

## **Why the lack of excitement in 11MP?**

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COMMENT The Eleventh Malaysia Plan (11MP) projects a gross domestic product (GDP) growth rate of five to six percent for Malaysia between 2016 and 2020. Given the growth rate achieved in the Tenth Malaysia Plan at 5.3 percent, the projected growth in the next five years is better compared with the recent five years.

Despite not being included as one of the four key cities earmarked under 11MP, Penang is expected to outperform Malaysia, with a 6.1 percent growth rate. Penang's growth is ranked third highest, behind Kuala Lumpur (7.5 percent) and Selangor (6.9 percent).

The 6.1 percent growth in Penang is likely to come from the manufacturing sector (6.5 percent growth) and services (6.1 percent growth); whereas growth KL is likely to be driven strongly by construction, which is projected to grow 11.3 percent a year. This construction sector growth is likely to be related to the various infrastructure projects that are under way.

### **11MP has not inspired confidence**

The direction of the stock market sends a strong signal as to whether the 11MP is good and transformative to the country as smart money and investors vote with their feet. In the three days after the tabling of the 11MP, the FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBMKLCI) fell by 2.4 percent against an overall rising stock market environment in Asia.

Hong Kong's Hang Seng Index was up 1.5 percent; Japan's Nikkei Index was up 1.1 percent and Singapore's Straits Times Index was up 0.7 percent. Hence, investors have not given a positive endorsement to the 11MP.

### **Larger role of government in the economy**

Investors have not been excited by the 11MP for many reasons. One of which could be that growth is driven by the government as the government is going to play a larger role in the economy. Government services came to 7.8 percent of the GDP in 2010; but this is projected to grow to nine percent of GDP in 2020 – a 6.3 percent average annual growth between 2016 and 2020.

As the private sector has been known to be more productive and innovative, the increasing role of government services in the economy might crowd out the private sector and might not benefit the country in the long run.

The strong role of the government can also be seen in the 6.7 percent projected growth in civil service emoluments, which is above the five to six percent GDP growth, under the

operating expenditure of the federal government.

### **Debt improvement dependent on economic growth**

The federal government's financial position is projected to improve under the 11MP. Total debt to GDP is expected to fall to 43.5 percent. The fall in debt/GDP is driven mainly by growth of GDP as total debt is expected to continue to increase from RM622.7 billion in 2015 to RM774 billion in 2020.

Therefore, if the GDP fails to match the projected growth rate, total debt to GDP ratio might not decrease that much.

### **Government's debt service cost creeping up**

Although total debt to ratio might fall, debt service cost has been creeping up. Between 2010 and 2013, the debt service cost took up 9.8 percent of the operating expenditure.

However, by 2020, the debt service cost is going to be RM31.9 billion and is expected to take up 11 percent of the operating expenditure. This means that more resources will need to be allocated towards servicing debt, rather than for investment and social welfare programmes.

Besides, although a debt service ratio of 11 percent is manageable from an international perspective, the borrowing cost (debt service cost divided by total debt) used in 11MP is 4.1 percent and might be too low.

Although the borrowing cost of 4.1 percent is higher than the rate between 2008 and 2015, which averaged 3.9 percent, this might not be high enough as interest rates in the last eight years have been kept artificially low due to the loose monetary policy adopted in the developed world.

Going forward, the United States has already signalled interest rates are going to start rising. If one uses the actual borrowing cost in Malaysia between 2006 and 2007 (i.e. pre-financial crisis) of five percent, debt service cost would have to rise to RM38.7 billion from RM31.9 billion by 2020.

### **Revenue to rely more on direct, indirect taxes**

Under the 11MP, the federal government expects oil and gas revenue to fall to 15.5 percent of government revenue. Nevertheless, federal government revenue is expected to increase 7.9 percent - a rate which is above the five to six percent GDP growth rate. The higher revenue is mainly due to the 10.7 percent increase in direct tax. Direct tax was 49.5 percent of revenue in 2010, but will increase to 62.9 percent of revenue in 2020.

As direct tax consists of corporation tax and individual income tax, this might imply more taxpayers, more companies and individuals achieving higher incomes and thus contribute

more tax; or the direct tax rates are increased.

As long as the government recognises the need to improve tax competitiveness vs other countries, many of which are already offering lower direct tax rates, the diversification away from relying on oil and gas revenue is good.

Nevertheless, provision of low taxation is only one factor to economic competitiveness. This is because successful businesses might relocate should the business environment (e.g. degree of corruption, red tape bureaucracy) does not improve. Malaysia also suffers from significant brain drain and 11MP lacks attractive initiatives to address this.

With the goods and services tax (GST) replacing the sales and services tax in April 2015, indirect tax in 2015 is RM48.1 billion. Nevertheless, indirect tax is expected to grow at 6.4 percent per annum to RM65.6 billion.

### **Will the GST rate be increased?**

As the indirect tax growth rate is above the five to six percent projected GDP growth, this implies that GST rate might be increased, or the scope of chargeable goods and services will be expanded, perhaps after the next general election.

Alternatively, the above GDP growth in increase in indirect tax can be due to the 10.2 percent increase in private expenditure consumption in the 11MP. As the mean and median household income growth rate has been four to six percent in the past, the 10.2 percent increase in private expenditure might be due to more households, or it could be debt-financed spending or spending that is reliant on government handouts.

A debt-financed private consumption is sustainable as household debt ratio has already reached 87 percent of GDP in 2013; while private consumption paid for via government handouts is unhealthy as it creates a dependency culture.

Overall, the projected growth rates in 11MP might be too optimistic. This is because although the US economy is improving, the global economic landscape over the next few years remains challenging. China is rebalancing its economy towards a slower growth trajectory and Europe is still struggling with its recovery, even eight years after the financial crisis.