

Malaysia Macro View

Budget 2013 Preview: Balancing Populism and Prudence

- **PM Najib will announce Budget 2013 on 28th September** – With elections to be held no later than April 2013, this will be the third – and certainly the last – “pre-election” Budget in a row. But with the threat of credit rating downgrades unless progress is made on fiscal consolidation, the Budget will have to walk the tightrope between populism and fiscal prudence.
- **Continuing with modest fiscal consolidation** – The 2012 fiscal deficit target of 4.7% will likely be met despite higher expenditures, given revenue overshoot on efficiency gains, with the 2013 target likely to be reduced slightly to 4.3% of GDP, taking into account further efficiency gains in revenue collection. Taking into account refinancing needs of around RM53bn in 2013, and around RM3bn of maturing 1Malaysia Sukuk (issued in June 2010 with 3-year tenors), this should bring gross issuance of MGS and GII to about RM99bn in 2013, higher than the RM94bn for 2012.
- **Expenditure to be reallocated to deliver best political bang for the buck** – Rather than a large increase, expenditure will likely be reallocated to groups that deliver the best political bang for the buck – including the 1.3mn civil servants, agriculture, and disadvantaged groups. We would not rule out further civil servant bonuses, further (front loaded) handouts for lower income/disadvantaged groups, and other incentives for rural settlers, although handouts may not be as large as in 2012.
- **Keeping housing affordable** – Measures to keep housing affordable will be concentrated on the supply side, but we would not rule out demand measures including changes to RPGT, higher minimum prices for house purchases by foreigners, or credit measures such as further reduction of LTV ratios or the banning of creative financing schemes. However, we stress that demand side measures are more likely politically expedient rather than economically effective.
- **No income tax cuts or GST implementation, though higher sin taxes possible** – Any hoped for cuts in personal or corporate income taxes will likely have to wait till GST is implemented after elections, although a pre-announcement of cuts in 2014 would be a positive surprise. However, higher sin taxes on tobacco could be under consideration given the recent introduction of a new price control on cigarettes as part of its anti-smoking campaign. Taxes on alcohol could also be hiked.
- **More improvements to the investment climate, especially human capital** – We expect a heavy emphasis on human capital development, including training subsidies, measures to attract overseas talent, and education, and possibly liberalization of services sub-sectors. We do not expect any reforms involving changes to affirmative action policies – any such meaningful reform will have to wait until elections are over and will depend crucially on the outcome.

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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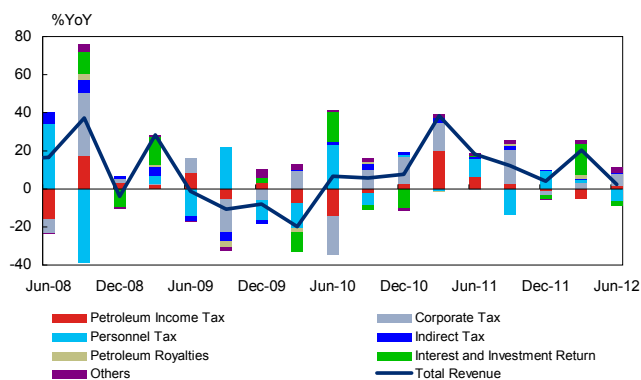
Budget 2013 Preview: Tightrope Between Populism and Prudence

PM Najib will announce Budget 2013 on 28th September. With elections to be held no later than April 2013, this will be the third – and last – “pre-election” Budget in a row. But with the threat of credit rating downgrades unless progress is made on fiscal consolidation, the Budget will walk a tightrope between populism and fiscal prudence. The 2012 fiscal deficit target of 4.7% will likely be met despite higher expenditures, given revenue overshoot on efficiency gains, with the 2013 target likely to be reduced slightly to 4.3% of GDP, taking into account further efficiency gains in revenue collection. Rather than a large increase, expenditure will likely be reallocated to groups that deliver the best political bang for the buck – including the 1.3mn civil servants, agriculture, and disadvantaged groups. We would not rule out further civil servant bonuses, further (front loaded) handouts for lower income/disadvantaged groups, and other incentives for rural settlers, although likely handouts need not be on the same scale as in 2012. Measures to keep housing affordable are likely, concentrated on the supply side, but we would not rule out demand measures including changes to RPGT. Any hoped for cuts in personal or corporate taxes will likely have to wait till GST is implemented after elections, although a pre-announcement of cuts in 2014 would be a positive surprise. Finally, to improve the investment climate, we expect a heavy emphasis on human capital development, including training subsidies, measures to attract overseas talent, and education, and possibly liberalization of services sub-sectors.

2013 Fiscal Deficit Target of 4.3% of GDP (2012: 4.7%)

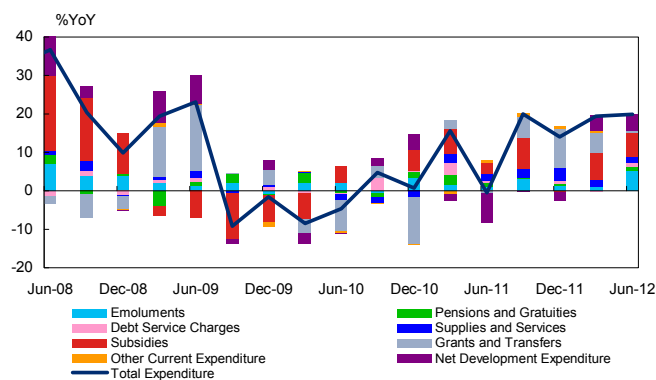
Despite aggressive frontloading of FY12 fiscal expenditure, the Jan-Jul fiscal deficit stands at RM14.3bn vs. the full-year target of RM43bn. Between Jan-Jul, expenditures surged 21.7%YoY, past the Budget 2012 target of 0.5%, led by an explosion in the subsidy bill as well as higher emoluments, grants and transfers, and net development expenditure. However, revenues have also outperformed, rising 10.1%YoY, nearly five times Budget expectations of a 1.9% increase, reflecting higher collections of corporate taxes as well as interest and investment returns.

Figure 1. Federal Government Revenues (YoY %pt contribution)



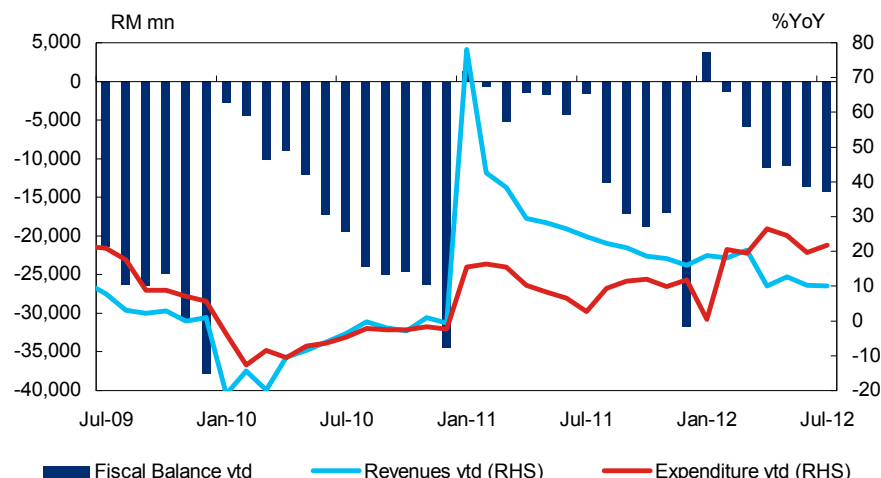
Source: CEIC, Citi Research

Figure 2. Federal Government Expenditures (YoY %pt contribution)



Source: CEIC, Citi Research

Figure 3. Fiscal Deficit YTD

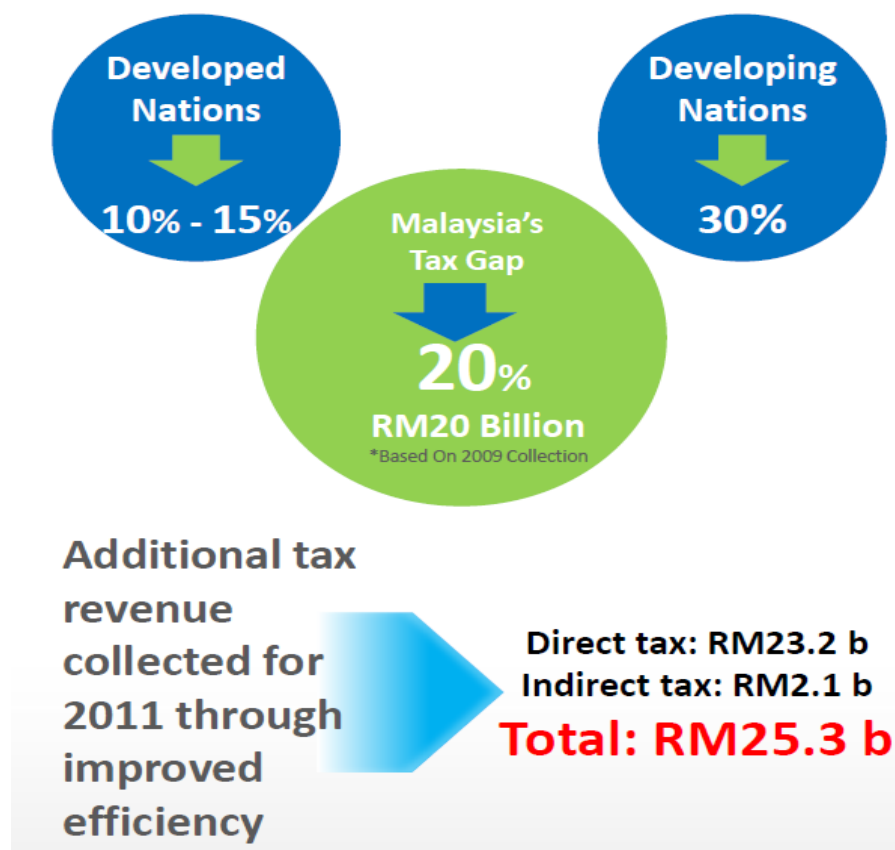


Source: CEIC, Citi Research

Given stronger revenues, policymakers appear confident of achieving the Budget 2012 targets for now. In Jan-Jul 2012, the government collected RM117.1bn of revenues, and with around 53% of the full-year revenues typically collected in the first seven months, a simple extrapolation suggests a full-year revenue figure of around RM221.0bn, a full RM34.1bn larger than the budgeted revenue of RM186.9bn envisaged last October. However, this estimate appears too conservative – Deputy Finance Minister Datuk Lim Siang Chai has stated that the government expects RM200bn in revenues this year, which is spot on with our [earlier estimates](#).

With the implicit real GDP growth assumption of around 5% for 2012 lower than the Budget's original 5-6% forecast, the outperformance in revenues largely reflects administrative improvements to close the tax gap since last year (difference between how much tax should be collected vs. what is actually collected), which at 20% in Malaysia is larger than most developed countries at around 15%. According to Pemandu, these administrative efforts alone yielded an additional RM25.3bn in tax revenues collected, out of total tax collections of RM136bn. Put another way, these administrative efforts have raised tax revenues as a % of GDP from 13.8% in 2010 to 15.4% in 2011, likely staying at around 15% of GDP in 2012. Higher oil prices may have also resulted in a higher Petronas dividend of RM30bn, compared to the originally budgeted RM28bn.

Figure 4. Pemandu: Malaysia's Tax Gap



Source: Pemandu

Figure 5. Direct and Indirect Tax Revenues

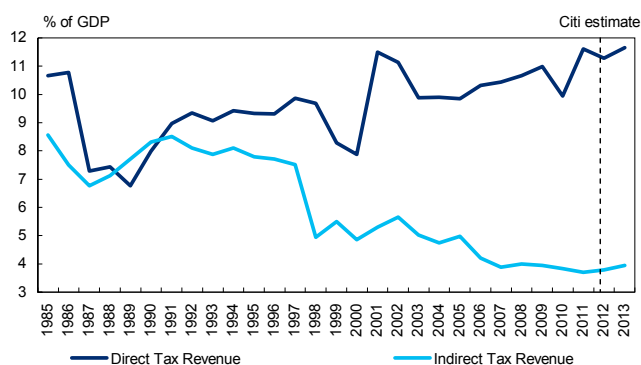
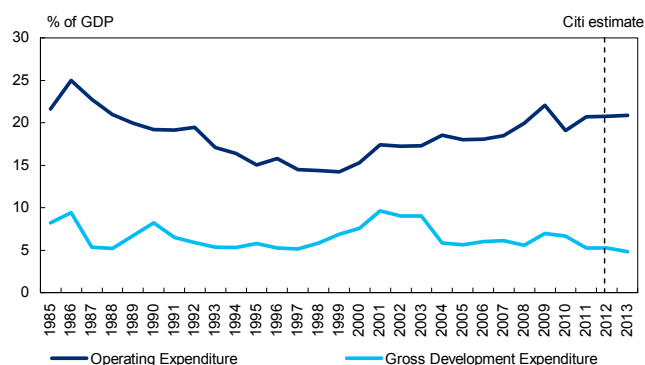


Figure 6. Operating and Gross Development Expenditures



The revenue outperformance should be able to fully cover the overshoots/upward revisions in operating expenditures, which largely reflect the RM13.8bn supplementary Budget tabled in June 2012 and RM2bn of civil servant bonuses in August 2012. The supplementary Budget includes: [1] RM360mn to the Election Commission to prepare for the 13th General Election; [2] RM113mn to the Prime Minister's Department; [3] RM446mn to the Works Ministry; and [4] RM11.2bn for "Treasury General Services", which includes RM7.5bn for subsidies and cash transfers

Overall, we expect the resulting 2012 deficit will come in at around RM44bn, only slightly larger than the Budgeted target of RM43bn. With the government now expecting real GDP growth to come in close to the top of its 4-5% forecast range, and with a larger rebased GDP, the 2012 nominal GDP forecast will likely be revised upwards as well, and we expect the deficit to amount to about 4.7% of GDP as targeted.

Figure 7. 1H Historical Averages of Revenues and Expenditures

| | 2012 Budget (Oct 2011) | 1H12 | 1H as Historical Average % of Full Year | Full Year Estimate Implied by Historical Average | 2012 Citi Estimate |
|---------------------------------------|------------------------|--------------|--|---|--------------------|
| | RM bn | RM bn | % | RM bn | RM bn |
| Direct Tax Revenues | 102.1 | 52.3 | 48.1 | 102.1 | 106.5 |
| Corporate | 47.5 | 18.4 | 37.1 | 49.7 | 49.7 |
| Personal | 21.3 | 18.3 | 85.1 | 21.5 | 21.5 |
| Petroleum | 26.2 | 11.8 | 41.6 | 28.4 | 26.5 |
| Others | 7.1 | 3.8 | 42.5 | 8.8 | 8.8 |
| Indirect Tax Revenues | 33.5 | 16.2 | 45.6 | 35.5 | 35.8 |
| Export Duties | 2.1 | 1.0 | 44.2 | 2.4 | 2.4 |
| Import Duties | 2.0 | 1.0 | 45.6 | 2.3 | 2.3 |
| Excise Duties | 11.9 | 5.7 | 43.9 | 13.0 | 13.0 |
| Indirect Sales | 9.0 | 4.2 | 45.5 | 9.3 | 9.3 |
| Service Tax and Others | 8.6 | 4.2 | 47.9 | 8.8 | 8.9 |
| Non-Tax Revenues | 51.3 | 30.1 | 35.4 | 85.0 | 58.2 |
| Licenses and Permits | 11.7 | 3.7 | 43.5 | 8.5 | 8.5 |
| Petroleum Royalty | | 3.1 | 49.9 | 6.2 | 6.2 |
| Interest and Investment Returns | 34.0 | 20.1 | 30.3 | 66.4 | 36.0 |
| Others | | 2.4 | 43.4 | 5.5 | 5.5 |
| TOTAL REVENUES | 186.9 | 98.6 | 44.0 | 224.1 | 200.5 |
| Operating Expenditures | 181.6 | 93.8 | 41.3 | 227.0 | 196.2 |
| Emoluments | 52.0 | 26.2 | 45.4 | 57.6 | 56.0 |
| Pension and Gratuities | 12.1 | 7.5 | 51.7 | 14.6 | 13.0 |
| Debt Service Charges | 20.5 | 8.5 | 45.8 | 18.5 | 20.5 |
| Supplies and Services | 30.5 | 12.3 | 32.4 | 37.9 | 31.0 |
| Subsidies | 33.2 | 18.5 | 31.0 | 59.8 | 40.0 |
| Asset Acquisition | 1.1 | 0.4 | 13.3 | 2.7 | 1.2 |
| Grants, Transfers, and Others | 32.2 | 20.6 | 43.4 | 47.3 | 34.5 |
| Gross Development Expenditures | 49.2 | 18.8 | 32.9 | 57.2 | 49.2 |
| GROSS TOTAL EXPENDITURES | 230.8 | 112.7 | 39.0 | 288.7 | 245.4 |

Source: MoF, CEIC, Citi Research Estimates

Note: We sum operating expenditures and gross development expenditures to obtain gross total expenditures

Into 2013, we expect the government to refocus its efforts on fiscal consolidation once elections are out of the way, possibly bringing the fiscal deficit down to about 4.3% of GDP.

We expect the revenues to increase 7.6%, with them edging up to 21.3% of GDP in 2013, from 21.2% in 2012 and 21% in 2011. This reflects:

- **Continued administrative efforts to close the tax gap, which will likely raise tax revenues to 15.6% of GDP** (2012E: 15.1%, 2011: 15.3%), concentrated largely in non-oil direct tax revenues, especially corporate and personal income taxes collections, both of which we expect to see an increase of 0.1%-pts of GDP (we assume no cuts in corporate/personal taxes as GST will not be implemented in 2013). Indirect tax collections, especially excise taxes and export/import duties, could likewise see increases.
- **Increases in petroleum income tax, driven largely by an expected increase in production** as new oilfields start to come onstream by end-2012, offsetting revenue losses from tax incentives to encourage marginal oil field development. Note that with our forecast for Brent at around US\$99/bbl in 2013, we expect Tapis to average around US\$105-110/bbl in 2013 (vs. YTD of around US\$120/bbl).
- **Higher tax revenues will offset a decline in non-tax revenues, due primarily to the decline in the Petronas dividend**, as Petronas seeks to eventually cap its dividend to the government at 30% of its net income, although this will be done in a stepwise manner. Based on this 30% guideline, Petronas would probably be paying around RM18bn of dividends, rather than the RM30bn it paid in 2012. We assume a Petronas dividend will be cut instead to RM25bn, although partly offset by other investment incomes from divestment gains.

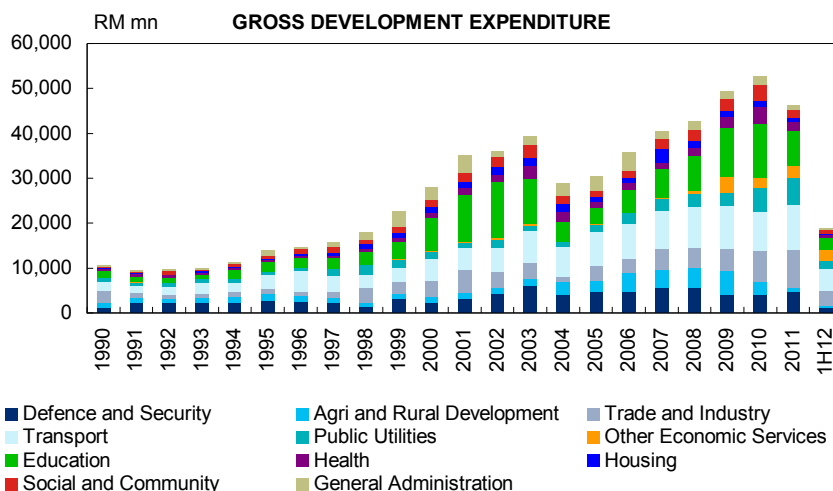
With elections on the horizon, notwithstanding the desire to consolidate the fiscal position, there is little scope for significant cuts in overall expenditure, but expenditure will be reallocated to areas that deliver best political bang for the buck – Sectors deemed critical for the BN, including the 1.3mn civil servants, agriculture (linked to the rural Malay vote), and social welfare (for the urban poor) may be given higher allocations, while other "less essential" sectors may receive less priority, or even see reduced spending.

We expect operating expenditure to be kept at 20.8% of GDP in 2013, similar to 2012 and 2011:

- Within that, emoluments and pensions and gratuities are likely to see larger increases (given likelihood of yet another round of civil servant bonuses, and/or pay hikes) accounting for the lion's share (35.5%) of total operating expenditure.
- Politically sensitive spending on supplies and services will likely be kept high at 3.3% of GDP (similar to 2011 and 2012), or around 15.6% of the total operating expenditure, notwithstanding the usual rhetoric on open tender processes to keep such expenses under control.
- Subsidies will probably be brought down to RM34.5bn from almost RM40bn in 2012, reflecting both likely lower oil prices and hikes in RON95 prices after elections.
- Other expenditures deemed less politically sensitive, including asset acquisitions, refunds, grants to statutory boards, and "other expenditures", will likely see their share of operating expenditure fall from around 14.1% in 2012 to 12.2%

Gross development expenditure will be kept stable at RM49bn as mentioned by Second Finance Minister Datuk Seri Ahmad Husni Hanadziah. Within that, we would expect a larger allocation for politically sensitive sectors such as Agriculture and Rural Development & Defense (both of which have shrunk in recent years as greater allocations were given to transport and public utilities sectors), while education and housing may also receive larger allocations.

Figure 8. Gross Development Expenditure



Source: CEIC, Citi Research

Overall, in absolute terms, we expect only a slightly smaller deficit of RM43.2bn (4.3% of GDP) in 2013 vs. RM44bn in 2012 (4.3% of GDP). Taking into account refinancing needs of around RM53bn in 2013, and around RM3bn of maturing 1Malaysia Sukuk (issued in June 2010 with 3-year tenors) this should bring gross issuance of MGS and GII to about RM99bn in 2013, higher than the RM94bn for 2012.

Figure 9. Budget Estimates

| | 2011 Actual | | 2012 Budget (Oct 2011) | | 2012 Revised Budget (Citi Estimate) | | 2013 Budget (Citi Estimate) | |
|---|--------------|-------------|---------------------------|-------------|--|------------|--------------------------------|-------------|
| | RM bn | %YoY | RM bn | %YoY | RM bn | %YoY | RM bn | %YoY |
| Revenue | 185.4 | 11.8 | 186.9 | 0.8 | 200.5 | 8.1 | 215.8 | 7.6 |
| % of GDP | 21.0 | | 20.4 | | 21.2 | | 21.3 | |
| Direct Tax | 102.2 | 21.7 | 102.1 | -0.1 | 106.5 | 4.2 | 118.3 | 11.1 |
| Companies | 46.9 | 29.5 | 47.5 | 1.3 | 49.7 | 6.0 | 55.0 | 10.6 |
| Petroleum Income Tax | 27.7 | 27.4 | 26.5 | -4.5 | 26.5 | -4.5 | 29.0 | 9.4 |
| Individuals | 20.2 | 1.7 | 21.3 | 5.4 | 21.5 | 6.3 | 24.0 | 11.8 |
| Cooperatives & Others | 7.4 | 21.0 | 7.1 | -4.1 | 8.8 | 19.3 | 10.3 | 16.6 |
| Indirect Tax | 32.6 | 3.6 | 33.5 | 2.6 | 35.8 | 9.6 | 40.0 | 11.8 |
| Non-Tax | 50.5 | 0.4 | 51.3 | 1.5 | 58.2 | 15.1 | 57.5 | -1.2 |
| Expenditure | 227.9 | 7.9 | 229.9 | 0.9 | 244.5 | 7.3 | 259.0 | 5.9 |
| Operating Expenditure | 182.6 | 20.4 | 181.6 | -0.5 | 196.2 | 7.4 | 211.5 | 7.8 |
| % of GDP | 20.7 | | 19.8 | | 20.8 | | 20.8 | |
| Subsidies | 30.9 | 33.8 | 33.2 | 7.4 | 40.0 | 29.4 | 34.5 | -13.8 |
| Operating Expenditure ex Subsidies | 151.7 | 18.0 | 148.4 | -2.2 | 156.2 | 3.0 | 177.0 | 13.4 |
| Gross Development Expenditure | 46.4 | -5.6 | 49.2 | 6.0 | 49.2 | 6.1 | 49.0 | -0.5 |
| % of GDP | 5.3 | | 5.4 | | 5.2 | | 4.8 | |
| Loan Recoveries | 1.1 | -27.7 | 0.9 | -16.8 | 0.9 | -16.3 | 1.5 | 65.6 |
| Net Development Expenditure | 45.3 | -11.6 | 48.3 | 6.5 | 48.3 | 6.6 | 47.5 | -1.7 |
| Fiscal Balance | -42.5 | -1.8 | -43.0 | 1.2 | -44.0 | 3.6 | -43.2 | -1.9 |
| Fiscal Balance % GDP | -4.8 | | -4.7 | | -4.7 | | -4.3 | |
| Net External Borrowing | 0.5 | | | | | | | |
| Maturing MGS, GII | | | 50.0 | | 50.0 | | 52.9 | |
| Maturing One Malaysia Sukuk | | | | | | | 3.0 | |
| Estimated gross MGS issuance, based on fiscal deficit forecast | | | 93.0 | | 94.0 | | 99.1 | |

Source: MoF, Bloomberg, Citi Research Estimates

In terms of measures, we expect Budget 2013 to be focused on: [1] more direct cash transfers for households and civil servants; [2] measures to improve the affordability of housing; and [3] restatement of large construction projects in the works. Any hoped for cuts in personal or corporate taxes will likely have to wait till GST is implemented after the elections; although a pre-announcement of cuts to be implemented 2014 would be a positive surprise.

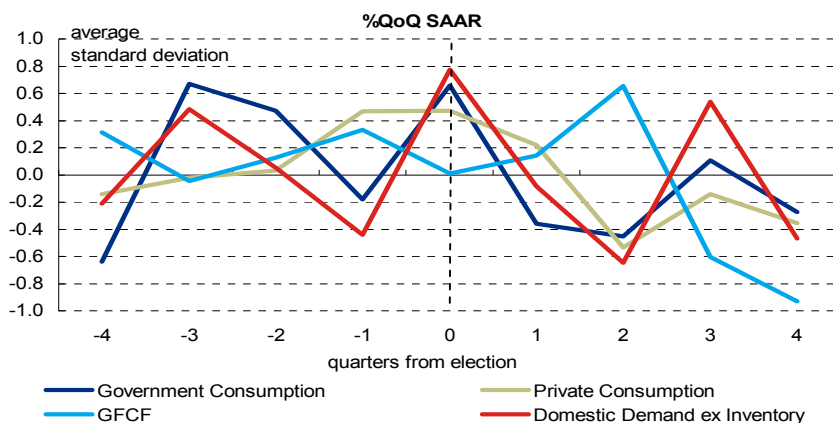
Pre-Election Fiscal Transfers for the Poor and Civil Servant Bonuses

Budget 2013 will likely have yet another array of direct fiscal transfers to households, which could provide a buffer for consumer spending. Parallels were evident in the RM13.8bn supplementary Budget in June, which had additional handouts for lower income groups (around RM1.8bn for 2H12), as well as the RM1.69bn allocated for the 112K Felda settlers upon the listing of Felda Global Ventures (though these were not included in Federal Government expenditure), and around RM2.2bn of civil servant bonuses.

As was the case in Budget 2012, we would not be surprised to see another half-month bonus for civil servants announced, and further (front loaded) handouts for lower income/disadvantaged groups and other incentives for rural settlers (for example incentives for rubber smallholders). However, with elections now widely expected in November 2012 (before the 2013 Budget takes effect) and not later than April 2013, the handouts (which in any case may deliver diminishing marginal returns politically) will be disbursed over a shorter period of time and hence need not be on the same scale as in Budget 2012 for example.

These direct fiscal transfers will serve two economic and political objectives. First, from a counter cyclical perspective, direct cash transfers may have a more immediate impact on domestic demand than large scale infrastructure projects, which may face implementation delays. With external demand clearly weakening and the burden of growth shifting more and more on domestic demand, this has likely become far more crucial than it was last year. Already, the RM4bn of handouts and civil servant bonuses in 2H12 will likely contribute around 0.4-0.5% of GDP (assuming a marginal propensity to consume of one). Given that GLC pay hikes tend to follow that of the civil service, the multiplier effects could be larger. But once this wears off, which is likely by year end, domestic demand momentum could slow in 1H13, just when export weakness becomes more intense. Put another way, historically, domestic demand fell off in the quarter after elections, as government consumption was pulled back. If elections are to be held in 4Q12, then it may be necessary to prolong fiscal support to avoid an unwelcome slowdown in consumption when the US fiscal cliff hits exports.

Figure 10. QoQ SAAR Growth in Quarters Before and After Elections

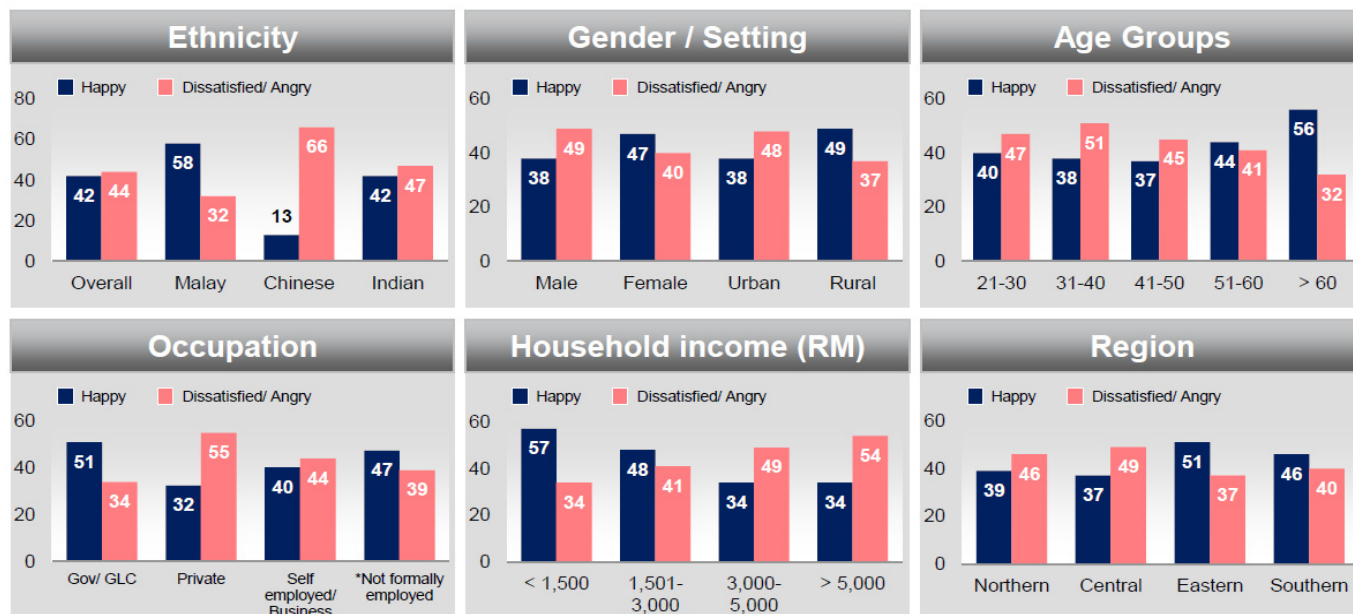


Note: Using the nine quarters surrounding the election (four quarters before, four quarters after, and the quarter of the election itself), we normalize the QoQ SAAR growth to the number of standard deviations from the mean for each election and then take the average standard deviations for each quarter across the four elections.

Source: CEIC, Citi Research

Second, from a political perspective, civil servant bonuses and fiscal transfers to the poor will help cement support from these traditional supporters of the government (who incidentally also are the lowest income groups which have the highest marginal propensity to consume, and the higher debt servicing burden). Many of the beneficiaries may also form the bedrock of support for UMNO, as the Merdeka Center polls suggest that support for the government is strongest amongst those earning less than RM3K/m, and also those working in the civil service or GLCs.

Figure 11. Merdeka Center: Perception Towards The Government



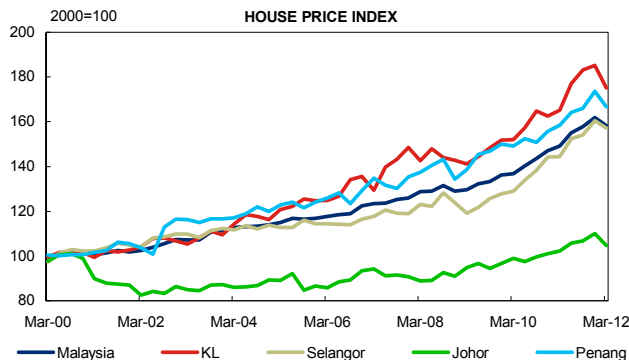
*Homemaker, retired, students, unemployed. Respondents were asked "Some people say they are happy with the government, while others are dissatisfied and others say they are angry. Which one best describes how you feel?" Survey period 22-29 June 2012.

Source: Merdeka Center

Keeping Housing Affordable

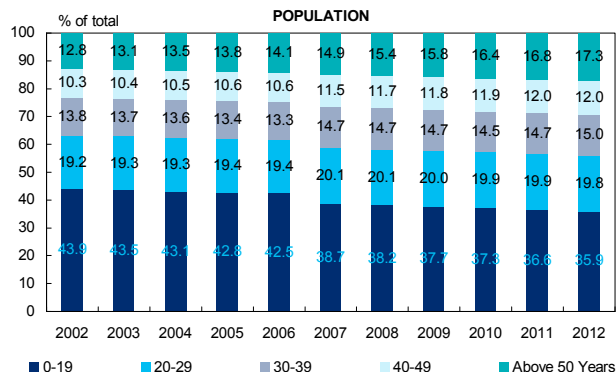
A possible second focus in the Budget would be keeping housing affordable, even if largely for political signaling effects. Despite the dip in home prices in 1Q12 (the latest quarter for which data is available), especially in Johor, KL, Selangor and Penang, this has not stopped the *perception* that young working adults have been increasingly priced out of the market. The issue is politically sensitive as young voters which would most likely be first time home buyers constitute a significant share of the voting population, including undecided "swing" voters. For example, those aged 20-29 comprise around 20% of the population, while 70% of the 4.2mn unregistered voters are between the ages of 21 and 40. Around 450,000 Malaysians turn 21 each year when they become eligible to vote, and given that it has been four years since the last elections, this implies 1.8mn new young voters, whose political inclinations are difficult to ascertain, but who are also likely to be first time home buyers.

Figure 12. House Price Index



Source: CEIC, Citi Research

Figure 13. Those Aged 20-29 Constitute Around 20% of the Population



Source: CEIC, Citi Research

We expect more supply side measures to address the shortage in affordable and middle income housing, which would likely be the most direct manner of tackling the housing issue. In Budget 2012, the government increased the limit of house prices under the My First Home Scheme (helping those earning RM3K/m) from RM220K to RM400K, though this was subsequently blamed for the increase in prices of supposedly “affordable” housing. This came on top of other schemes such as the PR1MA to develop affordable housing for the middle income. **Housing and Local Government Minister Datuk Seri Chor Chee Heung recently said that the allocation for existing affordable housing schemes could be increased, while the RM2.5k income ceiling for the PPR scheme could be raised to RM3k.**

Figure 14. Budget 2012 Measures To Increase Home Ownership

To meet the demand for houses from those earning below RM3,000/m, the Government launched the My First Home Scheme in March 2011. To expand the scheme, the Government proposes to increase the limit of house prices from a maximum of RM220,000 to RM400,000. This improved scheme will be available to house buyers through joint loans of husband and wife beginning January 2012.

To enable buyers to own houses, the Government established the 1Malaysia People's Housing (PR1MA) as the sole agency to develop and maintain affordable and quality houses, specifically for middle-income group. PR1MA will be the developer for projects on land owned by the Government. A total of 7,700 houses will be built in 2012 in Cyberjaya, Putra Heights, Seremban, Damansara, and Bukit Raja. House prices under this scheme are lower than market prices. 100% stamp duty exemption will be provided on loan instruments to purchase these houses.

To protect buyers from their houses being abandoned before completion of construction or delayed, the Government will encourage the construction of more houses using the build then sell concept. For this purpose, Islamic banks have agreed to provide shariah-compliant financing and undertake construction risks. Installments only commence after the house is completed. This scheme will be implemented for houses costing RM600,000 and below.

The Government will continue to implement the Program Perumahan Rakyat (PPR) by building 75,000 units of affordable houses nationwide under the 10MP. In 2012, RM443mn is allocated for the construction of 8,000 units for sale and 7,000 units to be rented.

The Rumah Mesra Rakyat (RMR) programme, managed by Syarikat Perumahan Negara Berhad (SPNB), will be continued to help the low-income group to own decent houses. Under this programme, those with land but without a house or live in dilapidated houses are eligible for financing to build a house. SPNB will build 10,000 units in 2012. Each house costing RM65,000 will be sold for RM45,000 and the Government will subsidise RM20,000. For this, the Government will allocate RM200mn.

Source: Budget 2012 Speech

Nonetheless, the government could decide that more demand side measures targeted at investors/speculators/foreigners might be needed to assuage young voters ahead of elections,

- There have been media reports¹ of a possible increase in RPGT rates to limit the rise in home prices. The Residential Property Gains Tax (RPGT) in Budget 2012 – 10% if residential properties are sold within 2 years of purchase, 2% between 2-5 years, and 0% after 5 years – was not seen as effective, as property is typically completed in two years, and those who flip upon completion could still end up paying less RPGT than under the old regime
- The government could also raise the minimum price for house purchases by foreigners – we note that it had proposed to double the price floor from RM500K to RM1mn earlier in the year – to address the perception that foreigners are to blame for higher prices. LTVs could also be reduced to deter speculation.
- Credit measures, such as further reducing LTV ratios, or the banning of creative financing schemes that defer loan repayments till after the properties are completed. However, we doubt this measure, which would effectively reduce affordability, would go down well with priced out voters.

Good politics aside, it is unclear how effective these additional measures will be, as while speculation and foreign buying have been blamed for pushing up house prices, we suspect the problem is more fundamentally a lack of supply from a shortfall in completions facing burgeoning demand from a young population. We understand that developers are already trying to cover the shortfall by launching more developments. According to the *New Straits Times*, industry experts have said that foreigners account for only 2% of home purchases and typically already buy homes above RM1mn anyway. Moreover, with house prices already softening, mortgage loan growth moderating since March, and loan applications likewise falling, it is not clear whether such measures are justified in the first place.

Attempts to micromanage the housing market also run the risk of policy mistakes. We recall that the My First Home Scheme introduced in Budget 2011 to allow young working adults to obtain 100% financing from banking institutions to purchase their first home, had to be expanded in Budget 2012 following complaints that the scheme was insufficient to meet the property prices in urban areas such as the Klang Valley and Penang, only to then come under pressure to relax eligibility criteria after registering dismal approval rates. Needless to say, a relaxation of eligibility criteria would do nothing to improve the household debt situation, especially for lower income groups for whom it would be financially prudent to take up debt to own a home. **Nonetheless, given the political imperatives of the day, this could be discounted against the need to court the young urban electorate.**

¹ Thomas Huang, "Solutions to housing concerns likely in Budget 2013", The Star Malaysia, 15th September 2012.

Corporate or Personal Tax Cuts Unlikely until GST is Implemented

With elections so close on the horizon, any talk of GST implementation has likely been deemed politically toxic. GST implementation will likely have to wait for after elections, especially if PM Najib can secure a stronger mandate to push through reform. Pemandu estimates that a 4% GST would result in net revenues gains of RM6.3bn in the first two years of implementation while a 5% GST would yield RM9.7bn and a 7% GST would result in RM25.7bn. As GST would replace existing 6% sales tax, increases in the GST rate above 6% would result in much higher revenues, i.e. the relationship between GST rates above 6% and revenues is non-linear.

With GST implementation only possible after elections, any hoped for cuts in personal or corporate taxes will likely have to wait, though a pre-announcement of cuts in 2014 would be a positive surprise – and probably a precursor to concurrent GST implementation.

If tax cuts are really in store, the government is more likely to slash personal income tax rates rather than corporate taxes. **First**, a cut in personal income taxes would likely score more political points, which will be a priority given impending general elections (though we hesitate to exaggerate this point as only one in ten workers pay personal income taxes). **Second**, with corporate taxes about 2-3 times the size of personal income taxes, a personal tax cut is a lot more affordable than a corporate tax cut for the time being. **Third**, cuts in top personal tax rates would also help Malaysia draw in badly-needed talent. **Fourth**, historically, top personal income tax rates have tended to align themselves with corporate income tax rates, albeit with a lag. In addition, rebates such as a higher child relief for the middle-income group and widening of tax bands are possibilities.

Figure 15. Top Personal Income Tax Rates

| % | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|-----------------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|
| China | 45 | 45 | 45 | 45 | 45 | 45 | 45 | 45 | 45 | 45 |
| Hong Kong | 15.5 | 16 | 16 | 16 | 16 | 15 | 15 | 15 | 15 | 15 |
| India | 30 | 30 | 30 | 30 | 30 | 30 | 30 | 30 | 30 | 30 |
| Indonesia | 35 | 35 | 35 | 35 | 35 | 35 | 30 | 30 | 30 | 30 |
| Korea | 36 | 36 | 35 | 35 | 35 | 35 | 35 | 35 | 35 | 38 |
| Malaysia | 28 | 28 | 28 | 28 | 28 | 28 | 27 | 26 | 26 | 26 |
| Pakistan | 30 | 30 | 30 | 30 | 20 | 20 | 20 | 20 | 20 | 20 |
| Philippines | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 32 |
| Singapore | 22 | 22 | 21 | 20 | 20 | 20 | 20 | 20 | 20 | 20 |
| Taiwan | 40 | 40 | 40 | 40 | 40 | 40 | 40 | 40 | 40 | 40 |
| Thailand | 37 | 37 | 37 | 37 | 37 | 37 | 37 | 37 | 37 | 37 |
| Vietnam | 50 | 40 | 40 | 40 | 40 | 40 | 35 | 35 | 35 | 35 |

Source: KPMG

Figure 16. Malaysia Historical Corporate and Personal Income Tax Rates

| Year | Corporate Tax Rate (%) | Top Personal Tax Rates (%) |
|------|------------------------|----------------------------|
| 1992 | 35 | 35 |
| 1993 | 34 | 35 |
| 1994 | 32 | 35 |
| 1995 | 30 | 32 |
| 1996 | 30 | 30 |
| 1997 | 30 | 30 |
| 1998 | 28 | 30 |
| 1999 | 28 | 30 |
| 2000 | 28 | 29 |
| 2001 | 28 | 29 |
| 2002 | 28 | 28 |
| 2003 | 28 | 28 |
| 2004 | 28 | 28 |
| 2005 | 28 | 28 |
| 2006 | 28 | 28 |
| 2007 | 27 | 28 |
| 2008 | 26 | 28 |
| 2009 | 25 | 27 |
| 2010 | 25 | 26 |
| 2011 | 25 | 26 |
| 2012 | 25 | 26 |

Source: KPMG, Citi Research

More Sin Taxes on the Way?

Higher sin taxes could also be under consideration given the recent introduction of a new price control on cigarettes as part of its anti-smoking campaign. Effective 1st September, the minimum price of all cigarette brands was set at RM7 and only packs with 20 sticks are permitted to be sold in the market. The last time tobacco taxes were hiked was a 3 sen hike in October 2010 to 22 sen a stick. While a hike in tobacco taxes could help fiscal consolidation at the margin, this risks an overall loss rather than gain of tax revenues if too many turn to the black market for their fix.

Apart from tobacco taxes, taxes on alcohol could also be hiked. The excise duty on alcohol currently stands at about RM7.40 per litre, one of the highest in the world. It is not clear that further hikes in alcohol excise duties would necessarily raise revenues, as demand for alcohol would become more price elastic beyond a certain price threshold, and/or encourage consumers to turn to the black market. Alcohol excise duties are already at an all-time high at 50% of brewers' total revenue, however, and per capita consumption of beer among non-Muslim adults actually fell 2.3% between 2004-2009.

New Construction Projects?

Budget 2013 is likely to come with the usual project announcements, some of which could be restatement of previously announced projects. While the announcement of more megaprojects would not come as a surprise – they can sometimes bring the promise of more government contracts for Bumiputera businessmen who are a key source of political support – the government would have to be mindful of the political ramifications of some of the more controversial mega-projects (100-storey Warisan Merdeka announced in Budget 2011 being case in point), not to mention the risk of exacerbating over supply in the commercial space. We would not rule out a shift towards small-scale projects in rural areas which can be implemented more quickly and sweeten the rural vote before looming elections. Given implementation lags, we would not raise our expectations too high even with new project announcements – in the past three budgets, after the budget announcement, there is usually limited, if not no news on those highways or projects that are announced after the budget.

Figure 17. Projects Announced in Previous Budgets

| Budget 2012 | Budget 2011 |
|--|--|
| Projects under Second Rolling Plan (RP2), including: | Kuala Lumpur International Financial District |
| ■ Gemas-Johor Bahru double tracking rail project | Mass Rapid Transit |
| ■ Lebuhraya Pantai Timur Jabor-Kuala Terengganu, Lebuhraya Pantai Barat Banting-Taiping, Lebuhraya Segamat-Tangkak and Lebuhraya Central Spine as well as construction of Kota Marudu-Ranau road | Highways, including Ampang-Cheras-Pandan Elevated Highway, Guthrie-Damansara Expressway, Damansara-Petaling Jaya Highway, Pantai Barat-Banting-Taiping Highway, Sungai Dua-Juru Highway, and Paroi-Senawang-KLIA Highway |
| ■ Redevelopment of Sungai Besi Kuala Lumpur Air Base | Warisan Merdeka |
| Development of regional corridors, including: | 300MW Combined-Cycle Gas Power Plant in Kimanis, Sabah |
| ■ Construction of Johor Bahru-Nusa Jaya coastal highway in Iskandar, Johor | Development of Malaysian Rubber Board land in Sungai Buloh |
| ■ Heritage tourism development in Taiping in Northern Corridor | International Islamic University Malaysia Teaching Hospital in Kuantan, Pahang |
| ■ Agropolitan scheme in Besut in East Coast Economic Region | Women and Children's Hospital in KL |
| ■ Palm oil industrial cluster project in Lahad Datu in Sabah Development Corridor | Integrated Health Research Institute Complex in KL |
| ■ Samalaju water supply in Sarawak Corridor of Renewable Energy | Academic Medical Centre |
| Rural Transformation Programme, for the construction and upgrading of amenities such as multipurpose halls, surau, drains, small bridges, street lights including repairs of dilapidated houses. | |
| Rural Road Programme and Village-Link Road Project to build road network of 2,749km to benefit 1.76mn rural population | |

Source: Ministry of Finance, Citi Research

Fixing the Human Capital Deficit

Finally, to improve the investment climate, we expect a heavy emphasis on human capital development and possibly liberalization of services sub-sectors. The human capital deficit has been brought to the fore once again with the recent launch of the Education Blueprint 2013-2025 and we expect the government to build on any momentum it has gained from this announcement. Budget 2013 could see more measures such as training subsidies, incentives to attract overseas talent, and more details on education reforms. Building upon past measures to attract overseas talent or the large Malaysian diaspora – lowering tax rates for experts, relaxing immigration criteria – could be a timely measure to attract the large numbers of Malaysian professionals working in Singapore, especially given Singapore's tightening of immigration rules over the last two years.

As we have argued before, the solution to Malaysia's human capital deficit is unlikely to be as simple as increasing education spending and providing more incentives:

First, the lack of proficiency in English remains a serious problem. Online recruitment agency Jobstreet.com in a survey among employers recently found poor English to be the second-most important cause of unemployment, outweighed only by the poor attitudes of jobseekers. But there remains little emphasis on English in the education system – while it is compulsory for students to pass the Malay language subject at the national examinations, it is not so for English. The government has also recently announced that it would abolish the teaching of science and mathematics in English. While there have definitely been implementation issues, it is likely the real reason the policy was dropped was political pressure from conservatives who view any attempt to improve proficiency in English as eroding the status of the Malay language. Former PM Mahathir, in defending the policy, was at pains to argue that the policy was not intended to improve proficiency in English but to help students master science and mathematics.

Second, in the rush to produce more university graduates, declining standards could also be contributing to wage stagnation by making it difficult for employers to distinguish between 'employable' and 'unemployable' graduates. One function of education is to act as a signal of an individual's ability to perform in the workplace – it is generally accepted that one has to be more capable and disciplined to graduate from university than say from secondary school. This allows employers to reliably categorize university graduates as more productive and skilled than secondary school graduates and to pay them accordingly. But if standards have declined to the point where it is no longer clear whether university graduates are indeed of a certain quality, employers are essentially rolling the dice with each hire as no job candidate would admit that they in fact fall short of expectations. This problem of asymmetric information results in employers being unwilling to pay the full wage of a qualified skilled worker as there is no way to distinguish between a qualified 'employable' graduate and an unqualified 'unemployable' one – wages are thus likely determined by the lowest common denominator in the workforce. Surveys by the World Bank among employers confirm that there are significant skill deficiencies amongst local skilled production workers and professionals. But any attempt to tighten standards would likely be viewed as denying a university education to the lower income groups.

Figure 18. Employers confirm that local skilled production workers in fact suffer from skill deficiencies



Source: World Bank (2005 and 2009c)

Figure 19. Local professional workers are not free of skill deficiencies either, though the problem is to a lesser extent than production workers



Source: World Bank (2005 and 2009c)

Third, affirmative action policies place non-Bumiputeras at a disadvantage in the Malaysian education system. Anecdotal evidence, backed by commentary in the *Malaysian Insider*², shows that the odds of gaining entrance into the one-year University Matriculation program directly after finishing one's SPM (the Malaysian equivalent of a secondary school finishing exam) increases significantly if the student is a Bumiputera. Moreover, Bumiputeras are in this case defined rather narrowly, such that even students of mixed ethnic parentage (one Bumiputera parent and another non-Bumiputera parent) could be rejected. Thus, these students have to take the long route, going through the two-year STPM pre-university program before entering university – and even then a place in university is not guaranteed.

Any attempt to meaningfully address the human capital deficit will inevitably involve changes to affirmative action policies, which will be met with strong resistance, especially from the Malay rights hardliners. To be fair, Najib has made some recent progress to improve human capital, including some success with the Talent Corp and income tax incentives for the diaspora to migrate back to Malaysia under the Returning Expert Programme. But we think this still falls short in addressing the more fundamental roots of the human capital deficit. Unless Najib is able to overcome resistance, there is little chance of more fundamental reform – never mind that all talk of reform with the slightest hint of controversy appears to have evaporated in the run-up to elections. **We therefore do not expect any significant reforms to be announced in Budget 2013 – any reform will have to wait until elections are over and will depend crucially on the outcome.**

² "How you become a Racist" by James China, 2 November 2009, The Malaysian Insider. <http://www2.themalaysianinsider.com>

Key Economic Data and Forecasts

Malaysia – Key Economic Data and Forecasts

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012E | 2013E |
|--|-------|-------|-------|-------|-------|-------|-------|--------|--------|
| Real Sector | | | | | | | | | |
| Real GDP (% yoy) | 5.3 | 5.6 | 6.3 | 4.8 | -1.5 | 7.2 | 5.1 | 5.0 | 5.3 |
| Domestic demand ex Inventory (% yoy) | 7.5 | 6.3 | 9.9 | 6.6 | 0.3 | 7.0 | 8.2 | 10.7 | 8.0 |
| Real Consumption: Private (% yoy) | 9.1 | 6.6 | 10.4 | 8.7 | 0.6 | 6.6 | 7.1 | 7.7 | 7.0 |
| Real Gross Fixed Capital Formation (% yoy) | 4.9 | 6.3 | 10.4 | 2.4 | -2.7 | 10.4 | 6.5 | 18.5 | 12.0 |
| Consumer prices (% yoy) | 3.0 | 3.6 | 2.0 | 5.4 | 0.6 | 1.7 | 3.2 | 1.8 | 2.4 |
| GDP (USD bn) | 143.5 | 162.8 | 193.7 | 231.1 | 202.4 | 247.0 | 288.2 | 301.0 | 317.6 |
| GDP per capita (USD) | 5,421 | 6,067 | 7,123 | 8,393 | 7,255 | 8,743 | 9,801 | 10,032 | 10,380 |
| Unemployment Rate (%) | 3.5 | 3.3 | 3.2 | 3.3 | 3.7 | 3.3 | 3.2 | 3.0 | 3.2 |
| External Sector | | | | | | | | | |
| Exports (% yoy, US\$) | 12.3 | 13.0 | 9.5 | 13.4 | -21.2 | 26.4 | 14.4 | 2.2 | 0.6 |
| Imports (% yoy, US\$) | 9.3 | 13.9 | 12.2 | 6.9 | -20.7 | 33.9 | 14.0 | 7.5 | 7.7 |
| Trade balance (US\$ bn) | 34.0 | 37.5 | 37.7 | 51.7 | 40.0 | 41.7 | 48.4 | 40.1 | 26.8 |
| Current account (% of GDP) | 14.4 | 16.1 | 15.4 | 17.1 | 15.5 | 11.1 | 11.0 | 5.0 | 4.0 |
| International Reserves ex. Gold (US\$ bn) | 70 | 82 | 101 | 92 | 97 | 105 | 135 | 153 | 150 |
| MYR/USD (period average) | 3.79 | 3.67 | 3.44 | 3.33 | 3.52 | 3.22 | 3.06 | 3.09 | 3.12 |
| Other | | | | | | | | | |
| 3-month KLIBOR fixing (% , average) | 2.9 | 3.7 | 3.6 | 3.6 | 2.2 | 2.7 | 3.2 | 3.2 | 3.3 |
| 5-year MGS yield (% , average) | 3.6 | 4.0 | 3.6 | 3.7 | 3.6 | 3.5 | 3.4 | 3.2 | 3.4 |
| Fiscal balance (% of GDP) | -3.4 | -3.2 | -3.1 | -4.6 | -6.7 | -5.4 | -4.8 | -4.7 | -4.3 |
| Population (persons million) | 26.5 | 26.8 | 27.2 | 27.5 | 27.9 | 28.3 | 29.4 | 30.0 | 30.6 |

Source: CEIC, Citi Research Estimates

Interest and Foreign Exchange Rate Forecasts

| | | 20-Sep | 4Q12 | 1Q13 | 2Q13 | 3Q13 | 4Q13 | In 3M | In 6M | In 12M |
|----|------------------------|--------|------|------|------|------|------|-------|-------|--------|
| MY | Overnight Policy Rate | 3.00 | 3.00 | 3.00 | 3.00 | 3.00 | 3.00 | 3.00 | 3.00 | 3.00 |
| | 3-Month Interbank Rate | 3.20 | 3.28 | 3.28 | 3.28 | 3.28 | 3.28 | 3.28 | 3.28 | 3.28 |
| | 5-year MGS | 3.28 | 3.10 | 3.20 | 3.40 | 3.50 | 3.50 | 3.11 | 3.19 | 3.49 |
| | USD-MYR | 3.05 | 3.08 | 3.11 | 3.13 | 3.13 | 3.12 | 3.07 | 3.10 | 3.13 |
| US | Fed Fund Rate | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |
| | 10-Year Treasuries | 1.77 | 1.65 | 1.75 | 2.00 | 2.25 | 2.55 | NA | NA | NA |

Source: Bloomberg, Citi Research Estimates

Appendix A-1

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