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BUDGET 2026: SUSTAINING GROWTH WITH FISCAL DISCIPLINE

View on the Budget 2026

Chart 1: Federal Government Finance

	Budget 2025	Budget 2026	
	2025	2025	2026
Real GDP (% y-o-y)	4.5-5.5	4.0-4.8	4.0-4.5
Fiscal Balance (% of GDP)	-3.8	-3.8	-3.5
Estimated Revenue (RM billion)	339.7	334.1	343.1
Tax Revenue (RM billion)	259.0	253.4	270.4
Indirect Tax Revenue (RM billion)	70.2	76.3	83.0
Non-tax Revenue (RM billion)	80.7	80.7	72.7
Revenue (% of GDP)	16.3	16.6	16.1
Total Expenditure (RM billion)	421.0	412.2	419.2
Operating Expenditure (RM billion)	335.0	332.2	338.2
Development Expenditure (RM billion)	86.0	80.0	81.0
Total Expenditure (% of GDP)	20.2	20.5	19.7
Debt (% of GDP)	64.0	64.0	64.0

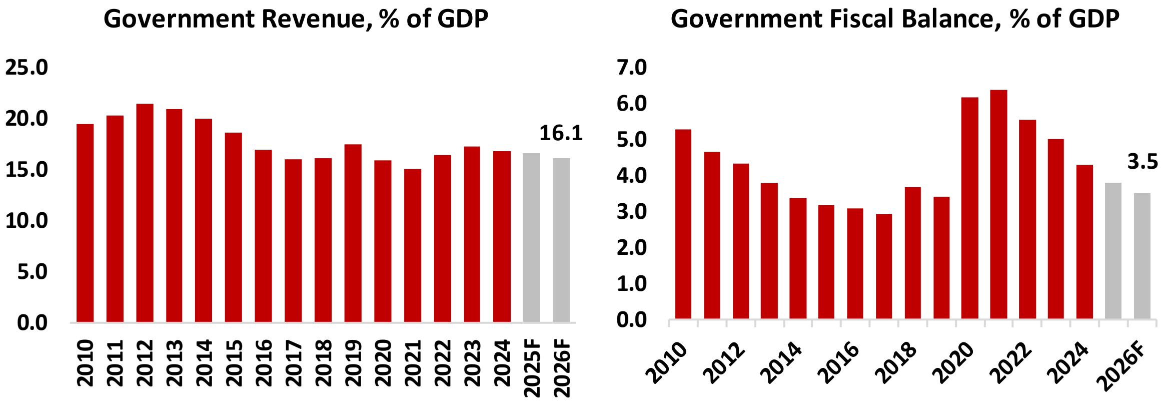
Sources: Ministry of Finance (MoF), Bank Islam

- **The Budget 2026 tabled by Prime Minister and Finance Minister Y.A.B. Datuk Seri Anwar Ibrahim on October 10, 2026, highlights the government's commitment to empower the *rakyat* while striving for technological advancements and developing high-value industries.** Malaysia's fiscal deficit is envisaged to narrow to 3.5% of GDP in 2026 from 3.8% in 2025, in line with the official medium-term target under the Ekonomi MADANI framework. Nevertheless, the improvement appears to be largely driven by faster nominal GDP growth and sustained development expenditure (DE) outlays, rather than a genuine strengthening of fiscal capacity. In essence, a healthier fiscal position should ideally stem from stronger revenue collection coupled with more disciplined spending. More targeted fiscal consolidation efforts will be crucial to ensure a sustainable path of improvement, enabling more effective revenue mobilisation that can be productively channelled into the broader economy. However, the Budget document appears bereft of significant structural reforms that would enhance either one side of the equation. Furthermore, Malaysia's fiscal structure reflects a diminishing share of DE, which is projected to ease to 3.8% of GDP, while operating expenditure (OPEX) takes up the bulk of more than 80% of total spending. As recurrent commitments such as emoluments, retirement charges and debt servicing charges continued to dominate government spending and growth-oriented investments is gradually weeded out, this trend highlights a fiscal stance increasingly geared toward preservation rather than expansion.

- **Government revenue is anticipated to expand by 2.7% to RM343.1 billion in 2026,** higher than the forecast of RM334.1 billion in 2025, underscored by accelerations across tax receipts amid ongoing policy reforms. Tax revenue – which makes up nearly 80.0% of total revenue – is expected to surge by 6.7% to RM270.4 billion (2025e: RM253.4 billion) following the full-year implementation of mandatory e-Invoicing, phase 2 of Service Scheme and Pay Adjustment (SSPA) and the Sales and Service Tax (SST) revision, encompassing a broadened tax base as well as rate hikes on selected categories. The latter could increase SST receipts to a record-high of RM59.6 billion in 2026 (2025e: RM53.4 billion), bolstering indirect tax revenue to increase to RM83.0 billion from RM76.3 billion in 2025. The government had also underlined other revenue enhancement measures such as limiting the vehicle tax exemptions in Langkawi and Labuan to vehicles below RM300K as well as hiking the excise duties on cigarette products and alcoholic drinks starting November this year. Nevertheless, the collection from these measures are likely to be insignificant in the bigger picture, highlighting the crucial need for more impactful restructuring that could meaningfully expand the government's long-term revenue stream. Policies in the pipeline, namely the proposed Carbon Tax and luxury goods tax, could serve as important pieces of the fiscal puzzle. However, the details of their implementation mechanisms have yet to be announced.

- **Meanwhile, direct tax revenue is anticipated to increase by 5.8% to RM187.4 billion in 2026 from RM177.1 billion in 2025,** underpinned by higher collections across the companies income tax (CITA) (2026: RM103.4 billion vs. 2025: RM97 billion) amid the aforementioned e-Invoice full-year implementation, as well as personal income tax (2026: RM49.1 billion vs. 2025: RM44.9 billion) categories. The improvement in personal income tax collection will be underscored by robust labour market conditions, the earlier minimum wage hike to RM1,700 and the second phase of the civil servant pay revision in January 2026. Nonetheless, petroleum income tax (PITA) is expected to continue its downward trend, easing further to RM15.7 billion in 2026 from RM16.9 billion in 2025 (2024: RM20.5 billion), weighed down by softer commodity prices and lingering global uncertainties. From a broader perspective, non-tax revenue is also projected to moderate to RM72.7 billion in 2026 from RM80.7 billion in 2025, reflecting lower investment income (2026f: RM36.7 billion vs. 2025: RM50.4 billion).

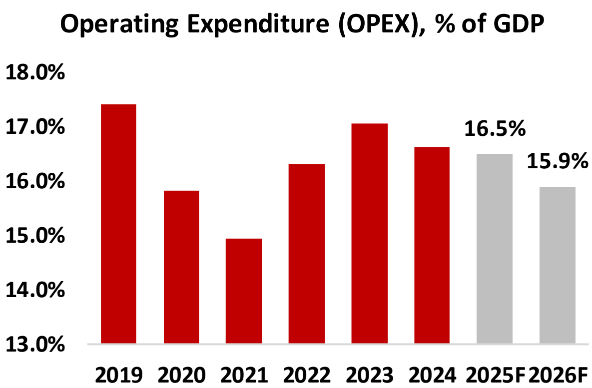
Chart 2: Government Revenue and Fiscal Balance

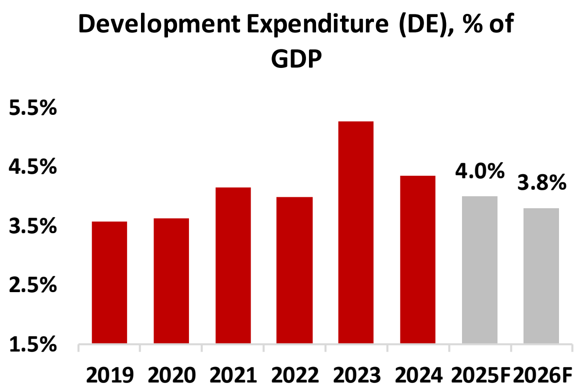


Sources: MoF, Department of Statistics Malaysia (DoSM), Bank Islam

- **While the official estimate of government revenue convey a sense of optimism, the revenue-to-GDP ratio tells a more measured story, expected to decline further to 16.1% in 2026 from an upwardly revised 16.6% in 2025.** This marks the lowest level since 2021, reflecting an environment of a stagnant tax base and weak non-tax revenue stream. Such underperformance was underlined in the medium-term fiscal framework (MTFF), projecting an average annual revenue of 15.7% of GDP for 2026–2028, well below the pre-pandemic norm of 17–18%. The conundrum of gradually declining revenue share underscores the absence of substantially impactful tax reforms in the country. Of note, Malaysia also stands among the lowest in ASEAN, with tax revenue constituting only 12.4% of GDP in 2024 (Thailand: 13.2%, Philippines: 14.4%). While the government had introduced many policies to diversify the tax framework thus far, it appears that these initiatives are just grazing the surface, failing to dig deep into the core issue of fiscal sustainability. Additionally, the tabling of Budget 2026 unveiled no fresh measures to accelerate tax collection, particularly through expanding the direct tax base or introducing consumption-based taxes. As the government weighs between delivering tough reforms and guarding public sentiments, coupled with the complicated terrain of implementing such measures, significant structural changes have yet to be realized. While the country's resilient economic growth could provide some support to revenue growth, a more concrete structural reform would result in long-term fiscal flexibility. This will shield revenue collection from external shocks while creating a virtuous feedback cycle, whereby the government's enhanced fiscal space allows greater social assistance for the people, circling back towards improving economic activities and government revenue.

Chart 3: Operating and Development Expenditure





Sources: MoF, Department of Statistics Malaysia (DoSM), Bank Islam

- **Malaysia's total expenditure is projected to reach RM419.2 billion in 2026, slightly higher than the forecasted figure of RM412.1 billion in 2025,** albeit only constituting 19.7% of GDP (2025: 20.5%). The larger share of total spending is allocated for OPEX (2026: RM338.2 billion vs. 2025: RM332.1 billion) amid rising emoluments (2026: RM109.4 billion vs. 2025: RM103.5 billion), retirement charges (2026: RM42.8 billion vs. 2025: RM40.1 billion) and debt service charges (2026: RM54.3 billion vs. 2025: RM58.3 billion). The rise in emoluments was driven by the 7%-15% salary hike for civil servants under the SSPA starting in January 2026 as well as related efficiency measures under the Government Service

Efficiency Commitment Act 2025 while higher retirement charges underscored the maturing civil service workforce in Malaysia.

- **Additionally, subsidies and social assistances are expected to ease to RM49.0 billion (2025: RM57.1 billion) amid the implementation of the Budi Madani RON95 (BUDI95) program.** The initiative reduces RON95 pump prices to RM1.99 from RM2.05 previously for all Malaysians with valid driving licenses, potentially reducing subsidy spending by RM2.5 billion. While the BUDI95 program as well as the diesel subsidy rationalization implemented last year have reduced prices on the consumer end, the broader positive impacts from the more targeted framework have also benefitted the government amid reduced leakages of subsidies, increased resource efficiency and higher fiscal savings. This solidifies the case that expenditure optimization measures such as blanket subsidy revisions and a targeted dissemination of resources will ultimately improve the outlook at large. Given the rollout and challenges encountered along the way, clear communication of the implementation mechanism and timely troubleshooting will be essential to securing public support and ensuring a smooth execution. Furthermore, the government had announced a RM2 billion increase in Sumbangan Tunai Rahmah (STR) allocation to RM15 billion alongside another round of RM100 Sumbangan Asas Rahmah (SARA) cash handouts for 22 million Malaysians starting mid-February 2026 following the positive reception previously, signaling its continuous commitment in upholding the welfare of the people.

- **As Malaysia embarks on the Thirteenth Malaysian Plan (13MP), the Development Expenditure (DE) is projected to rise to RM81 billion (2025: RM80 billion), standing at only 3.8% of GDP.** The slight uptick in DE underscores the government's fiscal consolidation commitment through stricter spending allocations. However, the restraint could come at a cost of economic growth as public investment momentum sputters. This reflects an improving fiscal outlook though short-term idealistic lens where reduced expenditure would result in a narrower deficit, discarding the long-term viability of the conservative step and its impact on growth potential. On the bright side, the DE is channeled through strategic growth-oriented projects that would embolden the economy in the long-term such as the transport, trade and industry, environment as well as social sectors. Transport infrastructure development projects are crucial in enhancing connectivity and ensuring logistics efficiency, giving them the utmost priority of RM17.5 billion (2025: RM16.4 billion). Several key highlights include the Pan Borneo Highway project, Penang Light Rapid Transit (LRT), Mass Rapid Transit (MRT) Circle Line and the Johor Bharu-Singapore Rapid Transit System Link (RTS). Of note, Sabah and Sarawak had received the highest Federal allocations of RM6.9 billion and RM6.0 billion, respectively. The packages include spending for the Southern Link Transmission project, Sabah water projects, MADANI Submarine Cable (SALAM) project and Sabah-Sarawak highway projects, among others. Beyond public investments, infrastructure development projects will be supported by the strong momentum of private investments, bolstered by incentives and strategic benefits highlighted in the Public-Private Partnership Master Plan 2030 (PIKAS 2030) as well as other MADANI documents. As such, it is not all doom and gloom for the construction sector, gaining major boost from other avenues which will consequently cast a rosier glow over the economic outlook.

Malaysia Economic Outlook 2026

Chart 4: Real GDP by Sector

	Share (%)	y-o-y, %		
	2025e	**2024**	**2025e**	**2026f**
Services	59.7	5.3	5.1	5.2
Manufacturing	23.0	4.2	3.8	3.0
Agriculture	6.1	3.1	1.2	2.2
Mining	5.8	0.9	1.1	-1.0
Construction	4.2	17.5	10.1	6.1
Overall GDP	**100.0**	**5.1**	**4.0 – 4.8**	**4.0 – 4.5**

Sources: Ministry of Finance (MoF), Bank Islam

- **Malaysia's economy is projected to grow between 4.0% and 4.5% in 2026,** according to official estimates**.** Our forecast of 4.4% GDP growth for next year lies at the upper end of this range, reflecting cautious optimism amid ongoing global uncertainties. The forecast range for next year is narrower than this year's projection of 4.0% to 4.8%, as downside risks are expected to persist, driven by ongoing geopolitical tensions, volatility in commodity and energy prices, and the potential escalation of trade disputes, all of which could negatively affect global trade and supply chain.

- **Growth in 2026 is expected to be underpinned by the continued resilience of the services sector**, which is projected to expand by 5.2%, slightly above the estimated 5.1% growth in 2025. We foresee a key driver of this performance will be the "Visit Malaysia Year 2026" (VMY 2026) initiatives, which is anticipated to stimulate tourism activity and generate positive spillover effects across related industries, particularly food and beverages, retail, accommodation, and transportation services. The VMY 2026 campaign aims to attract 47 million visitors, with an expected tourism revenue of RM329 billion. In Budget 2026, over RM700 million will be allocated to boost the tourism sector. Official projections indicate stronger performance in wholesale and trade with growth forecast at 5.0% in 2026, compared to an estimated 4.4% in 2025. Other services sub-sectors are also expected to strengthen, including finance and insurance (2.8%; 2025e: 2.1%), information and communication (4.3%; 2025e: 3.6%), and utilities (1.7%; 2025e: 0.8%). These trends reflect broad-based momentum within the services sector, supported by improving consumer sentiment and continued digitalization.

- Meanwhile, the manufacturing sector, the second largest contributor to GDP after services is projected to grow at a moderate pace of 3.0% in 2026, compared to an estimated 3.8% in 2025. We expect the deceleration is primarily attributed to weaker performance in the export-oriented manufacturing segment, which is predicted to face headwinds from rising global trade tensions. In particular, the potential intensification of protectionist trade measures through higher tariffs imposed by the Trump administration may adversely impact Malaysia's export competitiveness and weigh on external demand. However, the sector remains a key driver of economic growth, supported by other segments beyond export-oriented manufactured products.

- On a positive note, the agriculture sector is expected to continue expanding in 2026, with growth accelerating to 2.2%, up from an estimated 1.2% in 2025. A broad-based improvement is anticipated, mainly supported by stronger growth in oil palm production (3.4%; 2025e: 1.4%), which contributes nearly 37.0% to total agricultural output. Livestock production is also projected to grow slightly faster at 1.8% in 2026, versus 1.5% in 2025. However, forestry and logging output is likely remain in contraction, although the decline is expected to ease to -4.4% from 5.2%. This growth is further supported by the expectation of favourable weather conditions and ongoing investments in agricultural technology and automation aimed at improving productivity and sustainability.

- After experiencing double-digit growth for two consecutive years, the construction sector is anticipated to moderate to 6.1% in 2026, down from an estimated 10.1% in 2025. This slowdown is largely due to the normalization following the surge in infrastructure projects during the post-pandemics recovery phase, as well as potential delays in new project approvals amid tighter financing conditions. The shortage of skilled labor, coupled with rising construction material costs, could also result in project delays or even cancellations. However, other infrastructure projects - such as Southern Link Transmission Line project, water treatment plants, the Jeniang Water Transfer project, improvement to border infrastructure (including a new road from Kalabakan to Simanggaris and the upgrade of the Pasir Mas-Rantau Panjang railway line), road maintenance in federal and rural areas, the Inter-Terminal Transfer project between KLIA Terminal 1 and Terminal 2, airport upgrades in Penang, Sabah, and Sarawak, as well as large-scale solar generation projects – are expected to bolster the construction sector in 2026.

- However, mining sector is anticipated to contract by -1.0% in 2026, following a 1.1% expansion in 2025. The decline is mainly attributed to expectations of lower production volumes, particularly in crude oil and natural gas, as well as projected drop in global oil prices. Ministry of Finance (MOF) assume Brent crude oil price to trade between USD60 to USD65 per barrel. In addition, the sector may face ongoing challenges from depleting reserves, ageing oil fields, and limited new investments, which could further dampen output and weigh on overall performance.

- From the expenditure side, **domestic demand is expected to remain the primary engine of growth, driven largely by private consumption**, which accounts for almost 61% of GDP. Private consumption is projected to expand by 5.2% in 2026, slightly higher than the 5.0% estimated for 2025. This improvement will be driven by several key factors, including a resilient labor market, higher wage growth, the implementation of Phase 2 of civil servant salary adjustments beginning early next year, and continued cash assistance from the government including the Sumbangan Tunai Rahmah (STR) and a special financial aid of RM500 for public servants grade 56 and below and RM250 for pensioners/veterans, which scheduled to be distributed in early March next year. In addition, another round of the SARA program, expected to be disbursed by mid-February 2026, is set to benefit 22.0 million Malaysians aged 18 and above, providing further support for consumer spending. Under Budget 2026, the allocation for STR and SARA has been increased to RM15 billion, RM2.0 billion more than the

2025 allocation, benefitting 9.0 million recipients. The Visit Malaysia Year 2026 campaign is likewise aniticipated to boost private consumption, particularly in categories such as food and beverages, transportation, restaurants and hotels services, which together account for around 46% of total private consumption expenditure.

Chart 5: Real GDP by Expenditure

	Share (%)	y-o-y, %		
	2025e	2024	2025e	2026f
Domestic Demand	**96.7**	**6.5**	**6.1**	**5.4**
Private Expenditure	**78.3**	**6.6**	**6.1**	**5.7**
Consumption	60.9	5.1	5.0	5.2
Investment	17.4	12.3	10.0	7.8
Public Expenditure	**18.3**	**6.3**	**6.3**	**4.4**
Consumption	13.1	4.7	4.0	3.2
Investment	5.2	11.1	12.7	7.3
External Sector	**3.4**	**9.2**	**-15.0**	**-32.0**
Exports	66.4	8.3	1.9	3.8
Imports	63.0	8.2	3.1	5.8
Overall GDP	**100.0**	**5.1**	**4.0 – 4.8**	**4.0 – 4.5**

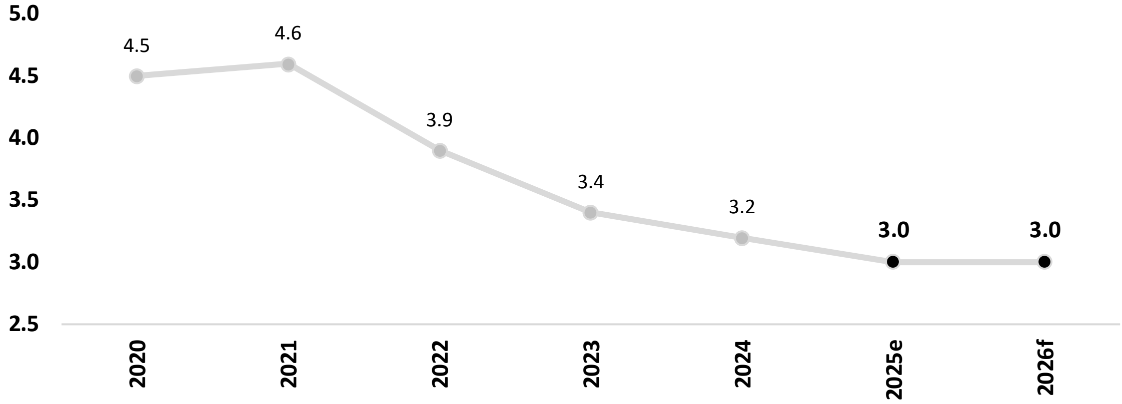
Sources: Ministry of Finance (MoF), Bank Islam

- Private investment, on the other hand, is projected to moderate to 7.8% in 2026, down from 10.0% in 2025. This growth, although slower, will continue to be supported by the key framework like Public-Private Partnership Master Plan 2030 (PIKAS 2030), ongoing mega infrastructure developments, flood mitigation initiatives, and continued recovery in construction-related investment activity. Realisation of approved investments and major national policies will further support private investment next year.

- Meanwhile, public expenditure is projected to soften in 2026, with public consumption growth easing to 3.2% (2025e: 4.0%) and public investment decelerating to 7.3% (2025e: 12.7%). This moderation is largely due to a more cautious fiscal approach aimed at maintaining budget sustainability and efforts to prioritize spending efficiency amid evolving economic conditions.

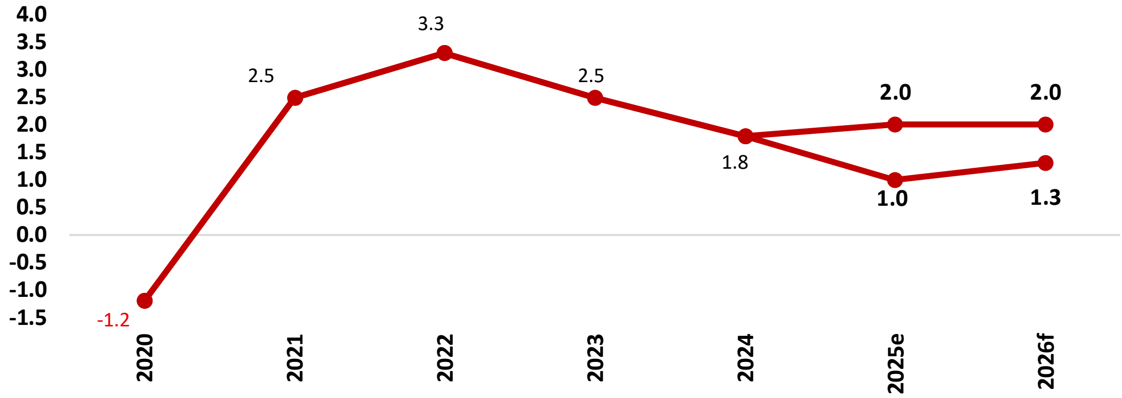
- **The official forecast projects the unemployment rate to remain at 3.0% in 2026**, slightly better than our projection of 3.1%. The marginally higher rate in our forecast is attributed to the expected weakening in trade performance next year, which could adversely impact export-oriented industries. These industries may implement hiring freezes, or in a worse scenario, face retrenchments, particularly among SMEs that may struggle to absorb the impact of higher tariffs under a Trump administration. This outlook is consistent with the anticipated sharp contraction in net exports, which are expected to decline by 32.0% in 2026, following an estimated 15.0% drop in 2025. Nevertheless, the anticipated boom in tourism activities may create job opportunities in the tourism-related sectors, helping to offset weaker hiring in export-oriented manufacturing industries.

Chart 6: Unemployment Rate, %



Sources: MoF, Department of Statistics Malaysia (DoSM), Bank Islam

Chart 7: Headline Inflation, y-o-y %



Sources: MoF, Department of Statistics Malaysia (DoSM), Bank Islam

- As for **headline inflation, it is expected to range between 1.3% to 2.0% in 2026**, a tad higher than this year's forecast range of 1.0% to 2.0%. Our projection is at the upper end of the range, at 2.0% due to the low base effect and the anticipated lagged impact of the Sales and Services Tax (SST) implemented this year, which is likely to be more fully reflected in 2026. In addition, other upward inflationary pressures may arise from domestic policy measures such as subsidy rationalization.