

PUBLIC SECTOR FINANCE

3

ECONOMIC REPORT
2005/2006

Fiscal Operations in 2005

The Government's fiscal policy continues to emphasise on improving its financial position while at the same time, assuring a stable and sound macroeconomic environment for the economy to continue to strengthen its growth. As such, in formulating its fiscal policy, the Government has given particular attention to ensure it remains supportive of the expansion of private sector activities so as to enable the private sector to enhance its role as the main engine of growth. This objective is in line with the overall macroeconomic strategy to stimulate and accelerate further domestic sources of growth.

The Government's commitment to strengthen its budgetary position is evidenced by the marked narrowing of its budgetary deficit from 5.6% of GDP in 2002 to 3.8% in 2005. The significant success in reducing this deficit has been achieved both by enhancing revenue as well as improving the efficiency and effectiveness of Government expenditure.

The reduction in deficit has provided the Government with the policy flexibility and the option to implement measures to effectively mitigate the potential adverse effects from uncertainties in the external sector and thus, minimising any negative impact on the growth

of the domestic economy. Given this flexibility, the reduction in deficit has not sacrificed growth of the economy. In fact, growth has further strengthened during the period.

The Government in 2005 has focussed its expenditure primarily on ensuring higher productivity and competitiveness as well as supportive of generating further economic activities. In this regard, development expenditure rose 5.7% focussed on smaller projects which have significant multiplier effects in creating economic activities in the immediate term, particularly in agriculture, construction and infrastructure in rural areas. It also remained focussed on the provision of essential services such as education, health and housing. In managing expenditure, emphasis has also been placed on maximising the use of existing infrastructure facilities so as to enhance the value of existing assets through greater productive use and regular maintenance.

Federal Government

Lower Federal Government deficit...

The Federal Government's financial position improved significantly with its fiscal deficit expected to continue its downward trend to 3.8% of GDP, as shown in *Table 3.1*.

TABLE 3.1

Federal Government Financial Position 2004-2006

	RM million			Change (%)		
	2004	2005 ¹	2006 ²	2004	2005 ¹	2006 ²
Revenue	99,397	105,856	115,561	7.3	6.5	9.2
Operating expenditure	91,298	98,244	101,246	21.4	7.6	3.1
Current balance	8,099	7,612	14,315	-53.4	-6.0	88.1
Gross development expenditure	28,864	30,511	33,502	-26.7	5.7	9.8
Less loan recoveries	1,346	4,215	744	29.3	213.2	-82.3
Net development expenditure	27,518	26,296	32,758	-28.2	-4.4	24.6
Overall balance	-19,419	-18,684	-18,443	-7.2	-3.8	-1.3
% of GDP	-4.3	-3.8	-3.5			

¹ Revised estimate.² Budget estimate, excluding 2006 tax measures.

CHART 3.1

Federal Government Finance Current Account

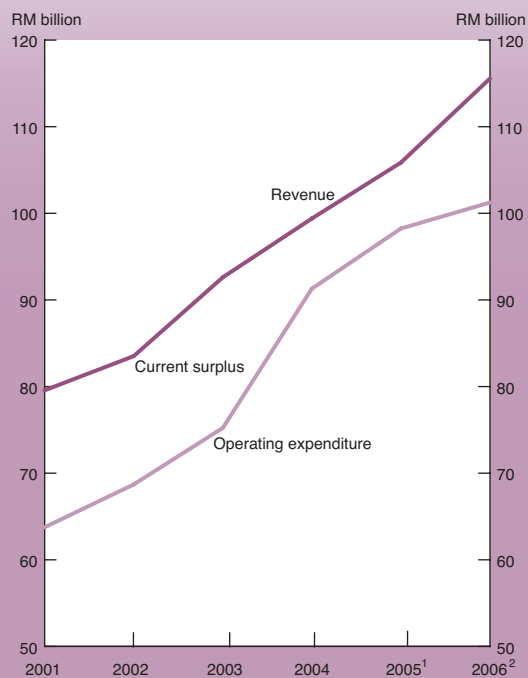
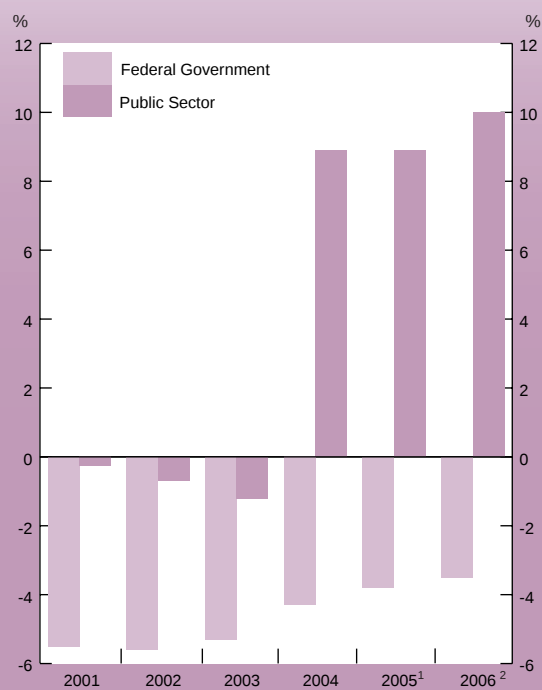
¹ Revised estimate.² Budget.

CHART 3.2

Percentage of Overall Deficit/Surplus to Gross Domestic Product

¹ Revised estimate.² Budget.

Revenue

Higher and more efficient revenue collection...

Revenue continues to strengthen, increasing by 6.5% to RM105,856 million, exceeding the RM100 billion mark, as shown in *Table 3.2*. The increase in revenue is mainly contributed by indirect taxes, particularly excise duties, sales tax and export duties. Non-tax revenue, largely from investment income, also contributed substantially to the higher revenue.

Direct tax is expected to decline by 0.7% to RM48,345 million (2004: 13.2%; RM48,703 million), largely on account of a significant decrease in corporate income tax collection by 15.9%, as shown in *Table 3.2*. This is due to the re-computation of current year corporate taxes on a net basis after taking into account treatment for tax refunds. On the other hand, Petroleum Income Tax (PITA), which is based on the

preceding year's income, surged by 28.9% to RM14,800 million and is expected to contribute significantly to total direct tax at 30.6%. This is largely due to oil companies having better financial performance in fiscal year 2004 as the average annual crude oil prices was higher at USD41 compared to USD30 per barrel in 2003. In addition, individual income tax collection is also envisaged to rise by 11.3% to RM9,991 million (2004: 12.4%; RM8,977 million) on account of efforts by the Inland Revenue Board (IRB) to enhance the efficiency of its revenue collection. The IRB also facilitates payment by taxpayers through awareness campaigns, setting up of mobile booths at strategic places and introducing Internet banking for purpose of tax payment.

Indirect taxes are envisaged to increase by 15.6% or an increase of RM3,643 million, constituting a quarter of total revenue. The increase is mainly on account of higher collection of excise duties, sales tax and export duties, as

TABLE 3.2

Federal Government Revenue 2004-2006

	RM million			Change (%)			Share (%)		
	2004	2005 ¹	2006 ²	2004	2005 ¹	2006 ²	2004	2005 ¹	2006 ²
Tax revenue	72,050	75,335	80,425	11.0	4.6	6.8	72.5	71.2	69.6
Direct tax	48,703	48,345	52,008	13.2	-0.7	7.6	49.0	45.7	45.0
of which:									
Companies	24,388	20,505	20,799	1.7	-15.9	1.4	24.5	19.4	18.0
PITA ³	11,479	14,800	17,694	35.6	28.9	19.6	11.5	14.0	15.3
Individuals	8,977	9,991	10,557	12.4	11.3	5.7	9.0	9.4	9.1
Indirect tax	23,347	26,990	28,417	6.7	15.6	5.3	23.5	25.5	24.6
of which:									
Excise duties	6,427	8,369	9,045	27.7	30.2	8.1	6.5	7.9	7.8
Sales tax	6,816	7,374	7,103	-14.4	8.2	-3.7	6.9	7.0	6.1
Non-tax revenue	27,347	30,521	35,136	-1.3	11.6	15.1	27.5	28.8	30.4
of which:									
Licences/permits	7,106	8,055	8,144	7.1	13.4	1.1	7.1	7.6	7.0
Investment income	17,778	19,969	24,371	17.0	12.3	22.0	17.9	18.9	21.1
Total	99,397	105,856	115,561	7.3	6.5	9.2	100.0	100.0	100.0
% of GDP	22.1	21.7	21.8						

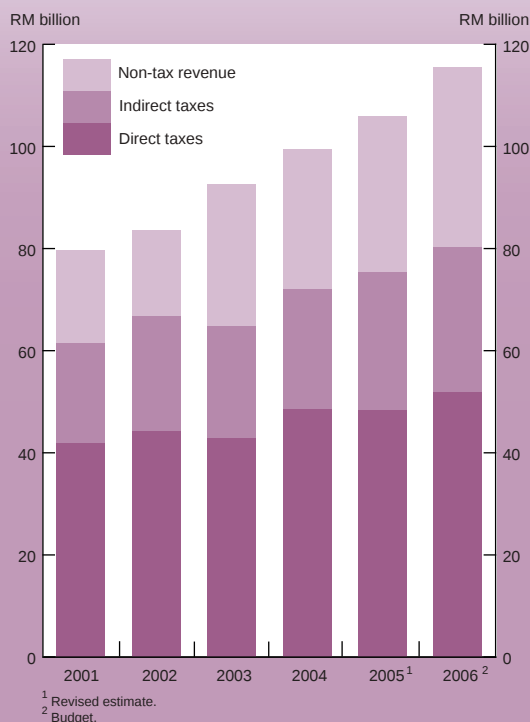
¹ Revised estimate.

² Budget estimate, excluding 2006 tax measures.

³ Petroleum Income Tax.

CHART 3.3

Major Components of Federal Government Revenue



shown in *Table 3.2*. Excise duties receipts are expected to increase significantly by 30.2% or RM1,942 million to RM8,369 million (2004: 27.7%; RM6,427 million) due mainly to higher motor vehicle sales of 7% to 520,000 units this year compared to 487,605 in 2004. The upward revision of excise duties on locally manufactured cigarettes and liquor in Budget 2005 also contributed to the increase in excise duties receipts. Similarly, in tandem with better consumer sentiment and rising consumption expenditure, revenue from sales tax is also expected to increase by 8.2%.

Despite the gradual reduction in import tariff, trade liberalisation measures and ASEAN Free Trade Agreement (AFTA) obligations, revenue from import duties is envisaged to remain at about the same level at RM3,881 million (2004: RM3,874 million), on account of higher imports. On the contrary, export duty receipts are expected to increase by 31.5% to RM2,104 million, mainly due to higher commodity prices which brought

about improved collection of export duties on petroleum products, palm oil and rubber.

Non-tax revenue is expected to total RM30,521 million, as shown in *Table 3.2*, with two-thirds coming from receipts from investment income which increase by 12.3% and contribute to RM19,969 million (2004: 17%; RM17,778 million). Following high oil prices, higher dividend payment from Petroliaam Nasional Berhad (PETRONAS) has also contributed to the increase in investment income this year. Receipts from licences, registrations and permits, which is the second largest component of non-tax revenue, show a significant increase of 13.4% to RM8,055 million. About 75% or RM6,016 million is contributed by receipts from motor vehicle licences and petroleum royalties, which are expected to increase by 21.4% and 31.9%, respectively.

The general improvement in revenue collection is also attributed to the various revenue-enhancing measures taken to improve tax buoyancy as well as efficiency. These include stricter enforcement measures, more stringent tax audits and vigilant anti-smuggling efforts. Efforts, particularly by the IRB, have resulted in more than 800,000 new income tax files in the last two years. To further improve the tax base and administration, efforts to expand revenue scope as well as streamline and simplify tax incentives are being implemented.

Expenditure

Prudent expenditure management focussing on enhancing efficiency and cost effectiveness...

One of the measures to contain expenditure is to enhance expenditure efficiency and effectiveness to reduce wastage and optimise the use of available resources. Through more stringent budgetary and monitoring processes, the Government has been reviewing programmes and projects to reprioritise them to ensure that projects with maximum benefits will be implemented as scheduled. In doing so, the Government continues to ensure a fair balance between economic and social projects. In the course of the year, the Government has also begun to review policies on subsidies and transfer

payments with the objective of reducing the Government's financial burden. To ensure value for money, the Government has given further emphasis to the implementation of the open tender system.

Total **operating expenditure** is projected to increase by a much lower rate of 7.6% to RM98,244 million (2004: 21.4%; RM91,298 million), as shown in *Table 3.3*. The bulk of the increased expenditure is for payment of subsidies, which accounts for 86.9% of the increase in total operating expenditure following sharp escalations in world crude oil prices. The increase in retail prices of petroleum products by 10 sen and 20 sen for petrol and diesel, respectively, helped reduce Government subsidies by about one billion ringgit. Despite the gradual price adjustment of petroleum products at the retail level, total subsidy payments remain high at RM11,833 million in 2005 (2004: 116.3%; RM5,796 million), an increase of 104.2%.

Emolument payment is expected to decline by 2.7% or RM642 million, as shown in *Table 3.3*. Slightly more than half of the emolument is for salaries of teachers, doctors and nurses whose terms and conditions of service have been improved with better incentives and higher allowances. Expenditure for pensions and gratuities is expected to be sustained at the previous year's level of around RM6 billion.

Outlays on supplies and services, the second largest component, is projected to increase by 16% to RM19,286 million, mainly for maintenance and repairs, rentals as well as payments for professional services. Debt service charges, though expected to be higher, totalling RM13,300 million will be contained at 13.5% of total operating expenditure (2004: 12%). Of the total debt service charges, 86.6% is for domestic debt.

Development expenditure for 2005 is expected to increase by 5.7% to RM30,511 million, as shown

TABLE 3.3

Federal Government Operating Expenditure by Object 2004-2006

	RM million			Change (%)			Share (%)		
	2004	2005 ¹	2006 ²	2004	2005 ¹	2006 ²	2004	2005 ¹	2006 ²
Emolument	23,779	23,137	23,587	9.5	-2.7	1.9	26.0	23.6	23.3
Debt service charges	10,920	13,300	12,726	3.5	21.8	-4.3	12.0	13.5	12.6
Grants to state governments	2,895	3,089	2,651	36.2	6.7	-14.2	3.2	3.1	2.6
Pensions and gratuities	6,060	6,227	6,633	3.2	2.8	6.5	6.6	6.3	6.6
Supplies and services	16,633	19,286	20,554	19.1	16.0	6.6	18.2	19.6	20.3
Subsidies	5,796	11,833	11,022	116.3	104.2	-6.9	6.3	12.0	10.9
Grants to statutory bodies ³	6,653	8,212	8,611	-2.8	23.4	4.9	7.3	8.4	8.5
Refunds and write-offs ⁴	5,023	322	357	89.0	-93.6	10.9	5.5	0.3	0.4
Others	13,539	12,838	15,105	53.6	-5.2	17.7	14.8	13.1	14.9
Total	91,298	98,244	101,246	21.4	7.6	3.1	100.0	100.0	100.0
% of GDP	20.3	20.1	19.1						

¹ Revised estimate.

² Budget estimate, excluding 2006 tax measures.

³ Includes emolument.

⁴ Consist mainly of tax refunds, which from 2005 onward are offset directly from revenue.

CHART 3.4

Federal Government Operating Expenditure

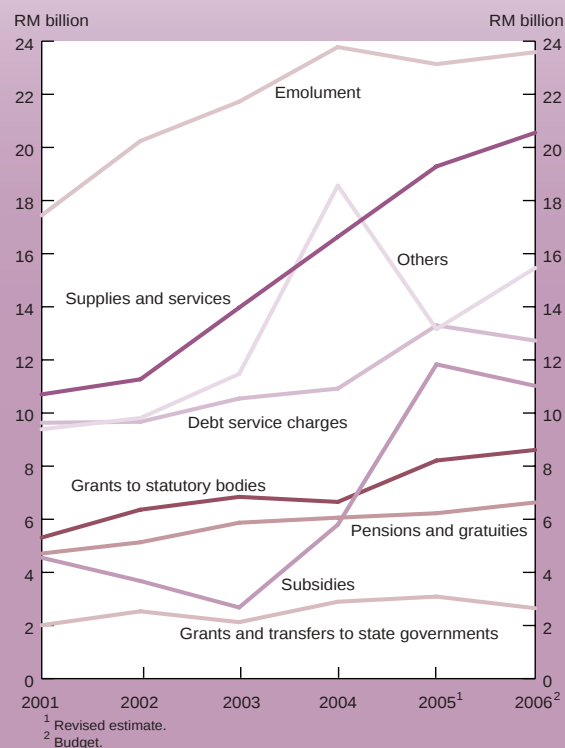
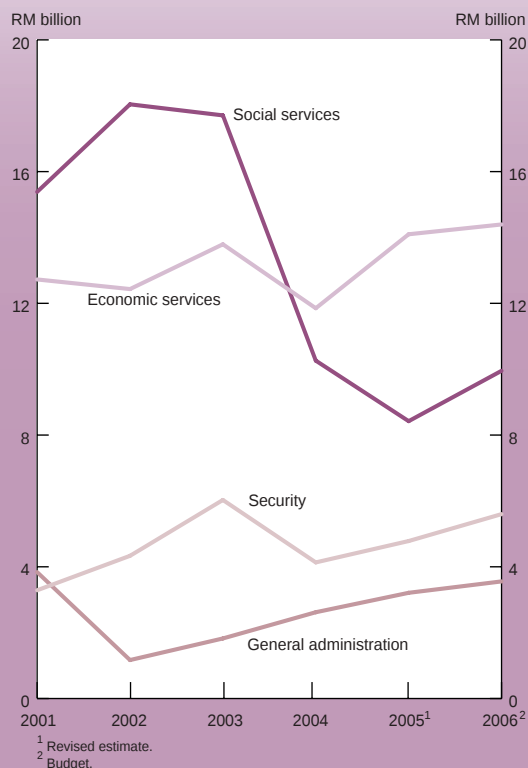


CHART 3.5

Federal Government Development Expenditure by Sector



in Table 3.4. Expenditure efficiency will continue to be enhanced, including the use of cost-benefit analysis to ensure maximum social and economic benefit. Development expenditure is mainly for infrastructure projects such as roads, bridges and water supply in the rural areas. These projects are expected to support and revitalise the agricultural sector, which has been identified as the third engine of growth as well as to increase income level of people in rural areas.

Total expenditure for the **economic** sector is estimated at RM14,097 million, representing 46.2% of total development expenditure in 2005 (2004: RM11,851 million; 41.1%). The transportation sub-sector accounts for the largest share of 24.4%, mainly for the construction, upgrading and repairs of roads, bridges and railways such as the Oya-Mukah-Balingian road, Muar-Melaka-Alor Gajah-Simpang Ampat road and the Rawang-Ipoh Double Tracking project.

Other infrastructure projects include capital dredging and deepening of Port of Tanjung Pelepas and ports in Sabah and Sarawak, construction and upgrading airports in Kuching, Miri, and Sibu as well as the new terminal for low cost carriers in Kuala Lumpur International Airport (KLIA).

Expenditure for public utilities is expected to increase substantially by 103.5% to RM1,924 million (2004: 2.7%; RM945 million) in line with Government efforts to bridge the rural-urban divide by improving rural accessibility to public amenities, such as electricity and water supply as well as telecommunications. A major share of expenditure for trade and industry sub-sector is for small and medium enterprises (SMEs) and tourism development projects. To provide adequate financing facilities for SMEs, a substantial allocation of RM190 million is channelled to increase the size of SMEs funds and credit

guarantee schemes, namely *Tabung Ekonomi Usaha Niaga* (TEKUN) and *Skim Jaminan Usahawan Kecil* (SJUK). Within the tourism sector, priority is given to the promotion and development of new tourism products as well as upgrading existing infrastructure facilities. In an effort to promote the growth of biotechnology industry, a sum of RM212 million is allocated to the National Biotechnology Directorate (BIOTEK).

Expenditure for **social services** sector amounting to RM8,422 million is the second largest component in development expenditure. Expenditure for education is lower at RM3,424 million in 2005 compared to previous year, as most of the education projects of the Eighth Malaysia Plan (8MP) have been completed in the earlier years of plan. A total of RM1,204 million is spent for upgrading of hospitals and health clinics and purchase of medical equipment in line with Government's emphasis to provide quality health care system. The construction of five new hospitals and thirteen clinics are expected to be

completed and will begin their operations in 2005. The five hospitals are in Temerloh, Sungai Buloh, Cameron Highlands, Jasin and Jempol. In addition, the upgrading of the Alor Star Hospital and Tengku Ampuan Aminah Hospital in Johor Bahru is in progress. The upgrading of 13 clinics has broadened the variety of treatment available at these clinics, thus enhancing health care accessibility to rural folks. Expenditure for housing remains a priority with a sum of RM1,729 million expected to be spent in 2005, of which RM687 million is for the armed forces and police personnel quarters, while the balance is for programmes such as the *Perumahan Rakyat* and *Perumahan Rakyat Bersepadu*, government quarters and other low cost housing projects.

Expenditure for **general administration** is expected to be at RM3,210 million to further improve service delivery system as well as working and service environment. Major expenditure items include the purchase of ICT equipment for the implementation of various initiatives under the

TABLE 3.4

Federal Government Development Expenditure by Sector 2004-2006

	RM million			Change (%)			Share (%)		
	2004	2005 ¹	2006 ²	2004	2005 ¹	2006 ²	2004	2005 ¹	2006 ²
Economic services	11,851	14,097	14,395	-14.0	19.0	2.1	41.1	46.2	43.0
of which:									
Agriculture and rural development	2,881	2,537	3,681	77.8	-11.9	45.1	10.0	8.3	11.0
Trade and industry	1,201	1,743	2,884	-65.2	45.1	65.5	4.2	5.7	8.6
Transport	6,630	7,442	5,439	-9.8	12.2	-26.9	23.0	24.4	16.2
Social services	10,260	8,422	9,951	-42.1	-17.9	18.2	35.5	27.6	29.7
of which:									
Education and training	4,316	3,424	5,025	-57.7	-20.7	46.8	15.0	11.2	15.0
Health	2,352	1,204	1,297	-12.3	-48.8	7.7	8.1	3.9	3.9
Housing	1,593	1,729	1,895	-17.4	8.5	9.6	5.5	5.7	5.7
Security	4,133	4,782	5,599	-31.4	15.7	17.1	14.3	15.7	16.7
General administration	2,620	3,210	3,556	43.6	22.5	10.8	9.1	10.5	10.6
Total	28,864	30,511	33,502	-26.7	5.7	9.8	100.0	100.0	100.0
% of GDP	6.4	6.3	6.3						

¹ Revised estimate.

² Budget estimate.

Electronic Government Application (e-Government) projects such as e-Procurement, Human Resource Management Information System (HRMIS), e-Service, Project Monitoring System (PMS) and Accountant General Department Financial and Accounting Modules (EG-AG), which are being implemented in stages. Concerns for national security and public safety remain an important priority of the Government. In this regard, expenditure for the **security** sector amounting to RM4,782 million is mainly for upgrading of military and surveillance equipment as well as enhancing the skill levels of security personnel.

Financing

Tapping domestic sources of financing...

Total gross borrowing of the Federal Government in 2005 is smaller, amounting to RM40,950 million compared with RM46,986 million in 2004, as shown in *Table 3.5*. The funds raised are for financing fiscal deficit as well as for redemptions of existing debt. As a prudent measure, the Government will ensure total revenue exceeds operating expenditure. Hence, Government borrowings are only for financing of development expenditure.

Given ample liquidity in the domestic system, the bulk of the Government's financing requirement is from domestic sources. The largest source of funding is Malaysian Government Securities (MGS) totalling RM34,500 million. In 2005, 13 issues of MGS have been raised *via* open tenders (RM25,500 million) and private placements (RM9,000 million). Of the total MGS issued, the Government reopened nine issues worth RM22,500 million to increase individual issue sizes, which has enhanced liquidity in the bond market. The Government also places out two new Government Investment Issues (GIIs), amounting to RM5,000 million. The regular issuance of Government securities provides the benchmark yield curve to facilitate further development of the ringgit bond market.

Malaysia's debt profile is well spread with 69.6% of MGS comprising five-year and more than five-

year maturities. The longer term MGS reduces risk and provides greater financial stability. During the year, MGS with maturities of five and ten years are issued at coupon rates ranging between 3.6% and 4.8% per annum. The rates on MGS issued in 2004 with similar maturity period ranged from 4% to 5.1%.

The Government also undertook the securitisation of its staff housing loans as a new tool for raising funds in the capital market, with the issuance of RM2.05 billion of Islamic Residential Mortgage Backed Securities (IRMBS) in July, 2005. Apart from providing a new source of funding, the issue will also pave the way for further progress and stronger growth of the Malaysian bond market.

For the year 2005, no new external borrowing is expected to be raised other than the drawdown of existing project loans in line with the objective of reducing external debt and minimising exposure to external risks. A total of RM1,450 million is

TABLE 3.5

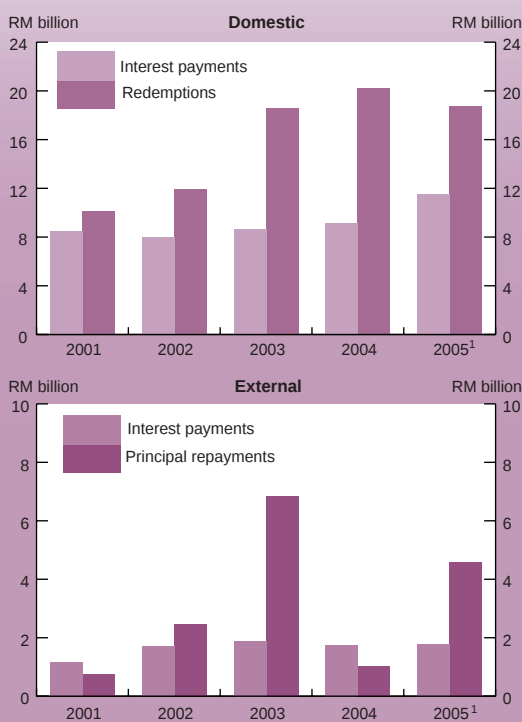
Federal Government Financing 2004-2005

	RM million		Share (%)	
	2004	2005 ¹	2004	2005 ¹
Gross borrowings	46,986	40,950	100.0	100.0
Domestic	45,850	39,500	97.6	96.5
Investment Issues	4,100	5,000	8.7	12.2
Government Securities	41,750	34,500	88.9	84.2
External	1,136	1,450	2.4	3.5
Market loans	-	-	-	-
Project loans	1,136	1,450	2.4	3.5
Repayment	21,215	23,396	100.0	100.0
Domestic	20,200	18,800	95.2	80.4
External	1,015	4,596	4.8	19.6
Net borrowings	25,771	17,554		
Domestic	25,650	20,700		
External	121	-3,146		
Change in assets	-6,352	1,130		
Total	19,419	18,684		

¹ Estimate.

CHART 3.6

Federal Government Loans Principal Repayments, Redemptions and Charges



¹ Estimate.

expected to be drawn down from bilateral and multilateral sources to finance ongoing projects and programmes such as education and training, water supply, sewerage system, poverty eradication as well as ICT venture capital.

Debt

No new external borrowings by Federal Government...

Debt management, as in the case of expenditure, is reflective of the prudent fiscal policy in place over the last few years. The nation's external debt continues to trend downwards from RM200,550 million to RM195,760 million although Federal Government overall debt is expected to increase by 10.1% to RM238,476 million (2004: 14.8%; RM216,624 million). Total outstanding Federal Government debt as a percentage of GDP at end-

2005 is expected to remain at 48.9% (end-2004: 48.2%), lower than the average of 53.3% recorded for the period 1988-2004. Taking into account the private sector and Non-Financial Public Enterprises' (NFPEs) external borrowings, the nation's external debt to GDP is projected to decrease to 40.2% (end-2004: 44.6%).

The increase in total outstanding **Federal Government debt** is largely due to higher domestic debt which is projected to increase to RM206,970 million, constituting 86.8% of total outstanding at end-2005, as shown in *Table 3.6*. With the lower level of foreign debt, the Government is able to minimise foreign exchange risk exposure. The Federal Government external debt as a percentage of total debt is expected to decline from 16% as at end-2004 to 13.2% as at end-2005. However, in terms of external debt service ratio, it has risen slightly to 1% (2004: 0.5%), given the substantial amount of principal repayment disbursed for matured loans. Debt servicing remains manageable and debt service charges as a percentage of operating expenditure and revenue are estimated at lower rates of 13.5% and 12.6%, respectively (2004: 12% and 11%). As the bulk of the loans is at fixed interest rates, the exposure to interest rates risks is minimised. The risk of bunching of repayments is also low with about 60% of total outstanding debt as at end-June 2005 having a maturity period of more than three years.

Provident and pension funds, as well as insurance companies continue to be major holders of MGS at end-June 2005. Banking institutions reduced their holdings of MGS to 11.9% of total outstanding MGS at end-June 2005 (end-2004: 15%). In the case of GILs, the major investors are banking institutions with 49.5% of total amount outstanding at end-June 2005.

Utilisation of domestic sources of financing has helped contain the **nation's external debt**, which is expected to decline to RM195,760 million or 40.2% of GDP, as shown in *Table 3.7*. The risk is reduced given that the bulk of national debt is medium and long term, with short-term debt comprising only 22.2% of the total. The Federal Government's component of external debt constitutes only 16.1%, while NFPEs, 30.5% and the private sector, 53.4%.

The ratio of short-term external debt to international reserves remains low. As at end-August 2005, short-term external debt is only 14.3% of international reserves. External debt service ratio, i.e. the ratio of principal repayment

and interest charges to the country's exports of goods and services, is also projected to remain low at 5.7%, reflecting the strength of export earnings to service external debt obligations.

TABLE 3.6

Federal Government Debt 2004-2005

	RM million		Share (%)		GDP (%)	
	2004	2005 ¹	2004	2005 ¹	2004	2005 ¹
Domestic debt	181,970	206,970	84.0	86.8	40.5	42.5
Treasury Bills	4,320	4,320	2.0	1.8	1.0	0.9
Investment Issues	9,100	11,100	4.2	4.7	2.0	2.3
Government Securities	154,350	173,050	71.3	72.6	34.3	35.5
Housing Loan Fund	14,200	18,500	6.6	7.8	3.2	3.8
External debt	34,654	31,506	16.0	13.2	7.7	6.5
Market loans	24,930	21,257	11.5	8.9	5.5	4.4
Project loans	9,724	10,249	4.5	4.3	2.2	2.1
Total	216,624	238,476	100.0	100.0	48.2	48.9

¹ Estimate.

TABLE 3.7

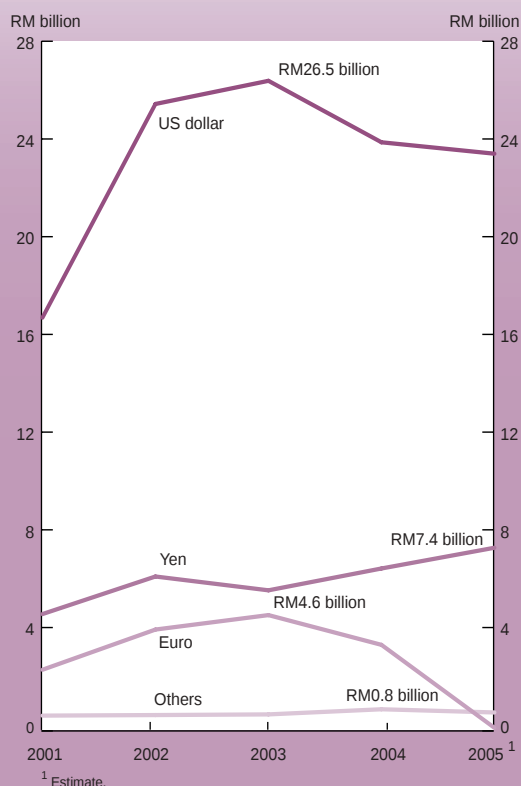
National Debt 2004-2005

	RM million		Share (%)		GDP (%)	
	2004	2005 ¹	2004	2005 ¹	2004	2005 ¹
Medium and long-term debt	156,553	152,276	78.1	77.8	34.8	31.2
Public sector	97,679	91,220	48.7	46.6	21.7	18.7
Federal Government	34,654	31,506	17.3	16.1	7.7	6.5
NFPEs	63,025	59,714	31.4	30.5	14.0	12.3
Guaranteed	19,402	21,982	9.7	11.2	4.3	4.5
Non-guaranteed	43,623	37,732	21.8	19.3	9.7	7.7
Private sector	58,874	61,056	29.4	31.2	13.1	12.5
Short-term debt	43,997	43,484	21.9	22.2	9.8	8.9
Total	200,550	195,760	100.0	100.0	44.6	40.2

¹ Estimate.

CHART 3.7

Federal Government External Debt by Currency



State Governments

Financial position of state governments remains manageable...

The consolidated financial position of the 13 state governments is expected to register a small overall deficit in 2005 despite having a surplus in 2004 due essentially to higher expenditures, as shown in Table 3.8. The overall deficit is financed by Federal Government loans and the use of accumulated financial assets of state governments.

The current account is expected to register a larger surplus with an increase of 14.6% due to better revenue performance. Total revenue is projected to grow by 16.1% to RM11,606 million during the year, with 73% of total collection originating from state sources, while the balance is grants from Federal Government. Petroleum and forestry

royalties, land premiums and taxes as well as profits and dividends from investments together contribute 58.2% to state sources. Fees on licences and permits, rents as well as sales of goods and services contribute the rest of state sources. To improve revenue collection, state governments are exploring and undertaking new measures, focussing on assessment arrears and unpaid dues as well as revising and imposing new rates for selected levies on forestry, water, rental and other services.

In line with efforts to provide better services and public amenities, state governments are expected to incur higher operating and development expenditure. These include maintaining roads, bridges and jetties; improving water supply; upgrading drainage and sewerage systems; implementing flood mitigation projects; constructing low-cost houses and developing industrial areas, agro-technology parks, food-

TABLE 3.8

Consolidated State Government Financial Position 2004-2005

	RM million		Change (%)	
	2004	2005 ¹	2004	2005 ¹
Current Account				
Revenue	9,995	11,606	17.0	16.1
Operating expenditure	5,612	6,584	5.7	17.3
Current account balance	4,383	5,022	35.5	14.6
Development account				
Gross development expenditure	3,826	5,205	-12.3	36.0
Development fund	3,521	4,776	-11.3	35.6
Water supply fund	305	429	-22.4	40.7
Loan recoveries	182	15	-66.6	-91.8
Net development expenditure	3,644	5,190	-4.5	42.4
Overall balance	739	-168		
% of GDP	0.2	-		

¹ Revised estimate.

based industries, livestock farming as well as upgrading public libraries. Emolument and supplies and services constitute 64.2% of the total operating expenditure, while the balance includes asset acquisitions as well as transfers to local authorities and statutory bodies. As for development expenditure, the bulk of which is for agriculture and rural development, public utilities and construction of rural roads.

General Government

Financial position of general government improves...

The financial position of the general government, which consists of consolidated accounts of the Federal Government, state governments, local authorities and statutory bodies, after netting intra-government transfers and lending, is estimated to record a small deficit of RM17,333 million or 3.6% of GDP, as shown in *Table 3.9*. The deficit is lower than the Federal Government deficit of RM18,684 million or 3.8% of GDP on account of some transfer payments from the Federal Government to state governments, statutory bodies and local authorities not being fully expended.

Non-Financial Public Enterprises (NFPEs)

Strong financial performance of NFPEs...

The NFPEs as a group continues to perform strongly, registering a healthy retained income and overall surplus for the year, amounting to RM100,212 million and RM60,810 million, respectively, as shown in *Table 3.10*. Total revenue increased by 8.7% to RM234,701 million (2004: RM215,858 million), contributed largely by PETRONAS, Tenaga Nasional Berhad (TNB) and Telekom Malaysia Berhad (TM), due to sustained high crude oil prices and greater demand of electricity and telecommunication services. In addition, operating expenditure is envisaged to increase marginally by 0.5%. Development expenditure, on the other hand, is expected to increase by 60% as a result of strategic investments, particularly abroad as part of the measures to internationalise NFPEs in a globalised market.

PETRONAS continues to perform well due to higher crude oil price that has resulted in the significant increase in its revenue. PETRONAS also expands its investments in both downstream and upstream activities domestically as well as

TABLE 3.9

Consolidated General Government Financial Position 2004-2006

	RM million			Change (%)		
	2004	2005 ¹	2006 ²	2004	2005 ¹	2006 ²
Current account						
Revenue	116,328	122,663	135,305	8.7	5.4	10.3
Operating expenditure	101,649	108,475	112,471	20.8	6.7	3.7
Current account balance	14,679	14,188	22,834	-35.9	-3.3	60.9
Development expenditure	31,992	31,521	39,437	-27.1	-1.5	25.1
Overall balance	-17,313	-17,333	-16,603	-17.4	0.1	-4.2
% of GDP	-3.9	-3.6	-3.1			

¹ Revised estimate.

² Budget estimate, excluding 2006 tax measures.

abroad in countries such as Pakistan and Sudan. Overseas investments include joint ventures with several international companies in Pakistan to explore and produce gas as well as to develop the gas processing plant in Ghotki, the Sindh province. In addition, the company has concluded sale and purchase agreements for the supply of liquefied natural gas (LNG) to Korea and Japan during the year. Other projects undertaken include the construction of new natural gas vehicles (NGV) service stations, MLNG2 debottlenecking project, upgrading and reconditioning of ships by the MISC Berhad. Hence, larger expenditures are expended to meet these investment requirements.

As for TM, the increase in revenue is mainly attributed to growth in the cellular, broadband and multimedia operations as well as better performance in its overseas operations. In addition, with recent introduction of Celcom 3G, positive revenue trend is expected to continue. TM has also expanded its operations globally through acquisition of several companies in countries, such as Ghana, Indonesia and Pakistan during the year. Most of the capital investment is for expanding and modernising its telecommunications infrastructure as well as improving international and local networks. The new major projects undertaken include the Asia

Pacific Cable Network 2 and Internet Protocol Digital Subscriber Line Access Multiplexer (IP DSLAM).

Revenue improvement in TNB is attributed to higher demand for electricity across all major economic sectors. In addition to higher domestic demand, the better revenue performance is also contributed by sales of electricity to the Electricity Generating Authority of Thailand (EGAT). The increase in revenue is, however, offset by higher fuel and material costs. Capital expenditure of TNB is mainly for capacity expansion projects such as Tuanku Jaafar Power Station Phase 2 in Port Dickson, Paka Power Station rehabilitation and the proposed 132kv ring project in Kota Kinabalu.

Consolidated Public Sector

Consolidated public sector financial position stronger...

The consolidated public sector financial position is expected to register an overall surplus of RM43,469 million or 8.9% of GDP (2004: RM39,838 million; 8.9% of GDP), as shown in *Table 3.11*, higher than the projected surplus of 1% of GDP made in September 2004. The surplus is largely due to higher contribution from NFPEs, particularly PETRONAS on account of higher crude oil prices.

Outlook for 2006

The financial position of the Federal Government is projected to improve further and strengthen in 2006, on account of a more favourable economic outlook, particularly greater private sector activities. The Government's fiscal policy will continue to stress on efficiency and effectiveness in its financial management. In this regard, measures will be taken to streamline tax procedures as well as improve tax administration and enforcement efforts to boost revenue. As a medium-term measure, the review of the tax structure and system, which is currently underway, will provide inputs for policy pronouncements by the end of next year. Continuous reviews on

TABLE 3.10

Consolidated NFPEs Financial Position¹ 2004-2005

	RM million		Change (%)	
	2004	2005 ²	2004	2005 ²
Revenue	215,858	234,701	38.5	8.7
Current expenditure	133,843	134,489	34.6	0.5
Retained income	82,015	100,212	45.3	22.2
% of GDP	18.2	20.6	27.7	12.7
Development expenditure	24,633	39,402	-38.7	60.0
Overall balance	57,382	60,810	252.5	6.0
% of GDP	12.8	12.5		

¹ Refers to 30 NFPEs.

² Revised estimate.

TABLE 3.11

Consolidated Public Sector Financial Position 2004-2006

	RM million			Change (%)		
	2004	2005 ¹	2006 ²	2004	2005 ¹	2006 ²
Revenue ³	116,328	122,663	135,305	8.7	5.4	10.3
Operating expenditure	101,649	108,475	112,471	20.8	6.7	3.7
NFPEs current surplus	81,875	100,120	100,712	47.1	22.3	0.6
Public sector current balance	96,554	114,308	123,546	22.9	18.4	8.1
Development expenditure	56,716	70,839	70,362	-31.9	24.9	-0.7
General government ⁴	32,083	31,437	39,429	-25.7	-2.0	25.4
NFPEs	24,633	39,402	30,933	-38.7	60.0	-21.5
Overall balance	39,838	43,469	53,184	-934.8	9.1	22.3
% of GDP	8.9	8.9	10.0			

¹ Revised estimate.

² Budget estimate, excluding 2006 tax measures.

³ Excludes transfer within general government.

⁴ Development expenditure differs from development expenditure in Table 3.9 due to transfers and net lendings.

subsidies will be undertaken as part of measures to reduce the financial burden of the Government as well as promote efficiency and competitiveness. Savings from these measures will be channelled to more productive programmes and projects that will have greater multiplier effect on the economy as well as those that enhance the quality of life of Malaysians.

The 2006 Budget will appropriate a sum of RM101,246 million and RM33,502 million under operating and development allocations, respectively. The operating allocation, which will increase marginally by 3.1% compared to 7.6% in 2005, is mainly for charged and locked-in expenditure items such as debt service charges, pensions and gratuities, emolument, supplies and services, subsidies and scholarships. As for development allocation, the bulk of it will be channelled to the economic and social sectors with emphasis on reducing disparities and imbalances between rural and urban areas.

Consistent with the thrusts of Budget 2006, allocation will focus on accelerating economic

activities, providing a business-friendly environment, enhancing the well-being and quality of life of the people and developing human capital. In addition, attention will also be given towards improving public sector service delivery and ensuring national security.

In agriculture, a substantial allocation is set aside to increase the production capacity of livestock industry, fruits and vegetable farming and fishery. To help promote and market Malaysia's agricultural produce in export markets, part of the allocation will be for the establishment of Agriculture Consular Offices. For a start, two consular offices will be set up in Beijing and The Hague. In order to make agriculture an attractive sector, the focus is also on retaining the existing workforce while also enhancing income from agricultural activities. To retain existing workforce, emphasis will be given to make agriculture attractive and remunerative through commercial farming. For income enhancement, allocation will be set aside for projects on entrepreneurial development, business infrastructure and marketing support.

To provide a more business friendly environment to accelerate economic activities, one of the measures taken is to continue improving public service delivery which include among others, computerisation and provision of online services by government agencies. This will facilitate and quicken the approval processes and hence create a more conducive business environment.

Projects and programmes to improve the quality of life and welfare of the people will continue to be given emphasis. On health care, additional allocations are provided for the recruitment of new health personnel and purchase of new medical equipment to upgrade the service levels at hospitals and clinics. Subsidy payments continue to account for a large proportion of the Budget allocation, such as subsidies for petroleum products, interest subsidies for higher education loans and toll roads compensation as well as *padi* and fertilizer subsidies. Other social programmes include the construction of low cost houses, the provision of school nutrition programme, pre-school assistance and tuition vouchers for the low-income group.

The development of human capital will also be emphasised through education and training to produce skilled and knowledge workers, which is essential to further enhance the country's competitiveness. Substantial increase in allocation by 20.5% is given for repairs and upgrading of industrial training institutes and MARA skills institutes to provide training to match industry requirements. Apart from education infrastructure such as schools, the allocation for scholarships will increase by 14.6%. Human resource development will also incorporate the development of soft skills such as proficiency in the English language, ability to communicate as well as instilling patriotism, develop character and build self-confidence among younger generation

through the National Service Programme (PLKN). The PLKN is expected to train 95,000 youths in 2006 compared with 85,000 in 2005.

As Malaysia becomes more urbanised and industrialised, the need to reduce degradation of the environment, enhance environmental conservation and to provide effective waste disposal management become more urgent. Allocation for environmental conservation will receive a 9.3% increase, while allocation for waste disposal management, particularly for the construction and repair of sewerage systems in the country and the treatment of solid waste disposal will be increased by 27.9%. An allocation is also provided to maintain cleanliness and quality of Malaysia's rivers, estuaries, coastal areas and islands.

With regard to internal security, a significant allocation will be channelled to upgrade capabilities of the police and the Malaysian Maritime Enforcement Agency (APMM). APMM was set up in July 2005 to coordinate enforcement and control of Malaysia's maritime resources, particularly within the Exclusive Economic Zone, which presently falls within the ambit of various enforcement agencies. With respect to defence, substantial allocation is earmarked for enhancing the capacity of the various wings of the defence forces.

The total Budget allocation for 2006 will amount to RM134,748 million and based on a projected revenue growth of 9.2% or RM115,561 million, the Federal Government financial position is expected to further improve, with the overall deficit decrease to RM18,443 million or 3.5% of GDP in 2006, as shown in *Table 3.1*. In contrast, the consolidated public sector fiscal position is envisaged to show a large surplus of RM53,184 million or 10% of GDP, as shown in *Table 3.11*.