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BUDGET 2027: SUSTAINING GROWTH, STRENGTHENING FISCAL RESILIENCE

Key Takeaways

- Malaysia enters Budget 2027 from a position of relatively strong economic momentum, with the economy expanding by **5.7% in 1H2026**, supported by resilient domestic demand, continued investment activity and firm external-sector performance. Against this backdrop, the Ministry of Finance (MOF) expects growth to remain resilient but moderate, with real GDP projected to expand by **4.2%-5.2% in 2027**, following an estimated **4.8%-5.3% growth in 2026**. Domestic demand is expected to remain the principal anchor, while investment, technology-related activities, tourism and continued implementation of national development plans provide additional support.

- The official outlook is therefore not one of a sharp cyclical slowdown, **but rather a normalisation from the stronger growth momentum of 2026 towards a more sustainable medium-term pace**. MOF expects domestic demand to expand by 5.1% in 2027, with private expenditure growing 5.3% and public expenditure 4.2%. Private consumption is projected to increase by 4.8%, while private investment remains particularly strong at 7.1%.

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- The supply side is similarly expected to remain broad-based. Services are projected to grow by 5.2%, manufacturing by 4.1%, construction by 5.7%, mining by 1.2% and agriculture by 0.5%. The composition of growth is significant: Malaysia is expected to rely increasingly on services, technology-intensive investment, digitalisation, tourism and higher-value manufacturing, rather than simply on traditional commodity and trade cycles.

- At the same time, MOF's inflation outlook remains relatively contained. Headline inflation is projected at **1.8%-2.8% in 2027**, with price pressures expected to be firmer at the beginning of the year before gradually easing. Nevertheless, the balance of risks is tilted to the upside, particularly from geopolitical tensions, energy and food prices, freight costs, supply-chain disruptions and weather-related shocks.

- The labour market is expected to remain supportive, with unemployment projected at **3.0% in 2027**, while employment is forecast to rise by 2% to 17.2 million persons. Labour productivity is projected to increase by 3.7%, reinforcing the Government's emphasis on productivity, technology adoption and higher-value economic activities.

- On the fiscal side, Budget 2027 represents a continuation of **gradual and calibrated consolidation rather than fiscal austerity**. Federal Government revenue is projected to rise by 4.7% to **RM380.8 billion**, while operating expenditure is budgeted at **RM376.8 billion** and gross development expenditure at **RM83.0 billion**. This results in an overall fiscal deficit of **RM77.5 billion, or 3.3% of GDP**, compared with the revised 2026 position.

- The quality of this consolidation, however, matters more than the headline deficit number. Revenue remains equivalent to only **16.4% of GDP**, while operating expenditure remains significantly larger than

development expenditure. Debt service charges are also projected to rise to **RM61.0 billion**, underscoring the continuing constraints created by accumulated debt.

- **Our overall assessment is therefore cautiously constructive.** The MOF outlook provides a credible pathway for Malaysia to maintain growth while gradually strengthening its fiscal position. However, the next phase of fiscal consolidation will increasingly depend on the Government's ability to generate **structural and recurring revenue gains, improve expenditure efficiency and ensure that development spending produces measurable productivity and private-sector multipliers**.
- This is ultimately the key test for Budget 2027: **not simply whether the deficit falls, but whether Malaysia is building stronger fiscal resilience while preserving the capacity to support long-term growth.**

Malaysia's Economic Outlook: Resilient Growth with Gradual Normalisation

- The official MOF outlook points to continued economic resilience in 2027, although growth is expected to moderate from the stronger pace anticipated in 2026.
- Malaysia's economy expanded by **5.7% in 1H2026**, with domestic demand remaining the principal driver. MOF estimates full-year 2026 growth at **4.8%-5.3%**, before moderating to **4.2%-5.2% in 2027**. The breadth of the forecast range reflects the unusually uncertain external environment, particularly geopolitical tensions, trade-policy developments, commodity prices and global financial-market conditions.

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- **Our in-house forecast of 4.6% positioned slightly below midpoint of the official range**, indicating greater uncertainty surrounding the economic outlook. The strong contribution from the external sector, particularly E&E exports recorded in 2026 is expected to normalize as favourable base effects fade. Furthermore, prolonged tensions in the Middle East, resulting in heightened energy price volatility, persistent global trade uncertainties involving Malaysia's key trading partners such as the U.S. and China, and the prospect of higher-for-longer U.S. interest rates could pose downside risks to growth by dampening external demand and exerting pressure on the ringgit.
- Importantly, the official outlook does not envisage a significant weakening in domestic economic fundamentals. Instead, the moderation reflects a normalisation of growth following the stronger performance expected in 2026. Overall, our GDP forecast sits comfortably within MOF's official range, suggesting that our central view is broadly aligned with the Government's assessment. Our inflation forecast of 2.2% is also within the official MOF range, although closer to the upper half of the range.

Table 1: Key Macroeconomic Outlook

Indicator	Share (%)	y-o-y, %	
		MOF	
	2026e	2026e	2027f
Real GDP growth	100.0	4.8 - 5.3	4.2 - 5.2
Domestic demand	96.3	5.4	5.1
Private Expenditure	78.0	5.6	5.3

Consumption	60.4	5.0	4.8
Investment	17.6	7.8	7.1
Public expenditure	**18.3**	**4.9**	**4.2**
Consumption	13.1	3.8	3.2
Investment	5.2	7.7	6.8
External Sector	**3.8**	**20.0**	**1.0**
Exports	72.2	11.4	3.0
Imports	68.4	11.0	3.5
Headline CPI	-	**1.8**	**1.8 - 2.8**
Unemployment	-	**3.0**	**3.0**

Sources: MOF, Bank Islam Economic Research; Note: e=Revised estimate; f=Budget estimate

Domestic Demand Remains the Main Growth Anchor

- MOF expects domestic demand to remain the key engine of the Malaysian economy in 2027, although its contribution is likely to moderate as overall expansion eases from 5.4% in 2026 to 5.1% in 2027. The softer momentum largely reflects a slowdown in private consumption growth, which accounts for more than 60% of GDP and is projected to expand at below 5.0%.
- This suggests that households may adopt a more cautious spending approach amid persistent cost-of-living pressures and continued uncertainty surrounding the global economic outlook. Nevertheless, consumer spending is expected to remain supported by favourable labour market conditions, steady wage growth, fiscal measures such as STR, SARA and targeted fuel subsidies, and resilient tourism-related activities. The influx of visitors and increased economic activity associated with major events such as Visit Malaysia 2026-2027 (VM2026-2027), LIMA 2027, and the 34th SEA Games are also expected to provide additional support to domestic consumption.
- From an economic perspective, this is an important distinction. The Government is not expecting consumption to accelerate materially; rather, it expects **household spending to remain sufficiently resilient to prevent a significant drag on growth**.
- This assumption is reasonable as long as employment remains strong and real income growth continues. However, the downside risk is that persistent food, energy and services inflation could erode real purchasing power, particularly among lower- and middle-income households.

Investment: The More Important Structural Growth Driver

- Investment is arguably the most important component of the 2027 outlook from a medium-term perspective.
- Private investment is projected to grow by 7.1%, supported by capital expenditure in technology-intensive services and manufacturing. Areas highlighted by MOF include hyperscale data centres, AI infrastructure, advanced manufacturing and other high-value activities. Additionally, investment momentum should remain underpinned by the implementation of ongoing multi-year projects and a healthy pipeline of strategic investments.

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- This follows strong investment momentum in recent years, with approved investments reaching RM431.1 billion in 2025. The Economic Outlook emphasises that the critical issue is increasingly the conversion of approved investment into actual productive capacity.
- This is particularly relevant because MOF's analysis estimates that a 10% increase in real private investment is associated with an immediate 0.49% expansion in real GDP. The implication is that the quality and speed of investment execution matter as much as the headline value of approved investments.
- Continued policy support through national development initiatives targeting high-impact sectors, alongside the outcome-based National Investment Framework (NIF), is also expected to encourage quality investments and sustain private sector investment activity over the medium term.
- For Malaysia, the opportunity is therefore to ensure that investments in data centres, semiconductors, AI and advanced manufacturing generate:
  - ✓ higher domestic value-added
  - ✓ technology transfer
  - ✓ stronger domestic supply chains
  - ✓ high-skilled employment
  - ✓ productivity gains
  - ✓ sustainable export capacity
- This is where Budget 2027 and the second year of the 13MP become particularly important.
- Meanwhile, **public investment is expected to remain supportive of economic growth in 2027, expanding by 6.8%** amid targeted development spending and steady capital outlays. Federal Government development expenditure will remain focused on rakyat-centric initiatives, especially the enhancement of healthcare and education critical public infrastructure. At the same time, investment by non-financial public corporations (NFPCs) is anticipated to be concentrated in strategic sectors such as energy, utilities, and transportation, supported by commitments under the Government-Linked Enterprises Activation and Reform Programme (GEAR-uP) program. Investment momentum will also be reinforced by the continued progress of major high-impact infrastructure projects, including:
  - ✓ Penang LRT Mutiara Line
  - ✓ ECRL Phase 2
  - ✓ Sabah-Sarawak Link Road (SSLR)
  - ✓ Pan Borneo Highway Sabah
  - ✓ Klang Valley Double Track Phase 2 (KVDT2)
- By strengthening transport networks and supporting economic integration, these projects are expected to improve public service delivery and expand productive capacity, thereby supporting sustainable and inclusive economic growth over the longer term.

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Chart 2: Real GDP by Sector

	Share (%)	y-o-y, %		
	2026e	2025	2026e	2027f
Overall GDP	**100.0**	**5.2**	**4.8 – 5.3**	**4.2 – 5.2**
Services	59.7	5.4	5.5	5.2
Manufacturing	23.2	4.5	6.2	4.1
Agriculture	5.7	2.2	-2.1	0.5
Mining	5.6	0.6	2.6	1.2
Construction	4.4	12.2	6.4	5.7

Sources: MOF, Bank Islam Economic Research; Note: e=Revised estimate; f=Budget estimate

Services Remain the Main Growth Engine

- The services sector is projected to expand by 5.2% in 2027, remaining the largest contributor to overall growth with a contribution of nearly 60%. The combination of resilient domestic demand, tourism-related activities, digitalization, and infrastructure development will continue to support the sector.
- Several subsectors are expected to perform strongly:
  - ✓ information and communication: 7.9%;
  - ✓ transportation and storage: 7.4%;
  - ✓ real estate and business services: 7.0%;
  - ✓ food, beverages and accommodation: 6.0%;
  - ✓ government services: 4.5%
  - ✓ wholesale and retail trade: 4.4%

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- The outlook reflects three structural forces: **digitalisation, tourism and rising investment-related activity.**
- The continued operationalisation of data centres, cloud computing, digital connectivity, JENDELA 2.0 and Sambungan Kabel Dasar Laut MADANI (SALAM) should support the information and communication sector.
- Meanwhile, the transportation and storage subsector is projected to benefit from improved connectivity and logistics efficiency, particularly with the commencement of the East Coast Rail Link (ECRL) and the Johor Bahru-Singapore RTS Link, which are expected to facilitate trade flows and increase passenger mobility.
- Investment-led activities, particularly in data centres, industrial parks and the JS-SEZ, are expected to drive demand for business, property and financial services. At the same time, services sector will continue to benefit from higher utilities demand driven by industrial and data centre expansion, with El Niño-related weather conditions providing additional support to electricity consumption.
- This is significant for Malaysia's longer-term growth model because services are increasingly moving beyond traditional retail and tourism towards **higher-value digital, professional, financial and business services.**

- Tourism, meanwhile, is expected to receive further support from VM2026-2027 and major international events such as Langkawi International Maritime and Aerospace Exhibition (LIMA) 2027, 34th South East Asian Games (SEA Games) 2027, and state-level tourism campaigns. These initiatives could generate additional spending and boost business activity on tourism-related sectors such as accommodation, food & beverage, transportation, retail, and recreational.

Manufacturing: Slower Growth, But Improving Quality

- Manufacturing growth is projected to moderate from an estimated 6.2% in 2026 to 4.1% in 2027.
- The moderation is not necessarily a sign of deterioration. Rather, it reflects the expected easing of the exceptionally strong technology and semiconductor cycle. The anticipated easing of the global semiconductor cycle in 2027 may in part weigh on demand for the E&E segment.
- The E&E industry is nevertheless expected to remain supported by AI-related demand, while the National Semiconductor Strategy should help strengthen Malaysia's position in higher-value activities such as integrated-circuit design and advanced packaging.
- The key issue therefore shifts from export volume to value-added. Malaysia's ability to capture more domestic value from the semiconductor and technology ecosystem will determine whether current investment inflows translate into a sustained improvement in productivity, wages and potential growth.
- While Malaysia continues to benefit from the China+1 strategy and its strategic position in the global semiconductor supply chain, uncertainties surrounding U.S.-China trade relations, broader global economic conditions, potential supply chain disruptions and elevated energy costs could also potentially affect external demand and increase operating costs for manufacturing businesses.

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Construction and Infrastructure Provide a Second Layer of Support

- Construction is forecast to grow by 5.7% in 2027, supported by continued implementation of infrastructure, industrial and data-centre projects. The ongoing activities across all construction subsectors, particularly non-residential buildings and specialised construction activities will continue to support the sector.
- Additionally, the development of new data centres in Selangor, Johor, and Negeri Sembilan, alongside other commercial and infrastructure projects, is expected to sustain demand for construction-related activities, including mechanical, electrical and plumbing works. Major infrastructure projects such as:

  ✓ East Coast Rail Link (ECRL Phase 2)
  ✓ Elevated Autonomous Rapid Transit (E-ART)
  ✓ Kuala Lumpur Northern Dispersal Expressway (KL NODE)
  ✓ LRT3 Phase 2
  ✓ Juru-Sungai Dua Traffic Dispersal Project

  are expected to support civil engineering activities. Meanwhile, the residential segment is likely to benefit from measures under the National Housing Policy 2026-2035 aimed at improving housing affordability and addressing delayed and abandoned housing projects.

- The construction outlook reinforces the investment story, particularly as public infrastructure provides the enabling capacity required for private investment.
- This creates an important policy feedback loop: **Public infrastructure => private investment => productive capacity => employment and income => domestic demand.**
- The challenge is ensuring that public investment complements rather than crowds out private investment, and that projects generate sufficient economic spillovers to justify their fiscal cost.

Modest Recovery Expectation in Agriculture Sector

- The agriculture sector is projected to recover modestly in 2027, expanding by 0.5% following an estimated contraction of 2.1% in 2026. The improvement is expected to be supported by a recovery in agro-food production, especially in the livestock and fisheries subsectors, driven by sustained household spending and tourism-related demand.
- Efforts to expand paddy cultivation, enhance irrigation infrastructure and promote the adoption of agricultural technologies are also expected to improve food production and productivity.
- Meanwhile, the rubber subsector is anticipated to rebound following the rehabilitation of untapped mature rubber areas and continued government support for plantation development.
- Nevertheless, **growth in the sector is likely to remain moderate as oil palm production is expected to experience a slight decline in FFB yields and CPO output** due to the biological yield cycle, while adverse weather conditions and persistently high input costs may continue to constrain performance across agricultural subsectors.

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Mining And Quarrying Sector Performance is Projected to Moderate

- The mining and quarrying sector is estimated to expand at a more moderate pace of 1.2% in 2027, following an estimated growth of 2.6% in 2026.
- Despite the slower pace of expansion, the sector will continue to be supported by both the natural gas and crude oil subsectors, underpinned by the:
  - ✓ operationalisation of PFLNG3 in Sipitang Sabah
  - ✓ progressive ramp-up of the Rosmari and Marjoram projects in Sarawak
  - ✓ additional output from newly commissioned fields, including Kasawari Phase 2, Berantai East and Irong Timur.
- These developments are expected to partially offset production declines from mature fields such as Gumusut-Kakap and Malikai.
- On the downside, growth may be constrained by moderating global oil demand amid the increasing adoption of electric vehicles, biofuels and energy-efficient technologies, with the official estimate the Brent crude oil prices to average USD85/barrel in 2027.
- Nevertheless, we view that the persistent geopolitical tensions between the U.S. and Iran may continue to generate volatility in global oil markets, with risks tilted towards higher prices. The situation could become more pronounced if military hostilities intensify and disrupt critical maritime

chokepoints such as the Strait of Hormuz and Bab el-Mandeb, potentially reducing global oil supply and driving prices higher.

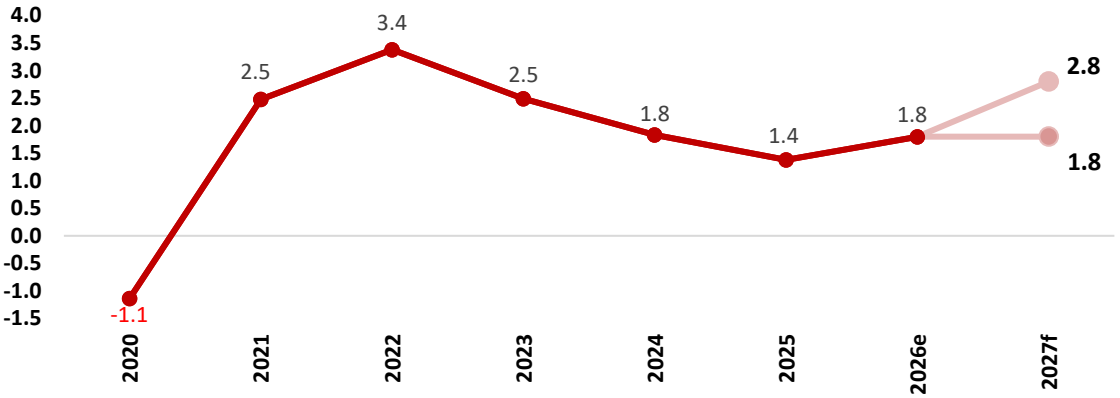
External Sector: Stronger but More Normalised Growth

- After an exceptionally strong export performance in 2026, MOF expects exports to expand by 3.2% in 2027, with manufactured exports rising 2.6%.
- The outlook remains supported by semiconductor demand and AI-related products, while mining exports are also expected to benefit from LNG and other mineral-related demand.
- Imports are expected to grow at 3.3%, slightly faster than exports, resulting in some narrowing of the goods surplus. Nevertheless, the current account is projected to remain in surplus at RM41.8 billion or 1.9% of GNI.
- This remains an important buffer for Malaysia because it reduces the likelihood of a structural external financing constraint.
- However, the external sector remains exposed to:
  1) global trade fragmentation
  2) U.S. trade policy
  3) geopolitical tensions
  4) semiconductor-cycle normalisation
  5) energy and logistics disruptions

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Inflation: Contained, but Risks Are Tilted Higher

Chart 3: Headline Inflation, y-o-y %



Sources: MOF, DOSM, Bank Islam; Note: e=Revised estimate; f=Budget estimate

- MOF projects headline inflation at **1.8%-2.8% in 2027**. The official assessment is that inflation may be firmer in the early part of 2027 because of carry-over effects and lagged pass-through from energy, food and other input costs, before easing as upstream costs normalise.
- Importantly, MOF does not expect significant demand-pull inflation because economic growth is not projected to operate materially above potential.
- However, the risks are increasingly **supply-side rather than demand-driven**.

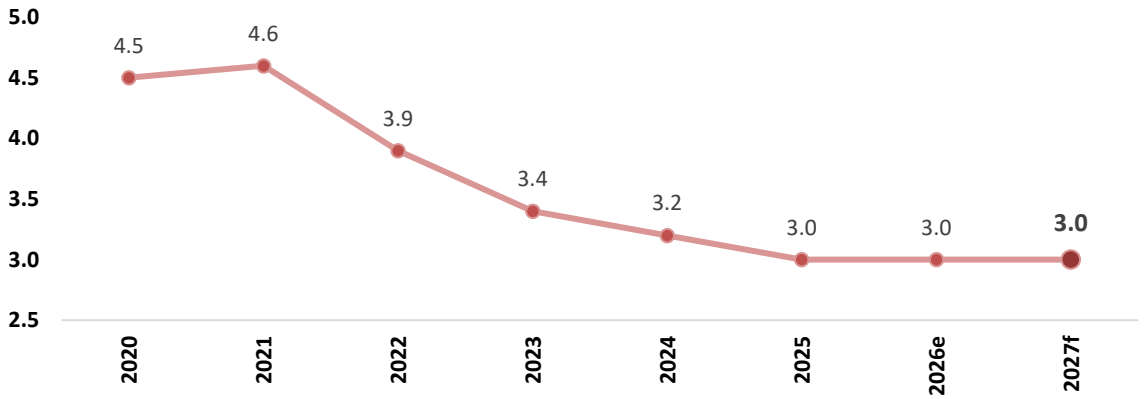
- Upside risks include:
  - ✓ renewed geopolitical escalation
  - ✓ higher global crude oil prices
  - ✓ food supply disruptions
  - ✓ higher freight and fertiliser costs
  - ✓ weather-related shocks
  - ✓ changes in administered prices and subsidy mechanisms
- This is broadly consistent with Bank Islam's **2.2% CPI forecast for 2027**, although our forecast is somewhat closer to the upper-middle part of MOF's range.
- For monetary policy, the implication is that inflation alone is unlikely to necessitate an aggressive tightening cycle. Nevertheless, a sustained supply-side inflation shock could create an **upside bias to the OPR**, consistent with our current house view of 2.75% with an upside bias.

Labour Market: Strong Employment, but Productivity Becomes the Next Challenge

- The labour market is expected to remain resilient in 2027. The official forecast projects Malaysia's unemployment rate to remain at 3.0% in 2027, slightly lower than our projection of 3.1%. The marginally higher unemployment rate in our forecast reflects expectations of softer external demand and slower trade growth, which could weigh on employment opportunities within export-oriented industries.
- In addition, elevated production costs arising from higher energy prices may prompt businesses to adopt a more cautious hiring approach, particularly among SMEs that have limited capacity to absorb rising transportation, logistics, and distribution expenses

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Chart 4: Unemployment Rate, %



Sources: MOF, DOSM, Bank Islam; Note: e=Revised estimate; f=Budget estimate

- MOF forecasts:
  - ✓ **unemployment rate: 3.0%**
  - ✓ **employment: 17.2 million**
  - ✓ **employment growth: 2.0%**
  - ✓ **labour productivity growth: 3.7%**

- The resilience of the labour market provides an important foundation for private consumption. However, the more important structural issue is productivity.
- Malaysia cannot rely indefinitely on increasing employment to generate economic growth, particularly as demographic pressures intensify. The official outlook therefore places greater emphasis on automation, digitalisation, technology adoption, skills development and productivity-linked wage structures.
- From Bank Islam's perspective, this is an important medium-term consideration because **stronger productivity growth is ultimately more sustainable than income support alone in lifting household purchasing power and financing capacity**.

Fiscal Outlook: Consolidation Continues, But Gradually

- Budget 2027 continues Malaysia's gradual fiscal consolidation.
- According to MOF, Federal Government revenue is expected to increase from RM363.6 billion in 2026 to RM380.8 billion in 2027, while operating expenditure rises from RM363.1 billion to RM376.8 billion. Gross development expenditure increases from RM81.0 billion to RM83.0 billion.

Chart 5: Federal Government Fiscal Position (RM billion)

	2025	2026e	2027f
Revenue	336.1	363.6	380.8
Operating expenditure	330.8	363.1	376.8
Current balance	5.3	0.6	4.0
Gross development expenditure	81.9	81.0	83.0
Net development expenditure	80.6	79.1	81.5
Overall balance	-75.3	-78.5	-77.5
Fiscal balance (% GDP)	-3.7	~-3.6	-3.3

Sources: MOF, Bank Islam Economic Research; Note: e=Revised estimate; f=Budget estimate

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- The important point is that the **fiscal deficit declines in percentage-of-GDP terms without requiring a sharp contraction in development expenditure**.
- This is consistent with the Government's stated approach of pursuing consolidation while maintaining support for economic growth and development.

Revenue: Improvement, but Revenue Capacity Remains a Key Issue

Chart 6: Federal Government Revenue

Component	RM Million			y-o-y, %			Share, %		
	2025	2026e	2027f	2025	2026e	2027f	2025	2026e	2027f
Tax Revenue	**259,826**	**280,762**	**297,060**	**8.2**	**8.1**	**5.8**	**77.3**	**77.2**	**78.0**
Direct Tax	180,558	191,025	199,898	5.2	5.8	4.6	53.7	52.5	52.5
CITA	97,816	101,688	106,614	5.4	4.0	4.8	29.1	28.0	28.0
Individuals	45,570	48,829	51,837	10.9	7.2	6.2	13.5	13.4	13.6

PITA	18,063	20,528	20,528	-12.0	13.7	0.0	5.4	5.6	5.4
Indirect Tax	79,268	89,737	97,162	15.7	13.2	8.3	23.6	24.7	25.5
SST	55,874	66,999	73,341	24.8	19.9	9.5	16.6	18.4	19.2
Excise duties	12,789	11,746	11,784	-4.4	-8.2	0.3	3.8	3.2	3.1
Import duty	3,064	3,203	3,323	-0.3	4.6	3.7	0.9	0.9	0.9
Export duty	1,808	1 ,845	1,914	-13.5	2.0	3.7	0.6	0.5	0.5
Non-Tax Revenue	**76,243**	**82,878**	**83,757**	**-9.7**	**8.7**	**1.1**	**22.7**	**22.8**	**22.0**
Licenses & permits	15,526	15,544	17,229	-8.9	0.1	10.8	4.6	4.3	4.5
Investment income	43,982	46,108	46,656	-3.9	4.8	1.2	13.1	12.7	12.3
Total Revenue	**336,069**	**363,640**	**380,817**	**3.5**	**8.2**	**4.7**	**100.0**	**100.0**	**100.0**
% of GDP	**16.6**	**16.6**	**16.4**						

Sources: MOF, Bank Islam; Note: e=Revised estimate; f=Budget estimate

- **Government revenue** is anticipated to expand by 4.7% y-o-y to **RM380.8 billion in 2027 (2026e: RM363.6 billion).** Overall, the government's strategy continues to focus on revenue optmisation, underpinned by ongoing policy reforms, digitalization-led improvements in tax administration, and resilient economic activity. **Tax revenue** remains the bulk of total revenue, estimated to increase by 5.8% to **RM297.1 billion (2026e: RM280.8 billion),** reflecting continued efforts to strengthen enforcement, compliance and collection efficiency. The full implementation of earlier reforms, including the phased mandatory e-Invoicing, enhancements to the Sales and Service Tax (SST) framework, civil service wage adjustments and revisions to the personal income tax rate structure, should cumulatively broaden the tax base and support collections.

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- Meanwhile, **non-tax revenue** is expected to edge higher by 1.1% to **RM83.8 billion (2026e: RM82.9 billion),** driven by higher investment income (2027f: RM46.7 billion vs. 2026e: RM46.1 billion). The increase reflects continued contributions from key government-linked entities, including PETRONAS (RM32 billion), BNM (RM7 billion), Khazanah (RM3 billion) and KWAP (RM6 billion).

- **Direct tax revenue** is projected to expand by 4.6% to **RM199.9 billion in 2027 (2026e: RM191.0 billion),** supported by higher collections across corporate and personal income taxes, while petroleum income tax (PITA) remains broadly stable. Companies income tax (CITA) is set to increase by 4.8% to RM106.6 billion (2026e: RM101.7 billion) amid the full-year implementation of e-Invoicing, steady business activity, and continued compliance initiatives. The improvement in personal income tax collection (2027f: RM51.8 billion vs. 2026e: RM48.8 billion) will be underscored by firm labour market conditions and sustained wage growth. Additionally, stamp duty revenue is poised to record a stronger growth amid the gradual adoption of the Stamp Duty Self-Assessment System (STSDS). Meanwhile, PITA is projected to remain unchanged at RM20.5 billion as global oil prices are expected to moderate around USD85/bbl, compared to elevated levels in 2026, offsetting the potential gains from improved tax administration and compliance.

- **Indirect tax revenue** is expected to rise sharply by 8.3% to **RM97.2 billion (2026e: 89.7 billion).** SST collections are projected to increase by 9.5% to RM73.3 billion (2026e: RM67.0 billion), comprising of RM42.4 billion from service tax and RM30.9 billion from sales tax. The SST-to-Revenue ratio is projected to improve to 19.2% in 2027, significantly higher than 10.7% in 2022, underscoring the

effectiveness of of the revised SST framework in strengthening revenue contribution. Notably, the SST-to-GDP ratio is set to reach 3.2%, matching the level previously achieved under the GST structure. SST collections will also be supported by firm domestic demand and resilient household consumption, alongside stronger tourism-related spending stemming from major events on the 2027 calendar, including Visit Malaysia 2026-2027 and 34th SEA Games. However, excise duties (RM11.8 billion) and import duties (RM3.3 billion) are expected to remain relatively stable, given the absence of meaningful new tax measures and the extension of duty exemptions for locally assembled electric vehicles (EV) until the end of 2027.

- **Revenue optimisation measures is the key priority moving into 2027.** The government continues to remain focused on strengthening revenue generation through enhanced tax compliance, improved collection efficiency and ongoing efforts to minimise revenue leakages. A central component of this strategy has been the acceleration of digitalisation initiatives, particularly the implementation of the e-Invoicing framework and the ongoing transition to the Stamp Duty Self-Assessment System (STSDS). The rollout of e-Invoicing is expected to improve transaction transparency and strengthen tax administration via greater visibility over business activities and financial records. This will help facilitate more effective monitoring and auditing across the books, while tackling the issue of leakages. Meanwhile, the STSDS allows taxpayers to independently declare and remit stamp duties on chargeable instruments through a digital platform, which has contributed to a more efficient and timely collection system while supporting broader enforcement efforts.

- However, the key observation is that **revenue-to-GDP is still only 16.4%**, the lowest level since 2021. While this does pose an immediate concern, the long-term trend highlights a more persistent structural challenge. The revenue-to-GDP ratio moderated from 22.3% in 2009 to 18.6% in 2015, projected to trend downwards to 16.4% in 2027. Moreover, the ratio is averaging at 16.7% between 2022-2026, which highlighted how revenue has stagnated in recent years, suggesting that revenue growth has lagged the expansion of the economy. As such, the Government's fiscal consolidation strategy cannot depend indefinitely on economic growth alone. Stronger and more predictable recurring revenue mobilisation remains necessary to create fiscal space for future shocks.

- The government also has underlined its commitment to reduce reliance on **petroleum-related revenue, with its share to GDP expected to decline to 2.6% in 2027**, less than half of the 5.5% recorded in 2019. However, the domestic-based collection has been comparatively modest, with non-petroleum revenue projected to increase by only 1.8ppt to 13.8% in 2027 (2019: 12.0%). This points towards an increasingly diversified but ultimately rigid revenue structure. While the government has underlined comprehensive efforts to optimize collection from its revenue-generating matrix, the gains achievable through administrative and compliance reforms may be limited without broader measures to meaningfully expand the revenue base.

Petroleum Revenue: Still an Important Fiscal Buffer

- Petroleum-related revenue remains significant.

- MOF estimates petroleum-related revenue at around **RM61.2 billion in 2027**, equivalent to 16.1% of total revenue. This includes a higher PETRONAS dividend, while non-petroleum revenue is expected to reach approximately RM319.6 billion.

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- The declining dependence on petroleum revenue over time is positive. Nevertheless, the absolute contribution remains large enough for oil-price volatility to continue affecting the fiscal position.
- This creates an important fiscal vulnerability: **Higher oil prices provide short-term fiscal relief, but they should not substitute for structural revenue diversification.** This distinction is important when assessing the durability of fiscal consolidation.

Expenditure: The Quality of Consolidation Matters

- Operating expenditure is projected to increase 3.8% to RM376.8 billion in 2027.
- The largest components include:
  - ✓ **emoluments: RM111.6 billion**
  - ✓ **retirement charges: RM44.6 billion**
  - ✓ **debt service charges: RM61.0 billion**
  - ✓ **subsidies and social assistance: RM72.7 billion**
  - ✓ **grants and transfers: RM11.5 billion**
  - ✓ **supplies and services: RM45.1 billion**

Chart 7: Federal Government Operating Expenditure (OE) by Component

Component	RM Million			y-o-y, %			Share, %		
	2025	2026e	2027f	2025	2026e	2027f	2025	2026e	2027f
Emoluments	101,451	108,417	111,606	5.7	6.9	2.9	30.7	29.9	29.6
Retirement charges	38,559	42,801	44,597	7.4	11.0	4.2	11.7	11.8	11.8
Debt service charges	53,711	57,300	61,013	6.4	6.7	6.5	16.2	15.8	16.2
Grants & transfers to state governments	9,808	11,403	11,504	9.6	16.3	0.9	3.0	3.1	3.1
Supplies & services	42,174	41 ,629	45,052	12.0	-1.3	8.2	12.8	11.5	12.0
Subsidies & social assistance	55,268	74,473	72,729	-18.0	34.7	-2.3	16.7	20.5	19.3
Asset acquisition	1,281	922	1,312	7.8	-28.0	42.3	0.4	0.3	0.3
Returns & write-offs	435	547	552	-12.9	25.7	0.9	0.1	0.2	0.1
Grants to statutory bodies	15,120	15,037	17,094	8.0	-0.5	13.7	4.6	4.1	4.5
Others	12,969	10,526	11,381	36.1	-18.8	8.1	3.8	2.8	3.1
Total	**330,776**	**363,055**	**376,840**	**2.9**	**9.8**	**3.8**	**100.0**	**100.0**	**100.0**
% of GDP	**16.3**	**16.6**	**16.2**						

Sources: MOF, Bank Islam; Note: e=Revised estimate; f=Budget estimate

- The composition is important. There is some moderation in subsidies, but this is partly offset by higher emoluments, retirement charges and debt service costs. As a result, fiscal flexibility remains constrained by relatively large committed expenditure.
- This reinforces the importance of the Government's expenditure-efficiency agenda and the implementation of the Government Procurement Act 2026.

Development Expenditure: The Critical Test of Budget Quality

- Gross development expenditure is projected at RM83.0 billion in 2027, up from RM81.0 billion in 2026.

Chart 8: Federal Government Development Expenditure (DE) by Sector

Sector	RM Million			y-o-y, %			Share, %		
	2025	2026e	2027f	2025	2026e	2027f	2025	2026e	2027f
Economic	**38,758**	**37,135**	**37,655**	**-10.7**	**-4.2**	**1.4**	**47.3**	**45.8**	**45.4**
Transport	17,706	17,234	17,557	-13.5	-2.7	1.9	21.6	21.3	21.2
Trade & industry	3,020	3,281	3,513	1.2	8.6	7.1	3.7	4.1	4.2
Energy & public utilities	2,574	2,490	2,751	17.8	-3.2	10.5	3.1	3.1	3.3
Agriculture	2,804	2,793	2,921	-0.2	-0.4	4.6	3.4	3.4	3.5
Environment	2,825	3,418	3,605	7.6	21.0	5.5	3.4	4.2	4.3
Social	**27,592**	**27,442**	**27,988**	**7.8**	**-0.5**	**2.0**	**33.7**	**33.9**	**33.7**
Education & training	14,115	13,951	13,550	12.1	-1.2	-2.9	17.2	17.2	16.3
Health	6,068	6,669	6,907	3.4	9.9	3.6	7.4	8.2	8.3
Housing	1,836	1 ,457	1,681	14.6	-20.7	15.4	2.2	1.8	2.0
Security	**11,918**	**11,788**	**12,240**	**3.0**	**-1.1**	**3.8**	**14.5**	**14.6**	**14.7**
General administration	**3,653**	**4,635**	**5,117**	**6.4**	**26.9**	**10.4**	**4.5**	**5.7**	**6.2**
Total	**81,921**	**81,000**	**83,000**	**-2.5**	**-1.1**	**2.5**	**100.0**	**100.0**	**100.0**
% of GDP	**4.0**	**3.7**	**3.6**						

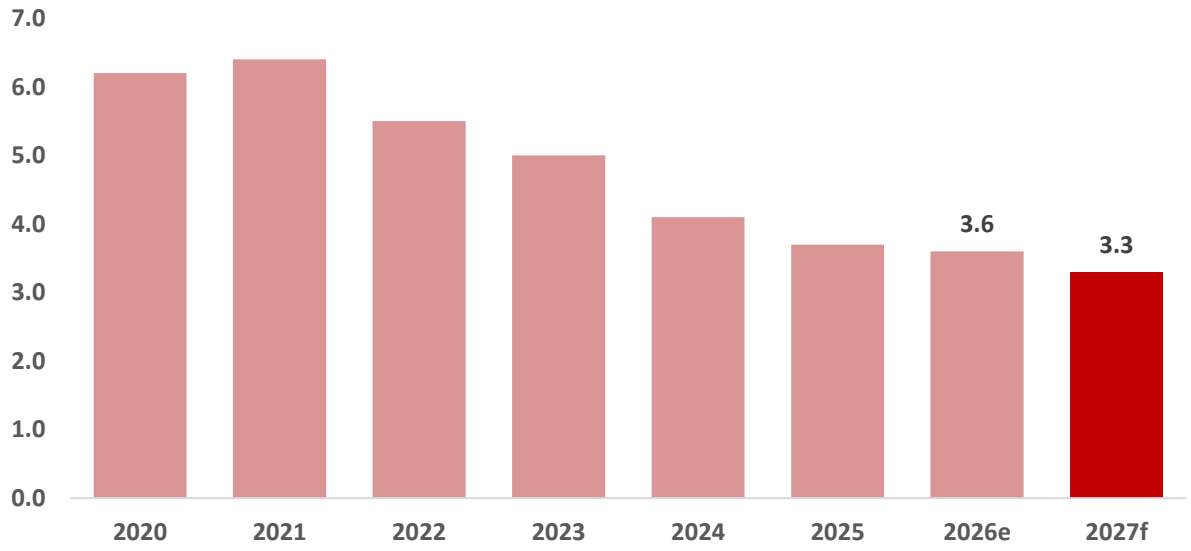
Sources: MOF, Bank Islam; Note: e=Revised estimate; f=Budget estimate

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- The economic sector remains the largest recipient at approximately RM37.7 billion, followed by the social sector at RM28.0 billion, security at RM12.2 billion and general administration at RM5.1 billion.
- The allocation supports:
  - transport and connectivity
  - trade and industry
  - energy and utilities
  - agriculture
  - environmental resilience
  - education and training
  - healthcare
  - housing
  - digital public infrastructure
- From an economic perspective, the key question is no longer simply how much development expenditure is allocated, but how effectively it raises Malaysia's productive capacity.
- This is particularly important given the Government's ambitious 13MP objectives.
- Development spending should ideally generate a multiplier through: **public investment => infrastructure => private investment => productivity => employment => income => revenue.**
- If that transmission mechanism is weak, higher development expenditure may support short-term activity without generating a comparable improvement in potential growth.

Fiscal Consolidation: Progress, But Still a Long Road

Chart 9: Fiscal Deficit, %



Sources: MOF, Bank Islam; Note: e=Revised estimate; f=Budget estimate

- The fiscal deficit is projected to narrow to 3.3% of GDP in 2027.
- This represents further progress towards the Government's medium-term objective under the Public Finance and Fiscal Responsibility Act 2023 (Act 850), which is to place the fiscal deficit on a path towards 3% of GDP or below.
- The Medium-Term Fiscal Framework for 2027-2029 assumes average real GDP growth of 5%, average crude oil prices of USD78/barrel and crude oil production of approximately 500,000 barrels per day. Over the three-year period, revenue is projected at RM1.164 trillion, while operating expenditure is estimated at RM1.148 trillion and gross development expenditure at RM253 billion.
- This provides a clearer indication of the Government's medium-term direction: gradual consolidation rather than front-loaded austerity.
- However, the quality of the consolidation will ultimately depend on whether the Government can:
  - ✓ raise recurring revenue
  - ✓ reduce leakages
  - ✓ improve subsidy targeting
  - ✓ control committed operating expenditure
  - ✓ preserve high-quality development spending
  - ✓ increase private-sector participation in infrastructure and development financing

The Key Question: Is Fiscal Consolidation Becoming More Durable?

- The headline numbers are encouraging. The fiscal deficit is projected to fall to **3.3% of GDP**, revenue rises to RM380.8 billion, development expenditure is preserved at RM83 billion and the Government remains committed to the medium-term objective of reaching a deficit of 3% of GDP or below.
- However, we believe the more important question is **what is driving the improvement**.

- There are three elements to monitor:
  1. Revenue quality - Revenue is rising, but revenue-to-GDP remains at **16.4%**. The Government has made progress through SST expansion, e-Invoice, better tax administration and compliance. The next challenge is converting these measures into a **durable structural improvement in the tax base**.
  2. Expenditure quality - Operating expenditure remains substantially larger than development expenditure. The reduction in subsidies is positive, but this is being partly offset by structural expenditure pressures from emoluments, pensions and debt service. The Government therefore needs to ensure that expenditure restraint does not disproportionately fall on productive development spending.
  3. Debt dynamics - Debt remains manageable, but debt service is becoming increasingly significant. The Government's strategy of maintaining a deep domestic bond and sukuk market, extending maturities and using diversified financing sources provides an important buffer. Nevertheless, **lower debt ratios alone should not be interpreted as equivalent to stronger fiscal fundamentals** if the improvement is heavily dependent on nominal GDP growth.

Assessment and Views

- Overall, we view the official MOF outlook as credible but relatively optimistic at the upper end of the growth range.
- Where we broadly agrees with MOF:
  - First, **domestic demand should remain resilient**. Our 2027 GDP forecast of 4.6% remains within MOF's 4.2%-5.2% range.
  - Second, **inflation should remain manageable but higher** than in the previous cycle. Our CPI forecast of 2.2% is within MOF's 1.8%-2.8% range.
  - Third, **the labour market should remain supportive**. MOF's 3.0% unemployment forecast is consistent with our view of continued labour-market resilience, although our 3.1% forecast is marginally more cautious.
  - Fourth, **investment is likely to be the key medium-term growth driver**. We agree with MOF's emphasis on technology, AI, E&E, data centres, digitalisation and infrastructure as sources of productive capacity.
- Where Bank Islam is more cautious:
  - **Our 4.6% GDP forecast is below the midpoint of MOF's 4.2%-5.2% range**. This reflects our view that the exceptionally strong technology and export cycle of 2026 is unlikely to be fully repeated in 2027, while global trade fragmentation and geopolitical uncertainty remain important risks.
  - Similarly, **our 2.2% inflation forecast is above the lower end of MOF's range**, reflecting the possibility of more persistent food, energy and services-related price pressures.
- **Budget 2027's macro-fiscal framework is broadly supportive of continued economic expansion while maintaining the direction of fiscal consolidation.**

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- The official MOF outlook envisages a Malaysian economy that remains fundamentally resilient, with **domestic demand, private investment, technology, services and tourism** providing the principal growth engines.
- The fiscal framework is similarly balanced. Rather than pursuing aggressive consolidation, the Government is opting for a gradual reduction in the deficit while preserving development expenditure and targeted support.

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