People and business-friendly Budget in the offing

Economic Update

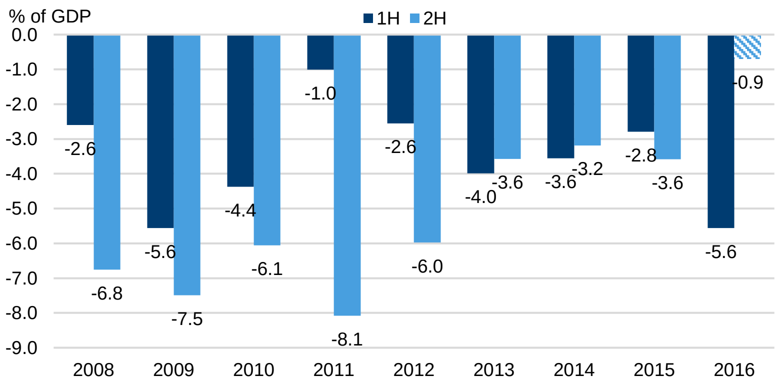
Budget 2017 Preview

Government remains committed to fiscal discipline at the same time

The 2017 Budget will be presented on 21st October 2016, with the theme *"Accelerating Growth, Ensuring Fiscal Prudence and Enhancing Well-being of People."* We believe the Budget proposals will likely be people and business-friendly, where the measures will largely be targeted towards the welfare of the Bottom 40% (B40) income group (such as higher BR1M allocation for households earning less than RM3,000 per month). The other strategies of the budget proposals will also be to stimulate private consumption and domestic demand, as well as incentives to alleviate the rising cost pressures facing businesses to support corporate profitability.

However, before the Budget tabling, some market observers have raised concerns of the deterioration in the country's fiscal deficit position, due to the shortfall in government revenue from oil-related revenues in 1H16. They claimed that Malaysia may miss the government target of 3.1% of GDP set for 2016, especially when the fiscal deficit rose sharply to -5.6% of GDP in 1H16 (-3.6% in 2H15). This indicates that government has to lower the deficit position drastically in 2H16, to around -0.9% of GDP in order to meet the 3.1% target.

Fig 1: Government fiscal balance in 1H and 2H



*Source: BNM, CEIC *2H16 estimate*

Government revenue to improve in 2H16 despite shortfall in 1H16

Nevertheless, the Government is confident that the country's economy has hit the trough at a low of 4% yoy in 2Q16, where economic growth may likely recover to 4.2-4.4% in 2H16, in line with its official real GDP growth of 4.0-4.5% for 2016. We believe that domestic demand growth, which rose to 6.3% yoy in 2Q16, the strongest pace since 1Q15, will continue, and the recovery in oil prices from a low of US$28 per barrel in mid-January 2016 to US$50 currently will likely be sustained (after the decision by OPEC to cut some production). Going into 2H16, the Government's revenue collection will likely improve in tandem with the country's economic recovery and other factors such as higher Petronas dividend and petroleum income tax (PITA). About RM6bn has been received by the Government in 1H16 from Petronas dividend, where a higher portion of RM10bn will likely be collected in 2H16, bringing the total to RM16bn for the full year, as targeted. Similarly, with oil prices likely to be better than revised budget of US$30-35 per barrel, as announced in January 2016, and the lag between oil prices and PITA collection of about 3-6 months, there will be some upside from PITA revenue collection in 2H16.

Economic Research
(603) 2146 7540
alan.tan@affinhwang.com
yeeping.lim@affinhwang.com

Based on our assumption, the Federal Government's oil revenue is likely to increase by about RM2.0bn (as every US$1 per barrel increase in the price of crude oil will likely translate into a gain of about RM300m in Federal Government's revenue a year). We expect global oil price to average around US$43 in 2016. Furthermore, higher revenue is also expected through some revenue enhancement measures, such as reducing leakages on cigarette & liquor in duty-free islands (the leakages have resulted in revenue loss of nearly RM1bn to the government), amnesty for illegal foreign workers through Rehiring and Relocation Programme, as well as revenue from telecommunications spectrum (expected to collect about RM2bn in 4Q16). With companies registering for GST already exceeding 400k, we believe collection from Goods and Services Tax (GST) is on track to meet RM39bn target set for the current year 2016 (RM27bn in 2015). Cooperation between Customs and Inland Revenue Board (IRB) is encouraged to improve direct tax revenue collection going forward.

Higher opex in 1H16, but Government will exercise prudence

The Government will show strong commitment and continue to optimise their spending, especially on the supplies and services, asset purchase and transfers to statutory body. Reduction in the transfer to statutory body will be targeted at entities with high reserves and self-sustained, as these entities will be able to tap into their reserves to finance their expenditure. Going forward, Government is looking into micro-managing their expenditure, with non-fiscal measures and reforms that government is looking at to alleviate pressures on government expenditure. Some of the reforms under consideration may include revision of Government licences, permits and services fees.

Budget 2017 to address optimising OPEX and enhancing revenue

In Budget 2017, the Government will further address some of the structural problems and weaknesses of the country's economy, such as the persistent budget deficits, as well as to some extent the country's competitiveness in attracting investment. However, as expectations that the Budget proposals will be generous and people-friendly, after five years of existence from 2012 to 2016, the distribution of cash assistance to households through 1Malaysia People's Aid (BR1M) will continue in 2017 Budget with possible higher cash handouts. This will also be an incentive provided as the continuation of direct compensation arrangements to ease the tax burden on households from GST.

Fig 1: BR1M payments

RM	BR1M 1.0 (Budget 2012)	BR1M 2.0 (Budget 2013)	BR1M 3.0 (Budget 2014)	BR1M 4.0 (Budget 2015)	BR1M 5.0 (Budget 2016)
Households earning <RM3,000 per month	500	500	650	950	1,000
Households earning RM3,000-4,000 per month	-	-	450	750	800
Single unmarried individuals aged ≥21 and earn <RM2,000 per month	-	250	300	350	400
Participants in e-Kasih database with earning <RM1,000 per month	-	-	-	-	1,050
Allocation (RMbn)	**1.8**	**3.0**	**4.6**	**5.2**	**5.9**

Source: Malaysia's Budget, Ministry of Finance

For the medium income group earners, the government is likely to provide some personal income tax reliefs for spouse and children (higher tax deduction for individual), as well as reliefs for schooling students, insurance premiums, and other reliefs, See Appendix Table 7.

No change to GST rate, subsidy reduction to be gradual

Similarly, we expect Government to keep the GST rate unchanged at 6%, where this will help sustain the cost of living to households, while at the same time, lower cost of doing business. Raising GST rate from the current 6% to generate additional revenue may complicate the GST system for both customs and businesses. Where businesses required to account for the tax, the cost of complying with changes to the GST rate will likely be burdensome. Similarly, we also do not expect the Government to lift the GST relief on the domestic retail sale of RON95 petrol, alleviating the fear of higher inflationary pressure. In the last two years, Government has adopted some tough measures on the progress of subsidy rationalization, where we believe any further subsidy reduction (particularly for LPG) will only be implemented later without burdening the lower income groups as a result of higher cost of living.

Government likely to pre-announce another cut in CIT for 2018

In the 2015 Budget, the Government had pre-announced that corporate income tax (CIT) will be reduced by 1 percentage point from 25% to 24% (from 20% to 19% for SMEs) for year of assessment 2016. We believe the 2017 Budget will likely pre-announce further reduction in CIT for 2018, where revenue collection from GST becomes more consistent, as a move to cut the corporate tax rate will help to revive the country's competitiveness for the real sectors and exports, and enhance Malaysia's competitiveness as a location for investors. This will help to stimulate Malaysia's FDI inflows and private investment against regional competition. We also believe Government will provide further incentives (i.e. possible financial assistance) to encourage SMEs to undertake export promotion to penetrate new markets in view of the bilateral and free trade agreements.

Other measures in Budget 2017 focuses on first time homebuyers

To assist first time homebuyers in low cost houses, Second Finance Minister Datuk Johari Abdul Ghani was quoted in the press saying that a proposal to increase allocation of Employees Provident Fund (EPF) in Account Two from 30% of savings to 40% is understudy, where EPF contributors may withdraw for low-cost housing purchases. Similarly, we believe banks may also be encouraged to introduce some form of mortgage loan packages for first-time homebuyers to make purchase of low-cost affordable homes.

Allocation for development expenditure will likely be sustained

While the government may be cutting back allocations on operating expenditures, net development expenditure is projected to remain substantial at RM45bn in 2017, the same allocation as in 2016, to provide an expansionary stimulus to the economy. The government will allocate higher development expenditure for better social services (such as improving health and educational facilities and creating ample supply of affordable low cost housing), as well as higher allocation for sports.

Government's budget deficit will improve to 3% of GDP in 2017

Based on our own estimate, the Federal Government will likely incur a smaller budget deficit of 3% of GDP in 2017, compared with a deficit of 3.1% of GDP in 2016. However, there is downside risk in the event that the external environment deteriorates sharply. The Government is likely to project the country's real GDP growth will average around 4.0-4.5% for 2017, against our expectation of 4.4%. The International Monetary Fund (IMF) recently maintained its world real GDP forecast at 3.4% for 2017 (3.1% in 2016). We believe private consumption and investment will both remain supportive of growth for the domestic economy, supported by favourable labour market and steady income growth, which will support government's revenue generating from GST and direct taxation.

Appendix tables

Appendix table 1: Federal government finance (Affin Hwang's own estimates)

		2013	2014	2015	2016R	2017F*
Total revenue	RMbn	213.4	220.6	219.1	217.9	219.0
Operating expenditure	RMbn	211.3	219.6	217.0	211.2	213.5
Operating balance	RMbn	2.1	1.0	2.1	6.7	5.5
Gross development expenditure	RMbn	42.2	39.5	40.8	46.0	46.0
Loan recoveries	RMbn	1.5	1.1	1.5	0.8	1.0
Net development expenditure	RMbn	40.7	38.5	39.3	45.2	45.0
Fiscal balance	RMbn	-38.6	-37.4	-37.2	-38.5	-39.5
Fiscal balance	% of GDP	-3.8	-3.4	-3.2	-3.1	-3.0

Source: MOF, CEIC **Affin Hwang forecasts; 2016R based on oil price of US$35 per barrel*

Appendix table 2: Government finance comparison (1H15 vs 1H16)

	1Q15	2Q15	1H15		Budget 2015*	1Q16	2Q16	1H16		Budget 2016*
	RM bn	RM bn	RM bn	% of target	RM bn	RM bn	RM bn	RM bn	% of target	RM bn
Revenue	51.5	55.3	106.8	47.9	222.9	48.8	47.5	96.3	44.2	217.9
OPEX	55.4	51.8	107.3	50.5	212.4	57.4	52.1	109.5	51.8	211.2
operating balance	-3.9	3.4	-0.5	-	10.5	-8.6	-4.6	-13.2	-	6.7
DE (net)	7.9	7.3	15.1	31.9	47.5	9.2	10.4	19.6	43.3	45.2
Fiscal balance	-11.8	-3.8	-15.6	42.2	-37.0	-17.7	-15.0	-32.8	85.1	-38.5
% of GDP	-4.2	-1.4	-2.8	-	-3.2	-6.1	-5.0	-5.6	-	-3.1

Source: BNM, CEIC **revised budget based on oil price of US$35 per barrel*

Appendix table 3: Malaysia's personal income tax (PIT) and corporate income tax (CIT)

	YA2015			YA2016		
Chargeable income (RM)	PIT for individuals	CIT for SMEs*	CIT for large enterprises	PIT for individuals	CIT for SMEs*	CIT for large enterprises
0 - 5,000	0.0	20.0	25.0	0.0	19.0	24.0
5,001 - 20,000	1.0	20.0	25.0	1.0	19.0	24.0
20,001 - 35,000	5.0	20.0	25.0	5.0	19.0	24.0
35,001 - 50,000	10.0	20.0	25.0	10.0	19.0	24.0
50,0001 - 70,000	16.0	20.0	25.0	16.0	19.0	24.0
70,001 - 100,000	21.0	20.0	25.0	21.0	19.0	24.0
100,001 - 250,000	24.0	20.0	25.0	24.0	19.0	24.0
250,001 - 400,000	24.5	20.0	25.0	24.5	19.0	24.0
400,001 - 500,000	25.0	20.0	25.0	25.0	19.0	24.0
500,001 - 600,000	25.0	25.0	25.0	25.0	24.0	24.0
600,001 - 1,000,000	25.0	25.0	25.0	26.0	24.0	24.0
Exceeding 1,000,000	25.0	25.0	25.0	28.0	24.0	24.0

Source: Inland Revenue Board (IRB)
Note that highlighted in red shows that CIT is lower than PIT
**Company with paid-up capital not more than RM2.5m*

Appendix table 4: Revenue enhancement and opex rationalization measures

Revenue enhancement measures:

- Higher levy on foreign workers (effective 18th March 2016)
- Reform of sin taxes
- Increase in passenger service charge (PSC) rates
- Spectrum fee

Operating expenditure rationalization measures:

- Removal of fuel subsidy, implementation of managed loating mechanism (Effective 1st December 2014)
  Petrol prices have remained low in tandem with falling crude oil prices. The retail price for RON95 ranges between RM1.60 - RM2.26/litre since December 2015, compared to the controlled price of RM2.30/litre in October 2015.
- Rationalisation of wheat flour, rice, cooking oil, electricity subsidy
- Revision to toll rate and public transport fare
- No more health subsidy for foreign workers (effective 1st January 2016)
  Under the Fees (Medical) (Amendment) Order 2014, a new fee structure for foreign workers will be implemented in stages over a period of four years. In the first year, effective 1st January 2014, those seeking treatment will have to foot 30% of the itemised billing, second year 50%, third year 70%, and fourth year the entire cost. Nevertheless, given the challenging economic conditions, the subsidy removal was brought forward.

Source: various

Appendix table 5: Subsidy rationalisation progress

Area	2010 plan from PEMANDU	Progress till 2016 YTD
Fuel	Fuel prices will be increased gradually Petrol +15 sen/litre Diesel +10 sen/litre LPG +10% To streamline supersubsidy scheme +RM0.17-RM0.40 to RM1.60/litre Thereafter, +10 sen/litre every 6 months for fuel & +20% every year for LPG Government will save RM44.9bn in 5 years	The subsidy of petrol and diesels were removed in 2014 LPG price kept at RM26.60 for 14kg cylinder, excluding transportation cost. Government subsidy of LPG at RM20.86 for 14kg gas cylinders Supersubsidy scheme remains
Utility	Electricity tariffs will be increased Gas price (power) +RM4.65/MMBtu Gas price (non-power) +RM2.52/MMBtu Electricity tariffs +RM0.024/kWh Thereafter, gas price (power + non power) +RM3.00/MMBtu & electricity tariff +RM0.016/kWh every 6 months Government will save RM35.9bn in 5 years	Cut in electricity tariff rebate from RM2.25/kWh to RM1.52/kWh (Jan-June 2016), except Sabah & Sarawak But domestic consumers with a consumption of 300kWh of electricity or less per month will be excluded Rebate for electricity bill of RM20 and below would be given to domestic users *Effective Jan.2016, the gas tariff was based on incentives-based regulation (IBR) In June, gas tariff for non-power sector revised upward from RM25.53/MMBtu (5.9%) to RM27.05/MMBtu
Toll	Toll rates will be increased as per concession agreement Applicable only for toll highways which have alternative routes… Government will save RM3.7bn in 5 years Discount for toll users - 20% discount upon next reload (for more than 80 transactions per month). This will cost Government RM60m per year	Toll rate hike in 2015
Essential items	Price of sugar, flour and cooking oil will be increased Sugar +20 sen/kg (every 6 months until 2012) Flour +20 sen/kg (2010), +25sen/kg (2011) Cooking oil (1kg) +15% (2010), +15% (2011), thereafter 5% every year until Jan 2014 Government will save RM8.5bn over 5 years	The subsidy for sugar was removed in October 2013 Cooking oil stabilisation scheme is discontinued in 2016 Wheat flour subsidy of RM8.25 for 25kg-bag is removed in March 2016 Subsidy for Super Tempatan Rice (ST15) was abolished in November 2015

Source: PEMANDU, various media

Appendix table 6: Malaysia's GDP growth projection

	%yoy				% points to GDP growth			
	2014	2015	2016F	2017F	2014	2015	2016F	2017F
GDP by Expenditure Components								
Total Consumption	6.4	5.6	4.9	4.8	4.2	3.7	3.2	3.2
Private consumption expenditure	7.0	6.0	5.5	5.4	3.6	3.1	2.9	2.9
Public consumption expenditure	4.4	4.3	2.5	2.5	0.6	0.6	0.3	0.3
Total Investment	4.8	3.7	2.3	3.7	1.3	1.0	0.6	0.9
Private investment expenditure	11.0	6.4	3.0	4.0	1.8	1.1	0.5	0.7
Public investment expenditure	-4.7	-1.0	1.0	3.0	-0.5	-0.1	0.1	0.3
Domestic Demand	5.9	5.1	4.2	4.5	5.4	4.7	3.8	4.1
Net exports	12.8	-3.7	4.5	3.2	1.1	-0.3	0.4	0.3
Exports	5.1	0.7	2.0	2.5	3.9	0.5	1.5	1.8
Imports	4.2	1.3	1.7	2.4	2.8	0.8	1.1	1.5
Changes in inventories	170.6	-76.0	-3.3	0.0	-0.6	0.6	0.0	0.0
GDP (2010 real prices)	**6.0**	**5.0**	**4.2**	**4.4**	**6.0**	**5.0**	**4.2**	**4.4**
GDP By Kind of Economic Activity								
Agriculture, Forestry and Fishing	2.1	1.0	-0.3	1.0	0.2	0.1	0.0	0.1
Mining and Quarrying	3.3	4.7	2.0	2.5	0.3	0.4	0.2	0.2
Manufacturing	6.2	4.9	4.5	4.6	1.4	1.1	1.0	1.1
Construction	11.8	8.2	6.3	6.5	0.5	0.3	0.3	0.3
Services	6.5	5.1	5.0	5.1	3.5	2.8	2.7	2.7
Import duties	10.0	18.6	1.4	0.0	0.1	0.2	0.0	0.0
GDP (2010 real prices)	**6.0**	**5.0**	**4.2**	**4.4**	**6.0**	**5.0**	**4.2**	**4.4**

Source: BNM, CEIC, Affin Hwang estimates

Appendix table 7: Tax relief for individual taxpayers

	RM, unless stated otherwise	YA2012	YA2013	YA2014	YA2015	YA2016
1	Self and dependent	9,000	9,000	9,000	9,000	9,000
2	Tax relief for parental care (medical expenses)	5,000	5,000	5,000	5,000	5,000
3	Basic supporting equipment	5,000	5,000	5,000	6,000	6,000
4	Disabled individual	6,000	6,000	6,000	6,000	6,000
5	Education fees (individual)	5,000	5,000	5,000	5,000	7,000
6	Medical expenses for serious diseases	5,000	5,000	5,000	6,000	6,000
7	Complete medical examination	500	500	500	500	500
8	Purchase of books, journals, magazines and publications	1,000	1,000	1,000	1,000	1,000
9	Purchase of personal computer (once in every 3 years)	3,000	3,000	3,000	3,000	3,000
10	Net saving in SSPN's scheme (with effect from year assessment 2012 until year assessment 2017)	6,000	6,000	6,000	6,000	6,000
11	Purchase of sport equipment for sport activities	300	300	300	300	300
12	Subscription fees for broadband registered in the name of the individual (with effect from year of assessment 2010 - 2012)	500	-	-	-	
13	Interest expended to finance purchase of residential property. Relief of up to RM10,000 a year for three consecutive years from the first year the interest is paid.*	10,000	10,000	10,000	10,000	10,000
14	Husband/Wife/Alimony Payments	3,000	3,000	3,000	3,000	4,000
15	Disabled Wife/Husband	3,500	3,500	3,500	3,500	3,500
16	Ordinary Child relief (below 18 years of age)	1,000	1,000	1,000	1,000	2,000
17	Each unmarried child of 18 years and above who is receiving full-time education ("A-Level", certificate, matriculation or preparatory courses).	1,000	1,000	1,000	1,000	1,000
18	Each unmarried child studying at tertiary level	4,000	6,000	6,000	6,000	8,000
19	Disabled child	5,000	5,000	5,000	6,000	6,000
20	Disabled child aged 18 years old and above, not married and pursuing diplomas or above qualification in Malaysia @ bachelor degree or above outside Malaysia in program and in Higher Education Institute that is accredited by related Government authorities	4,000	6,000	6,000	6,000	8,000
21	Life insurance and EPF	6,000	6,000	6,000	6,000	6,000
22	Premium on new annuity scheme or additional premium paid on existing annuity scheme commencing payment from 01/01/2010 (amount exceeding RM1,000 can be claimed together with life insurance premium) - deleted from year assessment 2012 until year assessment 2021	1,000	1,000	1,000	1,000	1,000
23	Deferred Annuity and Private Retirement Scheme (PRS) - with effect from year assessment 2012 until year assessment 2021	3,000	3,000	3,000	3,000	3,000
24	Insurance premium for education or medical benefit	3,000	3,000	3,000	3,000	3,000
25	Tax relief on employees' contribution to social security protection scheme	-	-	-	-	250

Source: Inland Revenue Board (IRB)

Appendix 8: Major construction projects awarded year to date

Projects	RM million
Klang Valley Mass Rapid Transit Line 2 (Sg Buloh-Serdang-Putrajaya Line)	23,872
Pan-Borneo Highway, Sarawak	8,723
Sungai Besi-Ulu Kelang Expressway (SUKE)	4,636
Damansara-Shah Alam Highway (DASH)	3,252
Other projects	10,014
Total	50,497

Source: Various & Affin Hwang estimates

Focus charts

Chart 1: Composition of Government's revenue

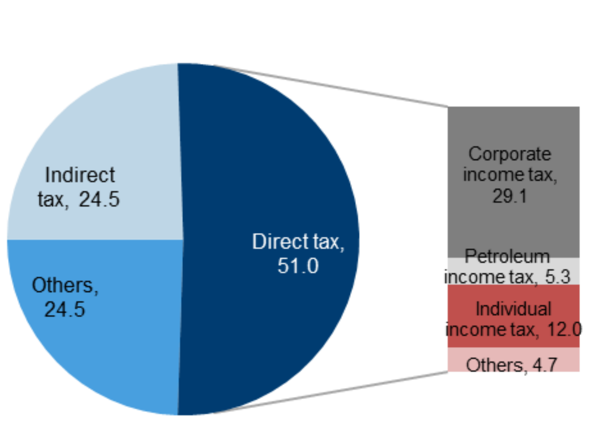


Chart 2: Oil-related revenue

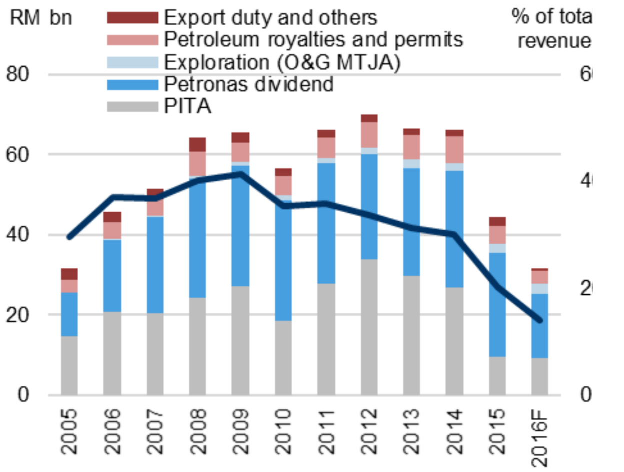


Chart 3: Quarterly government revenue

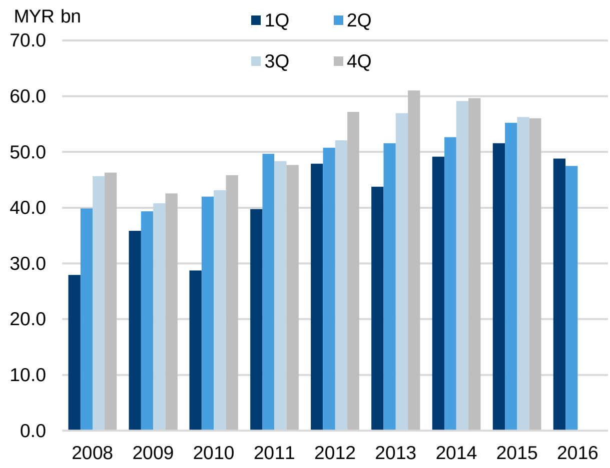


Chart 4: Components under direct tax revenue

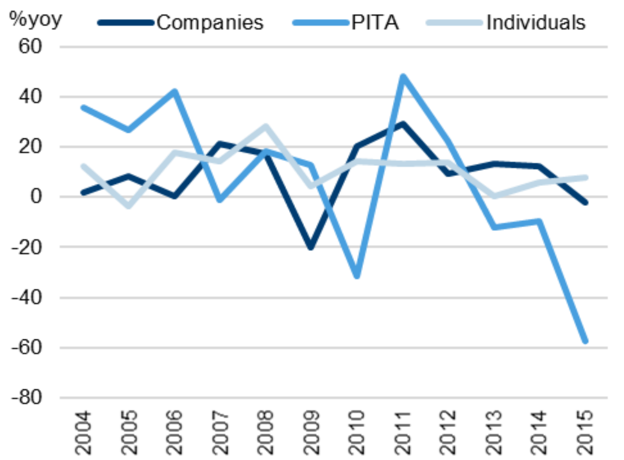


Chart 5: Asean corporate income tax comparison

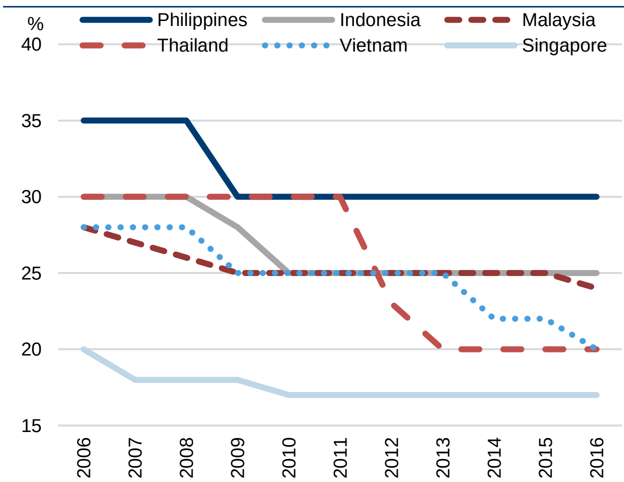
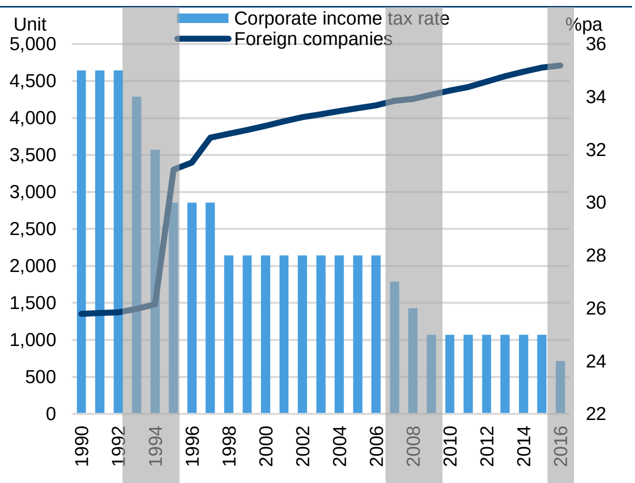


Chart 6: Malaysia's corporate income tax (CIT)



**Affin Hwang estimates*
Source: All data for charts sourced from CEIC and Bloomberg

Focus charts

Chart 7: WEF Global Competitiveness Index

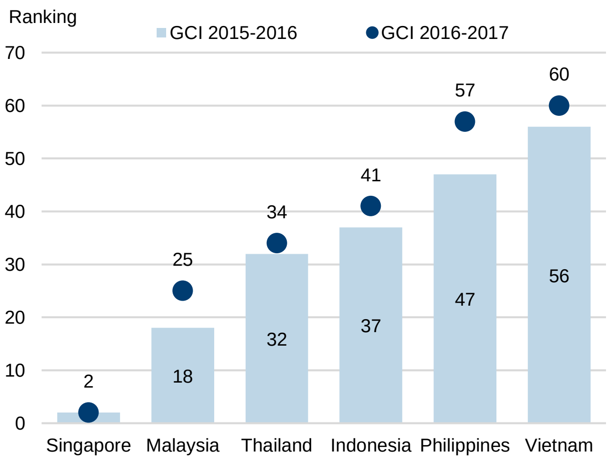


Chart 8: Asean GDP growth comparison

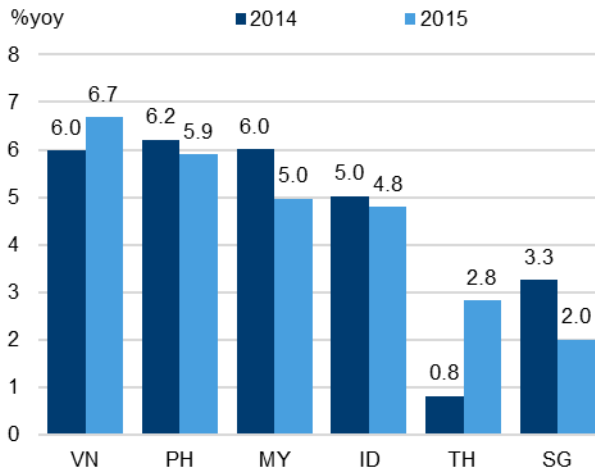


Chart 9: OPEX breakdown

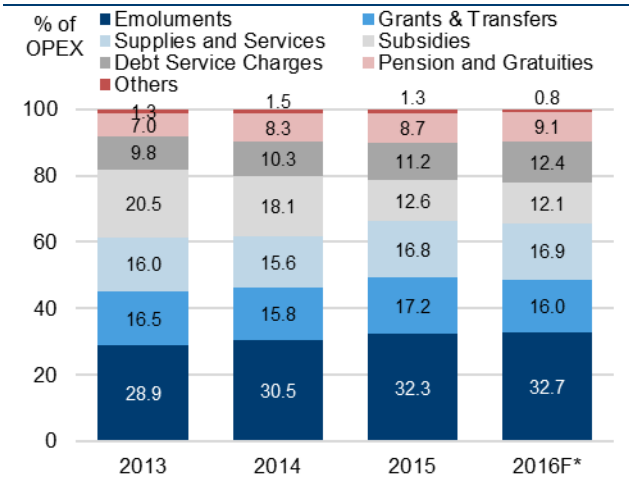


Chart 10: Growth on OPEX

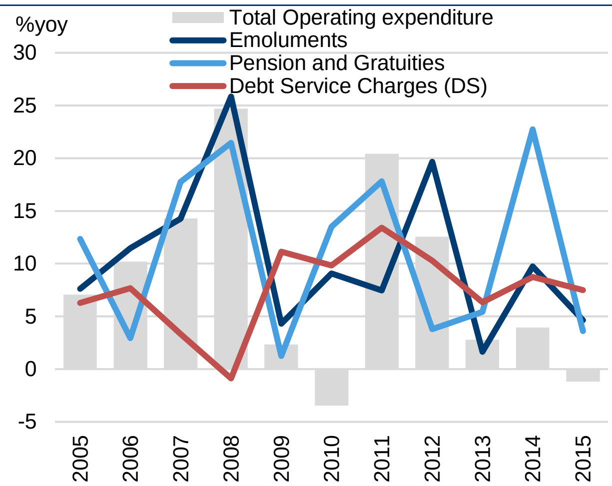


Chart 11: Revenue source of statutory bodies

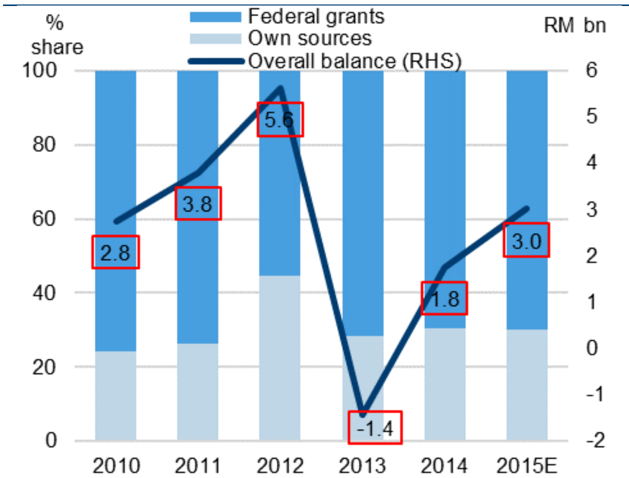
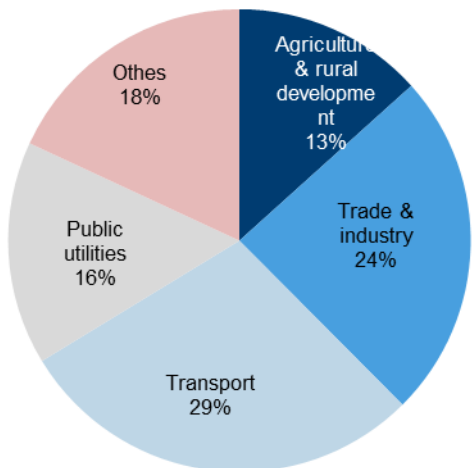


Chart 12: Breakdown of DE on economic services



*Affin Hwang estimates
Source: All data for charts sourced from CEIC and Bloomberg

Equity Rating Structure and Definitions

BUY	Total return is expected to exceed +10% over a 12-month period
HOLD	Total return is expected to be between -5% and +10% over a 12-month period
SELL	Total return is expected to be below -5% over a 12-month period
NOT RATED	Affin Hwang Investment Bank Berhad does not provide research coverage or rating for this company. Report is intended as information only and not as a recommendation

The total expected return is defined as the percentage upside/downside to our target price plus the net dividend yield over the next 12 months.

OVERWEIGHT	Industry, as defined by the analyst's coverage universe, is expected to outperform the KLCI benchmark over the next 12 months
NEUTRAL	Industry, as defined by the analyst's coverage universe, is expected to perform inline with the KLCI benchmark over the next 12 months
UNDERWEIGHT	Industry, as defined by the analyst's coverage universe is expected to under-perform the KLCI benchmark over the next 12 months

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3rd Floor, Chulan Tower,
No 3, Jalan Conlay,
50450 Kuala Lumpur.
www.affinhwang.com
Email : research@affinhwang.com
Tel : + 603 2143 8668
Fax : + 603 2145 3005