2021 Tapis crude price is the average year-to-date.

In the meantime, to plug the revenue shortfall, the government might have to resort to the familiar strategy of leaning in on the state-owned oil and gas company, Petronas, for special dividends. In August, Petronas declared an additional MYR7bn worth of dividends to the government, on top of the MYR18bn that it had previously committed. Last year, it added MYR10bn to the MYR24bn that was initially flagged. In 2019, it extended a record high MYR54bn, including a special dividend of MYR30bn to help cover the GST refunds backlog at that time.

Hence, it might not be too surprising to see the history of calling in the cavalry support of Petronas in crunch time to repeat itself soon. Indeed, if the recent commodity price run continues, a special dividend from Petronas might well form one of the key planks of the government's revenue strategy next year.

To peg Malaysia's revenue trajectory that closely to oil price once again is by no means a sustainable solution, considering how volatile oil price has been over the last few years – and not to mention the global structural shift away from fossil fuel over the medium term to fight climate change.

However, between choosing the immediate-period unpalatability of reintroducing GST and the medium-term concern of fiscal dependence on the fickle oil, the government might not have the luxury of choice at this point.

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