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Budget 2025 Preview: High Stakes

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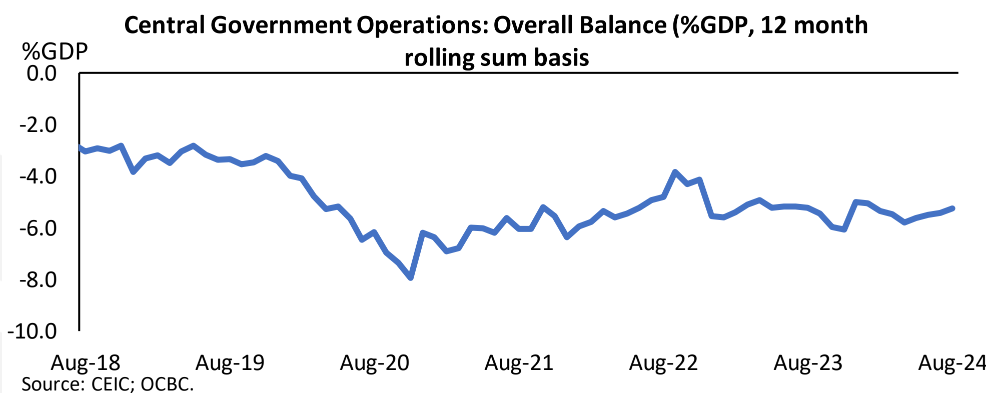
- Expectations are running high for Budget 2025, to be announced on 18 October. We expect the government to meet its fiscal deficit target of 4.3% of GDP in 2024 and target a narrower deficit of 3.5-3.8% of GDP in 2025.
- There are some ways for the government to achieve this fiscal consolidation but the elephant in room remains whether it will raise the GST rate from 0% currently and/or rationalise retail fuel prices.
- Concomitantly, monetary policy implications will depend on the nature of the fiscal announcements. Our baseline is for Bank Negara Malaysia (BNM) to keep its policy rate unchanged at 3.00% for the rest of 2024 and 2025.

"Budget 2025 will be a continuation towards realising the Ekonomi MADANI's vision." – *Pre-budget statement 2025*

The stakes are high ahead of the 18 October Budget 2025 announcement, as there is a need to balance the fiscal consolidation agenda with growth, development and social objectives. The message from the government was clear in its 2025 pre-budget statement. It will remain committed to boosting economic competitiveness, raising the standard of living while maintaining fiscal discipline.

Current state of fiscal play

The fiscal deficit stood at MYR55.2bn, as of end-August 2024, versus an annual 2024 budget deficit target of MYR85.4bn. On a 12-month rolling sum basis, we estimate that the fiscal deficit stood at 5.2% of GDP as of August 2024, compared to the full year budget deficit target of 4.3% of GDP.



Source: CEIC; OCBC.

The fiscal deficit run rate at the half year mark (i.e., 1H24) suggested that an overshot of the annual 2024 fiscal deficit target could not be ruled out. Revenue

growth fell to -6.3% YoY in 1H24 after rising by 7.0% in 2023 mainly from lower direct tax revenues. Petroleum, corporate and personal income taxes dropped significantly in 1H24 versus 2023, reflecting weaker commodity prices. Indirect tax revenue collections, however, held up supported by export and import duties as well as sales and services tax collections.

Summary of budget position

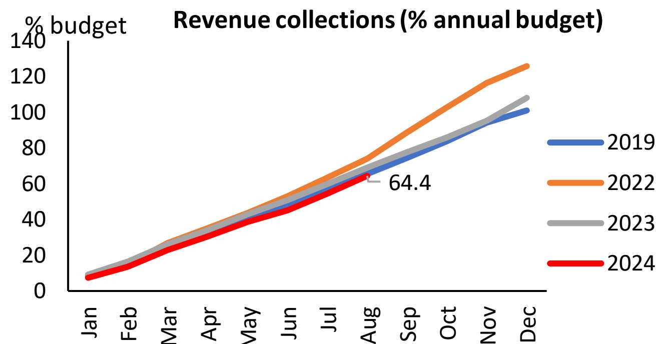
MYRbn	**2021**	**2022**	**2023**	**2024**	**1H24**	
	Actual	**Actual**	**Actual**	**Budget Estimates**	**Actual**	**%YoY**
Central Govt Revenue	**233.8**	**294.4**	**315.0**	**307.6**	**139.1**	**-6.3**
Tax Revenues	173.7	208.8	229.2	243.6	105.9	-7.8
Direct Taxes	130.1	153.5	171.3	185.0	74.5	-14.4
Indirect Tax	43.6	55.3	57.8	58.6	31.4	12.9
Non-Tax Revenues	51.1	79.6	79.0	64.0	33.2	-1.0
Central Govt Expenditures	**332.5**	**393.8**	**406.4**	**393.0**	**190.6**	**1.3**
Central Govt Current Expenditure	231.5	292.7	311.3	303.8	157.1	9.2
Emoluments	85.9	87.8	91.9	95.6	48.9	6.1
Pension and Gratuities	29.1	31.4	34.1	32.4	19.1	7.7
Debt Service Charges (DS)	38.1	41.3	46.3	49.8	24.4	9.9
Supplies and Services	24.9	34.7	35.9	38.0	15.4	11.2
Subsidies & Social Assistance	23.0	67.4	77.9	52.8	29.1	-16.6
Net Development Expenditure	63.3	70.2	95.1	89.2	33.5	-24.4
Gross Development Expenditure	64.3	71.6	96.1	90.0	33.9	-24.2
Loan Recoveries	1.0	1.4	1.0	0.8	0.4	2.4
Fiscal balance	**-98.8**	**-99.5**	**-91.4**	**-85.4**		
% GDP	**-6.4**	**-5.5**	**-5.0**	**-4.3**		

Source: CEIC; OCBC.

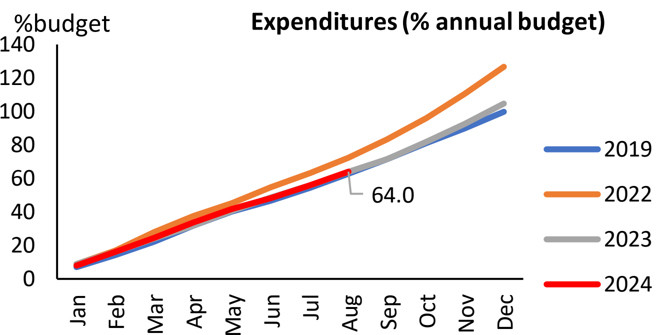
On the expenditure front, central government expenditure growth slowed to 1.3% YoY in 1H24 versus 3.2% in 2023. This was driven by a drop of 24.4% YoY in net development expenditures while operating expenditures were up by 9.2% YoY in 1H24. Emoluments, 'supplies & services' expenditures were the biggest drivers of operating expenditures. These more than offset the sharp drop in 'subsidies & social assistance' spending (-16.6% YoY versus 15.6% in 2023).

The fiscal trajectory, however, changed in July and August. Revenue collections were up by an average of 11.5% YoY in the two months while expenditure growth slowed to 3.9%, supported in part by diesel subsidy rationalisation[1]. Revenues and expenditures hit 64.4% and 64% of their respective annual budgets. As a result, the fiscal run rate slowed, and the 2024 fiscal deficit target now looks achievable.

[1] Retail diesel prices were raised by more than 50%, effective 10 June 2024. The government estimates that annual fiscal savings will be MYR4bn.



Source: CEIC;OCBC

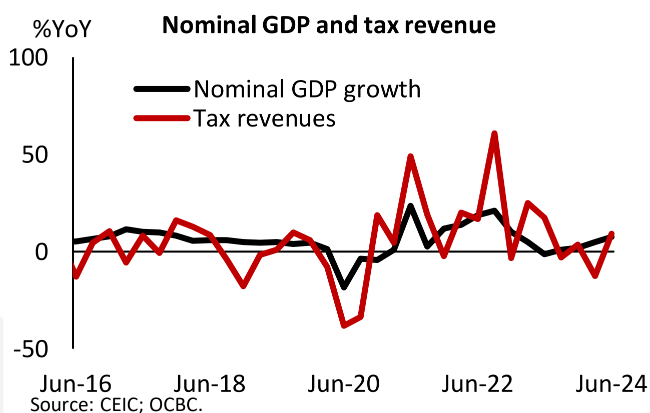


Source: CEIC; OCBC

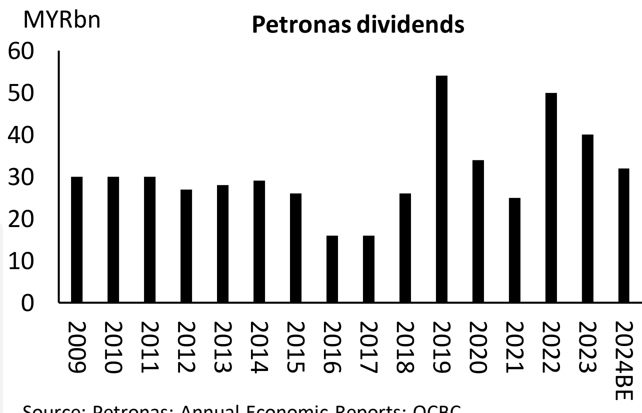
Shifting focus to Budget 2025

Looking beyond, the Medium-Term Fiscal Framework (MTFF) pegs the fiscal deficit at an average of 3.5% of GDP for 2024-26. This suggests that the fiscal deficit will need to be below 3% of GDP by 2026 and for 2025, we estimate that the fiscal deficit target will need to narrow to within the range of 3.5-3.8% of GDP.

On the revenues front, our analysis suggests that tax revenue collections, driven by changes in nominal GDP growth, Brent oil prices and non-revenue tax collections (with a two-quarter lag)[2], will grow by 6.0-6.5% YoY in 2025. This is based on our forecasts for growth in these factors to remain stable to modestly lower in 2025. Specifically, our house view is for Brent prices to average USD79/barrel in 2025 versus USD82/barrel in 2024 while we expect nominal GDP growth to be stable at 6.5% YoY (2024: 6.6%). In terms of non-tax revenues, Petronas dividends, which is usually quite significant, have come down since 2022. While higher dividend payments in 2024 (budgeted: MYR32bn) cannot be ruled out, we expect the budgeted dividend payments to be reduced over the medium-term.



Source: CEIC; OCBC.

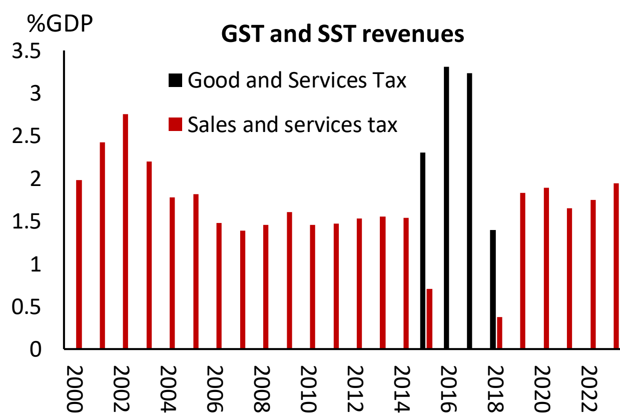


Source: Petronas; Annual Economic Reports; OCBC

[2] Our multivariate regression analysis using quarterly data from 1Q16 until 2Q24 explained 64% of the variations in tax revenue collections, with the three coefficients on nominal GDP, Brent prices, non-tax revenues (2-quarter lag) are significant at a 1% level of significance. The model passes the standard diagnostic tests of linear collinearity and heteroskedasticity.

This tax revenue growth, however, may not be adequate to ensure that fiscal consolidation is achieved in line with the MTFF. Tax revenue growth of 8-9% would make for a more comfortable consolidation path. Past budgets have already paved the way for some crucial tax changes in 2025 including widening e-invoicing to a broader tax base[3] and introducing a minimum global tax rate of 15%. There are also some potential new tax measures which could be considered in Budget 2025 including the high value goods tax, which was due for implementation on 1 May 2024 but was subsequently postponed, and a carbon tax to prepare for the implementation of EUDR on 30 December 2024. Recent statements from the Finance Ministry, however, suggest that a carbon tax may not be on the cards for Budget 2025[4].

Notwithstanding, the elephant in the room remains whether the Goods and Services Tax (GST) rate will be raised from the current 0%, replacing the separate sales and services tax (SST). Reports regarding this have been mixed. GST was implemented at 6%, effective 1 April 2015 but was reduced to 0% from 1 June 2018 and replaced with SST. The share of revenues from GST rose to ~20% of the total revenues in 2016-17, accounting for 3.3% of GDP. This was higher than SST, which accounted for a ~9% share of total revenues and 1.8% of GDP from 2000-14. While the authorities appreciate GST as a broad-based consumption, questions remain on the rate of re-introduction, the nature of exemptions etc.



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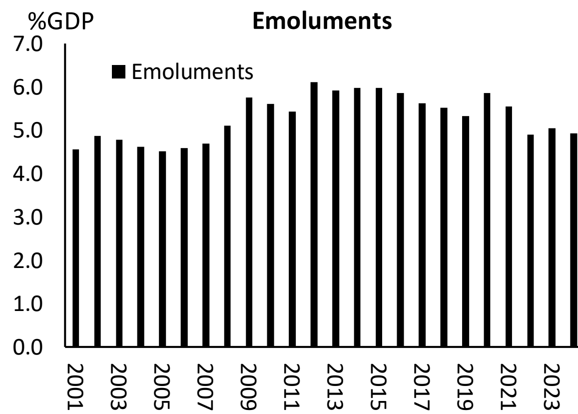


Source: CEIC; OCBC.

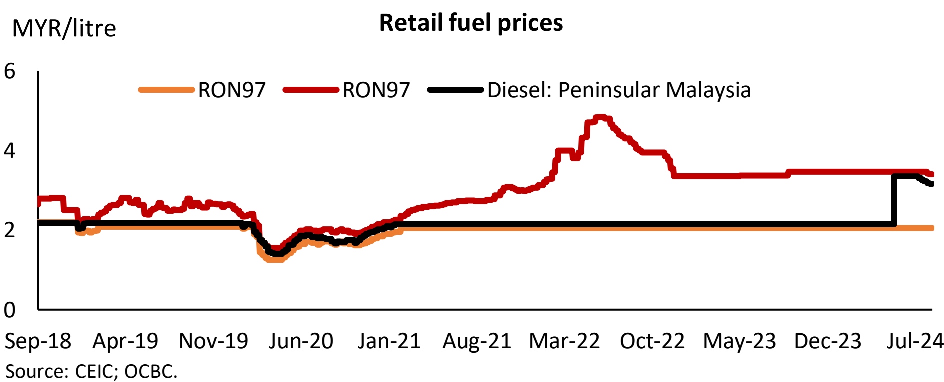
On the expenditures front, emolument expenditures are set to rise in 2025 given the civil servants salary increases. This increase will be implemented in two phases; the first phase will come into effect on 1 December 2024 and second phase on 1

[3] E-invoicing applies to all taxpayers undertaking commercial activities in Malaysia. In August 2024, it was mandated for taxpayers with an annual turnover/revenue of MYR100mn. In January 2025, it will be to taxpayers with revenues/turnover of above MYR25mn upto MYR100 and by 1 July 2025 to all taxpayers.

[4] Zafrul: Govt has no plans to introduce carbon tax in Budget 2025, The Edge Malaysia, 19 August 2024.

January 2026. It is expected to cost more than MYR10bn (0.5% of GDP) a year[5], with details forthcoming in Budget 2025.

To offset these higher emolument expenditures, expenditures on other items will need to be rationalised. To that end, RON95 price rationalisation is a clear choice, albeit hurtful to household balance-sheets during the initial adjustment period. RON95 prices have been 40% below RON97[6] on average in 2024, this is broadly similar to the price differential in 2023. The fiscal savings from RON95 price adjustments depends on the magnitude of the retail price adjustment. We estimate that the fiscal savings could be anywhere between 0.2% of GDP to 1.4% of GDP, for a 10% price adjustment to a complete removal of fuel subsidies[7], respectively.



Source: CEIC; OCBC.

Other avenues of expenditure rationalisation include reducing development spending. This is not likely to impact ongoing larger infrastructure projects but could lead to modifications in the way newer projects are financed. The strengthening of the public-private partnership (PPP) masterplan, as referred to in the pre-budget statement, could be one way for the authorities to focus on public infrastructure development in 2025.

Budget 2025 is also expected to focus on initiatives and schemes to boost competitiveness and attract foreign investments. To that end, announcements regarding the Johor-Singapore Special Economic Zone (JS-SEZ) will be watched closely, ahead of official announcements from both government's expected towards the end of this year. Schemes to bolster further digitalisation, particularly for Small and Medium Enterprises could also be announced along with incentives to support ESG priorities.

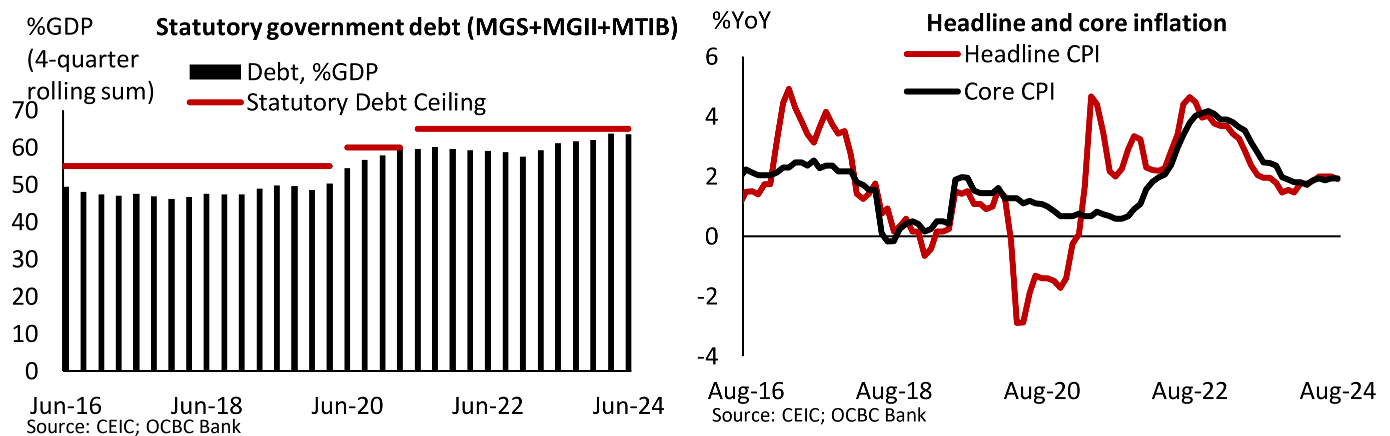
Public debt levels to remain manageable

[5] Malaysia PM says to increase pay for govt workers from December, Reuters, 16 August 2024.
[6] RON97 prices are determined through a managed float which is more reflective of global oil price changes.
[7] This is broadly consistent with the estimate provided in 2014-15, when RON95 subsidies were removed, and fiscal savings were estimated to be MYR20bn per annum.

In terms of public debt, the statutory debt (MGS, GII and MITB) to GDP ratio stood at 63.5% of GDP as of end-June 2024, by our estimates, below the debt ceiling of 65% of GDP. A reduced net issuance profile in 2024 and 2025 will allow the government's medium-term debt profile to remain manageable.

Monetary policy implications

The announcements in Budget 2025 will have monetary policy implications, particularly if the GST rate is raised and/or RON95 prices are rationalised. With either measure, inflationary pressures are likely to be higher compared to the benign inflation backdrop in 2024 (year-to-August headline and core inflation averaged 1.8% YoY and 1.9% YoY, respectively).



Our base case is for Bank Negara Malaysia (BNM) to keep its policy rate on hold at its 6 November meeting and in 2025. We will, however, closely monitor the inflation outcomes from fiscal changes. We cannot rule out the possibility of BNM raising its policy rate in 2025, particularly if demand-side inflationary pressures become more persistent.

That said, with most global central banks (including the US Federal Reserve) lowering policy rates, BNM maintaining the policy rate at 3.00% would already suggest relatively tighter financial conditions. Further to this, the currency (MYR) gained 14.4% versus USD in 3Q24, outperforming regional peers. Disappointments on the fiscal consolidation trajectory could, however, see some of these gains being reversed.

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