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Malaysia budget 2027 preview: Protecting reform gains, raising the growth ceiling

Key Points

- **Past fiscal reforms provide a timely buffer against the oil shock**. Stronger revenues and RM15.5bn of annual subsidy savings should help cushion higher energy costs, allowing fiscal consolidation to **slow rather than reverse**.
- **Budget 2027 should remain fiscally disciplined, with the focus shifting from new reforms towards execution**. On revenue, stronger tax collection and SST broadening reduce the need for another major tax overhaul, putting greater emphasis on compliance and collection efficiency. On spending, consolidation should rely more on **better targeting and efficiency than broad austerity**.
- **Household relief will remain necessary, but a return to blanket subsidies is unlikely**. We expect support to remain targeted through BUDI MADANI, STR/SARA and other measures, cushioning the cost-of-living shock without structurally raising expenditure.
- **Protecting development spending will be key to turning the investment boom into a productivity upcycle**. We expect Budget 2027 to maintain or increase development spending, with priorities around **human capital, connectivity, digital and industrial infrastructure, and energy capacity**, helping translate investment into domestic value-add, productivity and higher real wages.
- **Fiscal credibility should provide an anchor for MGS and MYR amid global volatility**. If higher subsidies remain a temporary response to the oil shock while fiscal reform and productive investment stay on track, the Budget should reinforce the **structural case for Malaysian bonds and the ringgit**.

PAST REFORMS ARE PAYING OFF AT AN OPPORTUNE TIME

Malaysia approaches Budget 2027 with a challenging external backdrop of elevated oil prices and a global bond market sell-off. Higher energy prices are sharply raising the cost of protecting households from rising cost of living. **As a result, this will make the government's fiscal consolidation path a delicate balancing act: providing household relief versus keeping subsidy reform intact; sticky current spending versus need to sustain development spending; and ultimately, near-term fiscal consolidation versus securing medium-term growth of 4.5-5.5%**. The government's pre-budget statement identifies two immediate imperatives: protecting households from the energy crisis and rising living costs while building a higher-value, more sophisticated economy under the 13th Malaysia plan and the Madani economic framework.

We expect the government to continue rebuilding its fiscal buffers by either keeping the current 3.5% budget deficit target for 2027 or announcing a somewhat lower deficit target. Malaysia is confronting this oil shock after several years of revenue broadening and subsidy rationalisation, which have increased the government's capacity to absorb temporary fiscal pressures without abandoning its medium-term fiscal objectives. The current shock provides perhaps the clearest demonstration yet of why the earlier fiscal reforms mattered. The pre-budget statement estimates that targeted subsidy reforms for chicken, eggs, electricity, diesel and RON95 fuel could generate savings of around RM15.5bn annually. This could help to partly offset the increased fuel subsidy bill. Our estimates suggest that total subsidies, including fuel subsidies, could rise towards RM70bn in 2026, versus around RM55bn in 2025 and the RM49bn originally budgeted for this year. The oil shock will likely slow, rather than necessarily reverse, fiscal consolidation. Moreover, the Public Finance and Fiscal Responsibility Act (FRA) 2023 binds the government to several medium-term targets, including lowering the fiscal deficit to 3% of GDP, keeping the federal debt levels at 60% of GDP, and debt servicing costs at 15% or less of annual budget.

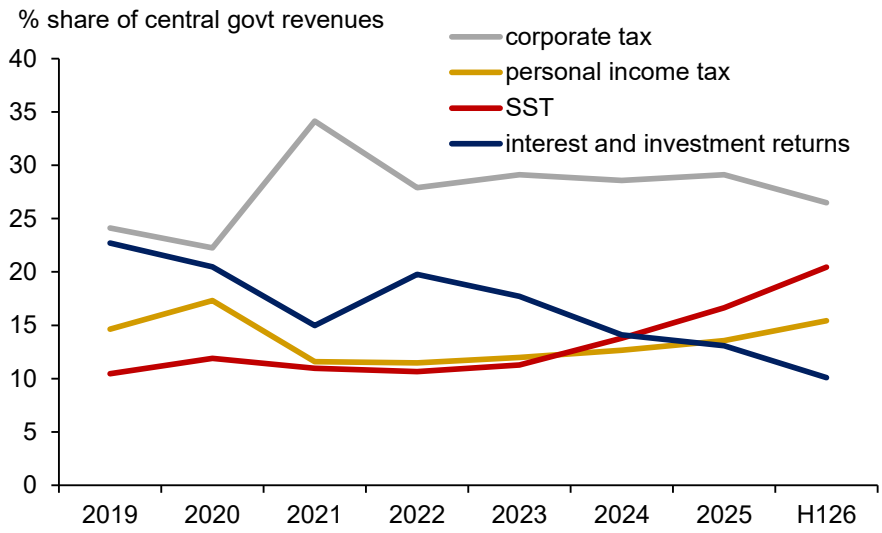
REVENUE REFORMS STRENGTHEN THE FIRST LINE OF DEFENCE

The other important fiscal buffer comes from the revenue side. Tax reforms, together with a strengthening domestic economy, with growth of 5.7% yoy in H1, have significantly improved government revenue collection, which rose 18.9% yoy over the same period.

Going into Budget 2027, the revenue story is likely to shift from raising tax rates and broadening the tax base towards effective implementation. The focus could increasingly be on improving collection efficiency and compliance, fine-tuning sales and service tax (SST) to minimise the burden on businesses, and deploying the additional fiscal space effectively to protect households while supporting Malaysia's investment and productivity momentum. In our view, this reduces the urgency for another major tax overhaul or a new consumption-tax reform.

More importantly, the improvement is not simply about stronger revenue growth, but also the **changing composition and quality of government revenues**, with less reliance on volatile petroleum-related receipts. Corporate income tax remains the largest revenue source, while SST is rapidly emerging as a second major pillar, rising from around 14% of revenues in 2024 to roughly 20% by H1 2026. This reflects the cumulative impact of tax reforms in recent years, particularly the widening of the SST base from July 2025, which could generate around RM10bn in additional annual revenue.

CHART 1: SST IS EMERGING AS A MORE IMPORTANT REVENUE PILLAR



Source: CEIC, MUFG GMR

SST collections have also approached 3% of GDP in Q2 and could reach around 3.2% by year-end, bringing them broadly in line with revenue collection under the previous GST regime before its repeal in 2018. The key difference is that stronger SST collection is now being achieved without a shift back to GST.

Taken together, a broader and more resilient revenue base gives the government greater room to absorb temporary expenditure pressures while preserving resources for development spending. Revenue reform has therefore strengthened Malaysia's first line of fiscal defence, while expenditure reform will increasingly determine how effectively that additional fiscal space is used to support the country's next phase of growth.

EXPENDITURE TRENDS POINT TO A BALANCING ACT

The expenditure side also imposes important constraints on fiscal allocation. A large share of operating expenditure is tied up in relatively sticky commitments, including emoluments, pensions and debt-service costs, which are difficult to reduce materially. As a result, the flexible portion of the fiscal envelope is considerably narrower than the headline expenditure numbers suggest. At the same time, the renewed rise in fuel subsidies adds further pressure to operating expenditure. The next phase of fiscal reform needs to therefore focus on raising the return on government spending. Fiscal consolidation and growth need not be competing objectives. Better targeting of recurrent expenditure can create more room for productive spending.

RAISING THE FLOOR: HOUSEHOLD RELIEF WILL REMAIN NECESSARY, BUT A RETURN TO BLANKET SUBSIDIES IS UNLIKELY.

Higher energy prices make additional support for households difficult to avoid, but we do not expect a wholesale return to permanent blanket subsidies. Such a reversal would run counter to the government's fiscal reform trajectory and further constrain the resources available for development spending.

Instead, Budget 2027 is likely to balance substantial near-term support with further improvements in subsidy targeting, eligibility and administration. There is a broader fiscal logic to this approach. A more targeted system allows the government to scale

up assistance temporarily during large external shocks without permanently increasing the structural cost of subsidies. This is also consistent with the pre-budget emphasis on improving subsidy management and spending efficiency, alongside efforts to strengthen tax compliance and address programme overlaps, leakages and implementation delays.

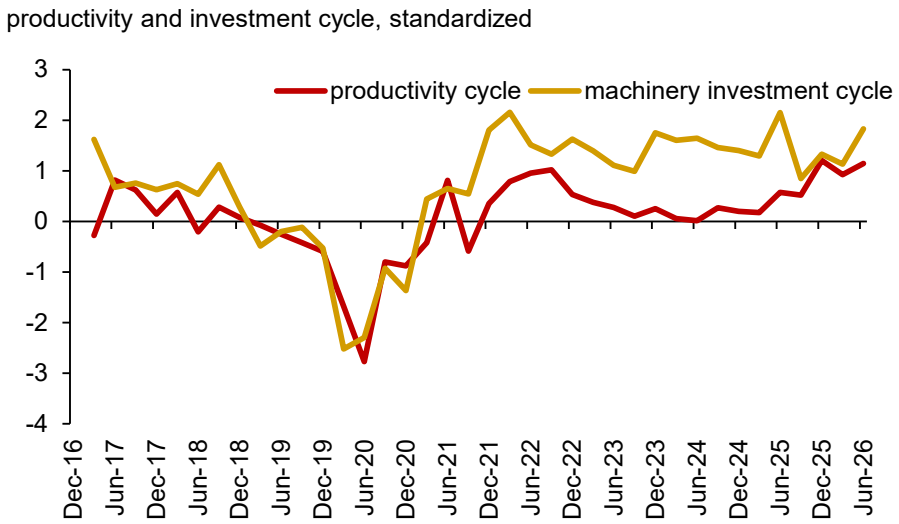
Against this backdrop, we see several priorities for Budget 2027:

- Cost-of-living protection: A potential increase in targeted household assistance through STR and SARA (est. RM15bn), maintain targeted fuel subsidies under BUDI MADANI (RM1.99/litre for RON95 and RM2.10/litre for diesel), tax reliefs and incentives for the middle-income Malaysians (M40) to increase disposable income and ease cost-of-living pressures, ensuring supply of essential goods and keeping those prices in check, and providing decent returns on the rakyat's savings funds.
- Social protection and the care economy: Extend protection to gig and informal workers, while building long-term care and caregiver capacity in preparation for population ageing (15% population will be 60 and above by 2030)

RAISING THE CEILING: FROM INVESTMENT BOOM TO A SUSTAINED PRODUCTIVITY UPCYCLE

The next phase of Malaysia's growth story should also increasingly shift from how much investment the country attracts to how much economic value that investment generates. The investment upcycle of recent years has already helped strengthen productive capacity. The challenge for Budget 2027 is to deepen these gains by encouraging capital deepening, technology adoption, skills upgrading and stronger linkages between foreign investment and domestic firms.

CHART 2: INVESTMENT UPCYCLE IS TRANSLATING INTO STRONGER PRODUCTIVITY



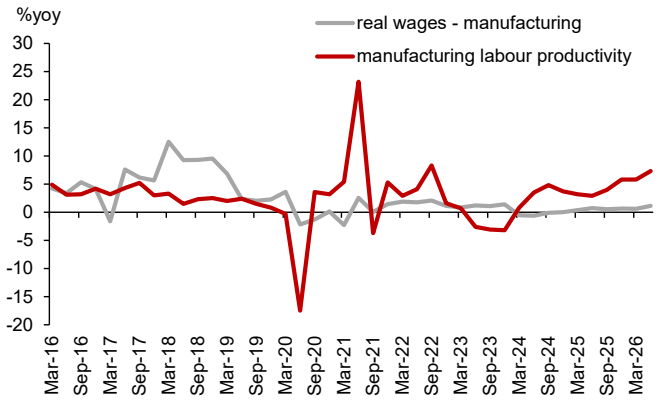
Source: Bloom CEIC, MUFG GMR est.

This distinction is particularly important across Malaysia's emerging growth sectors. In semiconductors, the priority should increasingly be to move further into higher-value activities while deepening domestic supply chains. For AI and data centres, expanding physical capacity is important, but the larger economic payoff will come from the diffusion of digital technologies across the broader economy, raising productivity among Malaysian businesses. In the energy transition, sufficient grid and

utility capacity will increasingly become an important part of industrial competitiveness. And for home-grown companies, the challenge is to scale up, adopt new technologies and participate more deeply in the supply chains generated by Malaysia's foreign-investment cycle. Through the GEAR-uP Programme, government-linked corporates will support government efforts to channel domestic capital into local high-value industries and companies. Budget 2027 may also introduce measures that help ease access to financing and provide incentives for these promising local firms to scale and compete internationally.

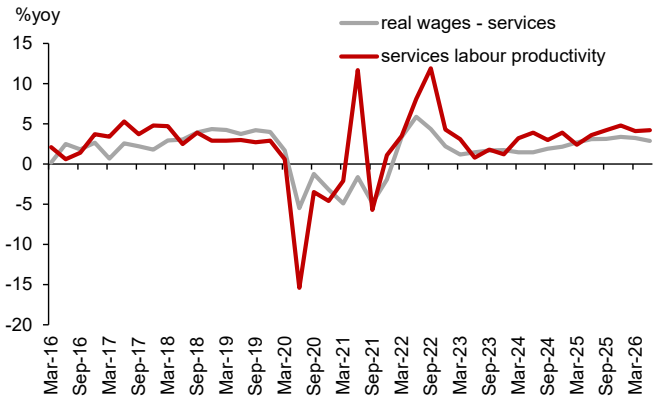
Encouragingly, **there are signs that the investment upcycle is already feeding into a broader improvement in productivity**. Both manufacturing and services productivity growth have strengthened. In manufacturing, productivity has outpaced real wage growth, helping to contain unit labour costs and preserve cost competitiveness. This also suggests that stronger manufacturing wage growth could be sustained if productivity continues to improve. In services, real wage growth has moved broadly alongside productivity gains, keeping unit labour cost growth relatively stable.

CHART 3: STRONGER PRODUCTIVITY IS CONTAINING MANUFACTURING UNIT LABOUR COSTS



Source: Bloomberg, CEIC, MUFG GMR

CHART 4: SERVICES WAGE GAINS REMAIN BROADLY UNDERPINNED BY PRODUCTIVITY



Source: Bloomberg, CEIC, MUFG GMR

Budget 2027 can help reinforce this cycle, such as focusing on upskilling workers, deepening domestic supply chains, accelerating technology adoption and reducing the cost of doing business, while improving the ability of Malaysian companies to capture more value from the investment cycle.

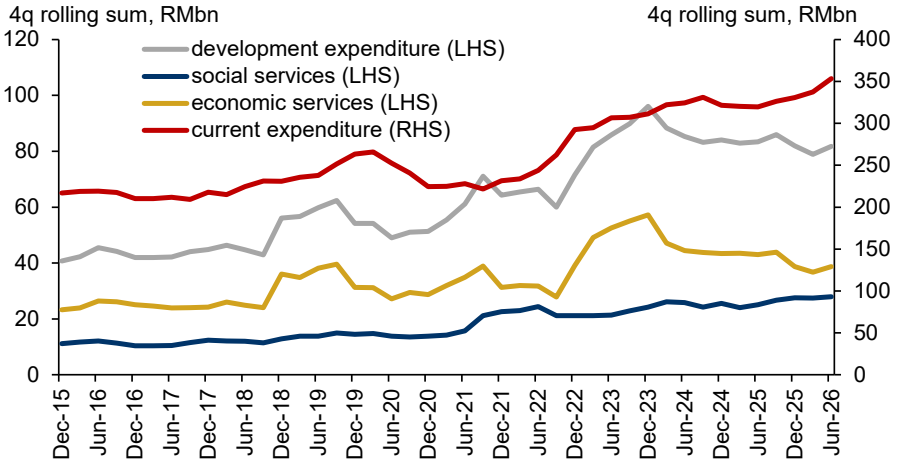
While Budget 2027 will still need to protect vulnerable households from near-term cost-of-living pressures, sustainable improvements in household purchasing power ultimately need to come from productivity-backed income growth. This creates two complementary policy objectives. Raising the ceiling means lifting Malaysia's potential growth through investment, technology, skills and productivity. Raising the floor means ensuring those productivity gains translate into better jobs and stronger real wages. If Malaysia can strengthen both sides of this equation, the investment upcycle can become not just a story of higher capital formation, but one of higher productivity, stronger incomes and more sustainable domestic demand.

DEVELOPMENT SPENDING LIKELY TO BE PROTECTED

Importantly, development expenditure should not become the residual balancing item simply because parts of operating expenditure are difficult to adjust. We expect budget 2027 to maintain or increase development spending

allocation. Notably, development spending has already fallen below earlier peaks and that further decline may weigh on productivity. Moreover, the government has pledged RM430bn for development expenditure over 5 years through 2030, implying an annual average of RM86bn to be allocated. The government's stated priorities point towards productivity and innovation, digitalisation and AI, energy transition, food security and skilled talent, while education and healthcare infrastructure remain important social priorities. The efficiency of development spending is crucial for investments and productivity gains.

CHART 5: RISING RECURRENT SPENDING RISKS CROWDING OUT DEVELOPMENT EXPENDITURE



Source: CEIC, MUFG GMR

HUMAN-CAPITAL INVESTMENT HAS MOVED UP THE SPENDING AGENDA

The composition of development expenditure also points towards a growing emphasis on human capital and essential public services, which could be sustained in budget 2027. There has been a rising emphasis on education (+4.7pp share of total development expenditure since 2024) and healthcare (+2.5pp). The government identifies education, healthcare and essential services as central to living standards, productivity and public confidence, with particular emphasis on TVET, STEM, digital and AI capabilities and healthcare capacity. We therefore expect **human-capital spending to remain relatively well protected in Budget 2027** despite pressure elsewhere in the expenditure envelope. And **for education, this means improving skills relevant for Malaysia's emerging industries**.

ECONOMIC INFRASTRUCTURE NEEDS RENEWED MOMENTUM

One concern from the expenditure data is that the shift towards social priorities appears to have coincided with a softer economic-investment impulse. Our analysis points to weaker momentum in areas such as transport, trade and industry, and agricultural development. We would not interpret this as a case for reversing the shift towards education, healthcare or social resilience.

Rather, Budget 2027 might seek a better balance. This is increasingly relevant because Malaysia's own investment success is generating new infrastructure requirements. We therefore see scope for Budget 2027 to restore selective momentum in strategic connectivity, industrial and digital infrastructure, utility capacity, agricultural productivity and innovation.

Indeed, rapid growth in advanced manufacturing and digital investment increases

demands on electricity and utility capacity. Notably, Malaysia has one of the highest ICT investments as a share of GDP relative to several regional peers, while also establishing itself as a data centre hub in the Asia region, with data centres concentrated in Johor Bahru. Further development of industrial clusters also requires connectivity and logistics. In addition, the budget could further improve regional development with focus on Sabah, Sarawak, and other rural areas.

BUDGET 2027: PROTECTING REFORM GAINS WHILE RAISING THE GROWTH CEILING

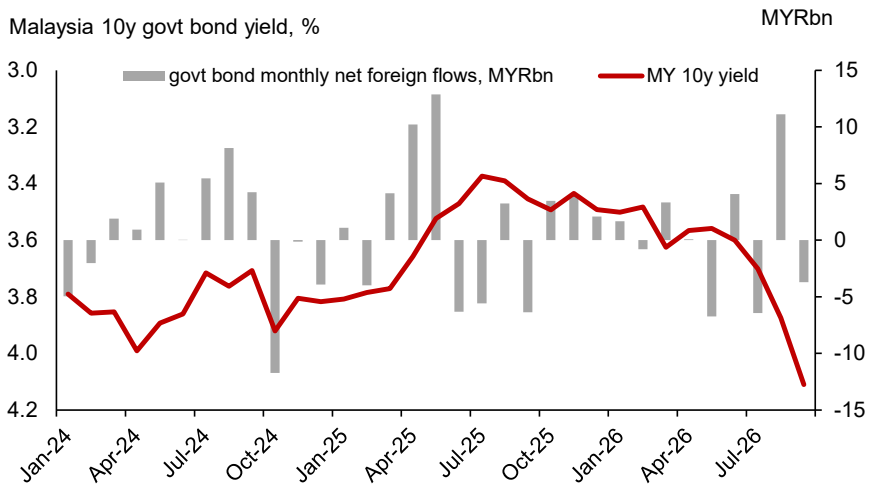
Taken together, we think Budget 2027 represents an important transition in Malaysia's economic reform story. The first stage has been about fiscal repair. Revenue broadening and targeted subsidies have strengthened Malaysia's underlying fiscal resilience. The renewed oil shock is testing those reforms, but it is also demonstrating their value. The second stage should increasingly be about spending quality. With large parts of operating expenditure difficult to adjust and subsidy pressures elevated, fiscal consolidation needs to rely more heavily on better targeting and spending efficiency rather than broad austerity. The third stage is about protecting productive investment. Development expenditure and human-capital spending need to be sufficiently protected, but allocations should increasingly demonstrate measurable economic and social returns. The final stage is about raising potential growth and wages. Malaysia has attracted significant investment. The challenge now is converting that capital into a sustained productivity upcycle.

MARKET IMPLICATIONS

The market implication is especially important for local government bonds and MYR, especially at a time of global uncertainties, inflation risks, and a global bond sell-off. A headline increase in subsidy spending could attract investor attention, particularly if it slows the pace of near-term deficit consolidation. However, investors should look beyond the gross subsidy number. If Budget 2027 demonstrates that targeted subsidy reform remains intact, additional spending is largely a temporary response to the oil shock, revenue reforms continue, development expenditure remains protected and productivity-focused, and the medium-term deficit trajectory is preserved, then higher near-term subsidy spending need not signal a structural weakening in fiscal policy.

Such an outcome should be supportive for Malaysian government bonds and, at the margin, the MYR. The recent sell-off in government bonds has also improved risk-reward, with the 10-year yield now trading close to our estimated fair value. While Malaysia recorded net foreign bond outflows in September amid heightened global rates volatility following the Fed's tightening, this makes a credible fiscal signal from Budget 2027 even more important. The renewed foreign inflows seen in August, together with strong demand for recent sovereign issuance, suggest that underlying investor appetite for Malaysian government bonds remains intact. Against this backdrop, a Budget that accommodates near-term cost-of-living pressures without compromising the medium-term fiscal framework could provide an important anchor for both MGS and the ringgit.

CHART 6: INVESTORS RE-ENGAGE WHEN BOND VALUATIONS TURN ATTRACTIVE



Source: Bloomberg. FMIP, MUFG GMR

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