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2007 BUDGET – No Pain, Some Gain

The 2007 Budget was drafted against the background of an increasingly uncertain macro-economic environment. Acknowledging that, the government has revised its 2006 estimates for real GDP growth down a tad to 5.8% from 6.0% previously. But even the lower version may prove too optimistic. The tech industry, which accounts for half of Malaysia's exports, is stuck in a lull period and that will be reflected in weaker export growth that could extend well into the first half of 2007. The US economy, Malaysia's biggest trading partner, is also slowing under the weight of past interest rate hikes. Although more resilient than before, Malaysia still remains vulnerable to any US economic slowdown. And the runaway Chinese economy is poised for a slowdown next year, whether government induced or not. Taken together, these factors are threatening to slow the economy to a walk, going forward.

Against this backdrop and to ensure that the National Mission is on track, the government, targeting a deficit of 3.4%, has unveiled a pro-business expansionary budget within prudential limits for next year. Armed with new allocation for a new planning cycle and made possible by higher oil revenue, the government will be spending again after a few years of belt tightening. Gross development expenditure is projected to increase substantially by 24.3% in 2007 after a 17.3% projected increase in 2006. That will provide a lifeline for the ailing construction sector. The Budget cuts across many sectors of the economy, focussing on new high growth areas such as bio-technology, the halal food industry, agriculture, ICT, tourism and Islamic banking to generate growth and to strengthen economic resilience. Measures were introduced to address investor's concerns over the unavailability of skilled workers, the lack of business opportunity, the rising cost of doing business and time-consuming approval procedures. Besides cushioning short-term external shocks, the 2007 budget, the first under the Ninth Plan, seeks to implement measures that supports the

medium-term national objectives of moving the economy up the value chain, tackling socio-economic inequalities, raising the nation's capacity for knowledge and innovation, and strengthening the institutional and implementation capacity of the government machinery.

Other notable measures include the development of human capital, the key element to Malaysia's competitiveness, the simplification and approvals of visas and work permits procedures to attract foreign skilled workers and efforts to tackle regional growth imbalances, and urban and rural imbalances through the setting up of three corridors.

The key highlight of the 2007 Budget is the pleasant but long overdue surprise of a reduction in corporate income tax from the current 28% down to 27% for 2007 and down further to 26% for 2008. Malaysia has been falling off the pace in the pursuit of foreign investments. China has not only diverted foreign investments away, its E&E exports have also overtaken those of ASEAN put together. Also, India is slowly opening up to foreign participation. And Singapore, attempting to get closer to Hong Kong's 17.5%, has been aggressively cutting its corporate income tax down to only 20%, the lowest in ASEAN. However, foreign investment is not all about taxation and incentives. Policy consistency and predictability are equally important. The Pantai incident and the controversies surrounding the proposed distributive trade guidelines are problems that Malaysia could do without.

Consumers, excluding those in the civil service, must be disappointed with the budget, with little being put into their pockets to offset the high costs of living. There was no reduction in personal income tax, no increase in personal reliefs and no reduction in employee's contribution to the EPF. Spending has been slowing, weighted down by higher costs conditions, poorer employment prospects and rising macro-economic uncertainty. With the lack of the 'feel good' factor, consumer will likely remain cautious spenders.

Another sector that received little from the Budget is the motor sector, currently mired in a massive overhang of unsold units. The overhang basically reflects the gross mismatch between supply and demand on the back of downward adjustments in prices following the announcement of the NAP.

Inflation in Malaysia this year is almost entirely been policy induced with very little pressure coming from the demand-side. And the government appears hesitant to place additional pressure on inflation. By capping next year's fuel subsidy bill at RM19 billion, the same amount as this year's, the government appears unlikely to reduce subsidy further next year, provided that oil prices do not rise significantly above the US70/bbl. In addition, the increase in sin taxes, another big push factor on current headline inflation, is also insignificant, ensuring a gradual improvement in inflation trend for the rest of this year. The government appears to be caught in two minds, wanting to deter smoking and drinking but wary of the inflationary implications.

Against the backdrop of a slowing global economy and with little budgetary cheer for consumers, the 2007 forecast of 6% appears bullish with the economy likely firing with only two cylinders (government spending and private investment). Government spending may mitigate some of the pain but unlikely to fully compensate for the slowdown in export demand and its consequent drag on consumer's and investor's sentiments. Also, the multiplier effect from fiscal expenditure tends to be lower during a business down-cycle as businesses and consumers (excluding the civil servants) are unlikely to spend in the face of weak sentiments due to weak employment, earnings and income prospects.

In this context, the need to ensure that funds are spent prudently in order to ensure an effective allocation of resources becomes even more critical. In the past, cronyism and the layers of middlemen have contributed to gross inefficiency, shoddy work and the wastage of public funds. Instead of a system

based on political connections, the country now needs a more transparent system that entirely promotes competitive bidding and meritocracy. That way, fiscal policy could be a more effective counter-cyclical tool in helping the economy to better withstand externally induced economic turbulence.

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