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Global Markets Research

Research Alert

Continuous moves towards fiscal reform

Odds of reintroduction of GST and RON95 fuel subsidy reform remain in the spotlight

GST will likely be less inflationary and has a greater positive impact on fiscal deficit

Temporary impact on consumption and growth; should normalize two quarters later

Preamble

Recently, there have been some chatters that the Government is discussing the possibility of reintroducing GST in place of the subsidy rationalisation on RON95 for Malaysia. Although this was subsequently denied by the Minister of Communication, Fahmi Fadzil, we thought it would be interesting to do a comparison on the impact between the two on government coffers, prices as well as consumption and growth. Just a recap, GST was first implemented back on 1 April 2015 at 6% and was subsequently reduced to 0% on 1 June 2018, while retail prices of RON95 has been fixed at RM2.05/ liter since March 2021.

The case for fiscal reform

Be it RON95 subsidy rationalisation or a reinstatement of GST implementation, we believe fiscal reform is still necessary and highly relevant for the Government to take stock of its fiscal vulnerabilities especially over the medium to longer term. These fiscal vulnerabilities include (1) inefficient allocation of government expenditure, especially in subsidies. Subsidies and social assistance account for approximately 25% of operating expenditure and 19% of total expenditure in 2023. (2) narrow revenue base which was and is still highly reliant on its oil-related revenue and direct taxes. Oil-related revenue and direct taxes accounted for 23% and 55% of total government revenue, which is susceptible to fluctuation in oil prices and economic growth. Understandably, Malaysia's Public Finance and Fiscal Responsibility Act 2023 is targeting a a cap on fiscal deficit at 3.0% of GDP by 2026.

To address these issues, the Government has started to strengthen expenditure control through introduction of subsidy roll back on various food items, diesel in Peninsular Malaysia and utilities, and has been exploring the implementation of an efficient and broad-based revenue options including but not limited to the like of GST. It is expected that GST would also increase tax compliance and redistribute the government tax burden proportionately to the ability to spend. To put things into perspective, less than 20% of the working population is paying taxes while private consumption accounts for about 60% of Malaysia's GDP.

Impact on CPI, government finances and GDP growth

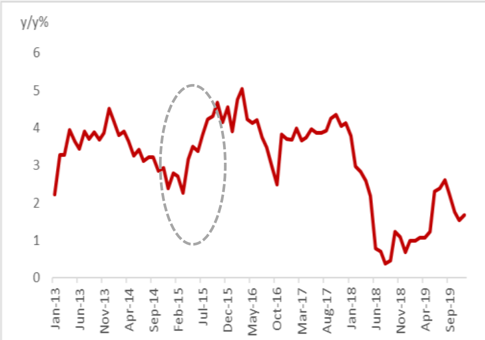
	GST	Free-floating of RON95
Impact on CPI (month of implementation) - ppt	+0.9	+2.6
Impact on Government finances (RMbn/month)	+3.0	+1.9*
Impact on Budget deficit (% of GDP)	+1.8	+1.2*

**Based on 2022 subsidy data and assuming total removal of subsidy for RON95. Impact is approximately half if subsidy is only removed for the T20.*

Source: HLBB Global Markets Research

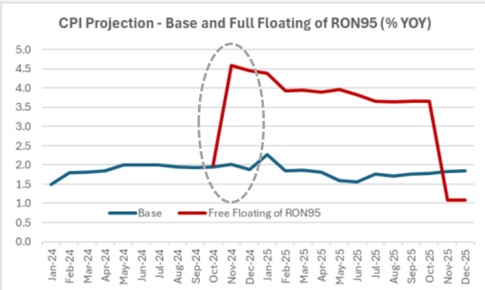
- **The inflationary impact from GST is expected to be less severe.** The switch from SST (5-10%) to GST (6%) on 1 April 2015 raised inflation by 0.9ppts during the month of implementation in 2015. Using this as a gauge and assuming similar

Figure 1: GST added 0.9ppts to inflation in the month it was implemented in April 2015



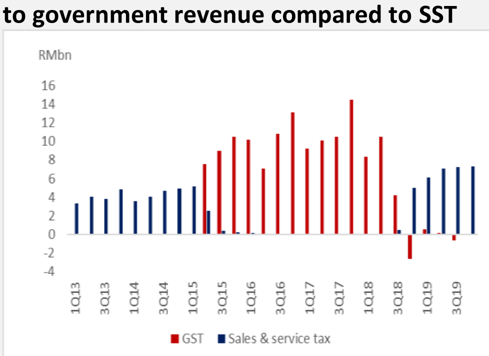
Source: DOSM, HLBB Global Markets Research

Figure 2: Full-floating of RON95 to market price is expected to lead to a 2.6ppt jump in CPI



Source: DOSM, HLBB Global Markets Research

Figure 3: GST offered a bigger contribution to government revenue compared to SST



Source: MOF, HLBB Global Markets Research structure and the same GST rate of 6.0%, ***GST appears to be the lesser of the evil as compared to a 2.6ppts points increase expected in CPI, if the government were to fully float RON95***. The impact from the subsidy removal for diesel in Peninsular Malaysia has been minimal so far, with CPI holding steady at 2.0% y/y in June and July after the rollout which took effect on 10-Jun-2024.

- In terms of public finance, **GST collection is expected to have a bigger positive effect on the government fiscal position compared to the savings generated from subsidy retargeting for RON95.** When GST was first implemented back in 2015, government revenue increased from RM17.2b in 2014 during the SST era to RM27.0bn in 2015 (9 months) and further to RM41.2bn in 2016. On a quarterly basis, GST contribution to government revenue averaged RM10.0bn per quarter from 2Q15 to 2Q18, compared to SST's RM7.5bn per quarter for the period 3Q18 to 2Q24.

- Assuming the same GST rate of 6.0% and current consumption level, GST collection could have reached approximately RM72.3bn, potentially providing the government an additional RM36.5bn in revenue (~RM3.0bn a month) over and above the projected SST collection of RM35.8bn for 2024. This is more than 50% higher compared to a total RM23.1bn or RM1.9bn a month (based on 2022 data) in estimated savings in government spending should the government totally remove the subsidies for RON95, ceteris paribus. The savings will be approximately half of it should the subsidy removal only apply to the T20.

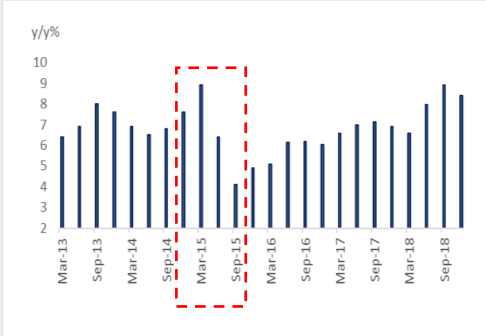
- In terms of growth, ***a temporary pullback in growth appeared inevitable*** immediately after the rollout of these reforms, be it tax or subsidy, as consumers tend to bring forward retail purchases especially on durable goods before the implementation and this behaviour usually creates bumps two quarters before and after the implementation date. Malaysia's private consumption spiked from an average of 7.0% y/y in 2013-2014 to 8.9% y/y in 1Q of 2015, grew by 6.4% y/y in 2Q and slowed to below 5.0% y/y for the period 3Q of 2015-1Q of 2016 (Figure 4). On an annual basis, consumption growth average lower at 6.0% y/y in 2015-2016 before normalizing to 6.9% y/y in 2017 and 8.0% y/y in 2018.

- Historical track record from Australia, Singapore, and New Zealand showed that the speed of recovery as well as depth of the dip will largely be attributed to the different stages of economic cycle when GST was introduced, GST rate and mix of taxes it replaced as well as compensation packages to accompany the GST, ceteris paribus. In this context, ***while q/q fluctuation is inevitable, a suitable timing for implementation could mitigate the impact on annual GDP***.

Budget 2025 to focus on fiscal reforms; inflation control and cost of living solutions

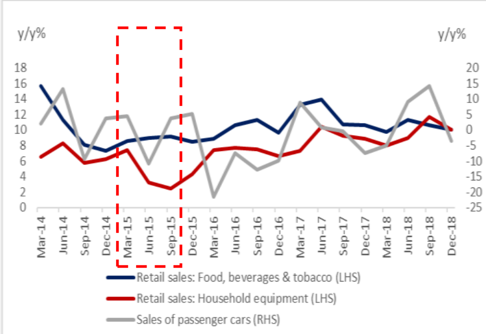
Budget 2025 is set to be tabled in Parliament on October 18th and will prioritise advancing fiscal reforms in line with medium term goals under the Public Finance and Fiscal Responsibility Act 2023 to reduce deficits and manage debt sustainability. In addition, according to the Prime Minister, the upcoming Budget will also focus on strategies to manage inflation and address the rising cost of living. In this regard, we believe the government will continue strike a fine balance between fiscal reduction and ensuring the wellbeing of the rakyat and longer-term growth prospects, be it the reinstatement of GST, rollout of RON95 subsidy retargeting, or any other forms of tax reforms and expenditure rationalization.

Figure 4: Frontloaded spending pre-GST followed by temporary pullback in private consumption growth post GST



Source: DOSM, HLBB Global Markets Research

Figure 5: Impact more pronounced for durable and big-ticket items rather than small ticket and perishable goods



Source: BNM, CEIC, HLBB Global Markets Research

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