

# Economic Briefing To the Penang State Government

## Penang GRP for Quarter 2, 2004

National Malaysian Q2 GDP for 2004 stood at 8% fuelled by private sector demand and strong external demand. In Penang, growth for Q2 echoed national growth trends, with major contributors to the State GDP coming from services and the manufacturing sectors. Penang GRP for Q2 2004 is 7.28%.

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### Penang Q2 2003 versus Penang Q2 2004: Facts and Figures

The tables below highlight the rate of growth of the five main sectors in Penang for Q1 2004 relative to the performance of Q2 2004.

**Table 1: Penang's Gross Regional Product by Economic Sectors for Q2 2003**

<u>Quarter 2 2003</u>		
Sectors	Penang Sect Share (%)	Volume (RM Million in 1987 Prices)
Agri., Hunting, Forestry & Fishing	1.6%	72
Mining & Quarrying	1.0%	47
Manufacturing	41.3%	1,871
Construction	2.1%	95
Services	54.0%	2,446
Sum	100%	4,531

Source: SERI

**Table 2: Penang's Gross Regional Product by Economic Sectors for Q2 2004**

<u>Quarter 2 2004</u>		
Sectors	Penang Sect Share (%)	Volume (RM Million in 1987 Prices)
Agri., Hunting, Forestry & Fishing	1.5%	74.9
Mining & Quarrying	0.9%	44.2
Manufacturing	42.4%	2,061.0
Construction	1.8%	87.5
Services	53.4%	2,593.3
Sum	100.0%	4,860.8

Source: SERI

**Table 3: Penang-Economic Sector Contribution to Overall Growth Rate, Q2 2004**

Sector	Relative Growth Rate	Sectoral Share (%)	Contribution to overall growth rate
Agri., Hunting, Forestry & Fishing	4.0%	1.5%	0.1%
Mining & Quarrying	-5.9%	0.9%	-0.1%
Manufacturing	10.2%	42.4%	4.3%
Construction	-7.9%	1.8%	-0.1%
Services	6.0%	53.4%	3.2%
<b>Total</b>	<b>7.28%</b>	<b>100.00%</b>	<b>7.3%</b>

Source: SERI

## Manufacturing

As the threat of high oil prices and imminent interest rate hikes loom on the US horizon affect global economic recovery, activities in the manufacturing front continue to gather more momentum in the 2<sup>nd</sup> quarter.

Export and import figures for the state surged by 27% and 20% respectively.<sup>1</sup> For the export-oriented industries, higher growth was recorded in the electronics, chemical products and rubber products industries. The SMI/Es in Penang demonstrated Y-o-Y Q2 growth in number, size and production figures. Most SMI/E's in Penang are export-based in the industries of automation, E&E and foodstuff. Strong expansion was seen in the electronics industry, particularly from high demand consumer electronics and communication devices.

**Table 4: Penang: Approved Manufacturing Projects By Industry**

Industry	Number of Projects		Total Investment (RM)	
	Q203	Q204	Q203	Q204
Electrical & Electronic	18	13	479,913,334.00	204,797,519.00
Basic Metal Products	-	2	-	18,300,000.00
Fabricated Metal Products	6	5	16,037,613.00	65,348,799.00
Machinery Manufacturing	2	1	16,530,000.00	5,902,600.00
Paper, Printing & Publishing	1	-	21,845,250.00	-
Plastic Products	2	3	1,700,000.00	14,710,413.00
Scientific & Measurement Equipment	-	2	-	9,500,000.00
Transport Equipment	-	2	-	820,000.00
Beverages & Tobacco	1	-	12,700,000.00	-
<b>TOTAL</b>	<b>30</b>	<b>28</b>	<b>548,726,197.00</b>	<b>319,379,331.00</b>

Source: MIDA

In the first half of 2004, Penang's share of manufacturing investments is 13.2% of Malaysia's 536 approved projects and 11.0% of the nation's total investment. Following the marked increase in amount of investments into Penang for Q1 2004, this quarter registered a decline in number of projects approved and the number of new local and foreign investments into Penang.

**Table 5: Penang: Number of Approved Projects and Investments (Local & Foreign)**

	Q2 2003	Q2 2004	Y-o-Y Growth
Number of Projects Approved	30	28	-6.7%
Potential Employment	3,035	2,568	-15.4%
Amount of Investment Approved	548,726,197	319,379,331	-41.8%
Local	92,766,754	83,143,050	-10.4%
Foreign	455,959,443	236,236,281	-48.2%

Source: MIDA

As at Quarter 2 2003 the share of local investments stood at 16.9% whilst the share of foreign investments stood at 83.1% as a total of the Penang manufacturing sector. Comparatively, for Quarter 2 2004, the share of local investment increased to 26% whilst the share of foreign investment fell to 74% of the total Penang manufacturing sector. This reflects the increasing role, significance and contribution of SMIs to our manufacturing sector.

## Tertiary

Strong consumer demand continues into the 2<sup>nd</sup> quarter with BNM consumption credit loans for Penang state registering a spike in Y-o-Y change of 11.2%. Consumption credit loans reflect loans for personal uses, credit cards and purchase of consumer durable goods.

<sup>1</sup> Source: Department of Statistics, Kuala Lumpur

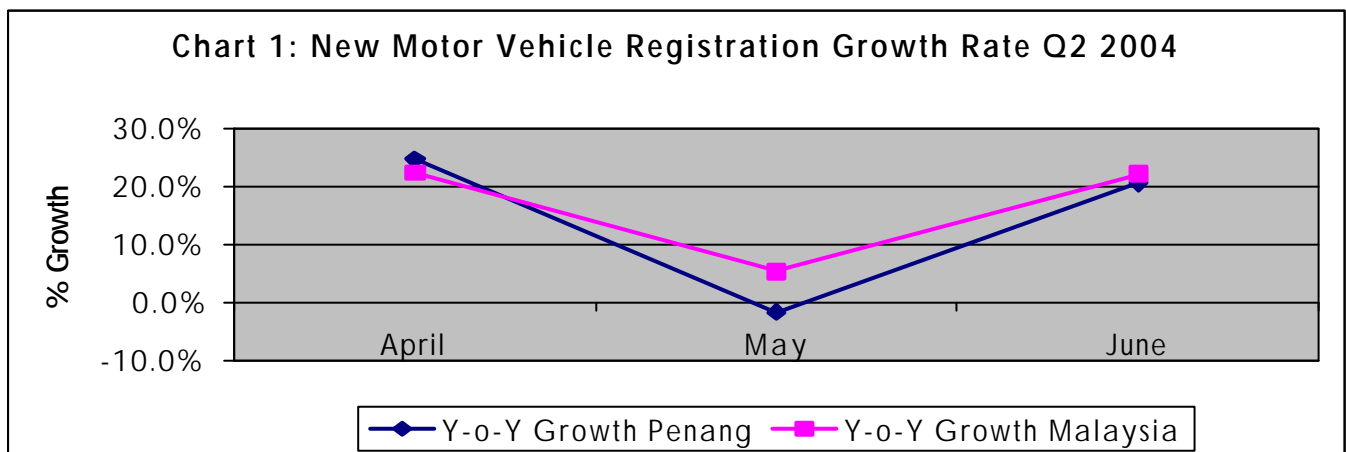
There was improvement in the tourism sector from its dismal Q2 performance in 2003. While national tourism figures have registered an increase of 70% for the 1<sup>st</sup> half of 2004, Penang has only seen improvements of approximately 20.5% in tourist arrivals. Penang lacks new tourism products to draw repeat tourists and is beginning to lose out on its market share to Thailand, Indonesia and other states within Malaysia.

On the property front for offices, there has been no increase in capital value, rental value and new office buildings. However, occupancy rates have improved by 3% compared to Q2 of 2003. For commercial buildings, Q2 2004 did not see the opening of any new establishments, whilst occupancy rates of existing retail commercial lots increased by 5% compared to Q2 2003. For residential areas in the state, the prime areas of Pulau Tikus, Tanjung Bungah, Green Lane, Jesselton and Butterworth town area registered capital appreciation of approximately 5% y-o-y.

**Table 6: Penang – New Motor Vehicle Registration**

	Penang		Malaysia		Y-o-Y Growth	
	2003	2004	2003	2004	Penang	Malaysia
April	6,751	8,424	65,045	79,657	24.8%	22.5%
May	7,883	7,752	68,606	72,266	-1.7%	5.3%
June	7,518	9,069	68,309	83,464	20.6%	22.2%
Total	22,152	25,245	201,960	235,387	14.0%	16.6%

Source: Road Transport Department, Malaysia



Source: Road Transport Department, Malaysia

New motor vehicles registrations are used as an important indicator of consumption demand. New motor vehicle registration for Malaysia and Penang experienced similar trends where there was a sharp improvement in consumer sentiment in the month of June. This signifies an optimistic outlook in consumer confidence towards spending.

The above-mentioned factors indicate resilience of consumption demand in Penang for Q2 2004. This has spurred the growth of our economy and is in line with Bank Negara's statement that Q2 GDP growth is predominantly driven by strong consumer demand.

### ***Agriculture, Hunting, Forestry & Fishing***

The most significant crops planted in Penang are paddy, vegetables and fruits. The first paddy harvest for the year was in April 2004. The incentive linked programme, the "10-tonne programme" has managed to increase paddy yields from approximately 4.3 metric tonnes per hectare to nearly 5.5 metric tonnes per hectare.

Through initiatives such as communal farming (projek kelompok) and ISO Projek Komersil to increase harvest yield, vegetable cultivation in Penang is becoming increasingly important and some produce have been sent to the states of Northern Malaysia. The areas of Seberang Prai Tengah and Seberang Prai Selatan hold much potential for agricultural farming whose monetary value and economic contribution to the State will be much more significant with

the contributions of bio-technology to increase the quality and quantity of these outputs.

In terms of productivity in monetary terms, fisheries have higher value added in this sector. A simple example is one kilogram of paddy retailing at RM2, whilst 1 kilogram of good quality fish retails at a minimum of RM 35. Growth in the aquaculture remains steady for Q2 2004 mainly due to increasing competition from Thailand in the export of high quality table fish to North Asian countries. BNM has recorded a promising increase of 7.1% in loans disbursed to our agricultural, hunting, forestry and fishing sectors.

## Construction

With limited property development in Penang, the consolidation of national mega-projects and the escalating costs of building materials, the construction sector has shrunk in Y-o-Y growth of approximately 8.4%. The table below highlights the increase in the costs of building materials for Q1 2004 (using the month of March as proxy) and Q2 2004 (using the month of May as proxy) both using July 2002 prices as base price. The price blow-out of building materials has been the major cause of the contraction in the construction sector nationwide.

The existing areas of property development in Penang are confined to the areas of Bayan Lepas, Teluk Kumbar and Sungai Ara and in Bertam and Kepala Batas on the mainland. Shortage of land in Penang also compounds to the builder's woes.

**Table 7: Building Materials Cost Index by Work Section and Region**

Work Section	Period	REGION					
		A	B	C	D	E	F
		Penang, Kedah, Perlis	Perak	Kuala Lumpur, Selangor, Negeri Sembilan, Melaka	Johor	Pahang	Kelantan, Terengganu
JULY 2002 = 100							
RC Piling Works	March 2004	105.5	110.0	112.5	108.3	108.4	109.8
	May 2004	125.0	128.1	129.6	123.9	128.3	127.5
Foundation Works	March 2004	102.0	107.0	111.4	107.6	107.4	108.1
	May 2004	118.1	122.0	125.5	120.6	123.7	122.7
RC Structural Works	March 2004	103.0	108.5	112.2	108.5	108.2	108.9
	May 2004	120.4	124.7	127.4	122.5	125.8	124.6
Steel and Structural Works	March 2004	131.4	129.5	129.6	130.5	103.9	128.6
	May 2004	141.1	138.8	138.8	139.9	140.7	137.7
Brickworks and Blockworks	March 2004	105.0	99.6	108.8	105.2	105.9	110.2
	May 2004	105.1	101.8	109.1	106.3	106.6	110.4
Roofing Works	March 2004	110.7	110.4	110.9	115.3	112.7	110.9
	May 2004	115.8	118.6	115.5	119.9	118.0	116.1
Doors and Windows Works	March 2004	112.4	112.3	112.4	112.2	112.4	111.3
	May 2004	113.1	113.5	113.5	113.5	113.7	112.5
Finishing Works	March 2004	99.8	100.3	100.5	100.8	100.4	102.3
	May 2004	100.0	100.4	100.8	101.0	100.5	102.4
Sanitary Fittings Works	March 2004	100.6	101.3	100.2	100.3	100.0	99.6
	May 2004	100.6	102.6	100.2	100.6	100.1	99.6
Plumbing Works	March 2004	109.2	108.2	106.0	108.6	106.3	102.7
	May 2004	113.6	114.3	110.5	113.7	108.9	107.8

Source: This index is compiled from data supplied by the Department of Statistics, Malaysia

### *Mining and Quarrying*

With approximately 13 quarries on the mainland and 4 on the island, the State's quarrying activities are the main source of blockwork supply to local construction firms. Sectoral contribution to Penang GDP remains below 1%, with its economic contribution tied to the performance of the local construction sectors.

### *BNM Loans*

Loan figures were used as an important indicator of growth in the given sectors. Penang recorded large increases in loan applications for Q2 2004 versus Q2 2003 for the purchase of securities, transport vehicles, residential property, credit card usage, quarrying, communication and transport services and for business services. All in all, the data highlighted in Table 8 below point to increased consumer spending patterns and strong export demand fuelling domestic growth.

**Table 8: Growth Rates in Loans by Sector**

Sectoral Loans	% Growth	
	Penang	Malaysia
Loans-purchase of securities	17.7%	-5.5%
Loans-purchase of transport vehicles	15.3%	12.0%
Loans-purchase of residential property	14.7%	15.4%
Loans-purchase of non-residential property	5.3%	6.4%
Loans-personal use	9.5%	10.7%
Loans-credit card	14.3%	13.8%
Loans-purchase of consumer durable goods	-20.1%	-13.6%
Loans-agriculture, hunting, forestry & fishing	7.1%	-1.0%
Loans-mining & quarrying	12.3%	6.2%
Loans-manufacturing	6.6%	2.3%
Loans-electricity, gas & water supply	-11.5%	-15.7%
Loans-construction	-9.3%	-6.6%
Loans-wholesale, retail, restaurant & hotels	4.1%	7.5%
Loans-transport, storage & communication	10.8%	14.7%
Loans-finance, insurance, real estate & business services	13.4%	-0.3%
Loans-community, social & personal services	-0.3%	-12.4%
Loans-sectors n.e.c.	-1.6%	-11.4%
<b>Total</b>	<b>9.7%</b>	<b>6.0%</b>

Source: Bank Negara Malaysia (BNM)

In line with the abovementioned factors, we conclude that **Penang's Q2 GRP** for the year 2004 stands at **7.28%** compared to national Q2 GDP figures at 8%. *§ Poh Heem Heem, Tan Yin Hooi & Dr. Chan Huan Chiang*

## FEDERAL BUDGET 2005: What It Means For Penang

The Federal Budget 2005 was formulated amidst optimistic sentiments over the both the international and Malaysian economies, and released on the 10 September 2004. The words most frequently used to describe this budget - such as well balanced, pragmatic and realistic – underline support for the basic thrust of the budget: to reduce the fiscal deficit whilst maintaining the rate of growth of the nation.

Fiscal deficits are incurred when government spending exceeds government revenue. The post-Asian crisis years saw the government doing exactly that to support our battered economy. Whilst many corporations were reeling in shock over the currency devaluation and its impact on their profit and loss statements, property valuation and business viability, government spending became the main engine of growth.

Excessively large fiscal deficits as a percentage of Gross Domestic Product (GDP) are frowned upon as it is deemed unsustainable. The sustainability, or lack of it, arises when the country concerned finds itself mired deeper and deeper in borrowings to finance its expenditure, otherwise known as the debt-trap. All revenue earned then goes towards paying off the borrowings rather than reinvested into the economy to generate further growth. With fiscal consolidation measures in place, the Federal Government's overall deficit is projected to decline further from 5.3% of GDP in 2003 to 4.5% of GDP in 2004.

### Private Sector as the Growth Engine

With the reigning in of public sector spending, the onus for growth lies within the private sector. The formulation of the 4 strategies of the budget, namely to:

- Enhance the effectiveness of Government financial management, efficiency of the delivery system and competitiveness;
- Accelerate the shift towards a higher value-added economy;
- Develop human capital as a catalyst of growth; and
- Ensure the well-being of the *rakyat* through improving the quality of life

seem to address the support issues needed by the private sector in order to be able to shoulder this great responsibility.

### Addressing the "Under-Investment" Climate

The first strategy reflects efforts to re-engineer the public sector, thus helping to enhance the overall investment climate in Malaysia. The streamlining of the service delivery system and increasing emphasis on disclosure-based regulations, together with fostering a culture of high performance within government personnel and offices, will accentuate efficiency and productivity within the public sector.

It also looks into existing infrastructure and its maintenance. Though Malaysia has 1<sup>st</sup> world infrastructure and amenities, many of its people still possess 3<sup>rd</sup> world mentality when it comes to caring for public goods and services. It is thus hoped that this first strategy will inculcate and reinforce the principles of integrity, accountability, transparency, good governance and positive values; again, important in addressing the issue of under-investment within the Malaysian private sector. Value of investments in the country fell by 11.8% for the 1<sup>st</sup> half 2004 compared to 1<sup>st</sup> half 2003. In Penang, the value of investments fell by 9.7% for the same period.<sup>1</sup> If the current situation of under investment persists, it may well be that the government will need to rely on private consumption to generate growth instead of private investment. This may not be a good idea as the risk associated with consumption-led growth is increasing price pressures on the economy.

A resilient financial system is needed to support the financing activities of the private sector. The existing financial system has undergone massive structural reforms with the recent spate of mergers, emerging more robust than before. Strengthening the capital markets<sup>2</sup> and the development of an Islamic Banking System will increase the range

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<sup>1</sup> Source: MIDA

<sup>2</sup> The capital market is the market where long term fixed income instruments are issued and traded for example, bonds. Bonds pay the bearer a known fixed amount of interest every year and guarantee principal repayment at maturity.

of financial instruments available to further complement the existing equity market. A well-developed capital market is an avenue for domestic funding for the government via the issuance of bonds and securitisation of government staff housing loans. Moreover, capital market flows are less volatile and its instruments are a less expensive method for private companies to raise funds compared to equity markets.

Budget 2005 does not address the deregulation of the financial market, which can broaden the financing options for the private sector and at the same time encourage foreign investment. Investors thrive on transparency within financial systems. Perhaps, the government is waiting for the banking structures to be streamlined and fortified, and the capital market to fully develop before complete market liberalisation takes place.

### **Strengthening the private sector**

Private sector growth can broadly be classified as coming from two categories, regardless of market sectors: firstly, the larger public listed local companies or Multinational Companies (MNCs) and secondly, the small to medium industries or enterprises (SMI/Es). Most SMEs survive by providing specialised support services to the larger companies. In getting the private sector to spearhead growth, private companies must be able to achieve sustainable growth with long-term resilience and competitiveness. The economic value generated must be passed down, through the different stages of the supply chain, to the people of Malaysia.

The increasing cost of doing business in Malaysia compared to China<sup>3</sup>, India and Vietnam, to name a few, has caused some MNCs to relocate. Thus, to depend on MNCs that may relocate elsewhere for economic wealth and technology transfer is a risky business. The second and third strategies of the budget aim to create added value here in Malaysia as part of a differentiation strategy to maintain and increase our market share of investments and to become self-sufficient in the near future. These strategies are targeted at the manufacturing sector and other sectors of economic potential such as agriculture and services.

Industry incentives provided in this budget were significantly less than those provided the previous year. This is understandably so, given the drive to lower government expenditure for the coming year. The incentives offered were mainly aimed at encouraging value-added activities, in line with the 2<sup>nd</sup> strategy of the budget. The exemption of import duty and sales tax for raw materials manufactured abroad and for semi-finished goods imported from contract manufacturers abroad will lower costs and allow manufacturers to outsource cheaper material; gradually shifting concentration from production-based activities to higher value-added activities such as design and research and development (R&D). In time, this will increase the manufacturers' competitiveness and encourage the birthing of local innovation. The double deduction on expenses incurred to obtain international quality standards is a win-win measure for both the state and the manufacturers, as it will encourage the manufacturers to up-grade the quality of their goods and services to achieve global standards, and at the same time, enable them to penetrate into other foreign countries and broaden their market base.

On the flip side, the incentives of a second round of Pioneer Status or Investment Tax Allowance given to existing companies that relocate their manufacturing activities to promoted areas in the Eastern Corridor of Peninsular Malaysia, Sabah and Sarawak will pose a threat to Penang as some manufacturers may be enticed to move out or divert their re-investments out of Penang.

Substantial emphasis was given to SMEs to step up the pace of development of these local industries, especially in high value-added activities. This is positive for Penang given that Penang has the highest number of SMEs in the Northern Region (approximately 23,774), whereby 4,912 companies are involved in manufacturing while the rest are involved in logistics, retail & wholesale and professional management services.<sup>4</sup> The significant increase in the allocation of soft loans and matching grants for SMEs to improve on their technological capability, market penetration and skills training are a big boost to the SMEs.

The increase in the funds will encourage these companies to accept new advancements in technology, to move with the changing times from traditional methods of manufacturing and venture into more hi-tech automation, effective marketing methods and good management practices. In the long run, it will help these SMEs to be frontrunners in the area of design, R&D and other high value-added activities.

<sup>3</sup> Cost of doing business is reported to be rising rapidly in certain coastal cities in China.

<sup>4</sup> Based on 2003 data. Source: SMIDEC

Undoubtedly, these were major efforts made to increase the level of financing available to SMEs. However, many SMEs still face difficulties in accessing the funds provided, citing problems such as ineligibility and a lack of transparency in application procedures. Thus making large amounts of money available will prove fruitless if it is not effectively utilised and does not benefit all SMEs equally. There is necessity for the government to address the specific needs of SMEs given that some may not require financial assistance as urgently as they may require collaborative help in R&D and in the usage and implementation of technology.

## **New Growth Areas**

In protecting the economy from external shocks, there is a need to diversify and improve the resilience of the Malaysian economy. New growth sectors have been identified as agriculture, in the form of its higher value added downstream activities; tourism, ICT, higher value added E&E exports, biotechnology and pharmaceuticals.

### **Agriculture**

Agro-based food production, aquaculture, deep sea fishing, ornamental fish breeding, livestock rearing, fruit and vegetable farming and floriculture have been identified as potential sectors for export. Advancement of these sectors can possibly lead to further downstream activities with greater export potential. For Penang, there is opportunity to focus on food processing & agro-based businesses. Penang already benefits from the strong presence of major food processing industries as well as good transport infrastructure in the form of airport, seaport and highways. Furthermore, its strategic location and close proximity to the states of Perlis, Kedah and Northern Perak highlight potential for Penang to become a "halal" food production hub for the northern region by processing agricultural products from these states into food items for export.

Land scarce Penang cannot benefit directly from the large-scale plantation industries or paddy cultivation activities. However, it can still focus on some high value cash crops like vegetables – especially organic vegetables which are gaining popularity and small animal husbandry such as chicken rearing and aquaculture. The key is to intensify and maximize whatever little land left for agricultural purposes.

Penang is strategically positioned to take advantage of the R&D incentives provided for the agricultural sector. With world-renowned research centres such as the Worldfish Centre, the National Fisheries Research Institute and Universiti Sains Malaysia's strong marine research facilities located here, there is much potential to look into the areas of developing new breeds of ornamental fishes, oyster cultivation and aquaculture (both marine and brackish water).

### **Health & Education Tourism**

The budget made provisions for new tourism incentives in the area of health and education. The relaxation of immigration regulations for foreign medical specialists, therapists and patients is certainly a timely shot in the arm for the health tourism industry which is presently suffering from a shortage of skilled paramedical staff.

The exemption of stamp duty and real property gains tax encourages mergers of private institutions of higher learning (IPTS) in order to raise the standards of the services offered. IPTS were encouraged to merge to form smart partnerships and to create strong and leading educational entities at par with renowned universities in developed countries. This is especially relevant to Penang, which currently has 41 private colleges in operation.<sup>5</sup> The Government's promise to hasten the approvals and accreditation of courses by IPTS will enable the IPTS to offer more options to both local and international students. Most importantly, it will be able to produce a new generation of skilled workers to bridge the current gap between industrial needs and graduate skill sets.

### **Information Communication Technology (ICT)**

The roll-out of Multimedia Super Corridor (MSC) to Penang, will enhance the state's strong foothold in the ICT sector as well as accelerate development of the k-economy in order to stay competitive.

There is opportunity for Penang to capture the new source of growth in the shared services and outsourcing industry since Malaysia has been ranked as the third best location in the world after India and China due to its well-developed, low-cost infrastructure and strong government support. In Penang especially, there is experience and

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<sup>5</sup> Department of Education, Penang

strength in the manufacturing sectors, particularly the electronic industry, that will help to promote the development of call centres and back office services, potentially creating more employment opportunities.

Necessary to the successful take-off of the ICT sector, however, is the need for adequately skilled human resources. This leads up to the 3<sup>rd</sup> strategy of the budget, developing human capital as a catalyst for growth. At present many of our graduates do not meet the requirements of the companies, creating an employment gap. In line with that, the recent Budget report also plans to put in place various measures in order to develop new sources of growth in the ICT sector, including training skilled manpower, developing technopreneurs, increasing international promotions and providing specific incentives to investors. Another important criterion is the ability to overcome emerging concerns over data security and intellectual property protection.

Penang has been chosen to pilot the e-Tanah initiative, an integrated and comprehensive approach utilizing ICT to modernize land office administration and its core processes by the end of 2004. Hopefully, this will spur the state government's effort in developing online internet-based facilities for its people. There are calls for more emphasis to be put by the state government on ensuring that the digital divide is narrowed or closed. The state should look into providing ICT kiosks at strategic places for transactions with government departments which will indirectly encourage IT literacy of public servants and allow greater accessibility for the public in reaching government departments.

Another critical factor is cheap, reliable and quality connectivity. The budget did not provide incentives to encourage the take up of broadband – internet communication network of high speed. Broadband will help to accelerate government's initiative to encourage more effective government-to-government (G2G), government-to-public (G2P) and government-to-business (G2B) dealings. The state should look into proposing more efficient and cost effective connectivity in the Broadband rollout plan.

### **Strengthening the Social Agenda**

Budget 2005 is not merely aimed at economic growth. The 4<sup>th</sup> strategy of the budget ensures the well-being of the Malaysian society by addressing a wide range of social issues i.e. hardcore poor, rural development, the disabled group and the environment. It has allowed more allocation for education and environmental awareness programmes and recognised the contributions of NGOs. These incentives provided for the purposes of rehabilitation and the education of disabled persons benefits many welfare organisations and NGOs which are based in Penang such as the Cheshire Home, St. Nicholas Home for the Visually Impaired and numerous orphanages.

With poverty reduction being an important agenda, it is surprising though that the focus is mainly on rural areas, with little mention of tackling urban poverty – especially when the alleviation of urban poverty had been given much publicity in the past few months.

In the past poverty in Malaysia was largely perceived as a rural problem. However rapid urbanization, structural transformation and rural urban migration has led to the issue of urban poverty becoming more critical than rural poverty. Existing policies and programmes to aid the poverty stricken are unlikely to make a serious impact on urban poverty given the inherent bias towards the rural sector.

Urban poverty is caused by multiple deprivation which are not adequately reflected in the current poverty line income (PLI) as urban households require higher incomes to avoid poverty. Households that are classified as near poor also require policy attention as they are the most vulnerable group during a crisis and are likely to move into poverty.

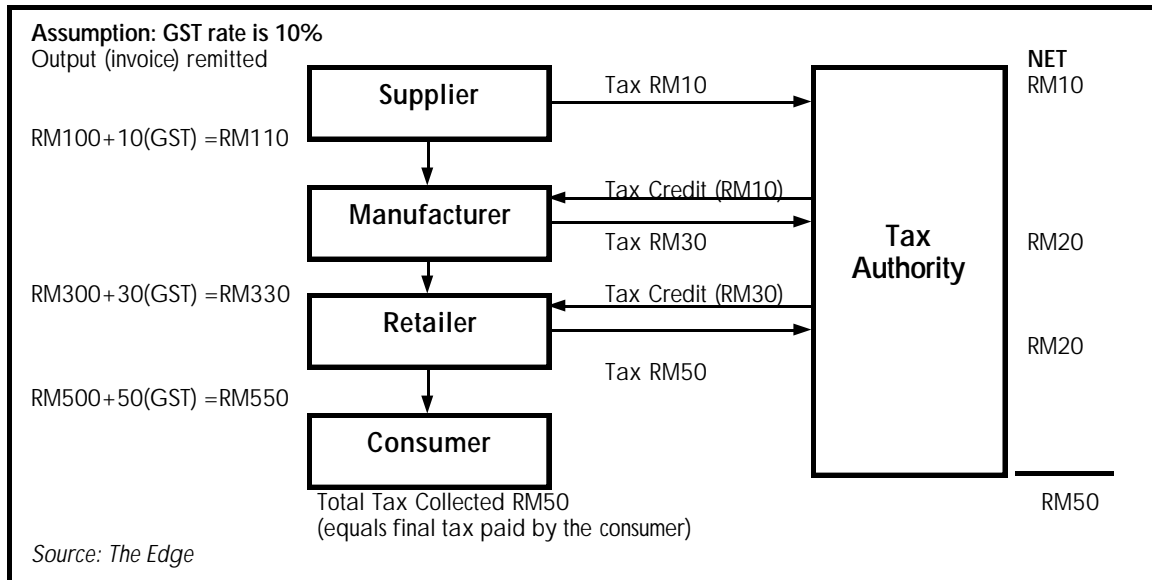
Apart from allocating RM177 million in loans to state governments for the construction of 3,000 units of low cost houses under Projek Perumahan Awam Kos Rendah, and the allocation of RM778 million for the construction of 21,000 units of low cost houses under the Projek Perumahan Rakyat for squatters in Kuala Lumpur and other towns, there was little policy attention aimed at addressing and overcoming problems and issues at the root of urban poverty such as unemployment, education and skills training.

### **Review of the Taxation System**

In line with the government's objective to create a more efficient, equitable and business friendly environment, the entire taxation system has been subjected to review; with the main thrusts of the review being clarity and transparency. As part of the tax reform, a broad-based consumption tax, namely the Goods and Services Tax (GST) will be implemented from 1st January 2007 to replace the existing sales and services tax.

**How does GST work?**

The GST is tax revenue collected by the government at every stage of the supply chain, which is believed to be a more effective and efficient system. It is levied at each stage of the product based on the value added to the product at that stage. It is a charge based on a percentage of a price with the actual tax burden visible at each stage in the production and distribution chain.



In the illustration, the manufacturer buys from the supplier raw material at a cost of RM100 and hence a GST of RM10 (10% of RM100) is paid by the supplier and is collected by the tax department. The manufacturer is able to add a value of RM200 to the original product and is sold to the retailer who now has to pay a GST of 10% on RM 300 totalling RM330. This RM30 in GST is paid by the manufacturer to the tax authority. At this stage the manufacturer would have overpaid on taxes because apart from the RM30 just paid, he had earlier paid an additional RM10 as GST when he purchased raw material from the supplier. This original tax paid of RM10 will be reimbursed by the tax authority as a tax refund which is shown as a tax credit on the diagram.

Assume the retailer adds further value of RM200 the product and sells it at RM500 to the consumer. The consumer ends up paying RM550 for the good (RM500 + 10% GST) and this RM50 in GST is paid to the tax department. However since the retailer had originally paid an earlier amount of RM30 as GST when he purchased the good from the manufacturer, he will be reimbursed the RM30 as a tax refund. The total amount of tax collected by the tax department would be a total of RM10+30+50, but note that at various stages of the chain, a total of RM40 would have been return as tax credits; and thus through the system, the tax department would have collected a total of RM50 from the consumer as intended, not directly but indirectly through the supply chain.

The rationale for the GST is an enhanced system of collection which would be more comprehensive, efficient, transparent and effective. Moreover, it is a means of increasing the governments tax revenue base by reaching out to a broader group of people namely consumers. Under the present direct taxation system only a small proportion of the people pay taxes because of the tax allowance made i.e. taxation brackets. Indirect taxes will thus be a source of higher and more stable revenue for the government because firstly, GST leads to a better tax compliance system as companies are compelled to maintain transparent and systematic accounts with less scope for tax evasion and secondly, there will be a broader tax base (depending on the breadth of the GST application) regardless of consumers income brackets.

The positive aspect of GST implementation is the likelihood of lower individual and corporate taxes making Malaysia more attractive to foreign investors. The negative aspects are inflationary pressures caused by GST and a regressive taxation system. As a consumption tax, consumers will bear the brunt of the GST. The goods and services targeted for GST application will determine the progressive or regressive<sup>6</sup> structure of the Malaysian taxation system. If the GST is

<sup>6</sup> A progressive taxation system is a system whereby the more you earn, the higher your tax rate. A regressive taxation system, is a system whereby the less you earn, the higher your tax rate.

highly selective and targets only goods consumed by the higher incomes, then it can remain progressive. But if the GST is all encompassing with the exception of basic foodstuffs and amenities, then the tax structure tends to be regressive. The typical argument is that studies show that consumption tends to reduce as a proportion of total income as people make more money.

### **Budget Weaknesses**

Although the budget was well-balanced and incorporated many social considerations, the perennial question remains: Is the private sector capable of generating sufficient growth to bridge the growth gap arising from the gradual reduction of public sector expenditure? One simply cannot ignore the global trend of increasing interest rates, energy prices and the accelerating costs of business worldwide. A trade dependent economy like Malaysia's is susceptible to external shocks and the volatility of the global business cycle. Even if successful in generating growth, apart from the creation of upward pressure on prices, will the level of growth generated be sufficient to sustain and buffer the economy through such strong external impacts?

Reducing the budget deficit has its benefits of improving the country's macroeconomic policy options to deal with future external shocks and could lead to the potential upgrading of the country's sovereign debt ratings over the near-term. However, reducing the budget deficit purely at the expense of spending is not the best option versus raising revenue and reducing wastage. There were no measures taken to reduce petrol subsidies. The cost of fuel subsidies to the government since 1999 is RM 31.9b. This revenue could have been better used for development spending. There were no measures to reduce gambling habits in the form of higher taxes and no measures to address AFTA Compliance for the Motor Sector in 2005.

Whilst most measures and incentives were focused on raising the standards of performance of the Malaysian economy and provide a general framework and direction for Malaysia, it lacks specific details and fails to follow through on some of the issues highlighted at the previous budget such as the micro-financing scheme. In lacking specific details, an example would be the measures and incentives to develop a knowledge society. In this regard, there were no reductions in the cost of broadband and internet access, and the possibility of collaboration between public and private sectors was not addressed. No immediate measures were mentioned to entice new MNCs to Malaysia and to maintain the existing ones.

### **Conclusion**

Overall, Budget 2005 reflects firm commitment on the part of the government to reign in on expenditure without sacrificing the economic and social development of the country. It is truly a balanced budget, ensuring that all layers of Malaysian society benefit. It is a budget that openly recognises the core problems of the country from the attitudes of a majority of its people regardless of race to the structural inefficiencies present within the system and proactively seeks to address these issues. The benefits of this budget are obvious, especially with the review of unnecessary mega-projects, Government Linked Companies, and the call for a more transparent nation. In this domestic-oriented budget, the government has identified niche areas and sectors where Malaysia has the potential to compete and has pushed for growth within those areas. The proposal of a two-year time frame to study and implement the GST is a further reflection of the clarity of mind taken in formulating the budget in which matters were not rushed and all issues given due consideration.

Penang has much to benefit from these measures given the emphasis on SME funding and the increasing attention and funds provided for the agricultural sector. The increased allocation for NGO's and charitable organisations will enable them to play their part in helping the government maintain focus on social and environmental issues that easily becomes sidetracked when pursuing economic growth. *§ Poh Heem Heem, Baharulnizam Baharum, Fatimah Hassan, Khor Hung Teik, Lim Poh Im, Loh Thiam Yoong & Tan Yin Hooi*