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4 PUBLIC SECTOR FINANCE

Overview

Pro-growth fiscal consolidation

The Government has embarked on the Public Finance Reform Initiative under the Fiscal Transformation Programme to further strengthen the Government's fiscal position. A number of initiatives have been implemented including enhancing tax administration and compliance; expenditure rationalisation and optimisation; improving fiscal policy institution; as well as strengthening budget management and control. The fiscal policy is anchored on three main objectives, namely to ensure economic stability through counter-cyclical measures, promote conducive business environment and enhance inclusivity. Over the period, the Government has gradually reduced its fiscal deficit as a percentage of GDP from 6.7% in 2009 to 3.1% in 2016.

The fiscal policy continues to emphasise on fiscal consolidation path while at the same time assuring a sound macroeconomic environment to support private sector activity. The Malaysian economy recorded a higher-than-expected 5.7% growth in the first half of 2017, reflecting the pro-growth fiscal consolidation initiatives. For the year, the Government continues to leverage on its fiscal policy instruments through revenue and expenditure measures to create fiscal space and achieve macroeconomic goals.

Total revenue collection for 2017 is estimated to record a growth of 6.1% in line with expected higher tax revenue, mainly from companies and individual income taxes, reflecting continued expansion in economic activity as well as stable commodity prices. Similarly, non-tax revenue is expected to record a higher collection contributed partly by divestment activity signifying Government's effort to gradually reduce its direct involvement in the market. Overall, the tax policy remains an effective fiscal instrument to generate sustainable revenue, support business activity and promote domestic investment.

On the expenditure side, the Government remains committed to implement optimisation measures to enhance spending efficiency, and prioritise rakyat-centric and high impact programmes. This is to ensure fiscal consolidation is on track and supports the economic growth momentum without compromising public service delivery. In addition, expenditure is geared towards maximising outcome, reducing leakages and enhancing value for money. Nevertheless, the Government continues to provide essential services, particularly health and education, and targeted social assistance to ensure the wellbeing of the rakyat.

In this regard, the thrust of fiscal policy will be further strengthened over the medium-term. The formulation of Medium-Term Fiscal Framework (MTFF) acts as the principal planning mechanism to drive fiscal consolidation efforts. Under the framework, the deficit level is targeted to be gradually reduced during the period of 2018 – 2020 to achieve a near-balanced budget. As fiscal deficit for 2017 is estimated to further reduce to 3.0% of GDP, the debt level for 2017 will remain below the self-imposed limit of 55% of GDP.

Table 4.1. Federal Government Financial Position 2016 – 2018

	RM million			Change (%)			Share of GDP (%)		
	2016	2017[1]	2018[2]	2016	2017[1]	2018[2]	2016	2017[1]	2018[2]
Revenue	212,421	225,337	239,860	-3.0	6.1	6.4	17.3	16.8	16.6
Operating expenditure	210,173	219,910	234,250	-3.1	4.6	6.5	17.1	16.4	16.2
Current balance	**2,248**	**5,427**	**5,610**	**7.5**	**141.5**	**3.4**	**0.2**	**0.4**	**0.4**
Gross development expenditure	41,995	45,962	46,000	3.0	9.4	0.1	3.4	3.4	3.2
Less: Loan recovery	1,346	648	600	-9.2	-51.9	-7.4	0.1	0.0	0.0
Net development expenditure	40,649	45,314	45,400	3.5	11.5	0.2	3.3	3.4	3.2
Overall balance	**-38,401**	**-39,887**	**-39,790**	**3.2**	**3.9**	**-0.2**	**-3.1**	**-3.0**	**-2.8**

[1] Revised estimate.
[2] Budget estimate, excluding 2018 Budget measures.
Source: Ministry of Finance, Malaysia.

Federal Government

The Federal Government financial position in 2017 is expected to record a higher current surplus of RM5.4 billion, reflecting the Government's policy of assuring revenue collection is sufficient to finance operating expenditure. This portrays prudent fiscal policy in managing expenditure within the Government's means. After taking into account development expenditure, fiscal deficit is estimated at 3.0% of GDP, lower than 3.1% in 2016.

From another perspective, primary balance which excludes debt service charges is estimated to record a deficit of 0.8% of GDP. This implies that the fiscal deficit to finance the current year programmes and projects is lower by 2.2 percentage points of GDP. Primary balance indicates the current fiscal efforts as debt service charge is predetermined by the size of previous deficits.

Revenue

Steady growth of tax collection

Federal Government's revenue in 2017 is expected to turn around 6.1% to RM225.3 billion (2016: -3%; RM212.4 billion) or 16.8% of GDP attributed to higher tax revenue collection of 6.4% (2016: 2.4%). This is driven by better collection mainly from companies income tax (CITA) and individual income tax. In addition, the Government's continuous efforts to diversify its revenue sources have resulted in less reliance on petroleum-related revenue.

Tax policy continues to play an important role in promoting conducive business environment, particularly in reducing cost of doing business. In order to ensure a more efficient and equitable tax system, improvements are continuously made to enable greater clarity and transparency of the nation's tax administration. In the 2017 Budget, the Government announced several tax measures to enhance business activities, improve small and medium enterprises (SMEs) competitiveness, increase disposable income and encourage graduate employability. The measures include reduction in companies and SMEs income tax rates, additional individual tax relief and extension of existing tax incentives. Despite the tax foregone, these measures are expected to improve tax payers' cash flow and consequently accelerate investment activities.

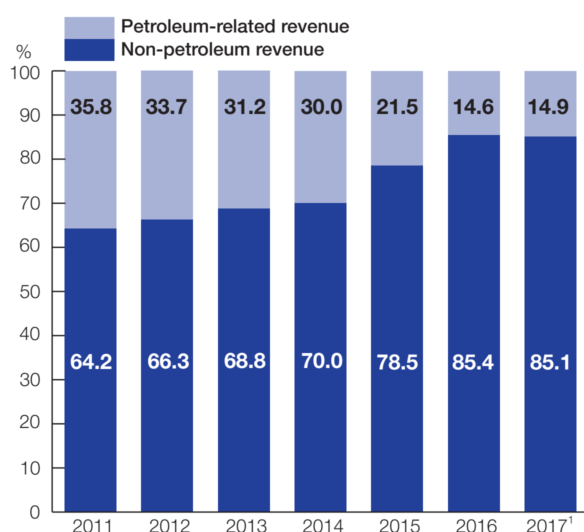
Tax revenue, with a share of 80% to total revenue or 13.5% of GDP remains the largest contributor to Federal Government's revenue. In 2017, tax revenue is estimated to increase 6.4% to RM180.2 billion. ***Direct tax*** is anticipated to grow 9.2% to RM119.7 billion contributed by higher collection from companies, individuals and petroleum income taxes. CITA is estimated to increase 6.6% to RM67.8 billion reflecting continued improvement in companies' profitability and ongoing efforts in improving tax compliance and administration. Likewise, individual income tax is expected to register RM30.1 billion on account of steady wage growth and higher number of individual income tax files of 7.2 million as at end-September 2017 (end-2016: 6.9 million files). Petroleum income tax (PITA) is estimated to increase 29.9% to RM10.9 billion

Table 4.2. Federal Government Revenue 2016 – 2018

	RM million			Change (%)			Share (%)		
	2016	2017[1]	2018[2]	2016	2017[1]	2018[2]	2016	2017[1]	2018[2]
Tax revenue	**169,343**	**180,194**	**191,569**	***2.4***	***6.4***	***6.3***	***79.7***	***80.0***	***79.9***
Direct tax	109,608	119,699	127,713	*-1.9*	*9.2*	*6.7*	*51.6*	*53.1*	*53.3*
of which:									
CITA	63,625	67,822	72,475	*-0.1*	*6.6*	*6.9*	*30.0*	*30.1*	*30.2*
Individuals	27,566	30,089	32,234	*4.7*	*9.2*	*7.1*	*13.0*	*13.4*	*13.4*
PITA	8,422	10,937	11,445	*-27.1*	*29.9*	*4.6*	*4.0*	*4.9*	*4.8*
Indirect tax	59,735	60,495	63,856	*11.3*	*1.3*	*5.6*	*28.1*	*26.9*	*26.6*
of which:									
GST	41,206	41,500	43,800	*52.5*	*0.7*	*5.5*	*19.4*	*18.4*	*18.3*
Excise duties	11,705	11,806	12,334	*-1.6*	*0.9*	*4.5*	*5.5*	*5.2*	*5.1*
Import duty	2,905	3,008	3,022	*6.3*	*3.5*	*0.5*	*1.4*	*1.3*	*1.3*
Export duty	980	1,222	1,400	*-5.7*	*24.7*	*14.6*	*0.5*	*0.5*	*0.6*
Non-tax revenue	**43,078**	**45,143**	**48,291**	***-19.7***	***4.8***	***7.0***	***20.3***	***20.0***	***20.1***
of which:									
Licences and permits	12,307	12,747	13,560	*-1.9*	*3.6*	*6.4*	*5.8*	*5.7*	*5.7*
Investment income	21,425	22,665	24,588	*-34.8*	*5.8*	*8.5*	*10.1*	*10.1*	*10.3*
Total revenue	**212,421**	**225,337**	**239,860**	***-3.0***	***6.1***	***6.4***	***100.0***	***100.0***	***100.0***
Share of GDP (%)	***17.3***	***16.8***	***16.6***						

[1] Revised estimate.
[2] Budget estimate, excluding 2018 tax measures.
Source: Ministry of Finance, Malaysia.

Figure 4.1. Share of Petroleum-Related and Non-Petroleum Revenue to Total Revenue



[1] Revised estimate.
Source: Ministry of Finance, Malaysia.

in tandem with higher assumption of average crude oil price at USD50 per barrel. Other direct taxes collection, which are mainly contributed by stamp duty and real property gains tax (RPGT), are expected to further improve in consonance with encouraging property market value.

Indirect tax is estimated to increase 1.3% to RM60.5 billion mainly on account of better collection from Goods and Services Tax (GST). In 2017, GST collection is anticipated to grow marginally by 0.7% to RM41.5 billion, primarily contributed by wholesale and retail trade, repair of motor vehicles and motorcycles sector. In addition, the number of registrants has increased to 454,609 as at end-September 2017. Similarly, excise duties are estimated to rebound 0.9% to RM11.8 billion following higher forecast sales volume of motor vehicles to 590,000 units[1] (2016: 580,124 units). Import duty is expected to record RM3 billion, an increase of 3.5%, largely attributed to completely built-up (CBU) motor vehicles, machineries and spare parts. Furthermore, export duty is forecast to increase to RM1.2 billion in line with higher estimated crude oil price.

Information Box 4.1

Update on the Implementation of Goods and Services Tax

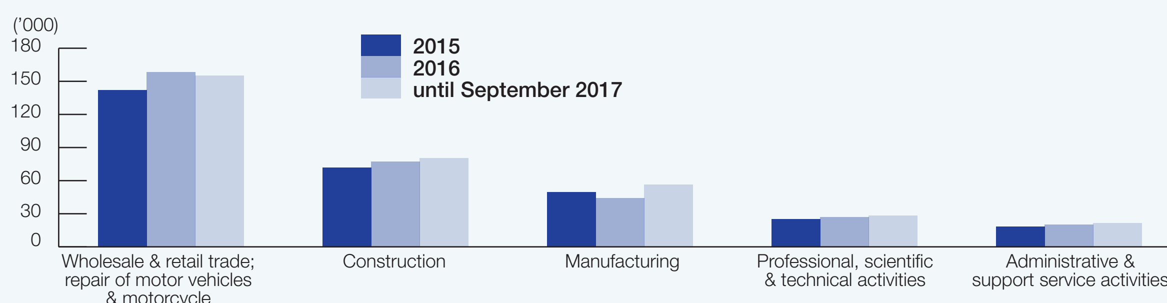
Introduction

Since the commencement of Goods and Services Tax (GST) on 1 April 2015, there have been several policy changes to the structure and treatment to further enhance the efficiency of the system. The introduction of GST at a rate of 6% has streamlined the structure of consumption-based tax to make it more effective and business-friendly. GST is proven to be an effective and efficient tax collection system while broadening the tax base. In addition, GST is transparent and has encouraged businesses to adopt proper recording and bookkeeping as well as modernise the tax system. In 2016, GST collection amounted to RM41.2 billion.

GST Registration

As at end-September 2017, a total of 454,609 business entities have registered under the GST. The bulk of registrants are in the wholesale, retail trade, repair of motor vehicles and motorcycles sector[1] accounting for 34.2% of total registrants. This is followed by the construction (17.7%) and manufacturing (12.4%) sectors.

Figure 4.1.1. Top Five Registrants by Sector



Source: Royal Malaysian Customs Department.

[1] According to Malaysia Standard Industrial Classification (MSIC).

[1] Malaysian Automotive Association (MAA) (2017). Retrieved October 4, 2017 from www.maa.org.my/pdf/Market_Review_Half_2017.pdf.

Changes to the GST Structure and Treatments

When the GST was introduced in 2015, a total of 553 types of goods and services were zero-rated while another 25 were exempted from GST. The Government continues to engage with the private sector to further improve the implementation of GST to ensure it is consistent with global best practices. Among the recent changes that enable Malaysia to be more competitive and attractive to domestic as well as foreign direct investments are as follows:

i. Effective 1 July 2017, the following services are not subjected to GST:
   - prescribed services[2] supplied to overseas customers in connection with goods for export;
   - prescribed services[3] supplied to overseas customers in Free Zones including Licensed Manufacturing Warehouses;
   - R&D services provided to overseas customers; and
   - non-recurring engineering expenses including expenditures on tools and machinery used in the manufacturing process of goods.

ii. Effective 1 July 2017, claims on warranty repairs made by distributors to overseas manufacturers are considered as cost recovery and are not subjected to GST.

GST Compliance

Among the measures to increase tax compliance, the Royal Malaysian Customs Department carries out regular audits and tax investigations. From April 2015 to July 2017, a total of 14,578 tax evasion offences were identified. Of this, a total of 2,097 cases were prosecuted with 928 cases imposed with fines.

Another measure to enhance compliance and optimise resources in administering GST is the introduction of GST Electronic Information System (GST EIS) on 1 July 2017. The pilot project involves 1,000 selected business premises in Kuala Lumpur and Selangor. The aim of the system is to ensure that GST declarations by businesses are consistent with their sales. The implementation of GST EIS involves the installation of a device at every point of sales for cash register machines located at business premises to capture and transmit real time information on supplies transacted.

Conclusion

The implementation of GST is one of the fiscal reform initiatives to further enhance the efficiency of the tax system and widen the tax base. In addition, this is also to diversify the Government's sources of revenue to ensure sustainable economic growth for nation's development. At the same time, the Government will continuously engage with various stakeholders to further improve the GST system and ensure compliance.

[2] Handling or storage services such as loading, unloading, reloading, stowing, securing shifting cargo and storage.
[3] Services such as manufacturing, installation, alteration, repair, cleaning, restoration or modification.

Non-tax revenue[2], is projected to increase 4.8% to RM45.1 billion, accounting for 20% of total revenue. This is supported by stable investment income primarily from Petroliam Nasional Berhad (PETRONAS) and Bank Negara Malaysia. The increase is also contributed by the divestment of equities in Sarawak Hidro Sdn. Bhd. In addition, proceeds from licences and permits are expected to rebound 3.6% to RM12.7 billion contributed mainly from petroleum royalty, motor vehicles licence, levy on foreign workers and telecommunication spectrum. As for monetisation of assets, it is expected to contribute RM1 billion to the non-tax revenue collection.

Expenditure

Moderate growth in expenditure

The Government will continue to emphasise on spending optimisation and enhance screening mechanism to ensure resources are distributed according to needs and priorities. Total Federal

[2] Includes non-revenue receipts and revenue from Federal Territories.

Table 4.3. Federal Government Operating Expenditure by Object 2016 – 2018

	RM million			Change (%)			Share (%)		
	2016	2017[1]	2018[2]	2016	2017[1]	2018[2]	2016	2017[1]	2018[2]
Emoluments	73,108	78,801	79,149	*4.4*	*7.8*	*0.4*	*34.8*	*35.8*	*33.8*
Retirement charges	21,029	23,648	24,550	*11.4*	*12.5*	*3.8*	*10.0*	*10.8*	*10.5*
Debt service charges	26,480	28,866	30,882	*9.0*	*9.0*	*7.0*	*12.6*	*13.1*	*13.2*
Grants and transfers to state governments	6,942	8,058	8,023	*0.3*	*16.1*	*-0.4*	*3.3*	*3.7*	*3.4*
Supplies and services	30,070	32,642	33,621	*-17.3*	*8.6*	*3.0*	*14.3*	*14.8*	*14.4*
Subsidies and social assistance	24,690	23,085	26,544	*-9.5*	*-6.5*	*15.0*	*11.7*	*10.5*	*11.3*
Asset acquisition	676	698	577	*-60.8*	*3.3*	*-17.3*	*0.3*	*0.3*	*0.2*
Refunds and write-offs	799	802	888	*-15.6*	*0.4*	*10.7*	*0.4*	*0.4*	*0.4*
Grants to statutory bodies	13,557	13,449	13,099	*-12.5*	*-0.8*	*-2.6*	*6.5*	*6.1*	*5.6*
Others	12,822	9,861	16,917	*-14.9*	*-23.1*	*71.6*	*6.1*	*4.5*	*7.2*
Total	210,173	219,910	234,250	*-3.1*	*4.6*	*6.5*	*100.0*	*100.0*	*100.0*
Share of GDP (%)	*17.1*	*16.4*	*16.2*						

[1] Revised estimate.
[2] Budget estimate, excluding 2018 Budget measures.
Source: Ministry of Finance, Malaysia.

Government expenditure has declined to around 20% of GDP in 2016 as compared with an average of 25% during the Ninth Malaysia Plan and Tenth Malaysia Plan. In 2017, although total expenditure is expected to increase 5.4% to RM265.9 billion, its share to GDP is estimated to further decline to 19.8%. Of this, a sum of RM219.9 billion (82.7%) is allocated for operating expenditure while the balance of RM46 billion (17.3%) is for development expenditure. While revenue collection is expected to grow, the Government remains committed to prudent and efficient spending to strengthen its finances by reprioritising programmes and projects as well as reducing discretionary expenses, without affecting public service delivery.

Operating expenditure (OE) is expected to increase moderately by 4.6% to RM219.9 billion or 16.4% of GDP (2016: -3.1%; RM210.2 billion; 17.1%) to cater for higher spending requirement mainly for emoluments, supplies and services, and debt service charges. ***Emoluments*** are expected to increase 7.8% to RM78.8 billion and remain the largest component of OE at 35.8% of the total. The rise is due to two salary increments, implementation of minimum wage and improvement to selected service schemes for support staff beginning July 2016. The growth in emolument bill, however, will be contained by maintaining the size of civil service at 1.6 million. The Government continues to gradually rationalise the public sector including minimising duplication of functions and roles among agencies. Meanwhile, ***retirement charges*** are estimated to increase 12.5% to RM23.6 billion representing 10.8% of total OE mainly due to the implementation of minimum pension payment beginning July 2016. The amount also includes special cash assistance of RM250 each in January and June 2017 to about 780,000 pensioners.

Supplies and services, which represent 14.8% of OE, are expected to increase 8.6% to RM32.6 billion (2016: 14.3%; -17.3%; RM30.1 billion). The increase is partly attributed to maintenance charges following the completion of several development projects. However, in terms of share to GDP, supplies and services are expected to remain at 2.4%, lower than the past five-year annual average of 3.1%. The Government continues to contain the growth of supplies and services expenditure by streamlining programmes and functions through the National Blue Ocean Strategy (NBOS) initiatives. In addition, line ministries and agencies continue to curb discretionary expenditure and optimise spending such as for travel, events and functions, and rentals of new office space.

Subsidies and social assistance, which comprise subsidies for goods and services, incentives and social assistance is projected to decrease 6.5% to RM23.1 billion (2016: -9.5%; RM24.7 billion). The decline is mainly due to rationalisation of cooking oil subsidy for 1 to 5 kilogramme bottle and implementation of weekly-managed float system for fuel prices to minimise the lag effect of daily crude oil price changes. These measures are expected to contribute to a savings of approximately RM1.2 billion in 2017. Nevertheless, the Government continues to provide targeted subsidies, incentives and welfare assistance, particularly for the agriculture, transportation, education and health sectors. 1Malaysia People's Aid (BR1M) payment

has been increased up to RM1,200 for eligible households in line with the shift towards targeted social assistance. A sum of RM6.6 billion is estimated to be disbursed benefiting 7.2 million recipients for both households and individuals.

Grants to statutory bodies are estimated to decrease 0.8% to RM13.4 billion (2016: -12.5%; RM13.6 billion) due to rationalisation of grants, in particular to entities with high accumulated reserves. Grants are mainly to finance emoluments, and supplies and services. Of the total grants, 56.9% or RM7.7 billion is allocated for public universities and teaching hospitals. The Federal Government also provides ***grants and transfers to state governments*** amounting to RM8.1 billion (2016: RM6.9 billion), of which RM5.8 billion or 71.8% are provided under the Federal Constitution.

Debt service charges or interest payments on loans are mandated items and are constitutionally required to be met before all other discretionary expenditures. In 2017, debt service charges are projected at RM28.9 billion. As a percentage of total OE, debt service charges remain manageable at 13.1%, which is below the threshold of 15% under the administrative fiscal rules.

The year 2017 is the beginning of the second rolling plan (2017 – 2018) under the Eleventh Malaysia Plan (11MP). A sum of RM46 billion or 17.7% of the total 11MP ceiling is allocated for **development expenditure (DE),** outlining about 4,900 new and ongoing projects and programmes encompassing the economic, social, security and general administration sectors. The projects and programmes are planned in accordance with the six strategic thrusts in the 11MP, namely enhancing inclusiveness; improving wellbeing for all; accelerating human capital development; pursuing green growth; strengthening infrastructure; and reengineering economic growth.

The allocated DE for 2017 is an increase of 9.4% (2016: 3%) from the actual expended amount of RM42 billion in 2016. The economic sector is the largest recipient of allocation with a share of 56.3% of total DE, followed by the social (26.4%), security (11.5%) and general administration (5.8%) sectors. Expenditure continues to focus on infrastructure projects and investments with high multiplier effect to create productive capacity for national development.

Total expenditure for the ***economic sector*** is estimated at RM25.9 billion. Expenditure in this sector is for infrastructure, entrepreneurship and industrial development, and poverty alleviation. In addition, the spending is also channelled for enhancing R&D; accelerating agriculture and rural development; and improving public utilities.

The *transport subsector* accounts for the largest share, constituting 23.4% or RM10.7 billion of total DE (2016: 18.6%; RM7.8 billion). The expenditure is primarily for maintenance of airports and ports,

Table 4.4. Federal Government Development Expenditure by Sector 2016 – 2018

	RM million			Change (%)			Share (%)		
	2016	2017[1]	2018[2]	2016	2017[1]	2018[2]	2016	2017[1]	2018[2]
Economic	25,113	25,897	26,342	*7.8*	*3.1*	*1.7*	*59.8*	*56.3*	*57.3*
of which:									
Transport	7,827	10,749	10,479	*16.9*	*37.3*	*-2.5*	*18.6*	*23.4*	*22.8*
Trade and industry	4,841	4,830	4,149	*-14.1*	*-0.2*	*-14.1*	*11.5*	*10.5*	*9.0*
Energy and public utilities	2,927	2,514	2,746	*-19.5*	*-14.1*	*9.2*	*7.0*	*5.5*	*6.0*
Agriculture and rural development	2,902	2,416	2,523	*-6.5*	*-16.7*	*4.4*	*6.9*	*5.3*	*5.5*
Environment	2,346	2,197	2,013	*76.3*	*-6.4*	*-8.4*	*5.6*	*4.8*	*4.4*
Social	**10,429**	**12,119**	**11,720**	***-6.6***	***16.2***	***-3.3***	***24.8***	***26.4***	***25.5***
of which:									
Education and training	3,727	5,904	5,256	*-21.7*	*58.4*	*-11.0*	*8.9*	*12.8*	*11.4*
Housing	2,238	870	1,167	*11.5*	*-61.1*	*34.1*	*5.3*	*1.9*	*2.5*
Health	1,495	1,532	1,910	*3.7*	*2.5*	*24.7*	*3.6*	*3.3*	*4.2*
Security	4,832	5,286	5,214	*1.6*	*9.4*	*-1.4*	*11.5*	*11.5*	*11.3*
General administration	1,621	2,660	2,724	*3.4*	*64.1*	*2.4*	*3.9*	*5.8*	*5.9*
Total	41,995	45,962	46,000	*3.0*	*9.4*	*0.1*	*100.0*	*100.0*	*100.0*
Share of GDP (%)	*3.4*	*3.4*	*3.2*						

[1] Revised estimate.
[2] Budget estimate, excluding 2018 Budget measures.
Source: Ministry of Finance, Malaysia.

and construction and upgrading of roads, railways and bridges especially in rural areas. Among major ongoing projects are the Pan Borneo Highway, Sungai Besi – Ulu Klang Elevated Expressway and West Coast Expressway connecting Taiping – Banting. The infrastructure is beneficial in creating seamless movement of people and goods, and improving efficiency and productivity of business activity.

The *trade and industry subsector* is allocated RM4.8 billion, which accounts for 10.5% of total DE (2016: RM4.8 billion; 11.5%). The bulk of the allocation is meant for export promotions, and entrepreneurs and tourism development programmes. With regard to entrepreneurship development, financial assistance in the form of soft loans is provided through Majlis Amanah Rakyat (MARA) and Perbadanan Usahawan Nasional Berhad (PUNB). In line with initiatives to enhance digital economy, allocation is also provided for online business programmes under the Malaysia Digital Economy Corporation (MDEC).

The allocation for the *energy and public utilities subsector* is expected to amount to RM2.5 billion or 5.5% of total DE in 2017 (2016: RM2.9 billion; 7%). This is in line with the Government's effort to improve rural accessibility to public amenities and utilities especially in Sabah and Sarawak such as water, electricity and telecommunications. In addition, a sum of RM2.2 billion is provided under the *environment subsector,* mainly for river restoration such as KL River of Life, Sungai Pahang conservation project, and Corridor and City Programme which include construction of sewage treatment plant, sewerage pipes and flood barrier in Sungai Segget, Johor.

Meanwhile, RM2.4 billion or 5.3% of total DE (2016: RM2.9 billion; 6.9%) is provided for the *agriculture and rural development subsector.* The allocation is mainly for agricultural development programmes and high value-added projects. These are targeted at increasing productivity such as modernising irrigation system for paddy plantation, replanting of oil palm and implementing integrated zone for aquaculture projects.

The second largest recipient is the ***social sector*** with a sum of RM12.1 billion or 26.4% of total DE (2016: RM10.4 billion; 24.8%). It is aimed at accelerating human capital development, improving rakyat's wellbeing and quality of life mainly through education and training, health services, and rural development. Allocation for the *education and training subsector* constitutes 12.8% (2016: 8.9%) of total DE, primarily for building, upgrading and maintenance of schools, higher learning and training institutions. In addition, part of the allocation is channelled to R&D, and technical and vocational education and training (TVET) programmes to produce skilled talents to meet industry requirements.

Taking into account 1Malaysia People's Housing Corporation's (PR1MA) financing needs is sourced from the market, the allocation for the *housing subsector* is estimated to be lower at RM870 million or 1.9% of total DE (2016: RM2.2 billion; 5.3%). However, allocations for People's Housing Programme (PPR) and 1Malaysia Civil Servants Housing (PPA1M) continue to increase in enhancing house ownership among low-income earners and civil servants.

A total of RM1.5 billion or 3.3% of DE is allocated for the *health subsector* (2016: RM1.5 billion; 3.6%) with the objective to improve healthcare services to the rakyat and ensure accessibility to quality healthcare. Substantial allocation is channelled to improve healthcare facilities through building, upgrading and maintenance of hospitals such as the Rembau Hospital, Seberang Jaya Hospital and University Putra Malaysia Teaching Hospital. Allocation is also provided for medical equipment and vehicles, and expanding rural and urban health services, such as in Beluran, Sabah; Kota Tinggi, Johor; and Lawas, Sarawak.

The ***security sector,*** comprising defence and internal security, remains a priority with an estimated outlay of RM5.3 billion or 11.5% of total DE (2016: RM4.8 billion; 11.5%). A total of RM4.3 billion (2016: RM3.9 billion) is allocated for the *defence subsector* while a sum of RM1 billion (2016: RM887 million) for the *internal security subsector.* The expenditure is mainly for enhancing the capability of armed forces and police; strengthening border security; upgrading military equipment, communication tools and information technology systems; as well as building of offices and quarters.

The ***general administration sector*** is allocated RM2.7 billion or 5.8% of total DE (2016: RM1.6 billion; 3.9%) for construction and upgrading of Government facilities, and enhancing access to information and communications technology (ICT). These include among others, the Government Integrated Telecommunication Network (1Gov*Net) project and construction of a new court complex in Kota Kinabalu, Sabah. The projects are implemented to enhance the productivity and efficiency of the public sector in order to continuously improve the level of service delivery.

Financing

Growing demand for Islamic instruments

Total **gross borrowing** of the Federal Government is expected to increase to RM108 billion in 2017 on account of higher debt redemption amounting to RM67.2 billion. The net borrowing of RM40.8 billion is utilised to finance DE. The bulk of the funding requirement will be raised from domestic sources, amounting to RM107.5 billion or 99.5% from total gross borrowing.

For ***domestic borrowing,*** *Malaysian Government Securities* (MGS) is expected to constitute 50% of total gross borrowing or RM54 billion while *Malaysian Government Investment Issues* (MGII) at 49.5% or RM53.5 billion. The Government allocates a higher proportion of MGII compared to previous years (2010 – 2015: 39.1%) and is expected to increase in the future to cater for the growing demand of Islamic papers. Furthermore, the recent inclusion of MGII in major indices such as the Dow Jones Citigroup Sukuk Index and Markit iBoxx Index has contributed to the development of sukuk market and subsequently enhances investors' confidence in Malaysia.

Average yields on 5-year MGS stood at 3.684% while 10-year MGS at 4.052% during the first half of 2017 (2016: 3.427%; 3.843%). Yields on 5-year MGII registered 3.818% while 10-year MGII recorded 4.143% during the same period (2016: 3.609%; 4.011%). The increase in yields for both instruments was mainly due to normalisation of monetary policy by the US Federal Reserve and higher expectation of growth in the US. Nevertheless, yields on 10-year MGS and MGII as at end-August 2017 compared with end-2016 have tightened by 32.4 and 32.5 basis points, respectively, contributed by sustained demand from domestic institutional investors as well as resumption of inflows from foreign investors since April 2017. On average, issuances of both instruments were oversubscribed by 2.3 times, reflecting strong demand for Government papers and ample liquidity in the domestic market.

On debt maturity profile, the Government has transitioned from short-tenured (less than 10 years) to medium- and long-tenured issuances (10 years and above). In 2017, the issuance of papers exceeding 10-year tenure for both MGS and MGII is expected to increase to more than 55% as compared with an average of 44% for the period 2014 to 2016. This is in line with debt management strategy to reduce refinancing risk by lengthening the debt maturity profile.

Gross ***offshore borrowing*** for 2017 is anticipated to be minimal in the absence of new *market loan* as there is no funding requirement for foreign-denominated debt papers. During the year, external *project loan* is anticipated at RM545 million or 0.5% of total gross borrowing. These loans are mainly to finance raw water transfer and development projects.

Table 4.5. Federal Government Financing 2016 – 2017

	RM million		Share (%)	
	2016	2017[2]	2016	2017[2]
Gross borrowing	**91,982**	**108,045**	***100.0***	***100.0***
Domestic	**86,000**	**107,500**	***93.5***	***99.5***
MGS	43,500	54,000	*47.3*	*50.0*
MGII	42,500	53,500	*46.2*	*49.5*
Offshore	**5,982**	**545**	***6.5***	***0.5***
Market loans	5,837	-	*6.3*	-
Project loans	145	545	*0.2*	*0.5*
Repayments	**53,289**	**67,219**	***100.0***	***100.0***
Domestic	48,141	66,750	*90.3*	*99.3*
Offshore	5,148	469	*9.7*	*0.7*
Net borrowing	**38,693**	**40,826**	-	-
Domestic	37,859	40,750	-	-
Offshore	834	76	-	-
Change in assets[1]	**-292**	**-939**	-	-
Total deficit financing	**38,401**	**39,887**	-	-

[1] (+) indicates a drawdown of assets; (-) indicates accumulation of assets.
[2] Estimate.
Source: Ministry of Finance, Malaysia.

Debt

Favourable debt composition

The **Federal Government debt** comprising cumulative Federal Government borrowings stood at RM685 billion as at end-June 2017. With a current account surplus, the increase in debt is to finance DE. The debt composition remains favourable with 96.7% of the papers denominated in ringgit while the balance was from offshore borrowing, reflecting minimal foreign currency risk exposure. The bulk of the offshore borrowing was denominated in US dollar.

The statutory debt limit of 55% under the Loan (Local) Act 1959 [Act 637] and Government Funding Act 1983 [Act 275] is confined to only outstanding MGS, MGII and Malaysian Islamic Treasury Bills (MITB) instruments. As at end-June 2017, the outstanding amount of these instruments is significantly lower at 46.5% of GDP. This provides ample fiscal space for the Government to implement counter-cyclical measures in the event of external shocks. Under the External Loans Act 1963 [Act 403], offshore borrowing remained stable at RM22.7 billion, lower than statutory limit of RM35 billion. Meanwhile, Malaysian Treasury Bills (MTB) stood at RM8 billion, below the RM10 billion threshold stipulated under the Treasury Bills (Local) Act 1946 [Act 188]. Nevertheless, consistent with prudent debt management policy, the Government remains

Table 4.6. Federal Government Debt by Instrument 2016 – 2017

	RM million		Share (%)		Share of GDP (%)	
	2016	2017[1]	2016	2017[1]	2016	2017[1]
Domestic debt	**624,822**	**662,353**	***96.4***	***96.7***	***50.8***	***49.2***
Treasury bills	4,500	9,500	*0.7*	*1.4*	*0.4*	*0.7*
MGS	357,422	362,953	*55.1*	*53.0*	*29.0*	*27.0*
MGII	234,500	261,500	*36.2*	*38.2*	*19.1*	*19.4*
Government Housing Sukuk	28,400	28,400	*4.4*	*4.1*	*2.3*	*2.1*
Offshore borrowing	**23,653**	**22,703**	***3.6***	***3.3***	***1.9***	***1.7***
Market loans	17,211	16,482	*2.6*	*2.4*	*1.4*	*1.2*
Project loans	6,442	6,221	*1.0*	*0.9*	*0.5*	*0.5*
Total	**648,475**	**685,056**	***100.0***	***100.0***	***52.7***	***50.9***
Memorandum item:						
Non-resident holdings of ringgit-denominated debt securities	191,764	171,067	*30.7*	*25.8*	*15.6*	*12.7*

[1] End-June 2017.
Source: Ministry of Finance, Malaysia.

committed to contain the total Federal Government debt within the self-imposed limit of 55% of GDP while ensuring debt consolidation in the long-run. As at end-June 2017, Federal Government debt as percentage of GDP stood at 50.9%.

Domestic debt amounted to RM662.3 billion as at end-June 2017, comprising mainly MGS and MGII. MGS remained the principal debt instrument of the Government with an outstanding amount of RM362.9 billion or 53% of total Federal Government debt. This is followed by MGII at RM261.5 billion or 38.2%, reflecting the Government's continuous support in promoting Islamic financial market whilst ensuring a vibrant domestic capital market. In line with prudent risk management, the Government will continue to source funding requirement from the domestic market, without crowding out the private sector.

Treasury bills, namely MTB and MITB, are short-dated government securities, yielding zero coupon but issued at a discount of its redemption price. These working capital instruments are issued periodically with maturities ranging from three- to twelve-month to better manage the cash flow of the Government. As at end-June 2017, outstanding treasury bills amounted to RM9.5 billion, accounting for 1.4% of total Federal Government debt. Meanwhile, total outstanding *Government Housing Sukuk* assumed under the Federal Government remained at RM28.4 billion or 4.1% of the total debt as there is no new issuance for this sukuk. Beginning 2016, the funding requirement for civil servant housing loans is under the jurisdiction of the Public Sector Home Financing Board (LPPSA).

Offshore borrowing which consists of market and project loans, stood at RM22.7 billion. *Market loans* account for 72.6% of total offshore borrowing, which are sourced from global sukuk issued in 2011, 2015 and 2016. Meanwhile, the outstanding *project loans* are from existing bilateral and multilateral arrangements to finance specific programmes and infrastructure projects such as housing, sewerage and reservoir.

To ensure a well-spread maturity profile, government issuances are concentrated towards long-tenured papers. After taking into account all schedule issuances this year, average time to maturity is expected to improve to 7.2 years compared with 6.4 in 2016, reflecting lower refinancing risk. This is attributed to more outstanding debt papers with maturity profile of 10 years and above, representing 60.5% of total outstanding debt. The balance is instruments with maturity between six to nine years (24%) as well as five years and below (15.5%). Refinancing risk remains low as only 10.6% of MGS and MGII will mature in 2017.

In terms of **Federal Government debt by holder,** a total of RM496.2 billion or 72.4% of Government bonds and sukuk is held by ***domestic investors.*** These include large and long-term investors such as Bank Negara Malaysia and banking institutions (29.7%), Employees Provident Fund (27.2%), insurance companies (4.5%) and Retirement Fund (Incorporated) (3.5%). The balance of RM188.8 billion or 27.6% is held by ***non-residents,*** of which 55.5% consist of long-term and institutional investors, namely central banks, supranationals and sovereigns (30.7%), pension funds (17.2%), insurance companies (3.1%) as well as multilateral and bilateral institutions and others (4.5%). Subscription of global sukuk at issuance were fairly distributed with non-residents accounting for 69.8% of which investors from Asia accounted for 25.8% followed by Europe (15.5%), Middle East (14.4%) and the US (14.1%), while the balance is resident investors. This signals continued global demand for Malaysia's debt papers and confidence in the country's economic fundamentals.

Table 4.7. Federal Government Debt by Holder 2016 – 2017

	RM million		Share (%)		Share of GDP (%)	
	2016	2017[3]	2016	2017[3]	2016	2017[3]
Resident	**438,247**	**496,256**	***67.6***	***72.4***	***35.6***	***36.9***
Employees Provident Fund	156,985	186,323	*24.2*	*27.2*	*12.7*	*13.9*
Retirement Fund (Incorporated)	26,653	23,910	*4.1*	*3.5*	*2.2*	*1.8*
Insurance companies	32,673	30,923	*5.1*	*4.5*	*2.6*	*2.3*
Banking institutions	170,808	203,643	*26.3*	*29.7*	*13.9*	*15.1*
Development financial institutions	20,747	20,697	*3.2*	*3.0*	*1.7*	*1.5*
Other non-bank financial institutions	754	870	*0.1*	*0.1*	*0.1*	*0.1*
Others[1]	29,627	29,890	*4.6*	*4.4*	*2.4*	*2.2*
Non-resident	**210,228**	**188,800**	***32.4***	***27.6***	***17.1***	***14.0***
Fund/asset managers	86,152	68,693	*13.3*	*10.0*	*7.0*	*5.1*
Central banks, supranationals and sovereigns	59,089	57,891	*9.1*	*8.5*	*4.8*	*4.3*
Banking institutions	18,466	15,397	*2.8*	*2.3*	*1.5*	*1.2*
Pension funds	31,907	32,515	*4.9*	*4.8*	*2.6*	*2.4*
Insurance companies	5,122	5,789	*0.8*	*0.8*	*0.4*	*0.4*
Others[2]	9,492	8,515	*1.5*	*1.2*	*0.8*	*0.6*
Total	**648,475**	**685,056**	***100.0***	***100.0***	***52.7***	***50.9***

[1] Include statutory bodies, nominees and trustee companies and co-operatives, securities placed by institutional investors at the central bank and unclassified items.
[2] Include nominees/custodians, individuals, non-financial corporations and unidentified sectors.
[3] End-June 2017.
Source: Ministry of Finance, Malaysia.

External Debt

Malaysia's **external debt** comprises both public and private sector debt. This includes offshore borrowing; non-resident holdings of ringgit-denominated debt securities; non-resident deposits; as well as other external debt which include trade credits, International Monetary Fund (IMF) allocation of Special Drawing Rights (SDR) and miscellaneous such as insurance claims yet to be disbursed and interest payable. The outstanding external debt was lower at RM877.5 billion or 65.2% of GDP as at end-June 2017 (end-2016: RM916.1 billion; 74.5%) on account of revaluation effect following the strengthening of ringgit against selected major and regional currencies as well as net repayment of interbank borrowing during the second quarter.

Offshore borrowing, the largest component of external debt, decreased to RM520.6 billion or 38.7% of GDP (2016: RM531.3 billion; 43.2%) mainly due to revaluation and lower interbank borrowing. For *medium- and long-term debt*, private sector debt contracted to RM165.4 billion on account of lower net borrowing by the bank and non-bank. Meanwhile, public sector offshore borrowing was sustained at RM127.1 billion or 9.4% of GDP, with public corporations as the largest contributor at 8.1% of GDP while the remaining is from the Federal Government. As at end-June 2017, the debt service ratio[3] for offshore borrowing declined to 13.7% (2016: 16%) as a result of higher export earnings.

Non-resident holdings of ringgit-denominated debt, which is primarily in the form of *medium- and long-term securities* also contributed to the decline in the overall external debt position. As a result of normalisation in the Fed's policy rate, non-resident holdings of ringgit-denominated domestic securities decreased to RM194.9 billion as at end-June 2017. This has also resulted in the reversal of non-resident holdings in ringgit-denominated Government securities which stood at 25.8% compared with 30.7% as of end-2016. Holdings by foreign investors were well-spread across different bond maturities, with more than 65% in medium and long-dated bonds of more than three years maturity while *short-term bonds* were mostly held by banks and asset managers. In addition, ***non-resident deposits*** in domestic banking institutions also decreased to RM78.8 billion.

Public Sector Debt

Public sector debt comprises debt owed by the Federal Government, statutory bodies and non-financial public corporations (NFPCs). This also

[3] Measures the principal repayment (excluding prepayment) and the interest payment of offshore borrowing as a proportion of gross exports of goods and services.

Table 4.8. External Debt
2016 – 2017

	RM million		Share (%)		Share of GDP (%)	
	2016	2017[3]	2016	2017[3]	2016	2017[3]
Offshore borrowing	**531,326**	**520,605**	***58.0***	***59.3***	***43.2***	***38.7***
Medium- and long-term debt	323,424	292,569	*35.3*	*33.3*	*26.3*	*21.7*
Public sector	133,962	127,116	*14.6*	*14.5*	*10.9*	*9.4*
Federal Government	21,087	17,733	*2.3*	*2.0*	*1.7*	*1.3*
Public corporations	112,875	109,383	*12.3*	*12.5*	*9.2*	*8.1*
Private sector	189,462	165,453	*20.7*	*18.8*	*15.4*	*12.3*
Short-term debt	207,902	228,035	*22.7*	*26.0*	*16.9*	*17.0*
Non-resident holdings of ringgit-denominated debt securities	**214,203**	**194,950**	***23.4***	***22.2***	***17.4***	***14.5***
Medium- and long-term debt	203,296	184,267	*22.2*	*21.0*	*16.5*	*13.7*
Federal Government	189,988	169,855	*20.7*	*19.4*	*15.4*	*12.6*
Others[1]	13,308	14,412	*1.5*	*1.6*	*1.1*	*1.1*
Short-term debt	10,907	10,683	*1.2*	*1.2*	*0.9*	*0.8*
Non-resident deposits	**86,184**	**78,809**	***9.4***	***9.0***	***7.0***	***5.8***
Others[2]	**84,405**	**83,139**	***9.2***	***9.5***	***6.9***	***6.2***
Total	**916,118**	**877,503**	***100.0***	***100.0***	***74.5***	***65.2***

[1] Include private sector and public corporations.
[2] Comprise trade credits, IMF allocation of Special Drawing Rights and miscellaneous.
[3] End-June 2017.
Note: Total may not add up due to rounding.
Source: Bank Negara Malaysia.

includes Federal Government guaranteed debt given to statutory bodies and NFPCs. Comprehensive information of consolidated public sector debt allows the Government to evaluate potential risk exposure to enable prudent management of public sector finance.

As at end-2016, public sector debt stood at RM901.2 billion or 73.3% of GDP (end-2015: RM870 billion; 75.1%) with the Federal Government accounting for RM648.5 billion or 72% of total public sector debt (end-2015: RM630.5 billion; 72.5%). Meanwhile, total debt of NFPCs stood at RM204 billion or 22.6% of total debt (end-2015: RM199.5 billion; 22.9%), while the balance of 5.4% by statutory bodies. For NFPCs debt, the increase was primarily due to offshore debts to finance utilities investment abroad. In addition, the debt of statutory bodies also increased to RM48.7 billion (end-2015: RM40 billion) mainly attributed to guaranteed issuances by LPPSA to fund civil servant housing loans and additional borrowings by Perbadanan Tabung Pendidikan Tinggi Nasional (PTPTN) to finance tertiary education loans.

Table 4.9. Public Sector Debt
2015 – 2016

	RM million		Share (%)		Share of GDP (%)	
	2015	2016	2015	2016	2015	2016
Federal Government	**630,540**	**648,475**	***72.5***	***72.0***	***54.5***	***52.7***
Domestic debt	609,063	624,822	*70.0*	*69.3*	*52.6*	*50.8*
Offshore	21,477	23,653	*2.5*	*2.7*	*1.9*	*1.9*
Statutory bodies	**39,972**	**48,700**	***4.6***	***5.4***	***3.4***	***4.0***
Domestic	39,972	48,700	*4.6*	*5.4*	*3.4*	*4.0*
of which: Guaranteed	39,972	48,700	*4.6*	*5.4*	*3.4*	*4.0*
Offshore	-	-	-	-	-	-
Non-financial public corporations	**199,470**	**204,025**	***22.9***	***22.6***	***17.2***	***16.6***
Domestic	123,455	123,893	*14.2*	*13.7*	*10.7*	*10.1*
of which: Guaranteed	123,455	123,893	*14.2*	*13.7*	*10.7*	*10.1*
Offshore	76,015	80,132	*8.7*	*8.9*	*6.5*	*6.5*
of which: Guaranteed	3,665	4,657	*0.4*	*0.5*	*0.3*	*0.4*
Total	**869,982**	**901,200**	***100.0***	***100.0***	***75.1***	***73.3***

Source: Ministry of Finance, Malaysia.

Feature Article 4.1

Government Guarantees: Catalysing Economic Growth

Introduction

As the nation transforms its economic structure, the Government continues to harness its resources by leveraging on fiscal instruments, mainly taxation and direct public expenditure. In this regard, another important fiscal instrument is the Government or Sovereign Guarantee (GG). In general, the International Monetary Fund (IMF) defines loan guarantee as a legally binding agreement of which the guarantor agrees to pay any or the entire amount due on a loan instrument in the event of non-payment by the borrower.[1] As for GG, this implies that the Government will legally indemnify or assume the payment obligation, in the event of default. The IMF has classified GG as an explicit contingent liability to the Government, where it is not accounted as direct debt, but recognised as a memorandum item to the balance sheet of the Government.

As a fiscal tool, GG brings about greater advantages compared with direct expenditure. This is especially where investments are generating viable cash flows in the long-run. In addition, it also applies when the Government, via its entities, is better-placed to undertake the investment, due to uncertainties or lack of private sector capacity to absorb the risk.

Governance

In Malaysia, GG is governed under Section 14 of the Financial Procedure Act 1957 [Act 61]. The Act mandates the Federal Treasury as the sole authority to undertake the guarantee. The Section further rules that state governments are not authorised to give a guarantee, unless with the approval of the Federal Government.

GG is specifically governed under the Loans Guarantee (Bodies Corporate) Act 1965 [Act 96], which authorises the Government to issue guarantee for loans, bonds, Shariah-compliant financing or sukuk raised by certain bodies corporate or entities, namely statutory bodies, government-linked companies, and state government companies or its subsidiaries. The loan or financing agreement is made under the name of the entity, and may be raised either in local or foreign currency. This means that the entity is responsible to undertake the financing obligation, while the Government acts as the secondary obligor of the agreement. As long as the GG remains effective, the entity is not permitted to enter into other financing or borrowing agreement, unless consented by the Government. In addition, under Section 8 of the Act, the entity is obliged to repay to the Government the sum paid (including interests or profit rate) in respect of any liability incurred by the Government under the GG.

Benefits

The main goal of GG is to facilitate risk allocation in infrastructure spending to meet the high expectation of the rakyat, and ultimately to propel the country into an advanced and high-income nation. The application of GG has created opportunities for private sector to participate in developing the nation and driving economic growth. Direct fiscal allocation through operating and development expenditure requires substantial upfront cash, which is constrained by revenue growth and fiscal consolidation. In addition, with growing and competing needs coupled with limited resources, GG gives fiscal space for the Government to deliver infrastructure and beneficial programmes to the rakyat, especially for projects which reward long-term dividends and carry high multiplier impacts.

Thus, GGs are issued to facilitate the entity to undertake development projects which are mainly infrastructure and social in nature, and those of national and strategic importance. Due to the social aspects of some of the projects, the entity is not well placed to assume all risks related to the projects such as public transport infrastructure, utilities and education. Therefore, the risks of such projects are better shared with the Government. The GG granted will provide certainty and comfort for the entity to manage its risk exposure.

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[1] Public Sector Debt Statistics: Guide for Compilers and Users (2011). IMF.

GGs are also granted to secure favourable financing conditions, which will protect the entity from financing and liquidity risks. This situation is applicable, particularly for large scale development projects with high level of technical expertise, to ensure the viability of the projects. Given Malaysia's favourable sovereign credit rating, the GG facility enables the entity to acquire financing or issue bonds with lower coupon rate, flexibility in repayment schedule and to some extent, eliminating conditions which require assets to be charged as security. GGs allow early execution of projects while enabling costs to be dispersed over a longer period and effectively resulting in a lower total cost.

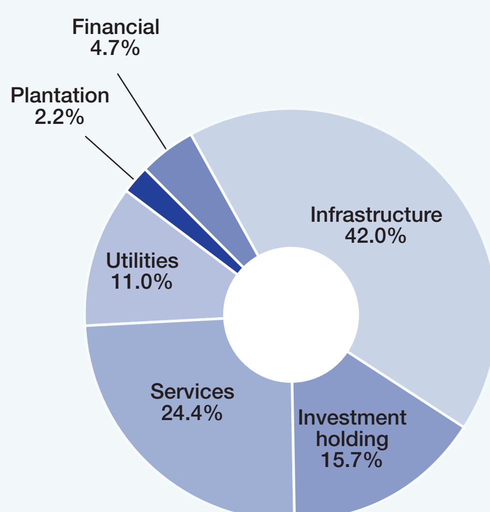
Managing Risk Exposure

GGs have always been associated as a potential source of fiscal risk. The credit risk of the entity must be thoroughly assessed and closely monitored to ensure that the financing obligations will not crystallise on the Government's budget. The Government will only be obliged to undertake payment responsibility in the event of default and hence, does not constitute as a form of direct liability to the Government. However, the GGs are classified as contingent liabilities and published annually in the Federal Government Financial Statements.

The Government is constantly reviewing and improving the process and conditions of granting GGs to extenuate the risk exposure to its budget. Among the measures taken include imposing a guarantee fee for selected issuances based on the level of risk for the projects. The financial accounts and repayments of the entities are also closely scrutinised by the Government to ensure revenue streams are stable and cash flows are sufficient to service their financing obligations. The utilisation of funds obtained from the borrowings is also monitored to ensure the funds are spent for their intended purposes. In addition, the Government has placed affirmative and restrictive covenants in certain financing agreements to protect the interests of the investors and limit the Government risk exposure.

The Fiscal Policy Committee (FPC) has also established a Technical Committee on Fiscal Risks and Contingent Liability[2] in May 2016. The main roles of the Technical Committee are to identify various sources of fiscal risks, including GGs, and to construct the appropriate measures to address the risks. The Committee is tasked to reassess government liabilities including risks emanating from the implementation of large scale development projects under GGs.

Figure 4.1.1. Government Guarantees by Sector



Source: Ministry of Finance, Malaysia.

Current Status

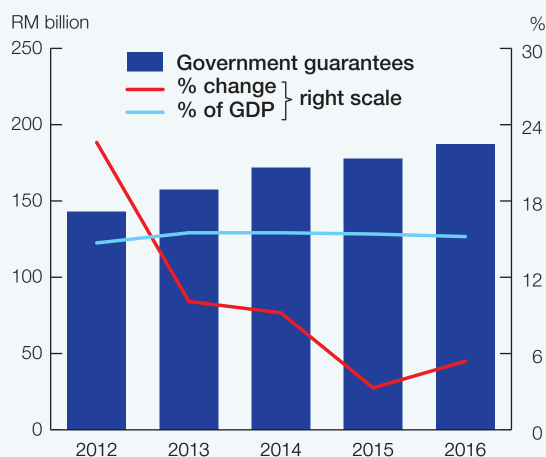
In terms of GGs portfolio, the investment is well-distributed across various segments. The main proportion of the GGs are extended for public infrastructure projects which include the mass rapid transit (MRT) and light rail transit (LRT), highways, airports, container port and tolled bridge. GGs are also granted for investment holding companies to venture into strategic investments, and for entities providing tertiary education loans and civil servant housing loans. Furthermore, GGs are also provided for entities in the utilities sector, particularly to upgrade water and electricity supply. As for the financial sector, the development financial institutions (DFIs) are sourcing the market loans to provide financing facilities to SMEs and strategic development projects.

Total outstanding GG debt stood at RM187.3 billion or 15.2% of GDP as at end-2016. The outstanding GG debt has experienced a lower

[2] Members comprise the Ministry of Finance, Economic Planning Unit, Public Private Partnership Unit and Bank Negara Malaysia.

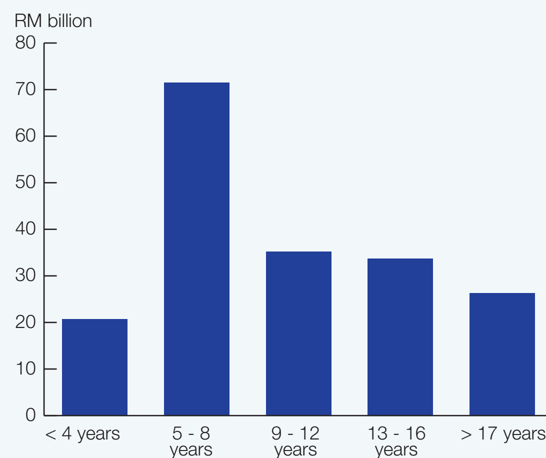
average annual growth rate of 4.3% in the past two years, compared with 14% in the year 2012 – 2014. This is attributed to a more selective and stringent evaluation process and more robust risk assessment. Approximately 97% of the outstanding GGs are denominated in ringgit while the remaining comprised Japanese yen and US dollar debt. Therefore, volatility in exchange rate has a minimal impact to the GG debt portfolio. In addition, the average-to-maturity of GGs stood at 8.6 years as at end-2016, reflecting the longer tenure of GG papers. More than 80% of the GG obligation is expected to mature beyond year 2020, hence reducing the exposure to refinancing risk. The list of outstanding GGs is published in the Federal Government Financial Statements, tabled in Parliament annually. Similarly, the quarterly frequency data for total outstanding amount of GGs are published in the National Summary Data Page, Bank Negara Malaysia, in accordance to the IMF's Dissemination Standards Bulletin Board.

Figure 4.1.2. Government Guarantees 2012 — 2016



Source: Ministry of Finance, Malaysia.

Figure 4.1.3. Maturity Profile of Government Guarantees
(End - 2016)



Source: Ministry of Finance, Malaysia.

Highlights of GG Investment

The financing of infrastructure through GG has brought positive impact to the nation's development. The commencement of the 51 kilometre MRT Sungai Buloh – Kajang Line service on 17 July 2017 is one of the highlights, where the Government successfully delivered and met the expectation of the rakyat. By leveraging private sector expertise, with the MRT Corp as the project delivery partner and DanaInfra as the fund raiser, the Government was able to reduce project delivery risk and restrict cost overrun. In fact, the Government was able to reduce the MRT construction cost to RM21 billion, recording a savings of RM2 billion from the initial estimated costs.

In addition, GG facility has helped accelerate the DFIs consolidation and enhance their capability. For example, Bank Pembangunan Malaysia Berhad has become less-reliant on GGs and is capable to launch its AAA financing programme, indicating market and investors' confidence in its ability to manage infrastructure loans. This has reduced the Government's burden in providing direct capital injection to DFIs, thus freeing up funds for social-oriented projects, such as schools and hospitals.

In general, GG facility has enabled the projects and programmes to be implemented successfully. Contrary to the concerns that GG has crowded out private sector investment, GG has in fact led to crowding in the private sector investment and participation in the economy. This has enabled the private sector to emerge as the engine of growth and catalyse economic development.

The Way Forward

While the management of GG risk profile has improved, there is a need to further enhance the risk management of GG to ensure its exposure remain minimal to the Government fiscal position. The Government is aware of the need for close monitoring of GG as the main source of contingent liability. Moving forward, the risk assessment framework will be further enhanced by adopting vigorous evaluation process and best practices to minimise credit and default risks. In order to manage liquidity risk as well as smoothen issuance, there is a need to closely monitor GG paper issuances as this may affect the pricing of the GG papers. Meanwhile, to further manage the moral hazard issues, the GG fees will be imposed based on its risk profile and its exposure to Government. The scope and duration of GG will be restricted according to the intended investment and the life-cycle of the asset.

Another important element which could be incorporated in the fiscal framework is the valuation and pricing of risk exposure, which should be constructed based on robust methodology. The Government has also explored the introduction of numerical rules for GG issuances, which is currently being applied in the Federal Government debt management. This would significantly improve the management of government liabilities in its fiscal framework.

Conclusion

GG plays an important role in facilitating and catalysing economic development in sustaining rapid and inclusive economic growth. As a component of fiscal risk management, the Government will continue to actively monitor and manage GG to ensure long-term financial viability and sustainability. By adopting best practices in managing GG, the Government is able to further enhance the effectiveness of GG in meeting fiscal consolidation objectives and supporting the nation's transformation agenda.

State Governments

State-generated revenue remains high

The consolidated **state governments** revenue is estimated at RM19.7 billion of which 76.3% is state-generated revenue, while the remaining is provided by the Federal Government through grants. State-generated revenue is estimated at RM15 billion (2016: RM14.9 billion) with royalties from petroleum, land premiums and investment income accounting for 53.5% or RM8 billion. Johor, Sabah, Sarawak, Selangor and Terengganu are the major contributors to the total state-generated revenue constituting 80.2% or RM12 billion.

Of the total consolidated revenue, ***tax revenue*** is estimated to constitute 22.1% or RM4.4 billion (2016: 20.8%; RM4.1 billion), non-tax revenue at 60% or RM11.8 billion while the remaining is contributed by non-revenue receipts. In terms of tax revenue, *direct tax* remains the largest contributor and is expected to increase 19.2% to RM2.6 billion (2016: 5.6%; RM2.2 billion), mainly from land-based taxes. Meanwhile, land premiums, investment income and royalties from petroleum contribute 68.1% or RM8 billion to the ***non-tax revenue***. ***Non-revenue receipts*** are estimated at RM3.5 billion, comprising mainly grants from the Federal Government.

Table 4.10. Consolidated State Governments Financial Position 2016 – 2017

	RM million		Change (%)	
	2016	2017[1]	2016	2017[1]
Revenue	19,631	19,695	*-7.1*	*0.3*
Operating expenditure	10,364	11,803	*-4.3*	*13.9*
Current balance	**9,267**	**7,892**	***-10.1***	***-14.8***
Gross development expenditure	8,682	12,720	*2.4*	*46.5*
Development Fund	8,533	12,441	*2.1*	*45.8*
Water Supply Fund	149	279	*16.2*	*87.4*
Less: Loan recovery	274	275	*-14.6*	*0.3*
Net development expenditure	8,408	12,445	*3.0*	*48.0*
Overall balance	**859**	**-4,553**		
Share of GDP (%)	*0.1*	*-0.3*		

[1] Estimate.
Source: Ministry of Finance, Malaysia.

The total consolidated expenditure of state governments is anticipated to increase 28.8% to RM24.5 billion. This is mainly due to a 46.5% surge in DE to RM12.7 billion in line with efforts to enhance public housing, agricultural and rural development, and energy and public amenities (2016: 2.4%; RM8.7 billion). OE is expected to grow

13.9% to RM11.8 billion (2016: -4.3%; RM10.4 billion) mainly attributed to higher emoluments, and supplies and services. Despite the higher OE, the state governments' consolidated current balance continues to record a surplus of RM7.9 billion. However, due to higher DE, the state governments' overall balance is expected to record a deficit of RM4.5 billion or 0.3% of GDP.

General Government

The consolidated **general government**[4] revenue is expected to rise 5.1% in 2017 to RM265.4 billion. OE is estimated to grow, albeit at a lower rate of 4% to RM248.4 billion. As a result, the current balance is expected to improve to RM16.9 billion. Nevertheless, DE is anticipated to register a higher growth of 17.1% to RM56.3 billion. After netting off all intra-transfers and net lending, the overall deficit is estimated at RM39.3 billion or 2.9% of GDP. Although the consolidated general government financial position is estimated to record a deficit, it will be financed through accumulated reserves and Federal Government borrowings. According to Article 111 and 112 of the Federal Constitution, all state governments except Sabah and Sarawak shall only borrow from or with approval of the Federal Government. On the contrary, statutory bodies and local governments are allowed to borrow but with prior approval from the Federal Government. Hence, the deficit and credit risk exposure of general government is contained within the Federal Government level.

Non-Financial Public Corporations

Resilient financial position

In 2017, the consolidated revenue of **NFPCs** is expected to increase 2.4% to RM353 billion, largely contributed by the energy, telecommunications and construction sectors. Although current expenditure is estimated to rebound 1.2% to RM285.1 billion (2016: -20.5%; RM281.6 billion), growth in revenue has outpaced expenditure. As a result, the current surplus continues to expand 7.7% to RM67.9 billion. Capital outlays are estimated to grow marginally by 0.5% to RM95.3 billion mainly to finance on-going projects such as the Refinery and Petrochemical Integrated Development (RAPID) complex at Pengerang; Jimah East Power plant at Port Dickson; and Mass Rapid Transit (MRT) Sungai Buloh – Serdang – Putrajaya Line. The NFPCs' capital expenditure is driven by commercial decisions which take into consideration business strategy and planning as well as market conditions.

Table 4.12. Consolidated NFPCs[1] Financial Position 2016 – 2017

	RM million		Change (%)	
	2016	2017[2]	2016	2017[2]
Revenue	344,618	352,971	*-11.2*	*2.4*
Current expenditure	281,556	285,058	*-20.5*	*1.2*
Current balance	**63,062**	**67,913**	***86.3***	***7.7***
Capital expenditure	94,867	95,309	*2.1*	*0.5*
Overall balance	**-31,805**	**-27,396**	***-46.2***	***-13.9***
Share of GDP (%)	***-2.6***	***-2.0***		

[1] Refers to 28 major NFPCs.
[2] Estimate.
Source: Ministry of Finance, Malaysia.

After taking into account all expenditures, the overall balance of NFPCs is expected to record a lower deficit of RM27.4 billion. As at end-2016, net worth of the top 15 NFPCs[5] stood at RM570.1 billion of which the assets are valued at RM984.6 billion, more than double the size of its liabilities at RM414.5 billion. Total outstanding debt amounted to RM194.6 billion, representing 47% of the liabilities. With a positive net worth, the NFPCs are able to finance its deficit through accumulated retained earnings and borrowings, backed by quality assets and future revenue streams.

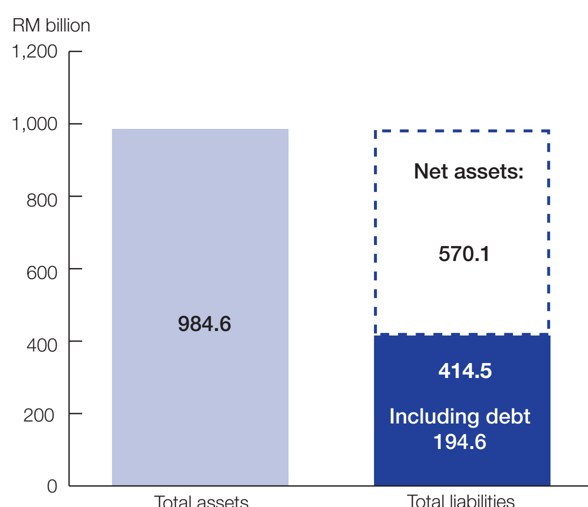
Table 4.11. Consolidated General Government Financial Position 2016 – 2018

	RM million			Change (%)		
	2016	2017[1]	2018[2]	2016	2017[1]	2018[2]
Revenue	252,550	265,362	279,019	*-3.2*	*5.1*	*5.1*
Operating expenditure	238,854	248,428	261,485	*-1.9*	*4.0*	*5.3*
Current balance	**13,696**	**16,934**	**17,534**	***-20.7***	***23.6***	***3.5***
Development expenditure	48,087	56,286	56,594	*1.8*	*17.1*	*0.5*
Overall balance	**-34,391**	**-39,352**	**-39,060**	***14.8***	***14.4***	***-0.7***
Share of GDP (%)	***-2.8***	***-2.9***	***-2.7***			

[1] Revised estimate.
[2] Budget estimate, excluding 2018 Budget measures.
Source: Ministry of Finance, Malaysia.

[4] Consists of the Federal Government, state governments, local authorities and statutory bodies.
[5] Ranked according to asset size.

Figure 4.2. Top 15 NFPCs: Assets and Liabilities
(End - 2016)



Source: Ministry of Finance, Malaysia.

Consolidated Public Sector

The financial position of the **consolidated public sector (CPS),** which consists of general government and NFPCs, is expected to record a higher current surplus of RM84.7 billion, supported by larger NFPCs' revenue. The consolidated DE is anticipated to increase 6.1% to RM151.5 billion due to higher capital outlays of both NFPCs and the general government. The CPS treats capital outlays of NFPCs as expenditure whereas under NFPCs account, it is treated as formation of assets which would generate future income stream. Public sector spending is expected to support investment in strategic areas such as public transportation and multi-modal commercial transportation network as well as areas lacking private sector participation such as agriculture and fisheries. Thus, the overall deficit of the CPS is estimated at RM66.8 billion or 5% of GDP in 2017. The financial performance of CPS remains resilient as NFPCs' investments are able to generate steady income streams and service debts.

Prospects

Financial Position 2018

In 2018, with positive global economic outlook and trade prospects, the domestic economy is expected to remain vibrant supported by private sector activity. In this regard, the Federal Government financial position is expected to perform better primarily due to higher revenue collection and modest expenditure growth. Thus, the fiscal deficit is targeted to reduce further to 2.8% of GDP or RM39.8 billion (2017: 3.0%; RM39.9 billion). Consequently, the Federal Government debt as percentage to GDP is projected at around 50%. This demonstrates the Government's firm commitment to further consolidate its fiscal deficit towards achieving a near-balanced budget in 2020.

Federal Government revenue is forecast to grow 6.4% to RM239.9 billion (2017: 6.1%; RM225.3 billion). In consonance with better economic activity and supportive business environment, tax revenue is expected to increase 6.3% to RM191.6 billion (2017: 6.4%; RM180.2 billion). The Government will continue to improve the tax revenue collection by enhancing tax compliance and administration. Furthermore, the Government has established the Collection Intelligence Arrangement (CIA) as part of continuous efforts to reduce tax evasion, avoidance and leakage. Members of CIA are the Inland Revenue Board, the Royal Malaysian Customs Department and the Companies Commission of Malaysia. CIA provides an integrated information sharing platform between agencies in enhancing enforcement and increasing compliance as well as addressing shadow economy. In addition, the Government is reviewing tax incentives to focus on targeted and critical sectors.

Table 4.13. Consolidated Public Sector Financial Position 2016 – 2018

	RM million			Change (%)		
	2016	**2017[1]**	**2018[2]**	**2016**	**2017[1]**	**2018[2]**
Revenue	224,438	234,344	243,046	*3.9*	*4.4*	*3.7*
Operating expenditure	238,569	248,202	261,210	*-1.9*	*4.0*	*5.2*
NFPCs current balance	90,690	98,540	111,228	*15.9*	*8.7*	*12.9*
Public sector current balance	**76,559**	**84,682**	**93,064**	***50.4***	***10.6***	***9.9***
Development expenditure	142,798	151,497	143,567	*1.7*	*6.1*	*-5.2*
General government	47,931	56,188	56,427	*0.9*	*17.2*	*0.4*
NFPCs	94,867	95,309	87,140	*2.1*	*0.5*	*-8.6*
Overall balance	**-66,239**	**-66,815**	**-50,503**	***-26.0***	***0.9***	***-24.4***
Share of GDP (%)	***-5.4***	***-5.0***	***-3.5***			

[1] Revised estimate.
[2] Budget estimate, excluding 2018 Budget measures.
Source: Ministry of Finance, Malaysia.

The 2018 Federal Government budgeted expenditure is RM280.2 billion, 5.4% higher than 2017 (RM265.9 billion; 5.4%). A sum of RM234.2 billion (83.6%) is assigned for **OE** (2017: RM219.9 billion; 82.7%) while the balance of RM46 billion (16.4%) is for DE (2017: RM46 billion; 17.3%). *Emoluments* will be allocated RM79.1 billion while RM61.3 billion is provided for charged expenditures mainly *debt service charges* (RM30.9 billion), *retirement charges* (RM24.5 billion) as well as *constitutional grants and transfers to state governments* (RM5.7 billion). Meanwhile, RM33.6 billion and RM577 million (2017: RM32.6 billion; RM698 million) will be allocated for *supplies and services* as well as *asset acquisition,* respectively. Total subsidies and social assistance is expected to increase to RM26.5 billion or 11.3% of OE (2017: RM23.1 billion; 10.5%).

DE allocation in 2018 remains at RM46 billion or 17.7% of the 11MP's ceiling. The allocation includes funding for the rollout of projects and programmes under the economic (57.3%), social (25.5%), security (11.3%) and general administration (5.9%) sectors. The ***economic sector*** will be allocated the largest sum of RM26.3 billion (2017: RM25.9 billion) which will focus on public infrastructure development and transportation network (RM10.5 billion), trade and industry (RM4.1 billion) as well as agriculture and rural development (RM2.5 billion). *Energy and public utilities subsector* will also continue to receive an allocation of RM2.7 billion, mainly for expansion of rural water supply, electricity and sewerage services.

The ***social sector*** will continue to be given priority in 2018 with a substantial allocation of RM11.7 billion or 25.5% of total DE provided mainly for education and training, health, housing and welfare services. The largest sum of RM5.3 billion or 11.4% of total DE (2017: RM5.9 billion; 12.8%) will be earmarked for the *education and training subsector* to enhance the education facilities and meet the growing demand for skilled workforce. Of this, RM3 billion is allocated for tertiary education, RM787 million for primary and secondary education while RM694 million is for skills and training programmes. In addition, pre-school education will be expanded and strengthened especially in rural areas to ensure a strong foundation in education at the early age. In order to enhance the access to quality and affordable healthcare especially for the low-income group, a sum of RM1.9 billion or 4.2% of total DE (2017: RM1.5 billion; 3.3%) is allocated for the *health subsector*. This allocation will be utilised mainly to upgrade healthcare facilities and services in rural and urban areas. Meanwhile, the *housing subsector* will be allocated a sum of RM1.2 billion mainly for the construction of low-cost houses and quarters for civil servants.

The ***security sector,*** which comprises defence and internal security, will be provided RM5.2 billion or 11.3% of total DE (2017: RM5.3 billion; 11.5%) to enhance the capacity and capability of the security forces. This will be for new procurements, upgrading of security assets and facilities as well as enhancing surveillance equipment. For the ***general administration sector,*** RM2.7 billion or 5.9% of total DE (2017: RM2.7 billion; 5.8%) will be allocated to undertake continuous improvements in public service delivery which includes ICT systems and equipment, and repair and maintenance of Government facilities nationwide.

Medium-Term Fiscal Framework 2018 – 2020

The MTFF continues to provide fiscal guidance and outlines the three-year fiscal projection along with required key policy initiatives based on the medium-term macroeconomic assumptions. It sets a three-year optimal spending level taking into account the revenue generating capacity and the Government's commitments. The framework provides indicative ceilings for ministries and agencies during the period, which allows a proper planning of programmes and projects beyond annual planning horizon to achieve specific desired goals in line with the fiscal consolidation plan. For the period of 2018 – 2020, the deficit level will be gradually reduced towards achieving a near-balanced budget in 2020.