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Budget 2004 - What is in store?

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BUDGET TIME IS COMING ROUND again. The 2004 Budget, to be presented on Sept 12 2003, represents a historic moment for the Malaysian public. This will be the last Budget presentation by Datuk Seri Dr Mahathir Mohamad, Prime Minister and Minister of Finance, before he retires in October 2003.

At this time of the year, Malaysians would be setting their expectations high on the Budget proposals, hoping for some sweeteners, in addition to the formulation of Budget policies that would navigate the economy onto a stronger path of recovery over the next 12 months. Investors will be looking out for business-enhancement policies or tax breaks while consumers are eyeing for more goodies and so forth.

A plain vanilla or an election-based Budget?

Some analysts have commented that the 2004 Budget could be a non-event budget, with no major surprises, the rationale being that the government had on May 21 2003 announced an RM7.3bn growth stimulus package containing 90 measures to generate economic activities in the short and medium term. Others anticipate an election-biased Budget, as the General Election is due to be held by November 2004 at the latest, meaning it can also be called at any time before that date, even towards fourth quarter this year or first quarter next year.

To test the presumption, we studied Budgets from 1980 onwards which were tabled either before or a month after the election year (See Table 1). In the 1991 and 2000 Budgets, individual income tax rates were reduced. The 1995 Budget, tabled prior to the election year (April 25 1995) saw a reduction in both corporate income tax rate (to 30% from 32%) and individual tax rates (a 2-3 percentage point).

Our findings seem to suggest Budgets tabled just prior to the General Election were generally people-oriented and business friendly (See Table 2).

Current and forward indicators suggest the recovery strength of the economy in 2003 is expected to continue into 2004. The forecasts are that growth in the world economy, particularly the US, will continue to recover firmly in 2004, supported by strong fiscal stimulus and low interest rates. Real GDP growth for Malaysia is expected to increase at a stronger rate of 4.8% in 2004.

Keeping up the growth momentum

The 2004 Budget strategy will continue to focus on policies that would ensure the domestic economy remains resilient against any negative external events.

Continuing with the policy measures recommended in the recently launched RM7.3bn economic growth package, we expect the government to make further policy adjustments and changes necessary to capitalise on the strong economic fundamentals now in place.

The short-term focus is to ensure economic recovery remains firmly in place given the moderate global recovery. Over the medium term, there is a need to strengthen the resilience and competitiveness of the economy so long-term economic growth remains sustainable.

Having said that, Malaysia faces the mammoth task of pursuing two conflicting goals:-

i. Consolidating the fiscal position towards achieving a Budget surplus of RM4.6bn by 2005 as planned in the Eighth Malaysia Plan (8MP) 2001-2005. For the period 2001-2002, the Federal government's gross development expenditure disbursed amounted to RM71.2bn and is equivalent to 64.7% of total planned gross development expenditure (RM110bn) for the 8MP. We expect to see continuing deficit, albeit smaller at least in the near-term before reverting to a budget surplus. A progressive reduction in the

budget deficit is desirable to restore fiscal discipline.

ii. The need to further enhance the role of the private sector as the key driver of growth.

Seventh year of consecutive deficit

We expect another year of fiscal budget deficit, at around 2-3% of total GDP for 2004

This will make it the seventh consecutive year of deficit since 1998. However, it is a smaller deficit when compared with the average deficit of 4.5% of GDP during 1998-2003.

Though the government is committed to fiscal consolidation, targeting to achieve a surplus of RM4.6bn in 2005 by the end of 8MP, this may not be achievable in the near term for various reasons.

Firstly, the withdrawal of government participation in the economy needs to be done in a gradual manner to minimise disruption to domestic growth. Between 1998 and 2002, the average gross development expenditure disbursed amounted to RM28.0bn per year, compared with RM13.2bn per year during the period 1993-1997. This essentially means that in order to contain the size of the budget deficit, a massive scale-back of development spending is required. We think this is unlikely to happen in the immediate term.

Secondly, the government's operating expenditure has been rising at 9.0% p.a. during the period 1998-2002, compared with 6.8% p.a. in 1993-1997. The bulk of operating expenditure in 2002 was on emoluments (27.3% of total operating expenditure), debt service charges (14.6% of total), subsidies (7.0% of total), supplies and services (17.8% of total) as well as pensions and gratuities (6.7%). The government is gradually phasing out subsidies on selected goods with a view to consolidating its burgeoning operating expenditure.

Budget strategy - enhancing competitiveness and rewarding productivity-driven growth

(i) A phased reduction in corporate tax rate

A major aspect of the tax reform is to review and streamline tax incentives to ensure they are consistent with the government's efforts to promote both domestic (especially SMEs) and foreign investments as well as to safeguard its revenue position.

As announced in the RM7.3bn economic growth package, the government has reviewed the FIC guidelines to provide greater flexibility on foreign equity participation in local companies. In addition, the application process will be streamlined to avoid duplication of functions among approving agencies.

Equity holdings in all manufacturing projects were also fully liberalised and there is no deadline for applications received. The government also recommended improvements to the existing tax incentives to further enhance the nation's competitiveness. These include the extension of pioneer status to 15 years from 10 years; investment tax allowance to 10 years from five years under the pre-package scheme; double deduction for R&D expenses; income tax exemption for existing operational headquarters and Malaysia international trading companies.

In the light of further reformation of the existing corporate taxation system, it is timely to consider a gradual reduction in corporate tax rates to 24% from 28% over a period of one-to-two years. This could give the corporate sector a boost and help spur new investment and reinvestment activities.

The corporate tax rate was last reviewed in 1998 when the rate was reduced to 28% in 1998 from 30% in 1997. In terms of regional comparison, Malaysia's corporate tax rate is comparatively higher than Hong Kong, Singapore and Taiwan but lower than Thailand and China (see Table 3).

However, after taking into consideration other tax incentives such as pioneer status and investment tax allowance and reinvestment tax allowance, the net effective tax rate was lower at 8% for the manufacturing sector.

From the viewpoint of tax-cum-incentives effectiveness, the way forward

is to have a tax regime that is transparent, and simple as well as easy to administer.

In the 2003 Budget, the small and medium-scale industries were taxed at a lower corporate rate of 20% on chargeable income up to RM100,000 while the remaining chargeable income is maintained at 28%. To further promote domestic investment among SMEs, the threshold level could be raised further to say, RM200,000-300,000. This, to be complemented by the provision of micro-credit finance, should help to accelerate growth in domestic SMEs.

The expected revenue loss from one percentage reduction incorporate tax rate is estimated at around RM800m. This will be partially compensated by higher oil revenue as oil prices are expected to stay firm at around US\$25 per barrel in 2004. With the government's high efficiency revenue-collection machinery, we do not expect a significant loss in revenue. During those years when corporate and individual tax rates were reduced, tax revenue has in fact increased. Unrelenting efforts directed at tax dodgers and those with past arrears continue to contribute to better revenue collection.

(ii) Streamlining of Personal Taxation System

We do not expect a reduction in personal tax rate for two reasons. One is that so far, the ongoing policy measures are deemed appropriate to enhance domestic consumption. These include the lowering of EPF rates for a year from June 1 2003 to May 30 2004; lower BLRs and a half-month bonus payment to civil servants. The other is revenue consideration.

Nevertheless, it is timely to further streamline the existing personal income tax band. Through raising the thres-hold taxable income level subjected to higher marginal tax rates from the current RM250,000 to say RM350,000, it would make the taxation system more conducive towards rewarding greater work efforts and productivity enhancing. In addition, the government could consider providing higher personal tax relief as well as relief for spouse and children.

As a measure to reduce the burden of education and medical insurance borne by individuals, the combined maximum tax relief of RM5,000 provided for contributions to approved pension funds and premiums on insurance should be separated and relief raised by RM5,000 to RM10,000. This is to encourage savings for education and health, as well as to develop the education and health care industries.

At present, bonus payments by companies are allowed as tax deduction in computing adjusted income. As the payment of bonus is an incentive to workers to increase productivity, it is therefore proposed that bonus payments received by employees be given tax exemption (up to a maximum of two months). This measure will help motivate employees to increase productivity further as well as contribute to higher net disposable income. In the recent growth stimulus package, government servants were given a half-month bonus and we expect another half-month in this coming Budget to boost public consumption.

Accelerating the growth of private investment

To further revitalise the growth of private investment, we expect continued emphasis to be given to foster investment in the key sectors of the economy. These include high-end manufacturing products, ICT, biotech and biochemical as well as downstream resource-based industries (such as in petrochemicals, oil and gas). Policy measures are likely to be tailored to R&D, technology and product development, marketing as well as export penetration strategy.

Domestic services sectors will be actively promoted to enable them to act as a catalyst for economic development and to explore opportunities for export services. Currently, tax incentives are widely available to selected industries in the services sector like hotel, tourism, shipping, communications and transportation sub-sectors. Tax incentives should be extended to cover the financial services providers such as the shared service centre and backroom operations.

As part of the initiatives to facilitate the entry of skilled foreign personnel, immigration procedures and conditions must be further liberalised with respect to visa applications. The domestic tourism sector is expected to get a bigger slice of the total Budget allocation (2003:RM600m; 2002:RM613.9m). To encourage more inbound travel and patronage of domestic hotels, convention centres as well as exhibition centres, corporate expenses incurred in arranging company trips to key tourist destinations as well as in organising international conventions of a certain size could come under consideration for tax deduction as a percentage of company sales.

On capital market development, on June 19 2003, the Securities Commission stated a ringgit-for-ringgit plan to boost trade on the KLSE. The plan would involve the matching of foreign funds invested with an equivalent amount from government-linked institutions to be placed with, and managed by, the fund managers. This proposal is expected to be implemented in the second half of 2003. Hence, a detailed spelt-out proposal is deemed appropriate to kick-start interest in the Malaysian equity market by foreign funds.

We do not expect any new measures to boost the property sector in this budget. A large part of the measures has already been implemented. Among these are tax relief on interest payments for houses costing between RM100,000 and RM180,000; a one-year exemption of real property gains tax from June 1 2003; and stamp duty exemption for houses costing not more than RM180,000.

A freer trade and market environment together with reduced cost of doing business

Competition must be encouraged among producers and sufficient supplies must be assured for the domestic market. Recent global events, especially in the iron and steel industry, seem to suggest a certain degree of protection is still needed (as a temporary stopgap measure) to shield domestic industries of strategic importance from the impact of massive dumping.

However, over time, further trade liberalisation will result in the restructuring of domestic companies as well as providing an avenue for them to remain competitive. Currently, domestic tariff protection for most industries has been brought down to low levels, in line with Malaysia's commitment to trade liberalisation of WTO and AFTA.

In 2002, Malaysia had included 96.6% of its products for tariff concession under the Common Effective Preferential Tariff (CEPT) scheme. The average CEPT rate was 2.6% in 2002. Malaysia will transfer the deferred CKD and CBU automotive products consisting of 218 tariff lines into the CEPT scheme beginning Jan 1 2005.

Producers of the economy will continue to be assisted, particularly to reduce the cost of procuring raw materials and equipment. Transparency in the systems and procedures governing imports will improve the efficiency of manufacturers. Hence, it is expected there would be further reductions in the imposition of duty and tax exemption to foster a freer trade and market environment. Consumers would benefit from more competitively-priced goods between local and imported products.

Towards this end, we expect a clear policy guideline with respect to the new duty structure for the motor sector to be announced in this Budget. This long overdue policy announcement will help to lay to rest endless speculation about what will it contain and its impact on car prices; the government's revenue; and the impact on finance companies.

Broadening the consumption and services tax base

The subsequent reduction in direct taxes as well as further trade liberalisation will lead to losses in revenue, and with the government's firm commitment of consolidating its financial position, there is a need to strengthen the sources of revenue over the medium term. Malaysia's revenue structure is skewed towards direct taxes (which contributes 53% of total Federal revenue) and indirect taxes (27% of total).

As part of the initiatives to broaden indirect taxes, helping to recoup some revenue losses from further import liberalisation, the government may widen the scope of service tax as well as introduce other forms of non-AFTA contravening taxes or measures to compensate for the loss of revenue. This is in line with the policy objectives of broadening consumption-based tax as contained in the Eighth Malaysia Plan.

One of the most vulnerable sectors that may be slapped with higher taxes is the liquor, malt and tobacco industry. The last hike in duties for tobacco products was in the 2002 Budget. The imposition of sin taxes is not expected to dampen sales of tobacco and beverages industry as the demand is price-inelastic. The additional revenue collected can be utilised to part-finance the setting of a Health Foundation Fund.
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