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Malaysia Budget 2023: Constrained Consolidation

In a nutshell: The 2023 Budget deficit target is set at 5.0% of GDP from 5.6% in 2022. The details of the budget suggest that despite weakening revenue collections, the government expects lower expenditures to help narrow the fiscal deficit. Although the revenue assumptions seem conservative relative to nominal GDP growth assumptions, weaker global growth and falling commodity prices exert downside risks; expenditure rationalisation is partly helped by the lack of a COVID-19 fund as well as some subsidy rationalisation.

Fundamentally, the 2023 budget is a step in the right direction with the introduction of more equitable taxation measures and some subsidy rationalisation. However, given the stickiness of other operational spending, the lack of broader tax measures and a well-defined push toward reducing/eliminating subsidy expenditures will constrain steady future fiscal consolidation.

Lower 2023 fiscal deficit target

PM Anwar introduced the 2023 Budget on 24 February. In his budget announcement, **he stated that the fiscal deficit target was narrowed to 5.0% of GDP in 2023 from a downwardly revised 5.6% of GDP in 2022. This is a positive surprise to our expectations.** Last year, under PM Ismail Sabri Yaakob, a 2023 Budget was announced in October but it was not passed as Parliament was dissolved in November. **This budget had pegged the fiscal deficit at 5.5% of GDP and we had expected the current budget would hold the line at a similar deficit.**

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Fading commodity tailwinds weakening revenues…

The 2023 Budget assumes a 1% YoY drop in total revenues led by non-tax revenues falling 14.4%. This mainly accounts for a 18.3% YoY drop in global oil prices from ~USD98/barrel in 2022 to USD80/barrel in 2023 (as assumed in the budget arithmetic). Consequently, dividends payments from Petronas will reduce to MYR40bn from MYR50bn in 2022.

Budget at a glance							
	2019	2020	2021	2022 Preliminary		2023 BE (Feb '23)	
	MYRmn	MYRmn	MYRmn	MYRmn	%YoY	MYRmn	%YoY
Revenues	**264415**	**225076**	**233752**	**294357**	**25.9**	**291500**	**-1.0**
Tax	**180566**	**154398**	**173703**	**208765**	**20.2**	**218270**	**4.6**
Direct	134723	112511	130116	153476	18.0	164140	6.9
Indirect	45843	41887	43588	55289	26.8	54130	-2.1
Non-tax	**83849**	**70677**	**60048**	**85592**	**42.5**	**73230**	**-14.4**
Licenses & permits	8712	6729	10578	15626	47.7	14178	-9.3
Investment Income	60058	46067	35018	58223	66.3	47930	-17.7
Petronas dividend	54000	24000	18000	50000	177.8	40000	-20.0
Expenditures	**315,913**	**312,720**	**332,509**	**393,872**	**18.5**	**385,440**	**-2.1**
Current expenditures	**263343**	**224600**	**231516**	**292693**	**26.4**	**289140**	**-1.2**
Emoulments	80534	82996	85854	87789	**2.3**	90765	**3.4**
Retirement charges	25894	27533	29095	31397	**7.9**	31079	**-1.0**
Subsidies	***23901***	***19793***	***23041***	***67358***	***192.3***	***58645***	***-12.9***
Debt service charges	32933	34495	38069	41269	**8.4**	46100	**11.7**
Net development expenditures	**52570**	**50101**	**63282**	**70200**	**10.9**	**96300**	**37.2**
Gross development expenditures	54173	51360	64257	71574	**11.4**	97000	**35.5**
Less Loan recoveries	1603	1259	992	1407	**41.8**	700	**-50.2**
COVID-19 Fund	**n.a.**	**38019**	**37711**	**30979**		**n.a.**	
Central government fiscal balance	-51498	-87645	-98740	-99515		-93940	
%GDP	**-3.4**	**-6.2**	**-6.4**	**-5.6**		**-5.0**	
Source: Ministry of Finance (MOF); Mizuho Bank.							

Meanwhile, **tax revenue collections are expected to slow to 4.6% YoY in 2023 after jumping 20.2% in 2022.** This is below nominal GDP growth assumptions of ~8%YoY, making tax revenue estimates relatively conservative. However, softer global economic conditions and easing oil prices does not eliminate the downside risks to revenue collections.

Changes to the personal income tax brackets, while aiming to make the system more equitable, is likely to lead to a loss of revenue. The government estimates that the loss of revenue from the middle-income tax cuts would be MYR900mn. Personal income tax brackets were adjusted from AY2023; the tax rate for the middle income brackets with annual incomes of MYR35,001-MYR100,000 were lowered by 2pp while for those with an annual income of MYR100,001-MYR1,000,000, the rate was raised between 0.5-2pp. The tax rate for those earning above MYR1mn/annum remains unchanged at 28%, with the highest rate of 30%.

Meanwhile, tax rates for micro SMEs was cut to 15% from 17% for the first MYR150,000 of earning but the government expects Prosperity Tax collections for AY2022 to boost **total corporate income tax collections by 17.4% YoY in 2023 from 2.9% in 2022.**

Beyond these measures, **the government proposed to introduce a luxury tax, starting this year, on items such as watches; an excise tax for liquid nicotine and potentially low rate capital gains tax on the disposal of shares of privately owned companies.** The government re-emphasized its stance to refrain from restoring GST on account of inflationary concerns.

There are limited details on these proposals making it unclear how impactful associated tax revenue collections will be in diversifying Malaysia's tax base away from petroleum related revenues. For this year specifically, the timing of the tax introduction as well as the tax rates and range of products will be crucial in determining whether they can provide an offset for the sharp drop in tax revenues associated with lower global oil prices. **The lingering unanswered question is if and when GST will be restored as the tensions between equitability and a broad enough tax base continue to persist.**

The bottom-line is that these measures may mitigate downside risks to tax collections but global headwinds could still render tax collections on a rolling basis vulnerable to the downside. In which case, the onus of fiscal consolidation will inevitably shift to expenditure rationalisation.

…while allowing for some subsidy rationalisation

The 1.2% drop in current expenditures is from a lower subsidy bill on account of reduced global oil prices. However, the subsidy and social assistance bill is budgeted to fall by ~13% YoY while oil prices are expected to fall by ~18%. **The government says it plans for a "gradual implementation of a targeted subsidy mechanism" but limited details are provided**. This admittedly provides some fiscal space to manoeuvre. Notwithstanding, cash handouts and continued support to lower and middle-income households, buttressed arguments of elevated inflation, are expected to **keep the subsidy and social assistance bill elevated at 3.1% of GDP in 2023 from 3.7% in 2022.**

All other forms of current spending including emoluments, pensions and debt servicing charges are set to remain elevated in 2023 and sticky over the medium-term reflecting the economic realities of Malaysia including an ageing population. Positively, the economy is no longer in need to COVID-19 assistance hence associated COVID-19 fund expenditures will no longer be at play this year.

Meanwhile, the jump in development expenditures by 37% YoY in 2023 is a sign that the government is committed to investing physical and social infrastructure to boost Malaysia's medium-term prospects. Even accounting for debt obligations such as 1MBD redemptions (USD3bn), this constitutes a robust pick-up in capital expenditures which apart from boosting longer-term capacity also provides more imminent buffers for soft spots in private sector investments.

An Eye On Debt

Even with fiscal consolidation underway, the government expects that federal government debt to reach 62% of GDP in 2023 from 60.4% in 2022, hitting close to the 65% debt ceiling. The risk given a challenging external backdrop and falling commodity prices is that revenues underperform and further complicate the process of debt reduction.

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