29 January 2016

ECONOMIC REVIEW | Budget 2016 Recalibrated

Budget 2016 Recalibrated: Fiscal Deficit Kept at 3.1%

- *Fiscal deficit was kept at 3.1% in the recalibrated budget, as the Government steadfast with its stand to continue with fiscal consolidation process.*
- *There was only marginal decline in GDP expectation, as the real GDP is narrowed down to 4.0-4.5% while nominal GDP was still in the range of 6-8% from our estimate. Inflation expectation was revised higher by 50 basis points, although we are more of the opinion that the revision was mostly due to the unexpected increase in tobacco tax in November last year.*
- *We estimate that the Government is expecting less oil-related revenue by RM4.2 billion and RM5.9 billion if the oil price average at $35 and $30 per barrel respectively. However, the additional cut of RM3.5-3.6 billion is believed to be due to lower economic activity as a whole. We expect that there exist a possibility that GST collection would be higher than the Government's initial expectation of RM39 billion. Furthermore, Government is expecting to keep its overall deficit at RM38.5-38.7 billion, only slightly lower than the initial target of RM38.8 billion.*

Fiscal deficit is kept at 3.1% despite various external headwinds. The Government is expecting to keep its fiscal consolidation pledge by keeping its fiscal deficit target at 3.1% despite various external headwinds which could affect Government's revenue. The recalibrated budget was done on two case scenarios, one is if the oil price averaged around $35 per barrel this year, and the other is if the oil price averaged at $30 per barrel. As the Government is planning to cut expenditure spending in line with the reduction in revenue, hence we could still see an expected fiscal deficit of 3.1% in both scenarios.

Petroleum-related revenue is expected to contribute only by 11.9% - 12.6% in 2016. With imputed lower average oil prices at $30 - $35 per barrel, petroleum-related revenue is expected to reduce to approximately RM25.8 – RM27.5 billion in 2016. This reflects that the contribution of petroleum-related revenue to total revenue will be reduced from 19.8% in 2015 to 11.9% - 12.6% in 2016 (initial budget 2016: 14.8%). In 11th MP, the government has laid out its target to reduce the dependency on petroleum-related revenue moving forward. In the revised 2016 budget, the government emphasis its commitment to maintain budget deficit at 3.1% while the petroleum-related revenue has been reduced.

Shortfall in non-oil tax revenue is estimated at RM3.5 – RM3.6 billion. The government has estimated a total revenue shortfall of RM7.8 – RM9.4 billion based on two oil price scenarios. We have previously estimated that the shortfall in petroleum-related revenue at RM4.2– RM5.9 billion based on the imputed oil prices of $30 - $35 per barrel. Therefore, the remaining balance of the shortfall should come from the non-oil tax revenue which is estimated at RM3.5 – RM3.6 billion.

No revision was mentioned on the expected GST collection in 2016. The government estimates that GST collection for year 2015 and 2016 at RM27 billion and RM39 billion respectively, significantly higher than their previous estimates of RM21.0 and RM23.2 billion. The upward revision in their estimates were due to the higher than expected voluntary registrants for the new tax system, where a total number of 390,378 business entities have registered under GST, compared to the initial figure of 300,811 during the mandatory period.

Total GST collection in 2015 exceeds our expectation. We had initially expected that the estimated GST collection of RM39 billion was optimistic as the first two quarters only saw net collection of GST at RM13 billion. However, based on recent announcement of total indirect tax revenue that amounts to RM51 billion, we have estimated that the net GST collection revenue in the fourth quarter to reach RM14 billion. The most recent quarter of GST collection exceeds our expectation hence we believe the government's estimate of RM39 billion is realistic.

50% of the expenditure cut will come from both operating and development expenditure each. Contrary to the market expectation previously, which was expecting that most of the cut will come from operating expenditure, the Government decided that both the development and operating expenditure will need to share the cut by the same margin. The Government is planning to have an expenditure cut by approximately RM8.0 billion if the oil price averaged at $35 per barrel, and will be increased to RM10.0 billion if it averaged at $30 per barrel. The cut is then divided equally between both operating and development expenditure at RM4.0 and RM5.0 billion each, for oil price averaged at $35 and $30 per barrel respectively.

Most of the cut for operating expenditure will be coming from supplies and services and grants, while development expenditure will be mostly cut from non-physical expenditure. Government is giving priority on projects with high multiplier impact, and pledged to not affect employment and income of the civil servants. However, the cut will still affect the economy marginally, as lower supplies and services and grants would lead to lower revenue for businesses which rely on tender from Government. Non-physical expenditure under the cut in development expenditure are mostly coming from allocation for social services expenditure and entrepreneurship.

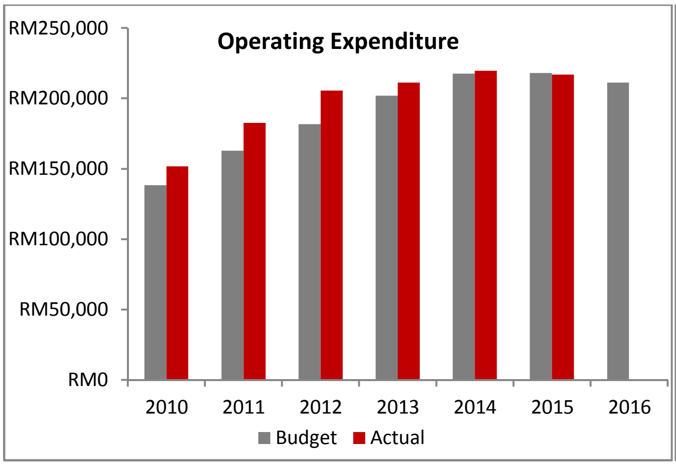
Despite a seemingly downward revision in real GDP, Government is not expecting significant change in nominal GDP. As Government is maintaining its overall balance in the range of RM38.5-38.7 billion, only slightly lower than the initial overall balance of RM38.8 billion, we could expect that the Government is still expecting a nominal GDP growth of around 6.0-8.0% in 2016. The GDP revision from 4.0-5.0% to 4.0-4.5% is reflecting that it is more likely that the economy will be slowing down this year relative to last year.

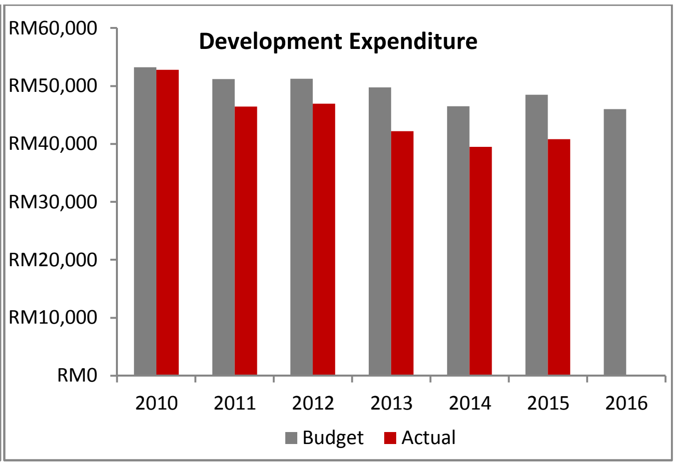
Table 1: Federal Government Finance

	RM million				YoY change			
	2015	2016	2016 Revised		2015	2016	2016 Revised	
Oil Price	$50	$48	$35	$30	$50	$48	$35	$30
Revenue	219,100	225,656	217,900	216,300	0.8%	1.4%	-0.5%	-1.3%
Operating Expenditure	217,000	215,224	211,002	210,700	-2.9%	0.9%	-2.8%	-2.9%
Current balance	2,100	10,432	6,898	5,600	781.9%	14.1%	228.5%	166.7%
Gross development expenditure	40,800	50,000	46,000	45,000	20.0%	5.4%	12.7%	10.3%
Less Loan recovery	1,500	785	800	800	-1.8%	-24.0%	-46.7%	-46.7%
Net development expenditure	39,300	49,215	45,200	44,200	20.6%	6.1%	15.0%	12.5%
Overall balance	(37,200)	(38,783)	(38,302)	(38,600)	-0.4%	4.1%	3.0%	3.8%
Overall balance as % of GDP	**-3.2**	**-3.1**	**-3.1**	**-3,1**	-			

Source: MOF, MIDF Research

Chart 1: Comparison between budget and actual expenditure





Source: MOF, MIDF Research

Historically, actual operating expenditure tends to be higher than the initial budget, while development expenditure tends to be lower. Looking at the trend since 2010, it could be seen that there is a tendency for the actual operating expenditure to exceed the initial budget allocation, while the opposite is true for the development expenditure. Furthermore, it could also be observed that the Government has a tendency to set the operating expenditure at an almost equal level with the previous year's actual operating expenditure, while to put the budget development expenditure significantly higher than the previous year's actual operating expenditure. However, as overall revenue collection and operating expenditure tends to be higher than the initial expectation, while the development expenditure tends to be lower, the actual overall balance are usually better than the initial budget.

Government is taking steps to stimulate domestic consumption. The reduction of EPF employee's contribution by 3% should help to cushion the economic slowdown, although it might not be able to stimulate stronger economic activity since both consumer and business sentiment remain at a very low level. Those who are worried of losing their job or having to experience a pay cut is likely to save the extra money as an emergency fund, rather than to use it on consumption. Nevertheless, for those who feel secured with their job, there is a high chance that they will spend the extra money. Despite that, further slowdown in domestic consumption is to be expected, and the measures taken by Government particularly to cut EPF contribution by 3% should help the economy in the short term. However, in the event that there is a prolonged period of economic slowdown there will be higher risk for the Government to extend the lower contribution requirement, as it would be bad if the contribution is being raised back again when the economy is still in recovery period. And for the longer period, it is essential to normalise the EPF contribution as it would risk income sustainability of future pensioners.

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