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MALAYSIAN BUDGET 2005 SUMMARY

September 2004

On Friday, 10 September 2004, Malaysian Prime Minister and Finance Minister, Abdullah Ahmad Badawi, tabled his 2005 Budget in Parliament.

In his speech the Prime Minister moved the second reading of a Bill intituled "An Act to apply a sum from the Consolidated Fund for the service of the year 2005 and to appropriate that sum for the service of that year".

The following are some of the highlights and major proposals in the Budget Speech:

Budget Strategy

Budget 2005 will continue the Government's focus on the following strategies:

> "First: Enhancing the effectiveness of Government financial management, efficiency of the delivery system and competitiveness;
>
> Second: Accelerating the shift towards a higher value-added economy;
>
> Third: Developing human capital as a catalyst of growth; and
>
> Fourth: Ensuring the well-being of the rakyat [the people] through improving their quality of life."

To pursue these strategies the Government will appropriate RM117.4 billion (US$30.89 billion) to the 2005 Budget, comprising Operating Expenditure of RM89.1 billion (US$23.45 billion) and Development Expenditure of RM28.3 billion (US$7.45 billion).

Operating Expenditure will be distributed as Emoluments (24.9%), Services and Supplies (21.1%), Fixed Payments and Grants (52.0%), purchases of office equipment and facilities (1.6%) and other expenditures (0.4%).

Development Expenditure will be distributed as expenditure on the economic sector (i.e. infrastructure, agriculture and industry) (49.1%), social sector (including education and training, health and housing) (26.9%), security sector (10.6%) and general administration (13.4%).

With projected revenue in 2005 of RM99.2 billion (US$26.11 billion) the Federal Government deficit will be reduced from 4.5 percent of GDP in 2004, to 3.8 percent.

Economic Performance

- In the first half of 2004, the economy expanded faster than expected, at 7.8 percent (2003: 5.3 percent) on the back of strong domestic demand and a buoyant external sector. GDP growth for the whole of 2004 is expected to be 7.0 percent, the highest since 2001. This momentum will continue in 2005, with 6 percent growth projected

- Inflation in the first half of 2004 remained low with the CPI increasing only 1 percent. Unemployment was 3.5 percent—effectively, full employment. The fiscal deficit is expected to be reduced to 4.5 percent of GDP (2003: 5.3 percent); and monetary policy is expected to remain accommodative

- Trade surpluses continued for the 81st consecutive month since November 1997. International reserves stood at a record US$54.45 billion in August 2004 (2003: US$44.86 billion) sufficient to finance 7.2 months of retained imports and equivalent to five times short-term external debt

- The overall balance of payments in 2004 is again expected to be stronger, at RM42.34 billion (2003: RM39.06 billion) with the overall surplus expected to continue in 2005 for a fifth consecutive year. Increasing surpluses in the goods account are more than offsetting the deficits in the services, income and current account transfer accounts

- The services sector, representing 57.1 percent of GDP, is expected to achieve higher growth of 6 percent in 2004 (2003: 4.4 percent) due to higher consumer spending and record tourist arrivals

- The manufacturing sector, representing 31.8 percent of GDP, is expected to grow 10.5 percent in 2004 (2003: 8.3 percent) due to the favourable external environment, especially higher demand for electronic and electrical (E&E) products

- In Q2 of 2004, 42 percent of manufacturers were producing at near-maximum capacity (Q1: 35 percent) with the numbers of manufacturers producing at lower capacity levels also edging upwards

- Malaysia's largest trading partners so far in 2004 were the United States (the trade surplus mainly due to E&E, textiles and apparel exports), Singapore (the trade surplus mainly due to E&E exports), Japan (the trade deficit mainly due to imports of E&E, plant & machinery and parts, against exports of E&E goods, and optical and scientific instruments) and China (the trade surplus mainly due to chemicals, E&E and palm oil exports)

- As at July 2004, there were 1.3 million registered foreign workers comprising 12 percent of total employment in the country. Professionals and highly-skilled workers (referred to as "expatriates") accounted for approximately 3 percent of the foreign workforce

Budget Proposals

Tax Reform

- Included in a review of some twenty sets of statutes and regulations, and the re-engineering of 104 public agency work systems, a Taxation System Review Panel will be established to restructure the whole tax system, to make it more efficient, equitable and business friendly

- A fund for income tax refunds will be established to expedite the return of taxpayers' money after first setting off any current year tax liabilities

- A broad-based consumption tax called the Goods & Services Tax (GST) will be introduced on 1 January 2007. GST will replace the existing sales and service taxes, and is intended eventually to enable income tax rates to be reduced. Details of the GST rates, exemptions for basic items and small businesses, input credit systems, etc, have yet to be announced

Manufacturing Sector

- A microelectronics centre will be established to develop and improve the competitiveness of the semiconductor industry. The new centre will consolidate and utilize existing institutions and facilities

- Local companies that outsource their production to local or foreign contract manufacturers can now claim import duty and sales tax exemptions on raw materials and semi-finished goods not available locally, as do conventional manufacturers. No definition of "local company" is given at this time

- Double tax deduction will be given for expenditure incurred in obtaining certifications for international quality standards

- To reduce the cost of doing business in Malaysia, import duties are abolished on 27 items, including surgical gloves and glassware, and reduced in respect of another 118 items, including selected raw materials used in the apparel industry

- To further encourage investment in the Eastern Corridor of Peninsular Malaysia, and Sabah and Sarawak, additional tax incentives, such as a second round of Pioneer Status / Investment Tax Allowance, will be given to "existing companies which relocate their manufacturing activities" to these regions

- Industrial building allowance (tax depreciation) claimed for capital expenditure on a building previously used as an industrial building will now be based on the taxpayer's cost rather than the seller's tax-depreciated value

- The tax depreciation period for capital expenditure incurred by companies on uninterrupted power supply equipment, is reduced from a minimum of four years, to two years

Capital Markets

- The Government will "allow up to five major foreign stockbrokers [and] five leading global fund managers to operate in Malaysia"

- The Government will "allow 100 percent foreign ownership in futures broking companies to increase liquidity and level of capital market risk management [and] in venture capital companies to increase funding and expertise to promote investments in the ICT sector"

- To inject more liquidity into the capital market, the EPF will be permitted to increase its placements with local fund managers, including non-bank-owned companies, from the current RM6.0 billion, to RM12.0 billion, within three years

- Foreign multinationals and supranational agencies like the World Bank, International Finance Corporation and Asian Development Bank will be permitted to issue Malaysian Ringgit-denominated bonds

- Interest income derived by non-resident companies from "ringgit-denominated Islamic securities and debentures, excluding convertible loan stocks, approved by the Securities Commission; and securities issued by the Government of Malaysia" will be exempt from income tax. No definition of "non-resident company" is given at this time

Small & Medium-sized Industries (SMIs)

- Further allocations are made for soft loans and matching grants to SMIs through the existing SMI Fund 2 (RM1.5 billion) and the New Entrepreneurs Fund 2 (RM550 million) and two new funds to assist in developing marketing capabilities (RM100 million) and enhancing product design and packaging expertise (RM50 million)

- The development finance institutions, Bank Industri & Teknologi [Bank of Industry & Technology] and Bank Pembangunan & Infrastruktur Malaysia [Development & Infrastructure Bank of Malaysia] will be restructured to make them more focused and avoid duplication of functions

- Malaysia Export Credit Insurance Berhad [Limited] and Export-Import Bank of Malaysia Berhad [Limited] will be merged to create economies of scale

Other

- The present income tax exemption for retirement benefits received by private sector employees only upon reaching a compulsory retirement at the age of 55 is extended to compulsory retirees at the age of 50 onwards. The exemption is RM6,000 for each year of service

- To promote the generation of energy from renewable and environmentally friendly resources such as biomass, hydropower and solar energy, the tax depreciation period for capital expenditure incurred by companies to generate such energy for their own use, is reduced from a minimum of four years, to one year

Further Information

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