OECD Economic Surveys
MALAYSIA
ECONOMIC ASSESSMENT

NOVEMBER 2016

OECD

OECD Economic Surveys: Malaysia 2016

ECONOMIC ASSESSMENT

OECD
BETTER POLICIES FOR BETTER LIVES

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

Please cite this publication as:
OECD (2016), *OECD Economic Surveys: Malaysia 2016: Economic Assessment*, OECD Publishing, Paris.
http://dx.doi.org/10.1787/eco_surveys-mys-2016-en

ISBN 978-92-64-26262-1 (print)
ISBN 978-92-64-26263-8 (PDF)
ISBN 978-92-64-26264-5 (epub)

Series: OECD Economic Surveys
ISSN 0376-6438 (print)
ISSN 1609-7513 (online)

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Photo credits: Cover © Zhukova Valentyna/Shutterstock.com.

Corrigenda to OECD publications may be found on line at: *www.oecd.org/about/publishing/corrigenda.htm*.

Table of contents

Thematic chapters

Boxes

Tables

Figures

This first OECD Economic Assessment of Malaysia was prepared by Hidekatsu Asada, Stewart Nixon and Thomas Chalaux, under the supervision of Vincent Koen. It benefited from contributions at various stages by Mohamed Rizwan Habeeb Rahuman, Abu Zeid Mohd Arif, Faisal Naru, Lynn Robertson, Ruben Maximiano, Massimo Geloso Grosso, Kazuhiro Sugie, Gernot Hutschenreiter and Philippe Larrue. Administrative assistance was provided by Mercedes Burgos and Sisse Nielsen.

The draft report was discussed at a meeting of the Economic and Development Review Committee on 19 July 2016, with participation by representatives of the Malaysian authorities. The draft was then revised in the light of the discussions. The cut-off date for data and information used in the Economic Assessment is 24 October 2016.

The Economic Assessment is published under the responsibility of the Secretary-General of the OECD.

Support from the governments of Japan, Australia and Malaysia is gratefully acknowledged.

BASIC STATISTICS OF MALAYSIA

(2015 unless noted otherwise, numbers in parentheses refer to the OECD)

LAND AND PEOPLE

Population (millions)	31.0	(1 277.7)	Population density per km²	94.3	(37.2)
Under 15 (%)	25.0	(18.1)	Life expectancy (years)	74.9	(80.2)
Over 65 (%)	5.9	(16.3)	Men	72.6	(77.7)
Foreign-born (%, 2013)[1]	9.6	(10.6)	Women	77.3	(82.9)
Latest 5-year average growth (%)	1.6	(0.6)	Latest general election	May 2013	

ECONOMY

Gross domestic product			Value added shares (%)		
In current prices (billion USD)	297.2	(50 933.6)	Primary	17.6	*(1.9)*
Latest 5-year average growth (%)	5.3	(1.7)	Industry including construction	27.8	*(26.4)*
Per capita (thousand USD PPP at current prices, 2014)	25.6	(39.1)	Services	54.5	*(71.7)*

GENERAL GOVERNMENT

Expenditure (% of GDP)	22.3	*(42.3)*	Federal government debt (% of GDP)	54.5	*(116.0)*
Revenue (% of GDP)	18.9	(39.1)	Share of public sector employees in total employment[2] (2014)	16.1	(16.7)

EXTERNAL ACCOUNTS

Exchange rate (MYR per USD, annual average)	3.90		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1, 2014)	1.44		Machinery and transport equipment	41.9	(37.3)
In per cent of GDP			Mineral fuels, lubricants and related materials	16.5	(6.7)
Exports of goods and services	70.9	(28.8)	Miscellaneous manufactured articles	10.8	(11.1)
Imports of goods and services	63.3	(28.7)	Main imports (% of total merchandise imports)		
Current account balance	3.0	(0.1)	Machinery and transport equipment	38.2	(39.3)
Balance of income	-2.8	(0.6)	Manufactured goods	11.5	(12.8)
Net transfers	-1.9	(-0.7)	Mineral fuels, lubricants and related materials	10.9	(11.0)

LABOUR MARKET, SKILLS AND INNOVATION

Employment rate for 15-64 year-olds (%)	65.7	*(65.8)*	Unemployment rate, Labour Force Survey (15-64 year-olds, %)	3.1	*(7.5)*
Men	78.2	*(73.7)*	Youth (age 15-24, %)	10.7	*(15.0)*
Women	52.2	*(58.0)*	Long-term unemployed (1 year and over, % of unemployed, 2013)	8.0	(35.1)
Participation rate for 15-64 year-olds (%)	67.9	*(71.2)*	Tertiary educational attainment 25-64 year-olds (%, 2010)	16.4	(27.8)
Average hours worked per week	45.4	*(34.0)*	Gross domestic expenditure on R&D (% of GDP, 2012)	1.1	(2.3)

ENVIRONMENT

Total primary energy supply per capita (toe, 2013)	3.0	(4.2)	CO_2 emissions from fuel combustion per capita (tonnes, 2013)	7.0	(9.5)
Renewables (% of TPES, 2013)	5.2	(9.0)	Fine particulate matter concentration (PM2.5, $\mu g/m^3$, 2013)	14.4	(14.0)

SOCIETY

Income inequality (Gini coefficient, 2013)	0.42	(0.33)	Education outcomes (PISA score, 2012)		
Health care expenditure, public and private (% of GDP, 2013)	4.0	(12.3)	Reading	398	(496)
Education expenditure, public (% of GDP, 2013)	6.1	(5.3)	Mathematics	421	(494)
Share of women in parliament (2014)	10.0	(27.3)	Science	420	(501)
Poorest/richest region GDP per capita (2014)	7.7	*(2.8)*[3]			

1. Foreign-born includes part of the illegal foreign residents.
2. Public sector employees include all government sector employment plus employees of publicly-owned resident enterprises and companies, operating at central, state (or regional) and local levels of government.
3. Latest year available between 2010 and 2012.

Note: OECD figures in italics refer to 2014.

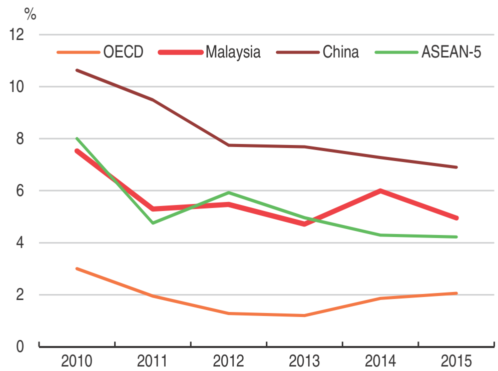
Source: Calculations based on data extracted from the databases of the following organisations: OECD, International Energy Agency, World Bank and various national sources.

Executive summary

- *Growth has been resilient*
- *Boosting productivity growth is essential to raise overall living standards*
- *Growth must continue to become more inclusive*

Growth has been resilient

Real GDP growth



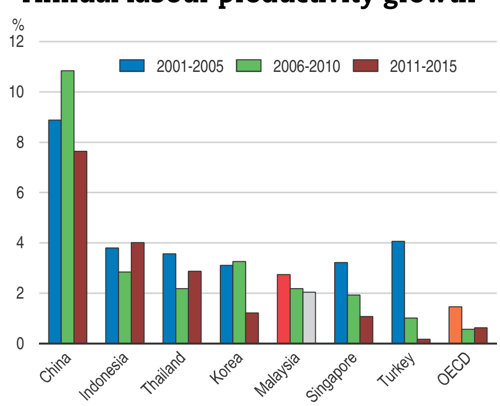
Source: OECD *Economic Outlook* database; national statistical offices.

StatLink http://dx.doi.org/10.1787/888933411097

Malaysia has sustained rapid average growth of over 6.4% per year since 1970. In recent years, growth has moderated somewhat in the face of severe global headwinds but has remained robust. The economy is projected to grow at over 4% per year in the course of 2016-17. Monetary and fiscal policy should remain prudent to help sustain growth and maintain the resilience of the economy to shocks. Stepping up structural reforms to increase productivity and inclusiveness would also improve the sustainability of growth over the medium run and help achieve Malaysia's ambition to become a high-income country around 2020. The effective implementation of the reforms featured in the 11th Malaysia Plan (2016-20) will be critical but challenging.

Boosting productivity growth is essential to raise overall living standards

Annual labour productivity growth



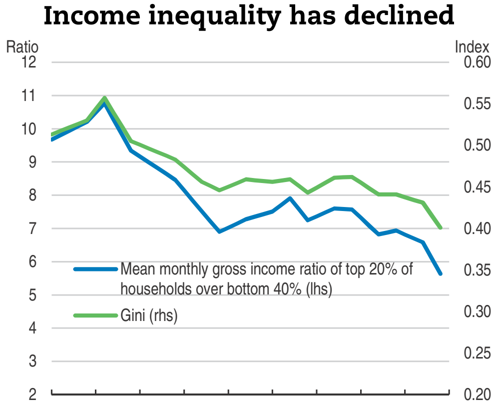
Source: OECD Productivity database; national statistical offices.

StatLink http://dx.doi.org/10.1787/888933411106

Labour productivity growth in the past 15 years has been below that of regional competitors, partly due to slower capital deepening. It has also been held back by a declining share of skilled workers in the labour force and insufficient technology diffusion and innovation. Reforms to improve the quality of education and skills training, promote innovation and the adoption of information technology are key. Enhancing the regulatory frameworks for competition and small and medium-sized enterprises, facilitating economic integration with the other countries of the region, raising public sector productivity and improving labour market functioning would also boost productivity.

Growth must continue to become more inclusive

Income inequality has declined



Source: OECD Income Distribution Database; World Bank (2014).

StatLink http://dx.doi.org/10.1787/888933411115

Income inequality has fallen over the past several decades as Malaysia has pursued a comparatively equitable development path. Absolute poverty has been largely eliminated and income inequality has gradually declined. The focus is now shifting to reducing relative inequality and to sustainable improvements in individual and societal well-being. This calls for reforms with respect to access to quality education, social protection, labour force participation of women and older persons, healthcare, pension adequacy and the inclusiveness of the tax and transfer system.

MAIN FINDINGS	KEY RECOMMENDATIONS
Maintaining resilient growth	
Despite global headwinds, growth has slowed moderately thanks to sound macroeconomic fundamentals and prudent fiscal and monetary policy.	Continue fiscal consolidation to provide a buffer should conditions deteriorate.
The government has steadily pursued fiscal consolidation, but the fiscal stance has at times been pro-cyclical.	Undertake an independent review of expenditure and revenue needs.
Tax revenue as a share of GDP is low and falling, in the face of rising social expenditure needs. Redistribution through income transfers is minimal and less than 10% of people over 15 years old pay income tax.	Over the medium term, consider: i) gradually reducing exemptions and then raising the rate of the goods and services tax, and ii) increasing the progressivity of income tax.
Rising energy demands and urbanisation challenge sustainable growth plans.	Increase the use of market mechanisms and stricter environmental standards to strengthen green growth strategies.
Boosting productivity	
PISA results indicate basic education outcomes are below regional peers and most OECD countries. Improving English language proficiency is critical. Tertiary enrolment has expanded but graduates often lack the skills required by industry.	Follow through with the revised school curricula based on international benchmarking and the improvements to teacher evaluation, training and upskilling. Increase the collaboration of tertiary institutions with industry to deliver job-ready graduates, with a focus on vocational education and training.
Public sector productivity is a focus of ongoing reform efforts as it is constrained by inadequate service delivery, duplicative institutions and functions, insufficient consultation and evaluation, centralised governance, and shortcomings in procurement.	Commission an independent review of public sector productivity.
Institutional governance deficiencies undermine innovation policy coherence.	Streamline innovation system governance through clear mandates for the National Science Council and Research Management Agency.
Inadequate resourcing and the absence of merger control powers are limiting competition policy enforcement.	Enhance the independence, staffing and financial resources of the regulator. Expand merger control powers.
Rigid bankruptcy laws impede business regeneration and SME competition.	Amend insolvency laws to facilitate the rescue of viable firms. Introduce out-of-court insolvency procedures.
Trade agreements and regional fora are driving reforms to labour markets, government procurement and competition.	Pursue further investment liberalisation to boost services sector growth and competition.
Fostering inclusive growth	
Informal employment and the absence of an integrated and targeted social safety net hinder effective labour market functioning and contribute to inequality. Participation rates are low, especially for women and older persons.	Develop a comprehensive social protection system, including by implementing an employment insurance scheme. Promote flexible work arrangements and invest more in early childhood care, lifelong learning and reskilling.
Pension adequacy is low for private sector workers and the public sector pension system is unsustainable.	Increase pension access ages in line with improvements in healthy life expectancy and reduce exemptions for early withdrawal. Enrol future public employees in the defined contribution scheme covering private sector employees.
The development gap between the richer and poorer states is widening.	Improve social services, transport and broadband connectivity in remote rural areas.

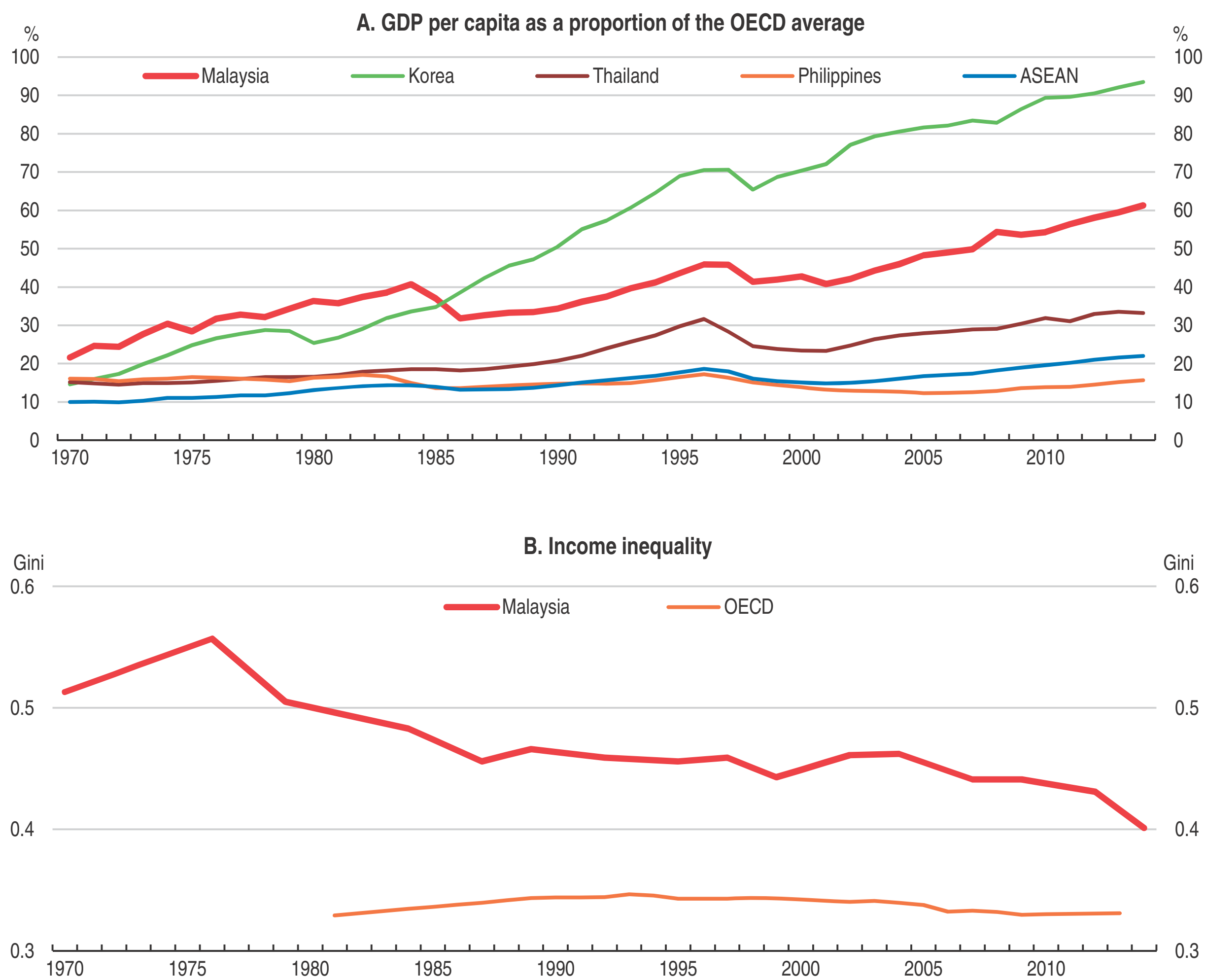
Assessment and recommendations

- *Four decades of rapid and inclusive growth*
- *Growth is moderating but cushioned by robust domestic demand*
- *Fiscal policy consolidation and reorientation towards productive and inclusive expenditure*
- *Monetary policy challenges with a weaker currency*
- *A diversified financial sector*
- *Boosting productivity to achieve high-income country status*
- *Fostering inclusive growth befitting an emerging high-income country*
- *Green growth*

Four decades of rapid and inclusive growth

Malaysia has sustained rapid and inclusive economic growth for close to half a century. Real GDP growth has averaged a commendable 6.4% per year since 1970, outperforming most of its regional peers (Figure 1.A). In the process, the Malaysian economy has undergone a dramatic transformation from dependence on agriculture and commodity exports to a more diversified and open economy with strong links to global

Figure 1. **Convergence to OECD income levels has progressed even as inequality declined**



Note: In panel A, GDP per capita is computed in real USD PPP terms; ASEAN excludes Myanmar; 1970-2011 data are from the Penn World Tables, 2012-14 data from the World Development Indicator database. In panel B, the Gini coefficients have been linearly interpolated for missing years; OECD is an estimate based on incomplete samples.

Source: World Bank (2016), World Development Indicators (database); Penn World Tables 8.1 (database); Economic Planning Unit, Malaysia (2016), Socio Economic Statistics (database).

StatLink http://dx.doi.org/10.1787/888933410590

value chains. The benefits of growth have been widespread and the high levels of income inequality inherited at independence gradually declined through a development model emphasising equitable growth, including increased participation of the Bumiputera (ethnic Malays and indigenous groups) in the modern economy (Figure 1.B).

Growth has been driven by a series of structural reforms that began in the 1970s. Malaysia harnessed its favourable geographical location on global trade routes to promote export-oriented industrialisation, encouraging regional integration through a relatively open environment to trade and investment. This has facilitated the development of manufacturing, boosting growth, employment and productivity by expanding access to global markets, capital, knowledge and technology. The country's response to the shock of the Asian financial crisis in 1997-98 was not to shy away from global integration. Instead, it chose to strengthen macro-prudential policies and reinforce the financial sector by enhancing institutional resilience, broadening and deepening financial markets – in particular local currency bond markets – and undertaking more pre-emptive and risk-oriented supervision. These efforts helped reduce the risks generated by turbulence on external financial markets and promoted the stability and resilience of the domestic economy. The concomitant emphasis on nurturing a business-friendly investment environment is reflected in Malaysia's 18th rank on the World Bank's *Ease of Doing Business 2016* index (World Bank, 2015a). The resilience achieved through structural reform helped hasten its recovery from the 2008 Global Financial Crisis, with real GDP growth averaging 5.3% per year between 2011 and 2015. During this period, growth has become more domestically driven, with the services sector now representing more than half of GDP

Inclusiveness has long been central to Malaysia's development objectives. The New Economic Policy introduced in 1971 combined growth aspirations with the ultimate objective of creating a fair, just and unified nation. It sought to eradicate poverty regardless of ethnicity and to ensure economic opportunities were available to all Malaysians regardless of background. Societal restructuring centred upon attaining income parity and employment opportunities for all. Job creation has been particularly impressive, averaging around 270 000 jobs per year in the past three decades, the majority in manufacturing and services. In 2010, the government's New Economic Model set the objective of the Malaysian economy achieving high-income status by 2020 while ensuring inclusiveness and sustainability (NEAC, 2010). The focus thereby shifted towards equitable economic participation, with more support for the bottom 40% of households by income (B40). New affirmative action instruments aim to optimise resource allocation and to avoid the economic distortions entailed by some earlier measures.

Against this backdrop, the 11th Malaysia Plan provides a reform blueprint to boost productivity and foster inclusive growth (see Box 1 and Table 1). In terms of productivity, Malaysia set itself the target of achieving high-income status by 2020 by sharply accelerating the growth of labour productivity, to 3.7% per year on average between 2016 and 2020 (EPU, 2015). In recent years labour productivity has slowed, like in many other countries, and has been outpaced by regional competitors, though it remains higher than the OECD average at around 2% per year in the first half of the 2010s (Figure 2). Declining global growth has held back capital investment, human capital development has slowed, while labour market skills mismatches and insufficient small business innovation also present challenges. Moving up global value added chains is not progressing as quickly as hoped, limiting the creation of suitable employment for skilled graduates. Low returns from work and labour market rigidities discourage participation by women and older

Box 1. **The 11th Malaysia Plan**

Since independence, Malaysia has practiced a system of centralised economic development planning with five-yearly development plans. Development planning is the responsibility of the Economic Planning Unit (EPU) in the Prime Minister's Department, which formulates the plans through an interactive process involving a broad range of stakeholders (including ministries, agencies, state governments, academics, private sector and non-government organisations). Development planning is underpinned by the key principles of federation, multi-ethnic society, economic openness, and combining free enterprise with active government support.

The five-year development plans seek to enhance national unity by emphasising social integration and a more equitable distribution of income and opportunities. This is to be achieved through sustainable economic growth and sharing the benefits of growth with all levels of society. The latest plan (*Eleventh Malaysia Plan (2016-2020): Anchoring Growth on People*) identifies six mutually reinforcing strategic thrusts to help Malaysia address the challenges and take advantage of the changing global economic and geopolitical landscape: enhancing inclusiveness towards an equitable society; improving well-being for all; accelerating human capital development for an advanced nation; pursuing green growth for sustainability and resilience; strengthening infrastructure to support economic expansion; and re-engineering economic growth for greater prosperity. It also highlights six game changers to accelerate Malaysia's development: unlocking the potential of productivity; lifting the bottom 40% households towards a middle-class society; enabling industry-led technical and vocational education and training; embarking on green growth; translating innovation to wealth; and investing in competitive cities.

To a large extent, these strategic thrusts and game changers are echoed by the key recommendations in this *OECD Economic Assessment* relating to maintaining resilient growth, boosting productivity and fostering inclusive growth (Table 1).

In addition to the overarching 11th Malaysia Plan, there are also many sectoral roadmaps with different horizons, such as the *Third Industrial Master Plan 2006-2020*, the *Malaysia Education Blueprint 2013-2025*, the *Malaysia Education Blueprint (Higher Education) 2015-2025*, the *Financial Sector Blueprint 2011-2020*, the *Services Sector Blueprint 2015-2020*, the *Logistics and Trade Facilitation Master Plan*, the *National Agrofood Policy 2011-2020* and the *National Commodity Policy 2011-2020*. These roadmaps supplement the 11th Malaysia Plan and provide the framework to operationalise the strategies under the 11th Malaysia Plan.

The impact of all these reform efforts very much depends on the implementation capacity of public institutions and the ability of the authorities to adapt and adjust the targets to the prevailing political and socio-economic environment. In some cases, the reform gestation period can straddle several five-year plans. For example, the introduction of the Goods and Services Tax was already envisaged in the 1990s but it did not become reality until 2015. More generally, and like in many other countries, there is ample room in Malaysia to reduce the gap between planning and implementation.

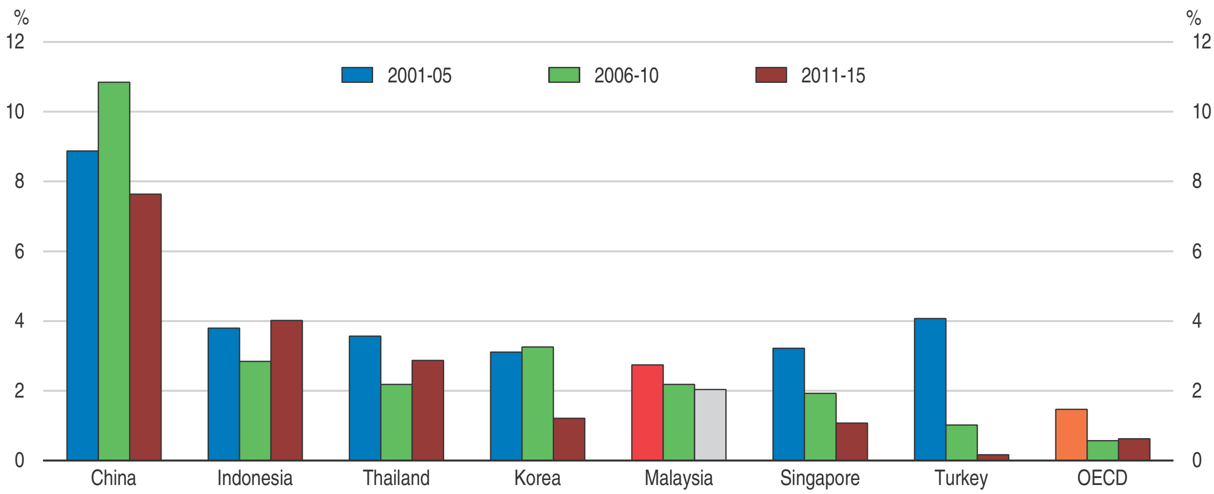
Table 1. **OECD key recommendations and the 11th Malaysia Plan**

Topic	OECD key recommendation	Objectives featuring in the 11th Malaysia Plan
Maintaining resilient growth	• Continue fiscal consolidation to provide a buffer should conditions deteriorate.	• Enhance fiscal flexibility to ensure a sustainable fiscal position.
	• Undertake an independent review of expenditure and revenue needs. Over the medium term, consider gradually reducing exemptions and then raising the rate of the goods and services tax, and increasing the progressivity of income tax.	• Strengthen the efficiency of revenue collection and undertake more disciplined and prudent use of Government funds. • Further enhance the efficiency and effectiveness of the existing taxation system following the implementation of the GST.
	• Increase the use of market mechanisms and stricter environmental standards to strengthen green growth strategies.	• Establish sustainable financing mechanisms – fund green growth through new economic instruments (e.g. green tax, carbon tax) where appropriate.
Boosting productivity	• Follow through with the revised school curricula based on international benchmarking and the improvements to teacher evaluation, training and upskilling.	• Improve professional development programmes for teachers and school leaders. • Improve the quality of teachers through specialised training programmes, as well as require all teachers working in public preschools to have a minimum diploma level qualification. • Enhance the school curriculum to build 21st century skills - embed relevant knowledge, skills, and values (e.g. language proficiency, higher-order thinking skills).
	• Increase the collaboration of tertiary institutions with industry to deliver job-ready graduates, with a focus on vocational education and training.	• Align curriculum of institutes of higher education with industry needs to prevent skills mismatch. • Develop holistic, entrepreneurial, and balanced graduates.
	• Commission an independent review of public sector productivity.	• Realign public sector institutions and reduce overlapping roles. • Restructure the public service.
	• Streamline innovation system governance through clear mandates for the National Science Council and Research Management Agency.	• Strengthen governance by creating a research management agency. • Enhance demand-driven research by streamlining public sector funding for research, development, commercialisation and innovation.
	• Enhance the independence, staffing and financial resources of the competition regulator. Expand merger control powers. • Amend insolvency laws to facilitate the rescue of viable firms. Introduce out-of-court insolvency procedures.	• Establish the Malaysian Aviation Commission to regulate competition and mergers in this sector.
	• Pursue further investment liberalisation to boost services sector growth and competition.	• Replace the current investment incentive programme with a more effective, transparent, and performance-based incentive one to attract quality investment and boost productivity.
Fostering inclusive growth	• Develop a comprehensive social protection system, including by implementing an employment insurance scheme.	• Introduce an integrated and comprehensive social safety net.
	• Promote flexible work arrangements and invest more in early childhood care, lifelong learning and reskilling.	• Enhance legislation to meet labour market requirements to address the rigidity of existing dismissal processes, resolve overlapping and contradicting provisions, as well as increase flexibility in working hours and registration of trade union membership.
	• Increase pension access ages in line with improvements in healthy life expectancy and reduce exemptions for early withdrawal. Enrol future public employees in the defined contribution scheme covering private sector employees.	
	• Improve social services, transport and broadband connectivity in remote rural areas.	• Deploy broadband as an essential service. • Maximise the usage of Urban Transformation Centres, Rural Transformation Centres and Mobile Community Transformation Centres. • Extend the provision of rural basic infrastructure, including road, water and electricity supply.

Source: EPU (2015), *Eleventh Malaysia Plan*.

Figure 2. **Labour productivity growth has declined**

Average growth of real value added per employee per year



Note: The underlying employment data for Malaysia might underestimate the number of legal and undocumented foreign migrant workers.

Source: OECD calculations based on data provided by national statistical office and OECD (2016), Productivity Statistics (database), *http://dx.doi.org/10.1787/data-00685-en*.

StatLink http://dx.doi.org/10.1787/888933410600

persons, while barriers to investment and competition in some services sectors limit incentives to increase productivity.

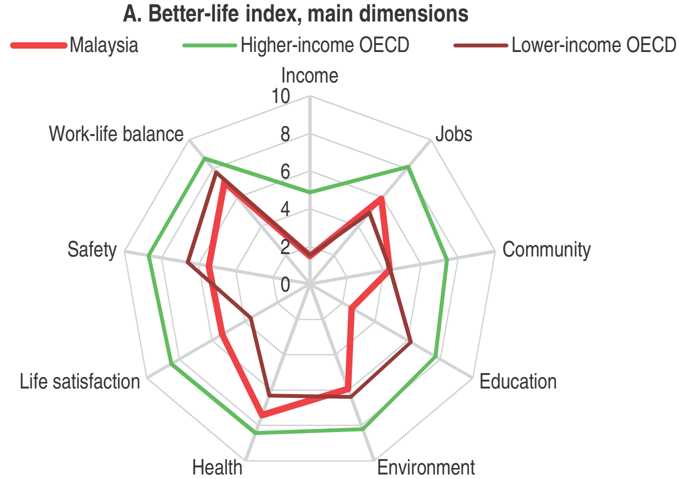
Malaysia's aspiration to attain high-income country status also involves striving for greater inclusiveness. It scores well on some indicators in the OECD *Better Life Index*, in particular long-term unemployment (Figure 3). However, the index illustrates relative weakness in areas such as educational attainment and skills, as well as personal earnings. Improving education quality and skills training is essential to achieve productivity gains, raise lifetime earning potential and social mobility while promoting social cohesion and well-being over the longer term. The index also highlights the need to further improve healthcare to increase healthy life expectancy. Maintaining universal access to quality medical services, particularly in rural areas and for low-income urban residents, would help narrow the life-expectancy gap with advanced countries.

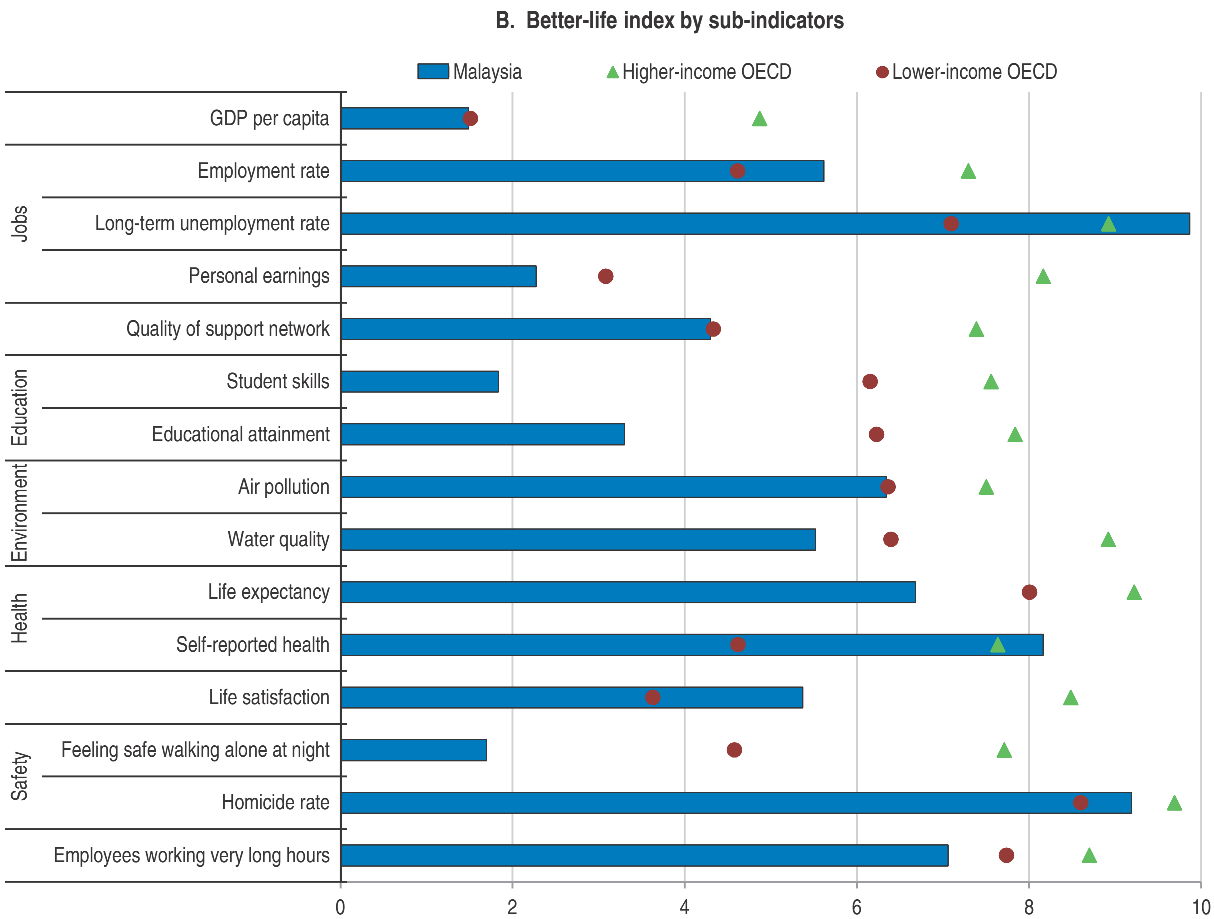
Sustained efforts to improve well-being have been successful in achieving development outcomes consistent with the United Nations' Millennium Development Goals (MDGs) and the successor Sustainable Development Goals (SDGs). Malaysia's achievements with respect to the former include the eradication of poverty and hunger, universal primary education, increased gender equality, low child mortality and environmental preservation. Meeting the higher ambitions of the SDGs will require further increasing the quality and sustainability of development, particularly in areas such as social protection, education, clean energy and inclusive growth. Malaysia has committed itself to the SDGs and the 11th Malaysia Plan mirrors their multi-dimensional nature, including by setting 2020 targets for indicators under the Malaysian Well-being Index (EPU, 2013).

Against this backdrop, the main messages of the first OECD Economic Assessment of Malaysia are:

- *Pushing ahead with structural reforms would reinforce economic resilience and sustainable growth.* While growth is expected to remain resilient despite global headwinds, monetary

Figure 3. **Well-being indicators point to further opportunities to foster inclusive growth**





1. Due to data availability, the indicators used in the OECD Better Life database are not necessarily identical with this exercise. Therefore, the higher and lower-income OECD data does not always correspond to the data in the OECD Better Life database.
2. In panel A, indicators are normalised to range between 10 (best) and 0 (worst) according to the following formula: (indicator value – minimum value) / (maximum value - minimum value) x 10. In panel B, a simple ranking of the OECD countries is applied.
3. OECD higher/lower income countries are countries belonging to the top/bottom 30% income quintiles of the OECD member countries.

Source: OECD calculations based on the data provided by OECD (2016), Better Life Index (database), *www.oecdbetterlifeindex.org*, national sources and UNESCO, UIS.stat (database).

StatLink http://dx.doi.org/10.1787/888933410617

and fiscal policy should remain prudent to maintain the resilience of the economy to shocks. The medium-term fiscal outlook would benefit from further improvements to the fiscal framework and a more sustainable revenue base. Stepping up structural reforms promoting productivity and inclusiveness would increase the sustainability of growth over the longer run.

- *Boosting productivity growth is essential to raise living standards*. Malaysia has reached a development stage where growth needs to be driven by productivity gains more than the sheer accumulation of capital and labour inputs. This calls for increasing the quality of education and skills training, spurring innovation, adopting information technology more widely, improving the functioning of the labour market and the regulatory framework for small and medium-sized enterprises (SMEs), fostering regional integration and raising public sector productivity. It also requires regular evaluation of strategic government plans and programmes to narrow the gap between planning and implementation, the use of performance benchmarks throughout the public service and reducing duplicative and excess public service jobs.
- *Growth must continue to become more inclusive*. Having largely eliminated absolute poverty through a relatively equitable development path, Malaysia's focus has turned to relative inequality. This calls for reforms with respect to access to quality education, social protection, labour force participation of women and older persons, healthcare, pension adequacy and the inclusiveness of the tax and transfer system.

Many of the ongoing or envisaged structural reforms to boost productivity and to promote inclusive growth can be mutually reinforcing. In particular, productivity gains through increased investment in education and skills training deliver strong and sustainable growth, but also make it more inclusive by raising labour participation rates and reducing income inequality.

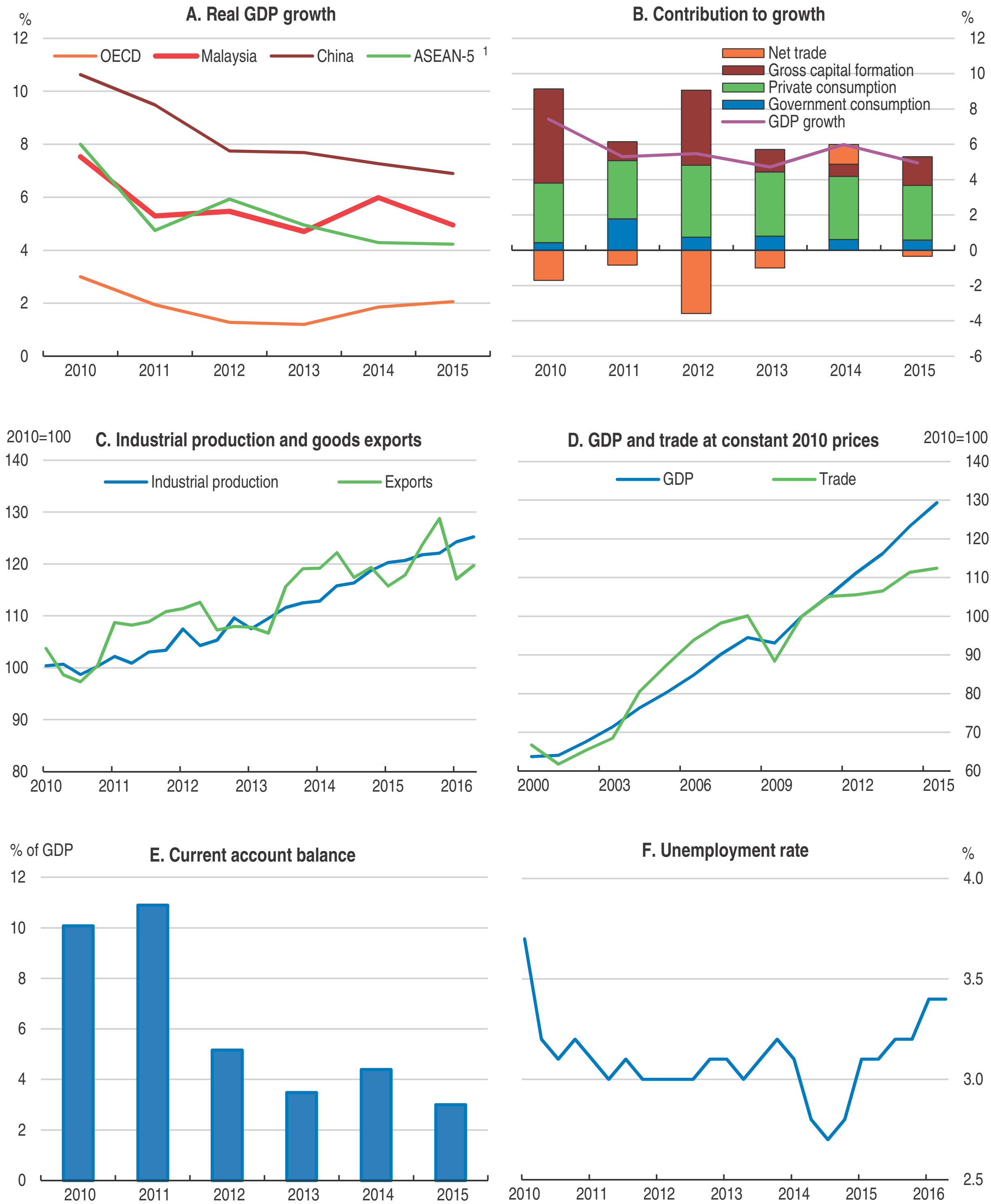
Growth is moderating but cushioned by robust domestic demand

Growth remained strong in 2015, at 5%, despite slowing global growth and a sharp fall in commodity prices (Figure 4.A). Sound macroeconomic fundamentals, disciplined fiscal policy and prudent monetary policy underpin Malaysia's resilience. Notwithstanding the boost to price competitiveness imparted by the sharp depreciation of the ringgit, exports grew moderately and the current account surplus shrank to 3% of GDP (Figure 4.E).

However, robust domestic demand did help sustain growth (Figure 4.B). The unemployment rate increased only marginally, to 3.1% in 2015, while services sector job growth contributed to total employment expanding by 1.7% (Figure 4.F). Private consumption surged in the first quarter in anticipation of the introduction of the Goods and Services Tax (GST) in April, but then slowed. Beyond the one-off anticipation effect of the GST, the slowdown in consumption reflects weaker consumer sentiment in response to moderating economic growth and rising living costs following the substantial removal of food and fuel subsidies (the latter amounted to 0.9% of GDP). Low-income households have been disproportionately affected by rising living costs, with prices increasing most for items such as food and public utilities that comprise a greater share of their expenditure. However, ad-hoc cash transfers have partly alleviated these pressures.

In the face of external headwinds, growth slowed down to just over 4% year-on-year in the first half of 2016 but is projected to remain resilient at around this pace in the remainder of 2016 and in 2017 thanks to the continuing strength of domestic demand, even

Figure 4. **Selected macroeconomic indicators**



1. ASEAN-5 is the weighted average growth rates of Indonesia, Malaysia, Philippines, Thailand and Singapore.
2. Panels C, D, and F display quarterly data.

Source: *OECD Economic Outlook* database, *http://dx.doi.org/10.1787/9572784d-en*; national statistical offices.

StatLink http://dx.doi.org/10.1787/888933410629

though momentum will be held back by the subdued pace of the global economy and still low commodity prices (Table 2). Trade will continue to grow at a slower rate than GDP (Figure 4.D). Sluggish world trade growth, at half the pre-global financial crisis rates, has particularly affected the growth potential of trade-exposed emerging market economies

Table 2. **Macroeconomic indicators and projections**

Annual percentage changes unless specified[1]

	2012	2013	2014	2015	2016 (projected)	2017 (projected)
Output and demand[2]						
Real GDP	5.5	4.7	6.0	5.0	4.2	4.2
Consumption	7.7	6.9	6.4	5.7	6.0	4.9
Private	8.3	7.2	7.0	6.0	6.3	5.4
Public	5.4	5.8	4.3	4.4	5.0	3.0
Gross fixed investment	19.0	8.1	4.8	3.7	3.3	4.1
Private	21.4	12.8	11.1	6.4	4.8	5.5
Public	15.9	1.8	-4.7	-1.0	0.5	1.2
Total final domestic demand	10.6	6.3	5.3	5.9	5.3	4.7
Stockbuilding[3, 4]	-0.1	-0.8	-0.6	0.6	0.1	0.0
Exports of goods and services	-1.7	0.3	5.0	0.6	0.4	0.5
Imports of goods and services	2.9	1.7	4.0	1.2	1.6	1.0
Net exports[3]	-3.6	-1.0	1.2	-0.4	-0.7	-0.3
Inflation and capacity utilisation						
Consumer price inflation	1.6	2.1	3.2	2.1	2.3	2.5
Unemployment (% of labour force)	3.0	3.1	2.9	3.1	3.5	3.6
Output gap (% of potential GDP)	-0.6	-0.9	0.1	0.3	-0.1	-0.5
Public finances (% of GDP)						
Federal government fiscal balance	-4.3	-3.8	-3.4	-3.2	-3.1	-3.0
Expenditures (operating + net development)	25.7	24.7	23.3	22.1	20.4	19.6
Revenues	21.4	20.9	19.9	18.9	17.3	16.6
Oil-related revenues[5]	7.2	6.5	6.0	4.1	2.5	2.3
Federal government debt[6]	51.6	53.0	52.7	54.5	53.2	53.1
External sector and memorandum items						
Oil price (spot market, Brent, USD per barrel)	111.6	108.7	99.0	52.4	43.5	45.0
Crude palm oil price (spot market, Rotterdam, USD per tonne)	999	857	821	623	660	650
World trade growth (volume)	3.2	3.3	3.7	2.5	2.1	3.2
Trade balance (% of GDP)	9.9	7.0	7.5	7.9	6.7	7.2
Current account balance (% of GDP)	5.2	3.5	4.4	3.0	1.0	1.1
Gross official reserves (end-year, USD billion)	139.7	134.9	115.9	95.3		
Total external debt (% of GDP)	60.1	65.2	66.6	71.7		
Three-month money market rate, average, in %	3.2	3.2	3.5	3.7	3.5	3.3
Ten-year Malaysian government securities, average yield, in %	3.5	4.1	4.1	4.2	3.8	3.8
Household debt (% of GDP)	80.5	86.1	86.8	89.1		
Nominal GDP (USD billion, at the market exchange rate)[7]	314	323	338	296	295	314

1. Through 2015, published data from the Ministry of Finance, Bank Negara Malaysia and the Department of Statistics, Malaysia.
2. At 2010 constant prices.
3. Contribution to GDP growth (percentage points).
4. Includes statistical discrepancy.
5. The projection assumes that PETRONAS dividends, based on profits one year earlier, will be MYR 13 billion in 2017.
6. The projection includes the reduction in the debt ratio stemming from the transfer of public servants' housing loans to the Public Sector Housing Financing Board, which is estimated at 1.8% of GDP.
7. The exchange rate is assumed to remain unchanged over the projection period at its 21 October 2016 level.

Source: *OECD Economic Outlook* database, *http://dx.doi.org/10.1787/9572784d-en*; Department of Statistics, Malaysia; Bank Negara Malaysia; Ministry of Finance, Malaysia; World Bank (2016a), *Commodity Price Outlook, April*.

like Malaysia, where exports plus imports of goods and services amounted to 134% of GDP in 2015. A slowdown in Malaysia's industrial upgrading during the period of high commodity prices has also contributed to diminishing trade competitiveness. Earlier ringgit depreciation will support stronger export growth, although the exchange rate has strengthened since the latter half of 2015. Low oil prices have already been factored into government budgeting, with a USD 30-35 per barrel assumption and further fiscal discipline factored into a budget update in January 2016, and a relatively cautious oil price assumption, at USD 45 per barrel, in the 2017 budget.

The balance of risks to growth is tilted to the downside and stems mainly from external factors. A slowdown of the global economy, in particular a marked deceleration in Chinese imports or in growth of emerging economies in the East Asian region, but also a slowdown in Europe, would affect Malaysia more than a number of nearby countries (Figure 6). The impact would be amplified if such a development hurt confidence and affected global financial markets (Dizioli et al., 2016). A more rapid than foreseen normalisation of United States monetary policy would also entail a downside risk to the projections, as open emerging market economies such as Malaysia are vulnerable to capital outflows. So would further fluctuations in global commodity prices. While Malaysia has diversified its economy (Box 2) and reduced its dependence on oil for government revenue, 19.2% of exports were agricultural and mining goods in 2015 and 21.5% of government revenue was still oil-related. If commodity prices were to fall further, the trade balance, corporate profits and fiscal revenue would be negatively affected. However, these external risks are arguably already priced in to some extent by market participants and Malaysian policy makers are keenly aware of them. Moreover, on the upside, higher crude oil prices, accelerating inflows of tourists from Asia, or higher-than-forecast palm oil prices if unfavourable weather conditions continue to affect production, could see growth exceed projections.

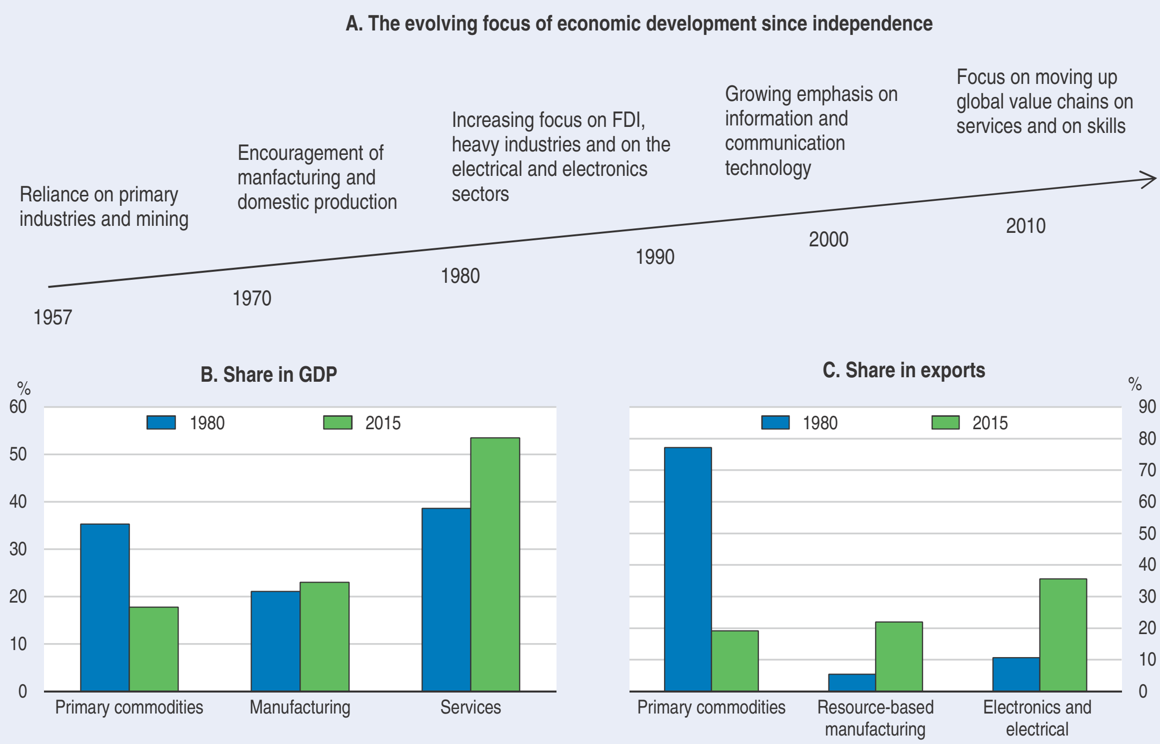
Domestically, household debt rose rapidly in the early 2010s, largely reflecting rising house prices that could weigh on private consumption (Figure 7). To address this potential risk, Bank Negara Malaysia (BNM) strengthened its macroprudential measures (see below), which helped to slow down the build-up of debt which as a share of GDP reached 89% by 2015. However, risks appear well contained, with 61% of household debt secured by property assets and principally guaranteed investments. Indeed, household assets accounted for 183% of GDP in 2015 (BNM, 2016b). Stress tests by BNM estimate a simultaneous default across all types of household borrowing would cause losses of MYR 65 billion, well below the banking system's MYR 117 billion in excess capital buffers at end-2015 (BNM, 2016b). Although systemic risk is thus contained, the elevated level of household debt warrants continued policy vigilance. On the upside, unexpectedly swift follow-through on reforms required by the Trans-Pacific Partnership Agreement (TPPA) could boost business and investor confidence, and growth. Some of the vulnerabilities that are difficult to assess in the context of this projection are discussed in Table 4.

Box 2. **Malaysia's economic diversification**

Prior to the 1970s, the natural resource rich Malaysian economy was dominated by the primary sector (Figure 5A). Malaysia was the world's largest producer of natural rubber and tin ore. Primary industries contributed nearly 50% of GDP and 80% of total exports in the 1960s and 1970s. The collapse of global rubber and tin prices in the early 1980s prompted a shift in commodity output, with crude oil, natural gas and palm oil becoming Malaysia's dominant commodities, which they still are today.

The sharp decline in key commodity prices as well as limited reserves of non-renewable resources such as oil and gas prompted Malaysia to pursue a diversification strategy aimed at reducing its vulnerability to future shocks and promoting industrial upgrading into higher value-added activities. Manufacturing sector development first focused on import substitution, then from the mid-1980s increasing openness to foreign investment drove export-led growth. The contribution of the manufacturing sector surged from only 22% of total exports in 1980 to around 80% in 2015, while the primary sector's declined from 77% to 19% and its share in GDP almost halved to 18% (Figure 5.B, C).

Figure 5. **Malaysia's economic development**



Source: Department of Statistics, Malaysia.

StatLink http://dx.doi.org/10.1787/888933410637

Box 2. **Malaysia's economic diversification** *(cont.)*

The successful development of the electronics and electrical (E&E) industry is particularly noteworthy from the perspective of diversification given its minimal links to resource-based industries. Its take-off created jobs for previously underemployed rural workers, accelerating urbanisation through job migration and boosting on-the-job upskilling. Since the 1990s, the E&E industry has been the leading contributor to Malaysia's participation in global value chains, producing components such as semiconductors for mobile devices and automotive components, as well as computer parts (ADB, 2014). E&E exports are presently Malaysia's largest exported component, accounting for approximately 36% of total export by 2015 (BNM, 2016a).

Trade liberalisation and diversification in production have been accompanied by a diversification in the direction of foreign trade. Malaysia's leading export destinations in 2015 - Singapore and China - accounted for around 14% and 13% respectively of total exports (Table 3). The European Union, Japan and the United States are also among the top five trading partners, while regional integration and global value chain development have increased regional interdependence over the past 15 years.

Table 3. **Malaysia's trading partners**

Percent share in 2015 in goods trade

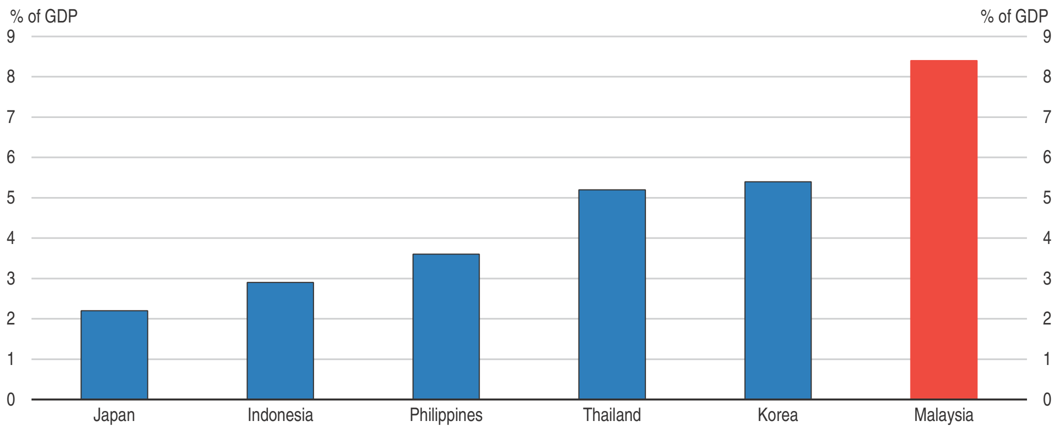
Export partners	Share
Singapore	13.9
China	13.0
European Union (28 countries)	10.1
Japan	9.5
United States	9.4
Thailand	5.7
Hong Kong, China	4.7
Indonesia	3.7
Korea	3.2
Import partners	**Share**
China	18.9
Singapore	12.0
European Union (28 countries)	10.2
United States	8.1
Japan	7.8
Thailand	6.1
Chinese Taipei	5.3
Korea	4.5
Indonesia	4.5

Source: Department of Statistics, Malaysia.

While diversification is neither sufficient nor necessary for economic development, it has been beneficial for Malaysia in creating job opportunities and in strengthening the resilience of its economy. A combination of long-term stability, shrewd government policies, strong private sector development and political and social stability all contributed to the success of economic diversification in the Malaysian context.

Figure 6. **Value-added exports to China are significant**

2011

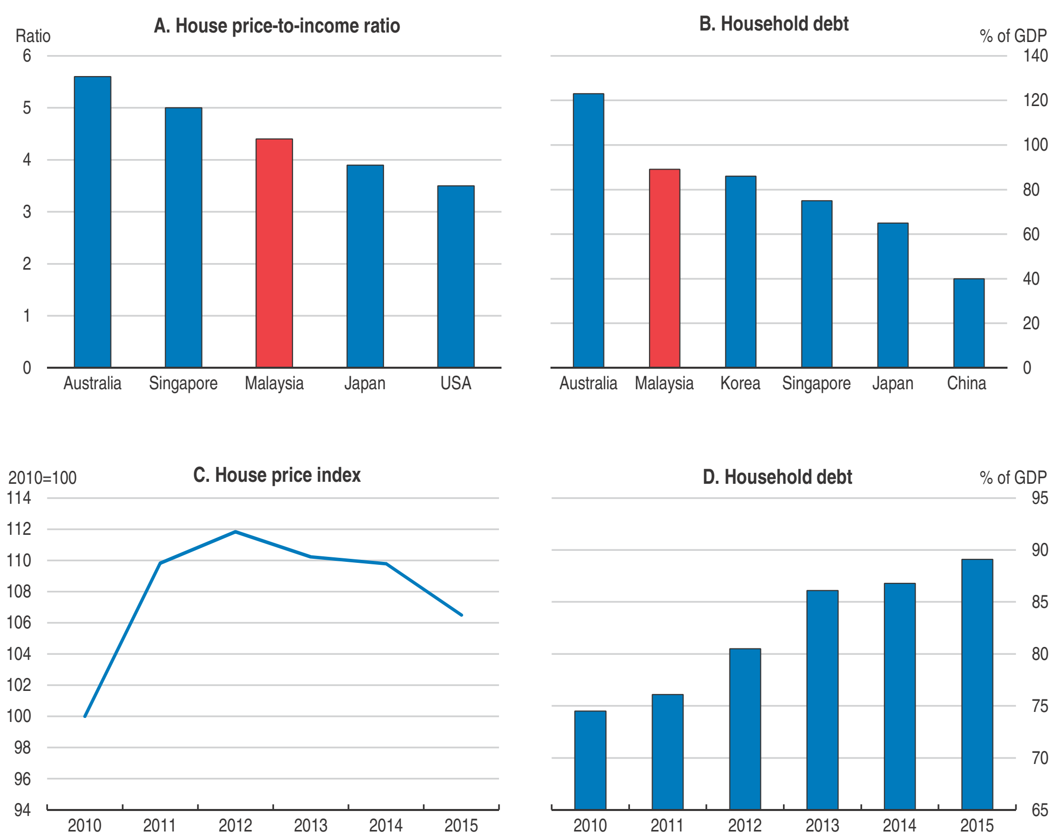


Source: OECD/WTO (2016), *Trade in value added*, OECD-WTO: Statistics on Trade in Value Added (database), *http://dx.doi.org/10.1787/data-00648-en*.

StatLink http://dx.doi.org/10.1787/888933410649

Figure 7. **House prices and household debt**

In 2015



1. Data for Panel A is 3Q 2015, reflecting the ratio of median house prices over gross median annual income per household.
2. Data for Panel B reflects gross debt as a share of GDP as at June 2015, except for Malaysia for 2015 average and China at December 2015.

Source: BNM (2016a), *Bank Negara Malaysia Annual Report 2015*; Standard Chartered Bank (2016), *Asia Leverage: After the boom*; National Property Information Centre, Malaysia.

StatLink http://dx.doi.org/10.1787/888933410650

Table 4. **Shocks that might affect economic performance**

Shocks	Possible outcomes
Environmental risks and natural disasters	Changing climate patterns may increase the prevalence of natural disasters such as severe storms, drought and flooding, creating significant economic losses to agricultural production and affected regions.
Geopolitical tensions	Malaysia has successfully managed its security for many years but the global security outlook is deteriorating. This might adversely affect trade and investment and increase security-related costs.
A sharp decline in global trade	With trade accounting for 134% of GDP in 2015, growth would be affected substantially.

Fiscal policy consolidation and reorientation towards productive and inclusive expenditure

Malaysia has demonstrated a firm commitment to medium-term fiscal consolidation during the past six years and is maintaining this prudent approach despite a challenging external environment. At the same time, it seeks to strengthen the process for prioritising short and medium-term fiscal expenditure and the evaluation of programme effectiveness. Given the external uncertainties, risks to fiscal sustainability remain, with a low revenue base and significant expenditure needs. Moreover, consolidation efforts have at times been pro-cyclical. Continued improvements to the fiscal framework and reorientation of expenditure towards inclusive growth and productivity-enhancing programmes will brighten Malaysia's longer-run macroeconomic outlook.

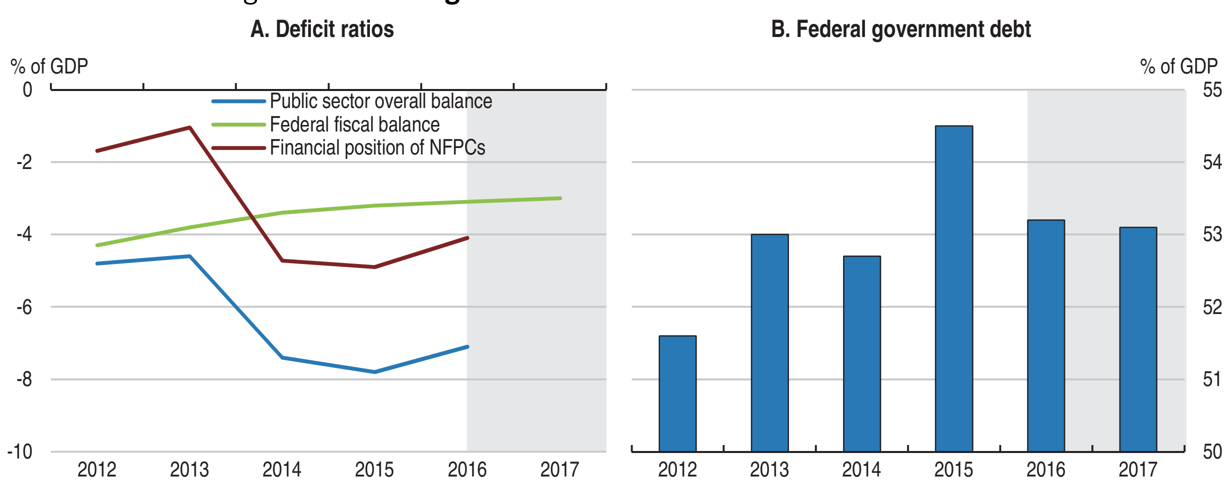
Fiscal consolidation

Malaysia's fiscal policy response to declining global commodity prices has been to combine diversification of its tax base away from commodities such as oil with reduced operating expenditure. Oil-related revenue declined sharply, with its share in overall revenue estimated to have halved between 2014 and 2016, to under 15%. An important tax reform was the introduction of the GST in April 2015, which compensated for a portion of foregone oil-related revenue. The substantial removal of fuel and food subsidies, commenced in 2010 and stepped up in 2014-15 amid the rapid decline in many global commodity prices, was the most significant cut to operating expenditure.

Fiscal policy is guided by commitments to eliminate the federal government fiscal deficit by 2020, to prevent federal government debt exceeding 55% of GDP and to maintain a surplus in the current fiscal balance (revenue minus operating expenditure), so that borrowing is only to finance development (capital) expenditure. While these targets do not reflect legally-binding rules, the government has been resolute in pursuing its commitments and is on course to meet them, albeit with the help of measures such as the recent transfer of 1.8% of GDP worth of housing loans to civil servants from the government balance sheet to a new off-budget entity. This raises government contingent liabilities, which before this move were estimated at around 15% of GDP (IMF, 2016). In the face of lower crude oil prices, the government revised the budget in both 2015 and 2016 to scale down revenue forecasts and cut operating expenditure. The new budget unveiled in October 2016 targets a fiscal deficit of 3% of GDP for 2017. Going forward, continued fiscal discipline is required to meet the consolidation targets in the coming years, with consolidation creating a fiscal buffer against future macroeconomic shocks and fiscal space to meet the expected costs of rapid population ageing. Gradual consolidation can be achieved without undermining economic momentum and while pushing ahead with productivity-enhancing capital investments. A repeat of spending on across-the-board public sector bonuses and untargeted cash assistance to households should be avoided in favour of reducing deficit and debt levels.

The federal government debt ratio is expected to level off over the next two years (Figure 8). While the federal government fiscal deficit has steadily declined in line with government commitments, a significant widening in the public sector overall deficit has been driven by increased development expenditure – both by the government and non-financial public corporations (NFPCs, commonly known as state-owned enterprises). The planned deferral and reprioritisation of government development expenditure is expected to reverse this deterioration. The wholly-government owned oil and gas company, PETRONAS, which accounts for the bulk of NFPC development expenditure, has scaled down its planned capital spending for upstream and overseas operations.

Figure 8. **Federal government fiscal consolidation is on track**



Note: The public sector overall balance is the sum of general government revenue and the current balance of NFPCs minus general government operating and development expenditure and NFPC development expenditure.
Source: Ministry of Finance, Malaysia and OECD projections (federal fiscal balance and federal government debt for 2016-17).

StatLink http://dx.doi.org/10.1787/888933410663

Strengthening fiscal frameworks

Malaysia has undertaken important reforms in recent years to improve the institutional frameworks supporting fiscal policy. Since 2013, a Fiscal Policy Committee (FPC) chaired by the Prime Minister and comprising key ministers and the central bank governor has been established to formulate policies that strengthen public finances as well as monitor progress with respect to fiscal sustainability and long-term macroeconomic stability. It was recently announced that the FPC would be supported through the creation of a Fiscal Risk and Contingent Liability Technical Committee responsible for analysing and recommending measures to manage fiscal risks and contingent liabilities. International experience suggests that the FPC's effectiveness could be further enhanced by adding independent experts to its membership to provide diverse perspectives (Beetsma and Debrun, 2016). Malaysia could further consider the creation of a fully independent fiscal advisory council, initially tasked with assessing the impact of fiscal policies on the medium-term framework and debt sustainability. Such bodies can impart additional fiscal discipline, holding government to its commitments and contributing valuable analysis in support of government decision-making. It could also increase the transparency and accountability of debt management, with information on government debt levels less available than for Indonesia and Thailand. Following Thailand's experience, and creating an independent debt management body would also be advisable (IMF and World Bank, 2014).

Since 2012, Malaysia has also moved towards outcome-based budgeting, which should improve expenditure efficiency through better alignment between spending and programme outcomes (IMF, 2015a). This will support broader efforts to improve public sector efficiency by linking fiscal policy to key performance indicators (KPIs) such as national targets for key socio-economic measures. A priority in this context will be to end the practice of parking fiscal buffers off balance sheet.

The recent introduction of a medium-term fiscal framework should further enhance fiscal discipline and improve budget planning over longer horizons. It complements the move to outcome-based budgeting in improving accountability and identifying underperforming programmes. This should help address personnel outlays exceeding budgeted ones by between 5% to 16% in each of the past five years. Fiscal discipline could be further enhanced through the formalisation of the aforementioned debt and deficit rules, and possibly through the adoption of spending norms.

Together these reforms strengthen fiscal institutional frameworks at the federal government level, where fiscal policy is overwhelmingly determined. Malaysia has an unusually high level of fiscal centralisation that reflects constitutional responsibility and control over a broader range of functions than in other federated countries (Hutchinson, 2014). The federal government was responsible for around 76% of expenditure (the sum of operating and development expenditure) in 2015 and around 82% of revenue collection, compared to averages of 53% and 65% respectively for federated OECD countries in 2014 (MOF, 2015; OECD Fiscal Decentralisation Database). The high degree of centralisation may be undermining policy efforts in areas where state or local government delivery of public goods such as education, health, policing and local infrastructure is typically more effective, enabling policy objectives to be implemented through local strategies. Some gradual decentralisation of certain expenditure functions to state and local governments, financed initially through fiscal transfers and then through a commensurate transfer of revenue collection functions could be considered to further strengthen medium-term expenditure effectiveness (Blöchliger et al., 2016). Korea's successful experience with property tax decentralisation may be instructive in this regard (Blöchliger, 2015).

Productivity and inclusive-growth-friendly fiscal policies

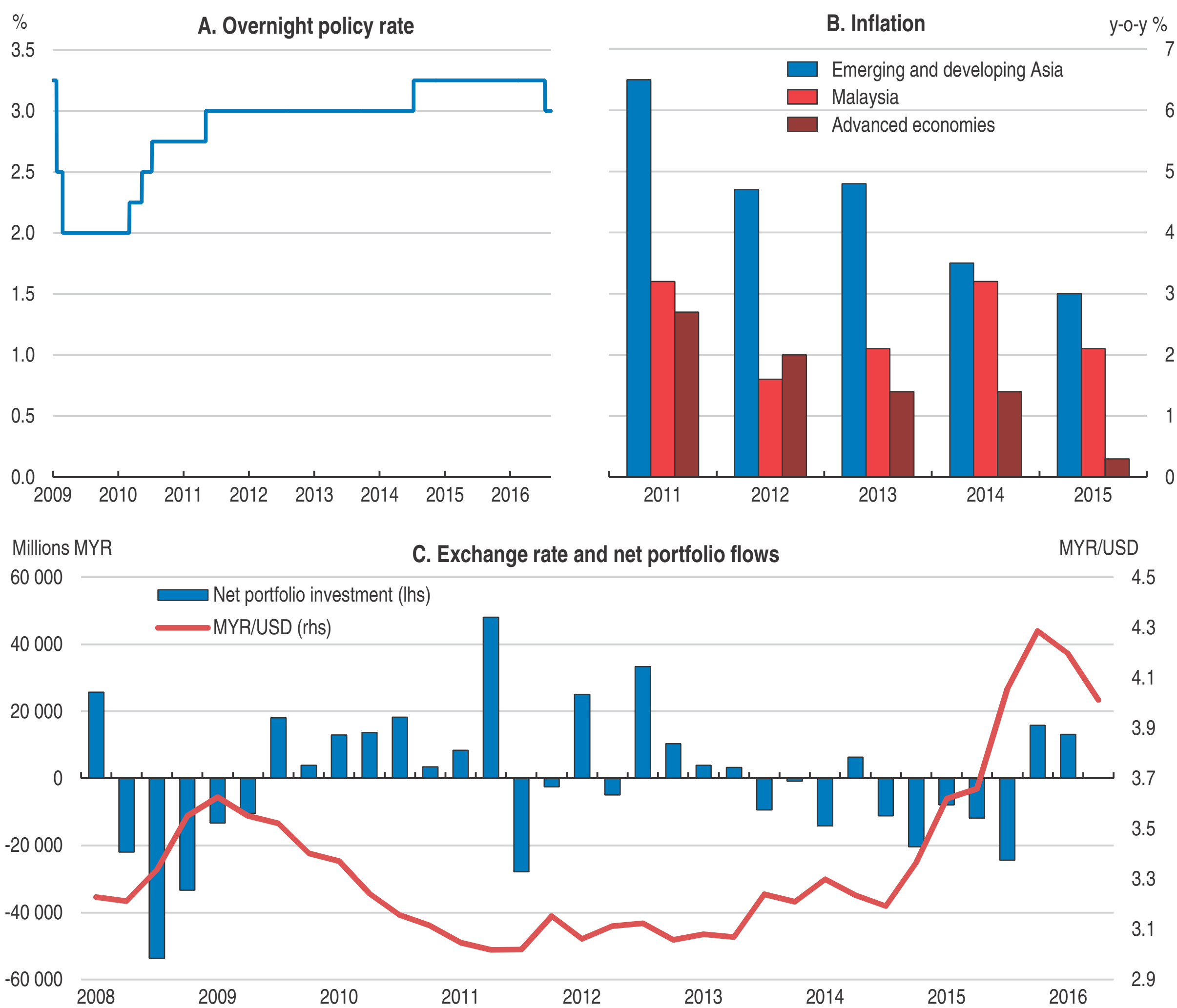
The focus of fiscal policy is shifting from the promotion of specific industries to investment in technology, innovation, infrastructure, markets and skills (IMF, 2015b). Dismantling industry-specific assistance in the form of generous tax incentives, grants and protectionist tariff and non-tariff barriers supports a more sustainable fiscal consolidation outcome while providing appropriate incentives for industries to increase their competitiveness through higher value-added activities. Malaysia is pursuing reforms through various free trade agreement commitments that reduce industry-specific assistance, while aiming to create a more effective, transparent and performance-based incentive programme to attract investment and boost productivity. Priority areas for further widespread, non-discriminatory (i.e. for all countries) removal of assistance include low-comparative advantage sectors such as steel and automotives and low-competitive advantage sectors such as food-crop based agriculture. Such a reorientation of fiscal policy would also galvanise private-sector led growth, improve market-based incentives and minimise opportunities for rent-seeking, anti-competitive behaviour and corruption.

Reducing distortive outlays to the aforementioned sectors will help make room for raising spending on social protection, especially to provide a safety net for disabled, unemployed and elderly persons unable to be gainfully employed. Additional expenditure on healthcare will also be required as Malaysia's population ages. Infrastructure and communications technology, particularly in rural areas, is another area where further investment would be beneficial to both productivity and inclusive growth. At the same time, public spending efficiency can be improved in areas such as education and innovation (see below).

Monetary policy challenges with a weaker currency

Malaysia has a long history of relatively low inflation. Consumer price inflation averaged 2.6% per year from 1995 to 2015, which is particularly benign for a fast-growing developing economy (Figure 9.B). Inflation remains at acceptable levels – just over 2% in 2015

Figure 9. **Monetary policy indicators**



Source: Bank Negara Malaysia; Department of Statistics, Malaysia.

StatLink http://dx.doi.org/10.1787/888933410678

and 2.7% in the first half of 2016 – with the one-off effect of GST implementation largely offset by the decline in oil prices.

Malaysia's independent central bank, Bank Negara Malaysia (BNM), has broad responsibilities, including for monetary policy, financial sector regulation (including insurance) and payment systems. Consequently, monetary policy focuses on price stability but also takes into consideration financial stability. BNM has adopted a discretionary, principles-based approach to monetary policy using interest rate targeting through its overnight policy rate, in contrast with the rules-based inflation targeting frameworks adopted by many OECD countries and several neighbours (Indonesia, Thailand and the Philippines). This approach has worked well and remains suited to Malaysia's circumstances. Malaysia was also one of the first countries to start normalising its policy rate in 2010 after injecting monetary stimulus in response to the global financial crisis of 2008 (Figure 9.A).

More recently, the overnight policy rate was cut by 25 basis points to 3% in July 2016 from the 3.25% level in place since July 2014. The move was in response to an uncertain global environment and weakened demand for exports, with global growth more susceptible to downside risks following Brexit. Prudent policy leaves the central bank with ample room to lower the policy rate should conditions deteriorate. BNM's policy toolkit also contains additional measures that can complement the use of monetary policy in such circumstances. For example, monetary policy adjustments have been coupled with a series of pre-emptive macro-prudential measures since 2010 to mitigate potential risks such as an overheating housing market and rising household debt. These measures include cuts in loan-to-value ratios on housing loans and stricter income qualification rules for loan approvals.

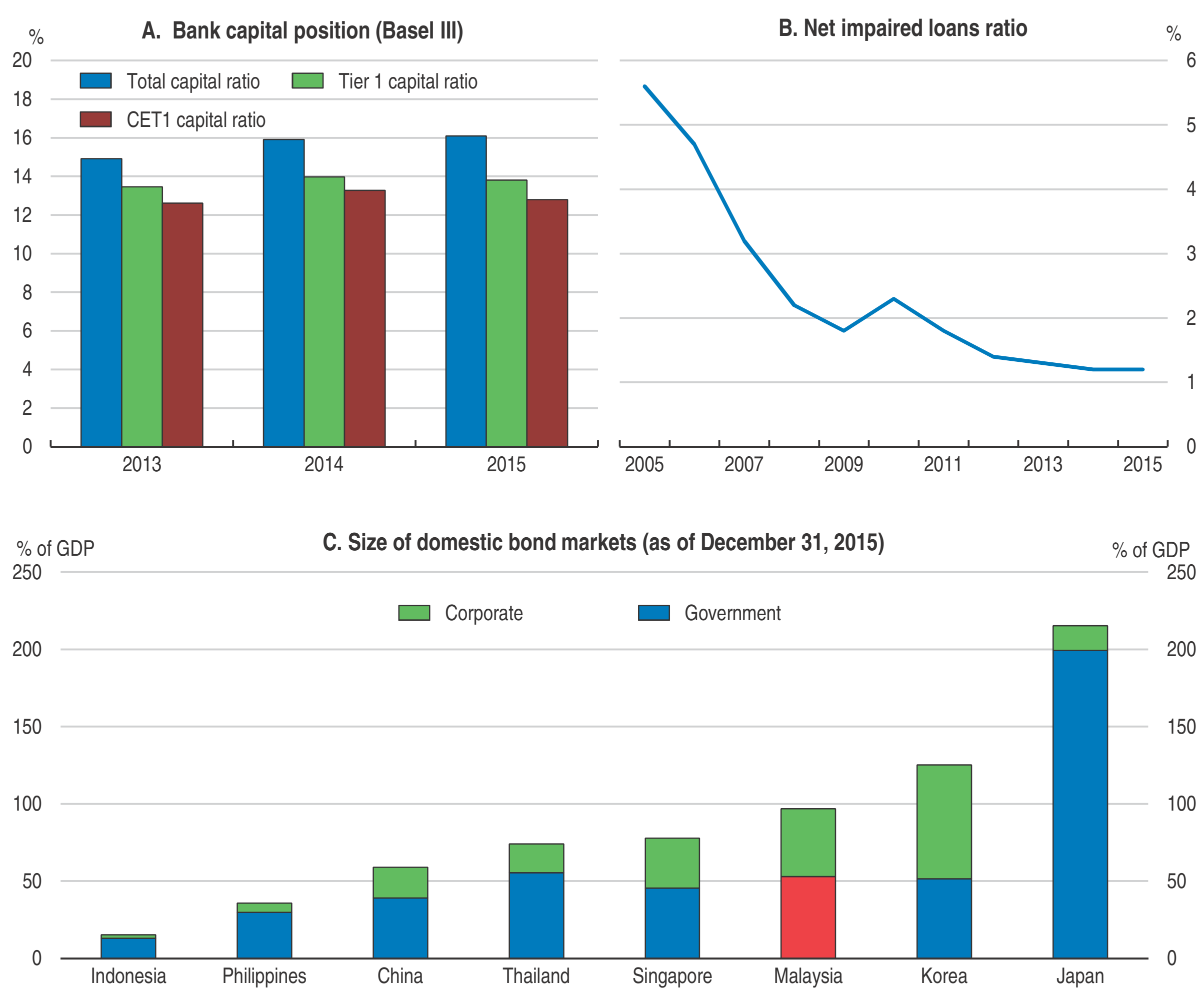
Monetary policy in major economies, especially the United States, has a pronounced effect on open emerging market economies such as Malaysia. Following monetary easing by advanced economies, emerging market economies including Malaysia receive large capital inflows. Quantitative and monetary easing measures by advanced economies resulted in substantial net inflows into Malaysia between late 2009 and early 2013. These inflows began to reverse in 2013, with more recent developments in the United States, together with falling crude oil prices, triggering substantial portfolio investment outflows in the latter half of 2015, weakening the ringgit and increasing exchange rate volatility (Figure 9.C). Exchange rate flexibility, adequate buffers, deeper and more diversified financial markets and a strong banking system have allowed Malaysia to weather episodes of high financial market volatility with minimal spillovers to the real economy. At the same time, foreign exchange reserves fell to USD 95.3 billion by the end of 2015, from USD 132 billion at end-August 2014, similar to the experience of Turkey (IMF, 2016). While reserves have inched up to USD 97.5 billion at 15 August and remain sufficient to cover around eight months of retained imports, higher reserve levels would provide a buffer against rising volatility.

A diversified financial sector

The financial sector in Malaysia has undergone major transformations since the 1997-98 Asian financial crisis, which prompted reforms that have enhanced financial stability. Post-crisis reforms have created a robust banking sector and a deeper bond market, in particular local currency bond markets. The number of banking institutions was reduced from 77 to eight domestic banking groups (excluding development financial institutions). Capital adequacy in the banking sector now comfortably exceeds the Basel III requirements, like in Turkey (BIS, 2016) (Figure 10.A), while the loan impairment ratio is very low (Figure 10.B). Larger and better capitalised banks are individually less vulnerable and the consolidated sector is easier for BNM to supervise. At the same time, a fully-fledged Islamic banking sector and bond market were set up, paralleling the conventional system. By providing a less volatile source of capital, Islamic finance contributes to financial sector stability (Box 3).

Malaysia has the third-deepest bond market in Asia after Japan and Korea, including a healthy private debt securities market (Figure 10.C). Malaysia is also the world leader in the issuance of Islamic bonds. The well-developed and diversified bond market has served as a cheaper and more durable alternative to bank financing, especially in financing long-gestation projects such as infrastructure and capital expenditure by the private sector. In addition, the foreign exchange and derivatives markets have grown in depth and liquidity. This has provided greater ease of doing business in Malaysia and enhanced avenues for risk management.

Figure 10. **A robust financial system**



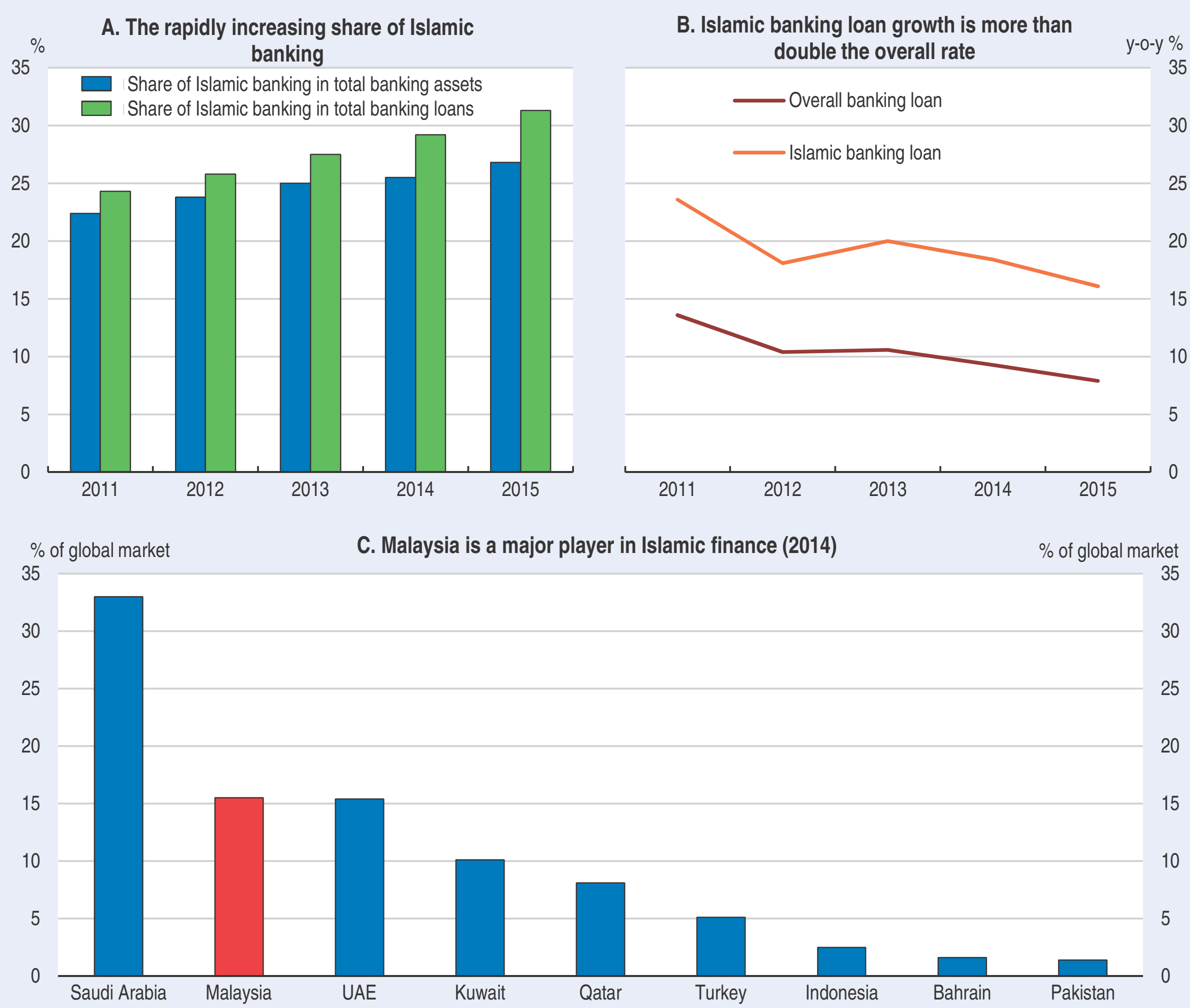
Note: Impaired loans in panel B are where the principal and/or interest on the loan is past due for more than 90 days.
Source: Bank Negara Malaysia; Asian Development Bank, Asian Bond online (database).

StatLink http://dx.doi.org/10.1787/888933410687

Box 3. **Islamic finance in Malaysia**

Islamic finance operates according to the principles of Islamic law, which prohibits usury and promotes risk-sharing and participatory asset-backed financing. The development of Islamic finance in Malaysia began with the creation of Bank Islam in 1983. A decade later, Islamic banking activities were allowed within conventional banks through the Islamic windows set-up, which starting in 2005 led to the creation of 16 stand-alone Islamic banks. Within three decades, Malaysia has developed a competitive, liberal and globally recognised Islamic finance ecosystem that operates alongside the conventional financial system, accounting for approximately one sixth of global Islamic finance activities (Figure 11). Domestic Islamic banking assets have expanded rapidly, with the share of total banking assets rising from just 0.07% in 1994 to 26.8% by end-2015 (Caporale et al., 2016). This compares with a share in Turkey of 5.2% in 2015.

Figure 11. **Islamic finance continues to grow in Malaysia**



Source: Ernst and Young (2015), *World Islamic Banking Competitiveness Report 2016*; Bank Negara Malaysia (2015), *Bank Negara Malaysia Financial Stability and Payment Systems Report 2014*.

StatLink http://dx.doi.org/10.1787/888933410698

Box 3. **Islamic finance in Malaysia** *(cont.)*

The development of a comprehensive Islamic finance ecosystem in Malaysia was guided by two roadmaps. The first one, the Financial Sector Masterplan (2001-2010), focused on three areas: enhancing institutional capacity to achieve significant competitive edge; promoting healthy competition among the Islamic banking and insurance (*takaful*) players; and strengthening the regulatory framework for Islamic finance to ensure effective functioning in parallel with conventional banking and insurance.

Under the second roadmap, the Financial Sector Blueprint (2011-2020), Malaysia aims to position itself as the premier global Islamic finance marketplace. This is a continuation of the Malaysia International Islamic Financial Centre (MIFC) initiative launched in 2006 to promote Malaysia as a platform for cross-border Islamic financial activities, particularly for international business. Malaysia has also taken the lead in strengthening the Islamic finance landscape, being one of the founding members of the Islamic Financial Services Board (IFSB) that develops international prudential standards and regulatory framework for Islamic finance, as well as the International Islamic Liquidity Management Corporation (IILM) that facilitates efficient liquidity management in the international Islamic financial system.

By end-2015, Malaysia accounted for 54% (USD 175 billion) of the total Islamic bonds (*sukuk*) outstanding globally, with the country having become a global multi-currency *sukuk* hub. By end-2015, 32 foreign currency *sukuks* by both domestic and foreign issuers, arranged by Malaysian banks, worth USD 21.3 billion had been issued in USD, SGD, JPY and CNY (BNM, 2015). Innovative *sukuk* structures have also been introduced, such as the sustainable and responsible investment *sukuk* that helps finance green technology and other ethical investments.

Malaysia has extensive experience in financing major infrastructure projects through *sukuk*. A recent example is the construction of the mass rapid transit lines in the Greater Klang Valley area, which has been financed by *sukuks* issued by Dana Infra Nasional. This has lowered the cost of financing compared to conventional lending, as the structure of *sukuk* products is well suited to long-term investments.

Recently, Malaysia has further strengthened the investment intermediation role of Islamic banks through the offering of investment accounts. This is further complemented by the launch of the Investment Account Platform (IAP), which serves as an online marketplace that matches investors with viable ventures that suit their risk appetites. Since its launch in February 2016, a transportation project (Perak Transit Berhad) in Malaysia has successfully raised MYR 10 million from a diverse range of investors through the IAP.

The emphasis on risk-sharing of Islamic finance serves to better anchor finance in the real economy. It reduces the overall debt exposure of the financial system and provides a potentially valuable example for advanced economies with high debt burdens.

More recently, the focus of financial sector reforms has shifted to expansion through liberalisation, with the Financial Sector Blueprint (2011-2020) aiming to provide greater flexibility for foreign banking institutions to expand operations in Malaysia. Restrictions on foreign ownership of local banks have been relaxed, allowing existing foreign banks to open more branches outside of the main urban centres. New Islamic banking licences have also been issued to six foreign banks with the aim to promote Malaysia as a global Islamic financial hub. This will boost competition in the banking sector and investment. Restrictions on foreign ownership of local insurance companies have also been relaxed, resulting in greater participation of foreign companies in the Malaysian insurance sector. In the Islamic insurance (*takaful*) sector, nine licences have been issued to companies with foreign partners since 2005. In August 2016, BNM issued enhanced corporate governance standards to promote a more prudent and sound risk culture across financial institutions in Malaysia. These include requiring boards of financial institutions to have a majority of independent directors, with a suggested nine-year tenure limit for these independent directors, plus a code of ethics supported by a transparent whistleblowing policy, as well as clear remuneration arrangements which are in line with prudent risk-taking.

Boosting productivity to achieve high-income country status

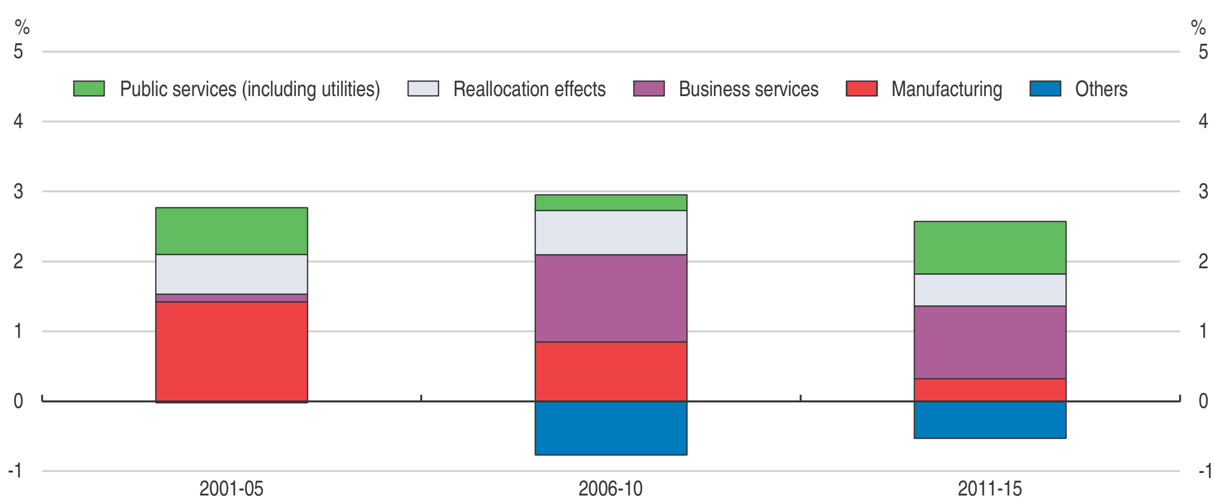
Productivity growth in Malaysia averaged 2.3% per year since the first half of the 2000s, helping to lift per capita income to higher middle-income country levels. Growth was driven by increased inflows of foreign direct investment and industry restructuring that shifted resources to higher value-added sectors such as electronics and electrical, and petrochemicals (APO, 2015). However, like in many OECD countries, growth in labour productivity has decelerated, with growth in the past decade well below 2001-05 rates and slower than for regional peers (Figure 2).

In the first half of the 2000s, productivity growth largely stemmed from the manufacturing sector (Figure 12). Slower capital deepening since the early 2000s has since held back productivity gains in manufacturing. A declining share of skilled workers in total employment, from 27.6% in 2010 to 25.7% in 2015 according to Labour Force Survey data, also weighed on labour productivity growth. Meanwhile, inflows of low-skilled migrant workers increased their share of total employment from 9.5% to 15%, increasing the overall share of labour-intensive, low productivity employment in the economy. The low level of innovation by domestic firms was another drag on productivity growth.

Malaysia has set itself an ambitious target of achieving labour productivity growth of 3.7% per year from 2016 to 2020, up from the 2% average growth recorded from 2011 to 2015. This reflects the recognition that productivity improvements will be essential to achieving high-income-country status by 2020. As the 11th Malaysia Plan suggests, raising productivity requires a comprehensive set of policies including acceleration of human

Figure 12. **Labour productivity growth by sector**

Average growth of real value added per employee per year at 2010 constant prices



1. Due to the changes of classification of sectors in 2010, data before and after 2010 are not entirely consistent.
2. The underlying employment data might underestimate the number of legal and undocumented foreign migrant workers.
3. Reallocation effects correspond to the impact of movements of labour between sectors.
4. Others include agriculture, fishery and forestry, mining and quarrying, and construction.

Source: OECD calculations based on data provided by Department of Statistics, Malaysia.

StatLink http://dx.doi.org/10.1787/888933410702

capital development, promotion of innovation, improvement in the regulatory framework and regional integration through trade and investment liberalisation.

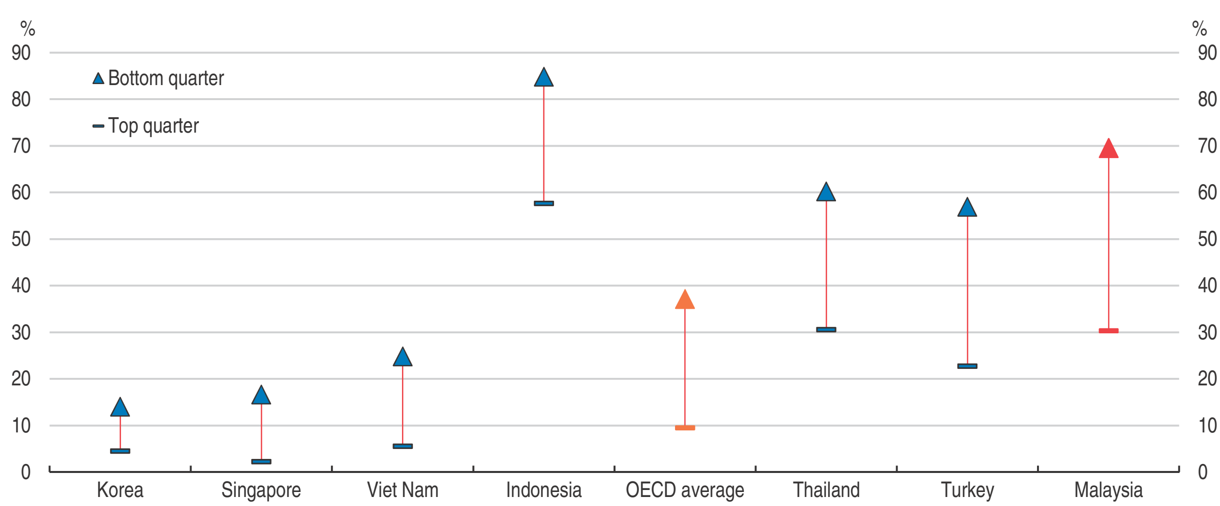
Improving the quality of education

Malaysia's education policy has long focused on inclusiveness, and access to education has improved significantly in recent years. In line with the Millennium Development Goals, it has reached near-universal levels, with primary education enrolment at around 98% in 2015 and pre-school and secondary education enrolment at around 95% and 89% respectively, according to Ministry of Education data. Malaysia has successfully addressed prior concerns with female education participation, exhibiting minimal gender differences in education access and performance levels. Schools strive to encourage attendance through engagement with rural communities, under-enrolled schools remain open to ensure access, while numerous programmes cater to special-needs students and student welfare including malnutrition. Nonetheless, education outcomes are still influenced by socio-economic status, with almost 70% of economically, socially and culturally disadvantaged students categorised as low performers in mathematics by the Programme for International Student Assessment (PISA). This compares to about 30% of advantaged students, with the 40 percentage point differential well above the gaps found in participating Southeast Asian countries and 12 percentage points higher than the OECD average (OECD 2016a, Figure 13).

Increasing the quality of education is critical to boosting human capital development and workforce productivity in Malaysia, increasing the availability of skilled workers and improving Malaysia's attractiveness to investment in higher value-added activities. Significant government expenditure on education has helped increase the quantity of graduates, but the tertiary sector is facing challenges to produce job-ready graduates with the skills required by industry. A decline in English language proficiency is also affecting one of Malaysia's competitive advantages within the region (World Bank, 2013). School-age students have achieved below average scores on PISA, with scores for mathematics,

Figure 13. **Socio-economic status affects PISA performance in mathematics**

Percentage of low performers in mathematics by socio-economic quartile



Source: OECD (2016a), *Low-Performing Students: Why They Fall Behind and How to Help Them Succeed*, *http://dx.doi.org/10.1787/9789264250246-en.*

StatLink http://dx.doi.org/10.1787/888933410711

science and reading among the lowest of the 65 countries surveyed in 2012 (Figure 14) (OECD, 2016b). While effectiveness concerns are paramount, the education system also has to become more efficient as fiscal consolidation weighs on overall funding.

Ambitious reforms are already underway to improve collaboration between industry and tertiary educators to align curricula to industry specifications and internationally recognised qualifications, while also increasing opportunities for work placements during and after the completion of studies. Efforts are ongoing to increase the appeal of technical and vocational education and training as a pathway to a fulfilling career, both to attract recent school leavers and to improve workforce participation rates through upskilling of unemployed, female and elderly workers. The role of TalentCorp in providing policy oversight for Malaysia's development and sourcing of demand-driven skills is also increasingly important to reduce labour market skills mismatches. Moreover, the 1Malaysia Training Scheme (SL1M) has enhanced graduates' employability through collaboration with government-linked and private sector companies to provide soft skills training and industry placement. These reforms will help address short-term skills mismatches in human capital development but one must not lose sight of longer-term development goals. Ongoing tertiary sector improvements should target the development of future innovators and thought leaders with global employability, sensitive to the changing needs of the Malaysian economy as it continues to develop. This in turn would improve the competitiveness of higher education institutions in attracting talented local and international students, consistent with Malaysia's ambitions to become a regional education hub and to maximise skilled migration.

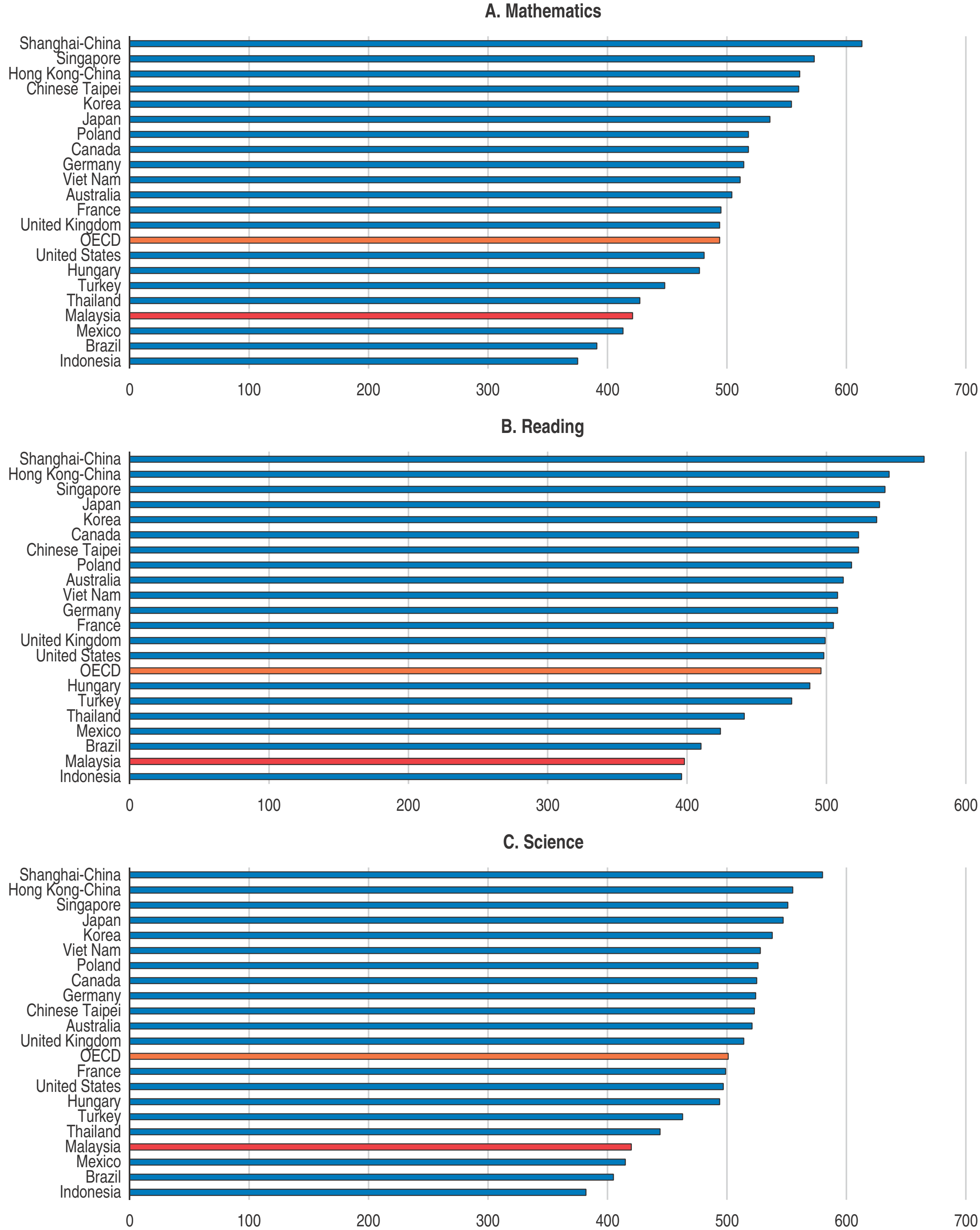
The Education Blueprint 2013-2025 provides the overarching framework for substantial reforms to basic education. Reforms have introduced more holistic examinations and student benchmarking, a comprehensive framework for teacher evaluation, training and career development, professional upskilling of English language teachers, increased use of KPIs for teachers and education officials, and higher English language requirements for graduating students. Malaysia is also in the process of implementing a revised school curriculum based on international benchmarks, while recent focused efforts to raise pre-school standards will be supported by a revised curriculum due in 2017. Financial support for children of low-income households and programmes to reduce malnutrition have also been expanded in recent years, with the aim to reduce the influence of socio-economic disadvantage. These reforms target the most pressing concerns with basic education and should be allowed time to ensure effective implementation and avoid adverse effects on education inclusiveness. Over the longer term, reforms could increase decentralisation of education governance, competition and accountability in the education system to maximise incentives for continuous innovation and effective resource utilisation. A strong focus on equity should also be retained, ensuring reforms to improve quality do not exaggerate differences between regions or socio-economic groups.

Strengthening innovation

As Malaysia seeks to become a high-income country, sustainable long-term growth will increasingly depend on the contribution of innovation-driven productivity gains rather than increasing factor inputs. Innovation will be key for competitiveness in international markets and participation in global value chains (GVCs), improvements in the quality of products and processes, and technology-driven enhancements of living standards.

Figure 14. **Student performance on PISA is low**

2012



Source: OECD (2016), *PISA: Programme for International Student Assessment*, OECD Education Statistics (database), *http://dx.doi.org/10.1787/data-00365-en.*

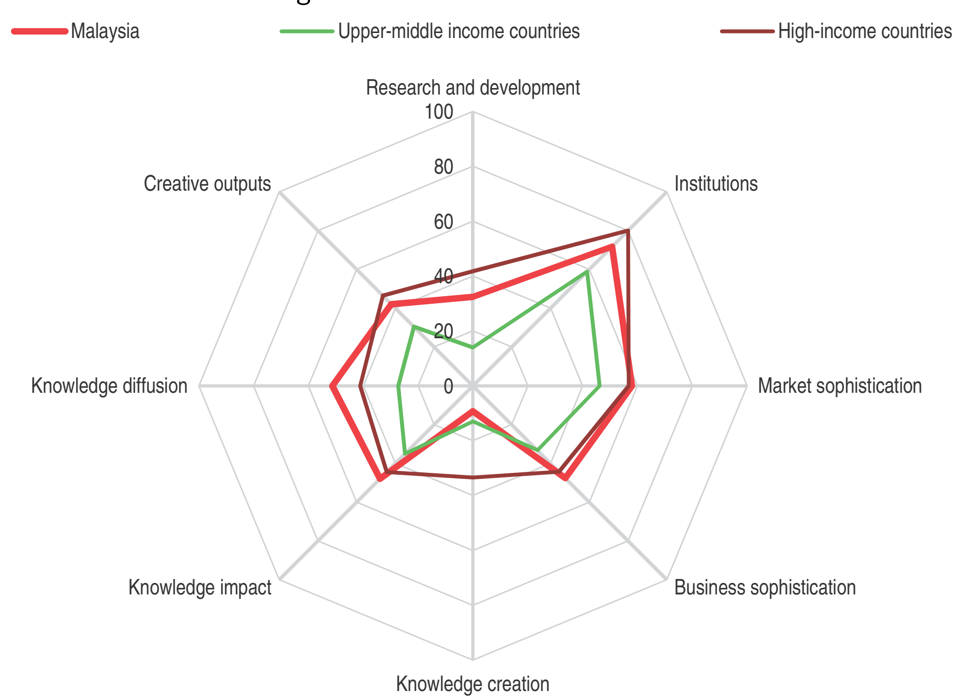
StatLink http://dx.doi.org/10.1787/888933410727

Malaysia already has high levels of overall gross (1.1% of GDP) and business (0.7% of GDP) research and development (R&D) expenditure for its income level. It is a strong innovation performer among upper middle-income countries, particularly on indicators of innovation system inputs (Figure 15; Cornell University, INSEAD and WIPO, 2015; OECD, 2016c). There is some evidence of solid returns from efforts to boost home-grown innovation, with residents filing an increasing proportion of patent applications both at home and abroad relative to non-resident applications in Malaysia (Figure 16).

However, commendable initiatives both past and present have been weakened by insufficient coordination, duplication and governance weaknesses that are in urgent need of repair, as documented in the *OECD Reviews of Innovation Policy: Malaysia 2016* (OECD, 2016c, Figure 17). Establishing a clear, streamlined and co-ordinated governance structure is essential to improve the orientation and implementation of innovation policy.

Improved governance arrangements would provide the foundation for the coordination and effective implementation of other innovation system reforms, including programmes to encourage increased business innovation. As a start, the recently established National Science Council (NSC) should be granted the mandate, authority, capabilities and necessary resources to streamline the innovation bureaucracy and programmes. The NSC should be tasked with managing innovation policy orientation with support from key ministries. The establishment of the proposed national Research Management Agency (RMA) with responsibility for the implementation and evaluation of competitive research and development grant schemes would also support the simplification and streamlining of the governance framework.

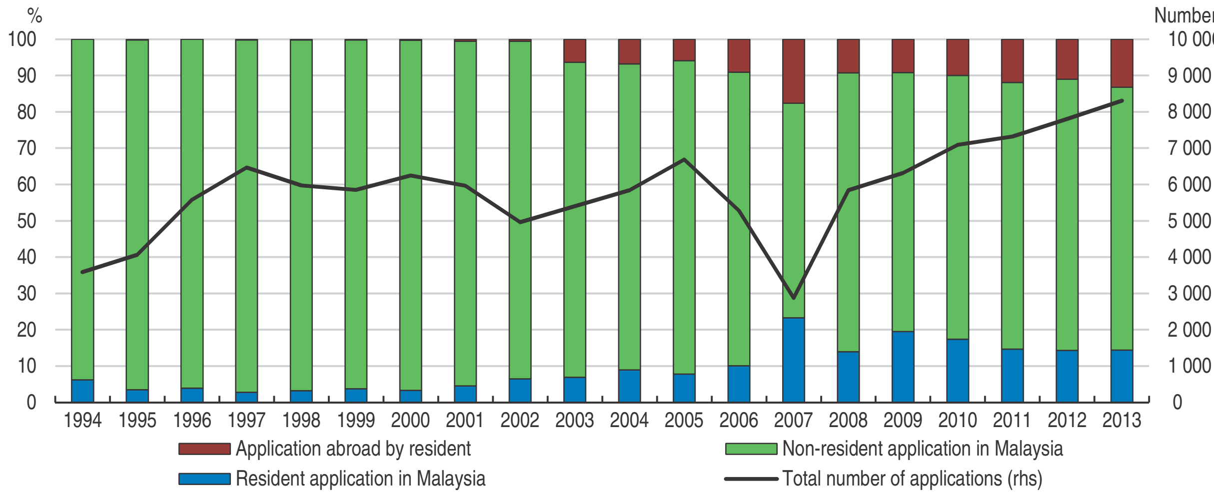
Figure 15. **Innovation indicators**



Note: Consistent with the source, the categorisation of upper-middle and high-income countries is based on World Bank classification as at July 2013.
Source: Cornell University, INSEAD and WIPO (2015), *The Global Innovation Index 2015: Effective Innovation Policies for Development*.

StatLink http://dx.doi.org/10.1787/888933410730

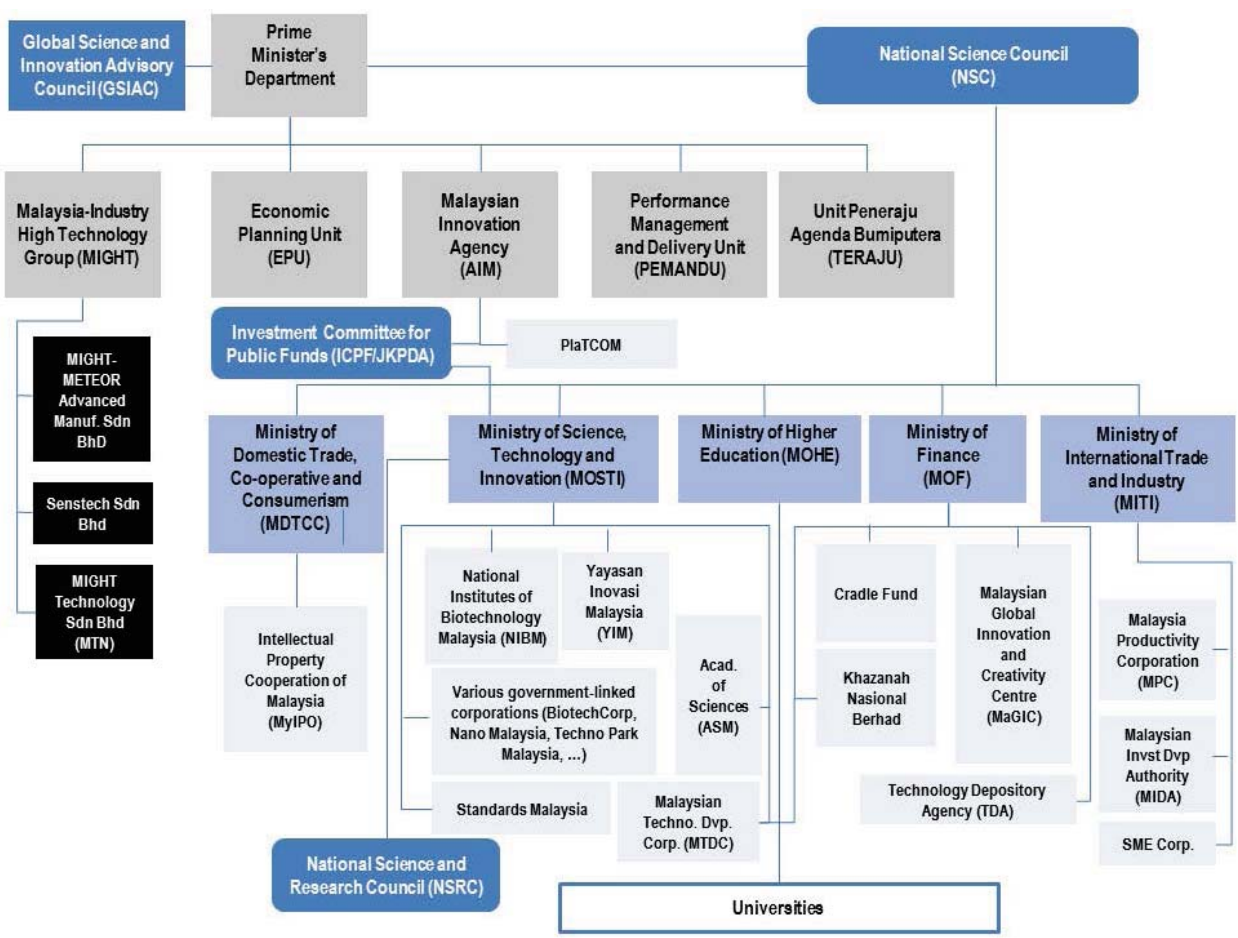
Figure 16. **Patent applications by Malaysian residents and non-residents**



Source: OECD (2016c), *OECD Reviews of Innovation Policy: Malaysia 2016.*

StatLink http://dx.doi.org/10.1787/888933410745

Figure 17. **Innovation governance involves a complex array of actors**



Note: Several other ministries involved in science, technology and innovation related activities are not represented in this figure, such as the Ministry of Energy, Green Technology and Water.

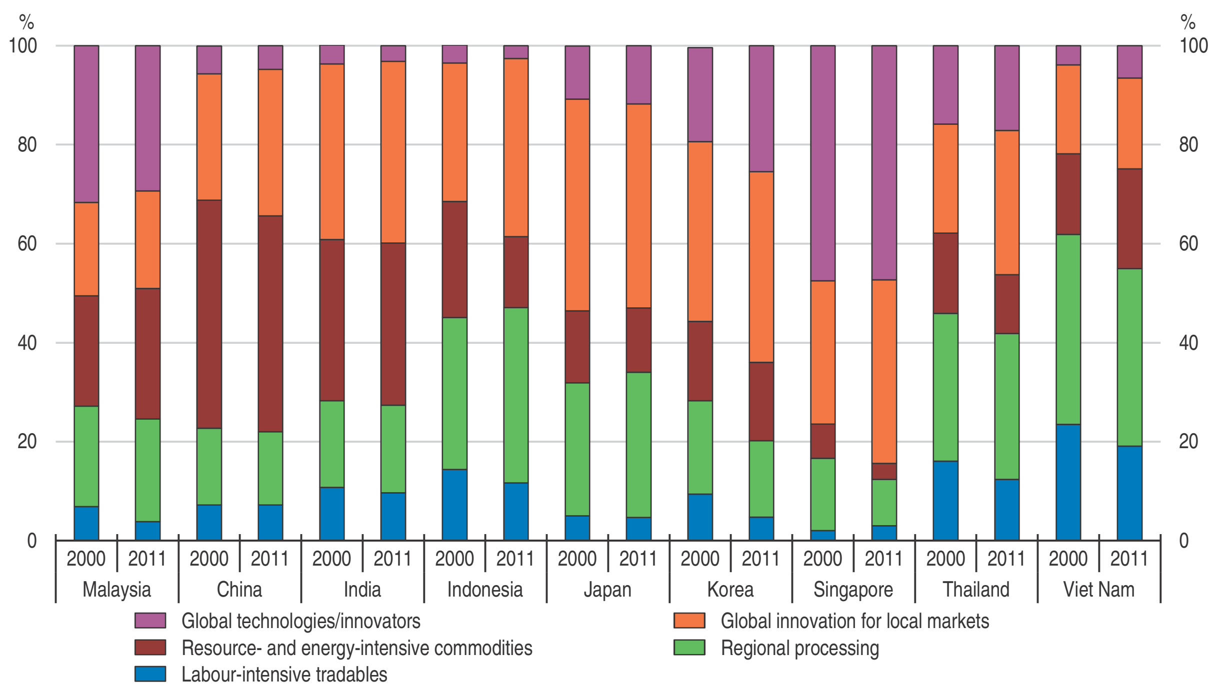
Source: OECD (2016c), *OECD Reviews of Innovation Policy: Malaysia 2016.*

Malaysia is already one of the few emerging economies where the business enterprise sector is the main performer and funder of R&D. However, there is a continued need to strengthen the innovation capabilities of businesses, especially the majority of SMEs that undertake little innovation or R&D. Malaysian businesses need to be more innovative to counteract rising competition from lower-cost regional competitors, with evidence suggesting the process of business upgrading has stalled (Figure 18).

The establishment of local innovation centres to harness the innovation potential of SMEs would deliver the largest potential gains in business innovation, as SMEs often lack the capability to access general government innovation programmes. The experience of Canada, France and Japan in developing centres that provide proximate, long-term and hands-on help from knowledgeable local experts provides a model for Malaysia that minimises the potential for support to become overly interventionist. Local innovation centres would complement existing initiatives such as SIRIM-Fraunhofer, Steinbeis, and the Public Private Research Network, which are virtual platforms providing expertise and vouchers for third-party finance but would benefit from dedicated, accessible local expert staff. They could also leverage efforts to increase the availability of innovation finance for SMEs, which include strengthened engagement with financial institutions, venture capitalists and angel investors and the introduction of equity crowdfunding platforms. At the other end of the spectrum, the contribution of large government-linked companies to innovation could be improved by either allowing privatisation to drive innovation or through the government utilising its controlling interest in these businesses to reorient their KPIs.

Figure 18. **Malaysia's technological upgrading has slowed**

Sector share of total manufacturing value added



Source: OECD (2013a), *Southeast Asian Economic Outlook 2013: With Perspectives on China and India*, *http://dx.doi.org/10.1787/saeo-2013-en*; Asian Development Bank (2013), *Beyond Factory Asia: Fuelling Growth in a Changing World*.

StatLink http://dx.doi.org/10.1787/888933410757

It will also be critical to strengthen the research capabilities and commercialisation of universities and public research institutes, enhance collaboration between business and researchers, and the development of human capital in areas of core science, technology and innovation (STI) capabilities. While Malaysia's recent focus on increased commercialisation by tertiary institutions could help increase the industry relevance of research, reforms must be holistically designed and carefully implemented so as not to detract from the important aforementioned reforms to the innovation system.

Further improving the competition framework

Effective regulatory frameworks enhance productivity through healthy, market-driven competition driving businesses to continuously improve their processes, products and services. Competitive markets require comprehensive competition legislation enforced by a competition authority with suitably qualified staff and adequate resources.

Malaysia's competition framework has improved in recent years, with the introduction of the Competition Act 2010 and the creation of the Malaysia Competition Commission (MyCC) in 2011 to enforce the new laws. Aside from the absence of merger control, the Competition Act generally reflects international standards. While acknowledging the relative infancy of the system and difficulties experienced in building institutional capacity, there remain concerns with the competition policy framework and its implementation, with further efforts necessary to increase the scope and consistency of legislation and build the capacity and independence of regulatory bodies.

The autonomy and independence of MyCC is constrained by broad ministerial discretion over personnel changes, and the ability to issue directions. MyCC independence and its capacity to perform its functions are also limited by the prominent role of the Minister of Domestic Trade, Cooperatives and Consumerism in determining its budget. MyCC resourcing is low in comparison to regional peers, holding back enforcement activities. For example, MyCC has less than desirable expertise in competition economics, employing too few experienced economists. Penalties for breaches to the Act have been few and relatively small. MyCC needs to intensify its enforcement activities to achieve effective deterrence, increase awareness and build stakeholder confidence.

Competition in the electricity and piped gas industries, the communications and multimedia sectors, and the aviation sector is governed by separate legislation and regulatory bodies. Direct upstream commercial activities of the petroleum sector are also exempt from the Competition Act 2010. Efforts are under way to improve collaboration and consistency. Even so, differences in key concepts under the legislation for these sectors and the lack of any evidence of enforcement by these regulators suggests a more consistent framework and enforcement would be beneficial.

Effective merger review is an important component of a competition regime, with competition law in almost all countries providing for control of mergers. Merger control can help prevent consumer harm from transactions that can reduce competition through the control, consolidation or closure of major rival firms. Malaysia is currently the only jurisdiction in ASEAN with a competition law that does not provide for competition merger control. The only exception is contained in the recently introduced Malaysian Aviation Commission Act 2015, which provides a useful template that could be extended to the broader economy through amendments to the Competition Act.

Enhanced regulatory frameworks for SMEs

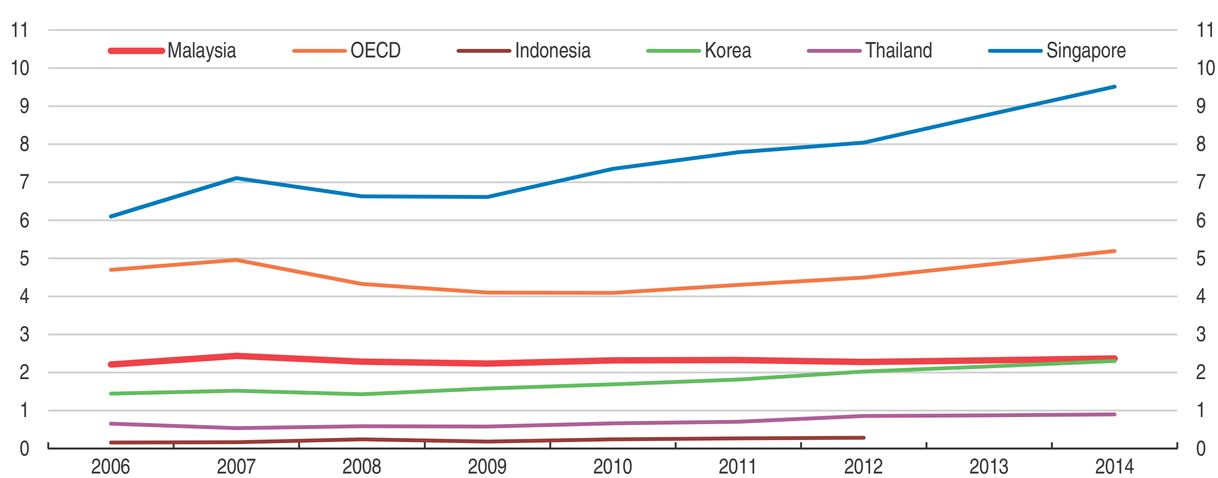
A supportive environment for SMEs is also essential to productivity gains. SMEs accounted for 97% of total business establishments in the 2011 economic census, but only 36% of GDP in 2015, below the 50% of GDP average for high-income countries. The labour productivity of SMEs is low compared to both large firms in the country and SMEs in other countries. Regulatory reform facilitating firm entry and exit would help improve their performance. Providing targeted policy incentives for promoting innovation-led growth in the sector, notably through wider use of information technology and skills training, would also boost SME productivity, as underlined in the SME Masterplan 2012-2020 and in the 11th Malaysia Plan.

Entry of new firms has stagnated over the past decade and remains below the OECD average and neighbouring Singapore (Figure 19). Institutional reforms that would encourage SME entry include reducing the cost of business registration, streamlining firm registration and introducing zero licensing procedures to facilitate entry in services and industry, increasing support for entrepreneurial education, and heightening awareness of the importance of shared learning from entrepreneurial initiatives (ERIA et al., 2014). While SMEs rely on banking loans rather than direct finance by stocks and bonds, expanding non-banking finance such as venture capital could enhance the entry of new firms (SME Corp, 2012).

Facilitating exit is another challenge for Malaysia due to its stringent bankruptcy law that hampers earlier and less burdensome debt relief. A Small Debt Resolution Scheme is available to help SMEs reschedule and restructure bank debt in cases where initial applications have been rejected. Reforms introducing more flexible repayment scheduling are being developed, while further reforms are needed to facilitate exits through automatic discharge, which is a common feature of an efficient insolvency regime in OECD countries (Adalet McGowan and Andrews, 2016). Bankruptcy procedures could be further enhanced by introducing a voluntary debt restructuring scheme similar to Chapter 11 bankruptcy laws in the United States. This would facilitate the rescue of viable firms. In addition,

Figure 19. **New business entry has not increased much**

Number of new limited liability corporations per 1 000 people aged 15-64



Note: 2013 or 2014 data are not available for Indonesia; for the other countries 2013 has been linearly interpolated.
Source: World Bank (2016), World Development Indicators (database).

StatLink http://dx.doi.org/10.1787/888933410767

bankruptcy processes could be reinforced by introducing out-of-court arbitration procedures to facilitate company restructuring. Automatic discharge of debts after a set period of time should also be introduced.

Furthering trade, investment and regional integration

Trade, investment and regional integration have been essential to Malaysia's development and provide increasingly important leverage for productivity-enhancing structural reforms. Malaysia is geographically and geopolitically well situated to benefit from ongoing efforts to increase the regional connectivity of trade, investment, people and markets. The free trade area under the ASEAN Economic Community and the recently concluded (but not yet implemented) TPPA respectively represent 27% and 38% of Malaysia's merchandise trade in 2015, while it is involved in processes working towards a Regional Comprehensive Economic Partnership (62% of its merchandise trade) and a Free Trade Area of the Asia Pacific (77%). Liberalisation helps encourage the integration of Malaysian businesses into GVCs, providing them with exposure to international best practice, frontier technology and competition, with further integration an important driver of future productivity. The challenging external environment will require Malaysia to enhance its competitiveness in attracting global capital, with advancement up the value chain critical to complement rising wages and human capital improvements.

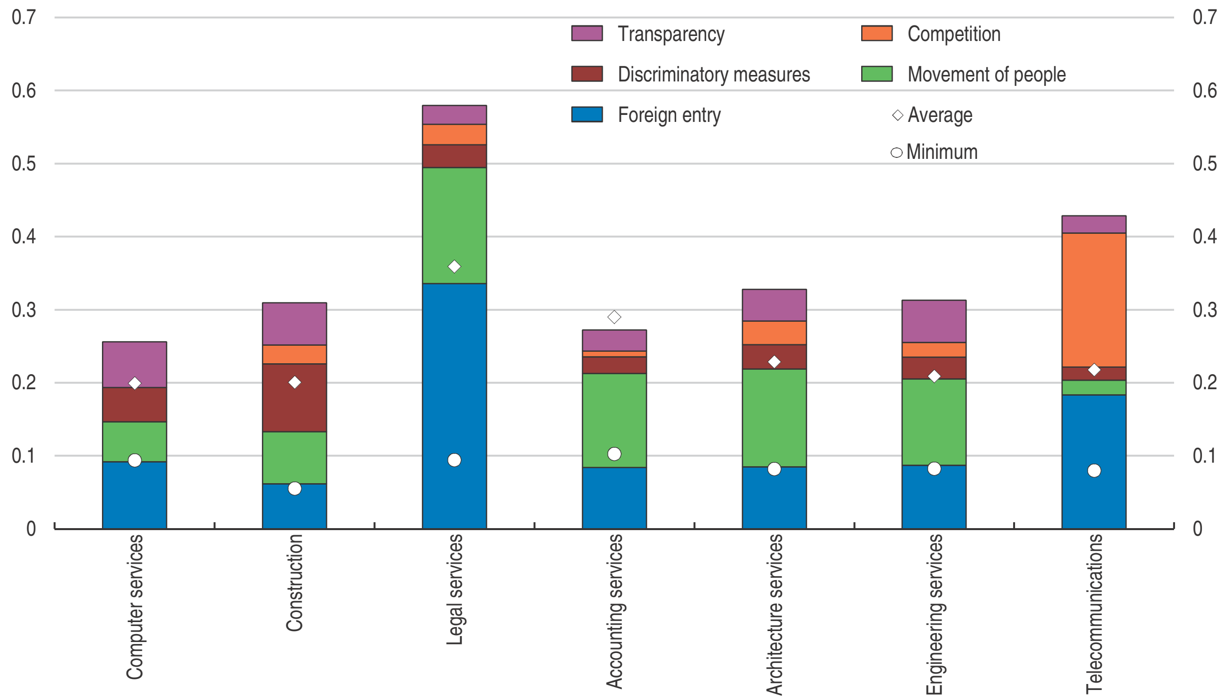
Malaysia would benefit from continued efforts to reduce non-tariff barriers to trade and investment through unilateral reforms, trade and investment agreements and regional integration. The newly compiled *OECD Services Trade Restrictiveness Index* (STRI) suggests that like in a number of other countries this may be particularly the case for business services and telecommunications, both of which are essential inputs in downstream industries (Figure 20). Areas involving the largest potential gains include the automation of border formalities and increased availability of information through information technology, enhanced cooperation with neighbouring and third-country border agencies and regaining momentum for liberalisation of investment in services. The TPPA exemplifies the potential benefits to Malaysia in areas such as the association of labour, government procurement, state-owned enterprises and competition policy (Figure 21). Using TPPA implementation as an opportunity to undertake structural reforms that go beyond minimum requirements would further boost productivity.

Boosting public sector productivity

A high-quality public sector contributes to overall economic performance by setting the regulatory framework for markets to allocate resources to their most productive uses. The efficient and effective delivery of public services, including education, healthcare, social protection and basic infrastructure, is also fundamental to promoting inclusive growth. Malaysia's 1.6 million employee public sector workforce represented a 16.1% share of total employment in 2014, higher than many of its neighbours but below certain OECD countries (Figure 22.A). Malaysia's public sector performance compares favourably in global terms, outperforming advanced economy averages across the spectrum of the World Bank's worldwide governance indicators and the government efficiency component of the World Economic Forum's *Global Competitiveness Report* (Figure 22.B, C).

Malaysia's relatively strong performance reflects ongoing reforms under the Special Task Force to Facilitate Business (PEMUDAH), a joint effort between the government and private sector since 2007 to streamline regulatory frameworks, reduce business licensing

Figure 20. **The STRI for selected sectors**



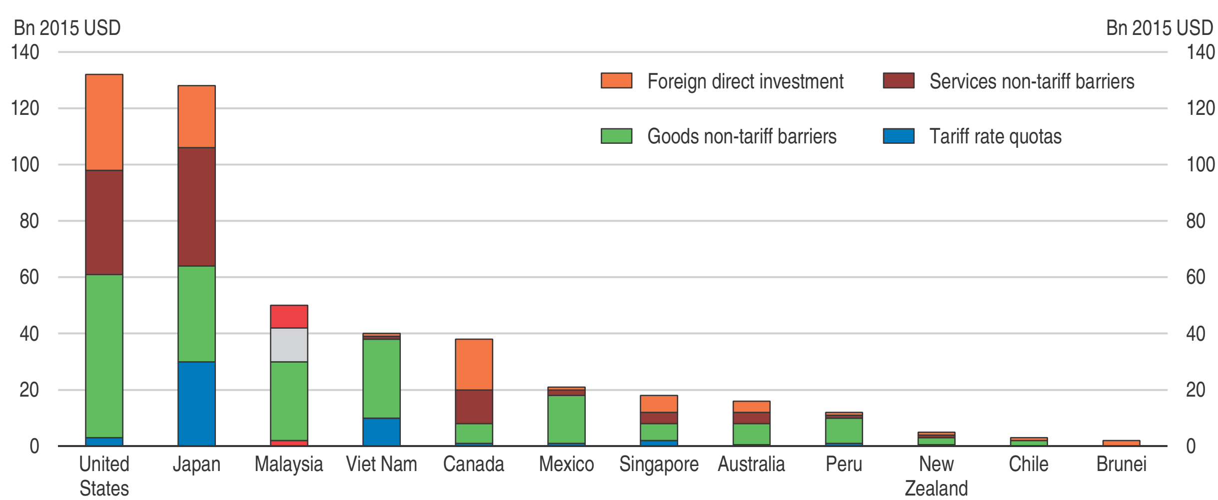
Note: The STRI indices take values between zero and one, one being the most restrictive. They are calculated on the basis of the STRI regulatory database which contains information on regulation for the 34 OECD Members, Brazil, China, Colombia, India, Indonesia, Latvia, Malaysia, Russia and South Africa. The STRI database records measures on a Most Favoured Nations basis. Preferential trade agreements are not taken into account.

Source: OECD (2016), Services Trade Restrictiveness Index.

StatLink http://dx.doi.org/10.1787/888933410774

Figure 21. **The Trans-Pacific Partnership Agreement will boost Malaysian real incomes through behind-the-border liberalisation**

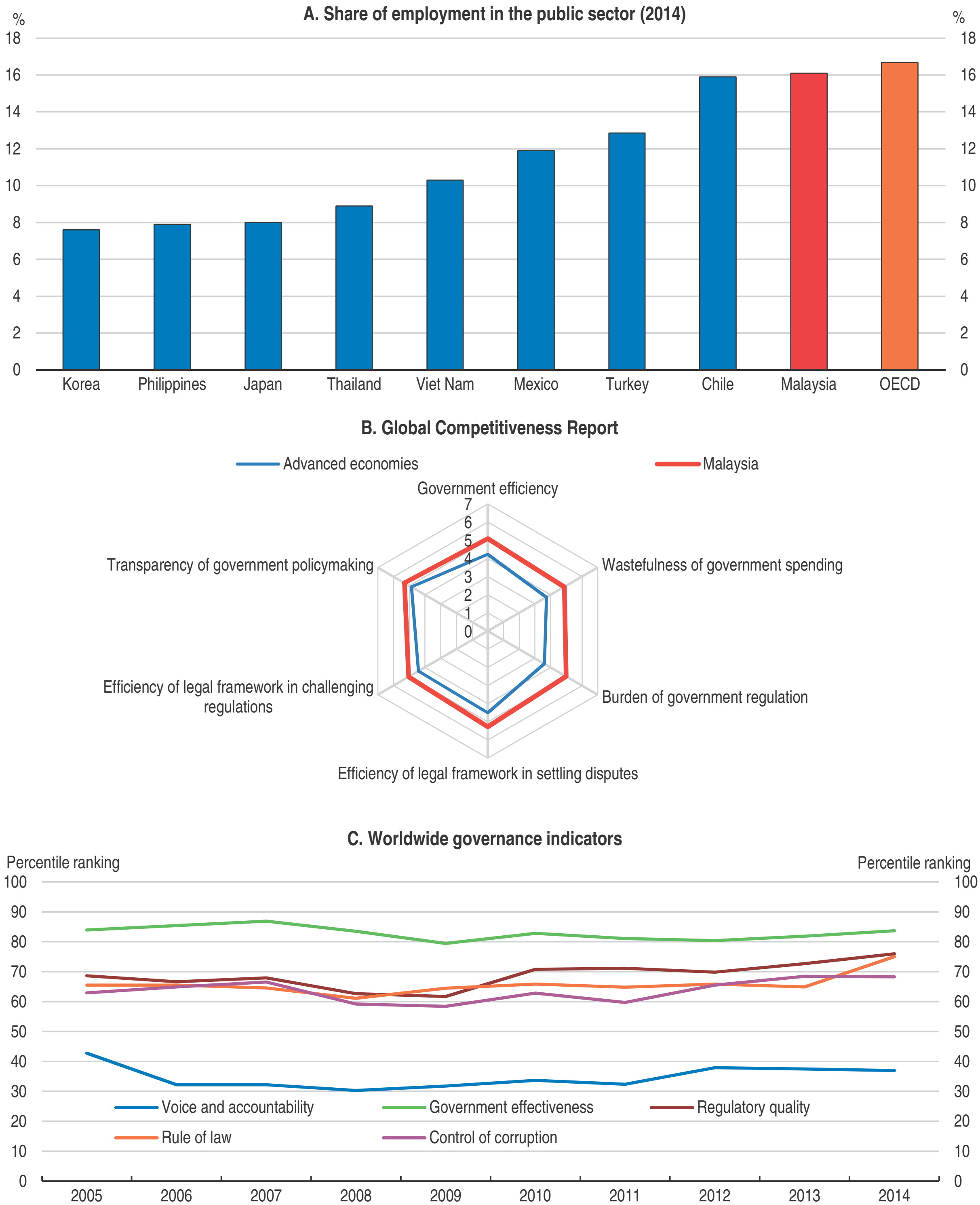
Real income effect in 2030, billion USD, 2015 constant prices



Source: Petri and Plummer (2016), "The economic effects of the Trans-Pacific Partnership: new estimates", *Peterson Institute of International Economics Working Paper Series* 16-2.

StatLink http://dx.doi.org/10.1787/888933410781

Figure 22. **Malaysia's public sector is large but its governance compares well internationally**



1. The share of public sector employment in panel A includes government sector employment plus employees of publicly-owned resident enterprises and companies, operating at central, state (or regional) and local levels of government.
2. Panel B scales ranges from 0 (lowest performer) to 7 (best performer).
3. Panel C is percentile rankings among 235 countries/territories, where the country at 100 is the top performer.

Source: ILO (2016), ILOSTAT database; World Economic Forum (2016), *Global Competitiveness Report 2015-2016;* World Bank (2016), Worldwide Governance Indicators (database).

StatLink http://dx.doi.org/10.1787/888933410798

requirements and promote information technology use by government agencies. The Malaysia Productivity Corporation is the key coordinating agency across the government, whose achievements includes the set-up of a regulatory impact assessment system that gauges the positive and negative effects of proposed regulations at an early stage of policy-making. Regulatory impact assessment and public consultation are increasingly embedded into the policy-making process to make it more evidence-based (OECD, 2015b).

Malaysia's federal government agencies are typically required to formulate, implement and monitor government policies to meet the needs of stakeholders. The remit and duties of the agencies have evolved over time with those needs, sometimes resulting in fragmentation and duplication of responsibilities and resources. This has impeded the efficient and effective delivery of public services. There remains significant scope to improve public service delivery by rationalising duplicative agencies and clarifying agency responsibilities. As an example, some 44 agencies and 10 ministries are involved in initiatives to support STI activities, with 14 agencies under eight ministries providing grants to support R&D alone (OECD, 2016c). Careful deliberation and clear identification of the roles and responsibilities for these new agencies is key to ensuring the avoidance of duplicative roles and to further enhancing the institutional landscape. The proposal in this case is to establish the National Science Council as the lead institution in streamlining the innovation bureaucracy and programmes. Commitments by the highest levels of government would help provide the strategic prioritisation needed to ensure effective rationalisation of these agencies.

Malaysia's public sector productivity can be further improved through reforms to empower state and local authorities, review programmes and undertake regular performance evaluations through independent audits, broader involvement of stakeholders in decision-making, enhance public procurement, combat corruption and incentivise officials (Figure 22.C). In particular, further involvement of stakeholders in policy-making enables governments to receive new ideas and feedback on policies and services. More transparent and efficient policy-making based on the rule of law enhances both the quality and compliance with public policies. As another priority issue, more rigorous performance evaluations provide the foundation for reforms to make programmes and public servants more effective, with Malaysia increasing the use of KPIs to measure the achievements of policy outcomes against pre-determined targets. Performance reviews using KPIs are expected to be gradually expanded from ministerial level to lower-level officials. Complementary reforms to better link performance management for a larger number of officials to rewards, penalties and career progression would promote healthy competition among staff, replacing opaque decision-making and a hierarchical culture with an expectation of procedural fairness in the public sector. Enhancing international cooperation on corruption contributes to transparency and efficiency of the government. Malaysia actively participates in the ADB/OECD Anti-Corruption Initiative for Asia and the Pacific region.

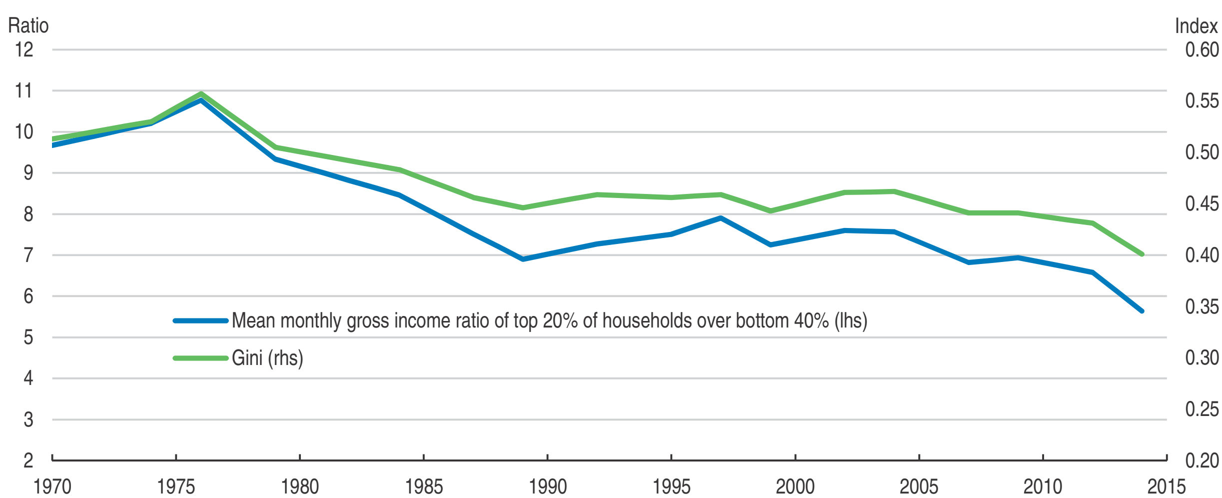
While each of these measures would contribute to increasing public sector productivity, a more comprehensive and detailed assessment would be beneficial to understanding the drivers of public service productivity. An independent review covering all aspects of public service productivity and programme effectiveness is needed to develop a robust and exhaustive framework and to enhance the integrity of the public sector.

In short, boosting productivity growth for Malaysia to achieve high-income country status will require some challenging but necessary structural reforms. The successful implementation of reforms to raise the quality of school and tertiary education to address labour market skills mismatches will be forefront, coupled with enhanced innovation-led growth through streamlined innovation policy governance and policies to harness the potential of SMEs. More robust regulatory frameworks for SMEs and competition, a reinvigorated trade and investment liberalisation agenda and a productive public sector will also help drive essential productivity improvements.

Fostering inclusive growth befitting an emerging high-income country

A sustained focus on enhancing inclusiveness has seen Malaysia follow a comparatively equitable development path, largely eliminating absolute poverty and greatly reducing ethnic inequality. Income and wealth inequality have declined from very high levels, with the relative income share of the top 20% and bottom 40% of households declining substantially since the mid-1970s (Figure 23). With the "people economy" at the centre of Malaysia's ambition to become a high-income country by 2020, the focus is shifting to the challenges of relative poverty and achieving sustainable improvements in individual and societal well-being. This shift would be aided by reforms in several policy areas where Malaysia may compare favourably within its region but less so relative to OECD countries.

Figure 23. **Income inequality has declined**



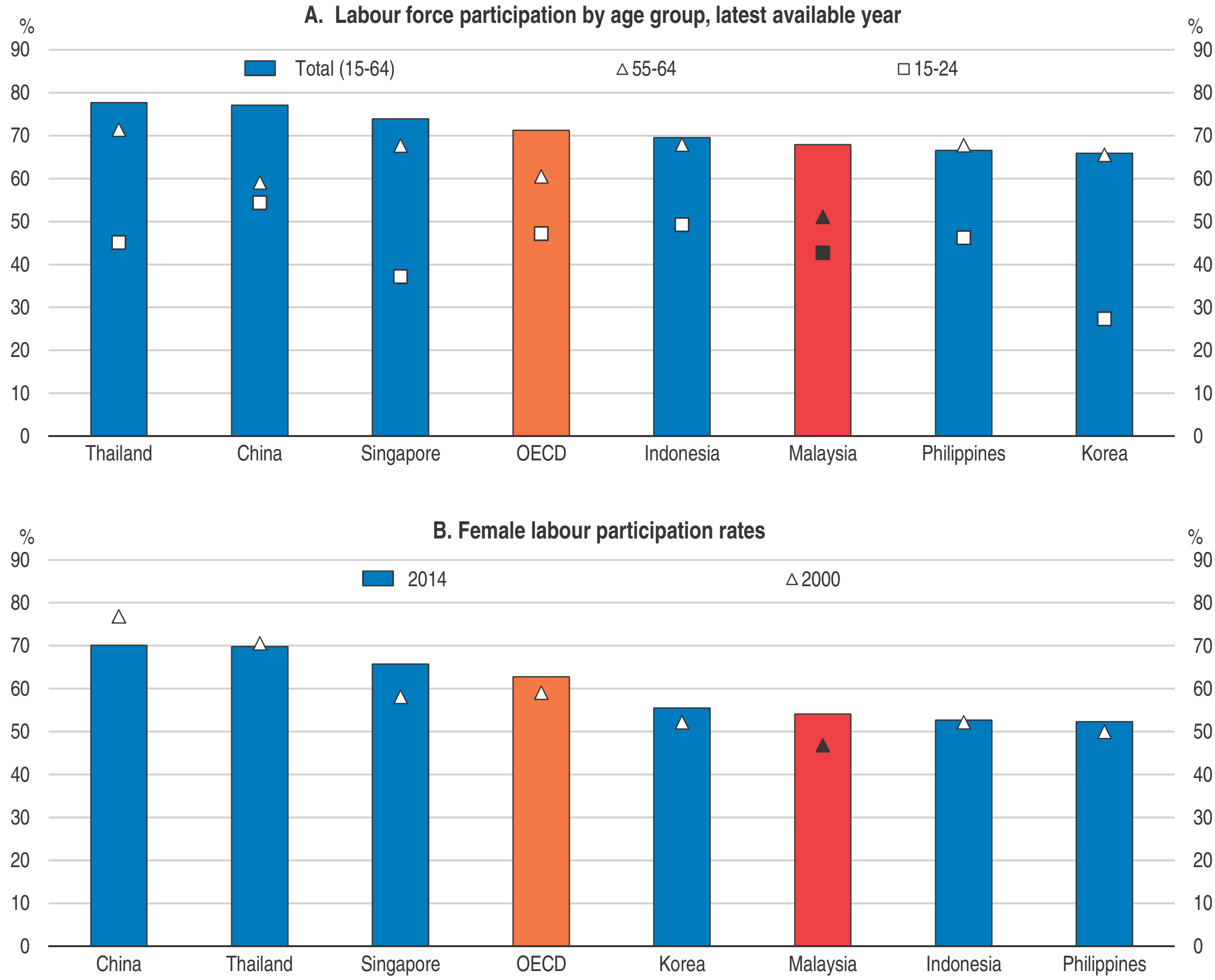
Source: Department of Statistics, Malaysia.

StatLink http://dx.doi.org/10.1787/888933410802

A more inclusive labour market

Malaysia faces challenges to make its labour market even more inclusive and productive. The country's strong record of full employment since the 1990s has been critical to improving well-being but returns to work remain relatively low and skilled job creation is lagging tertiary graduation rates. Inadequate pay and skills mismatches are resulting in youth underemployment and low participation by women and older persons (Figure 24). Informal activities (not registered with the authorities), low rates of unionisation, labour market rigidities such as cumbersome dismissal processes and

Figure 24. **Labour participation rates are relatively low**



Note: In Panel B, data for Malaysia is 2015 and 2014 for all others.
Source: ILO (2016), ILOStat database; OECD, Labour force statistics (database), *http://dx.doi.org/10.1787/oecd_lfs-2015-en*.
StatLink *http://dx.doi.org/10.1787/888933410819*

inflexible working hours and the underdeveloped and fragmented social safety net also prevent labour markets from functioning effectively.

Increased tertiary sector cooperation with industry to deliver job-ready graduates, notably through government scholarships, and the creation of TalentCorp (a government agency under the Prime Minister's Department implementing overarching labour and skills related policies) are already working to address skills mismatches. The introduction of a minimum wage in 2013 – which was substantially increased in 2016 – improved conditions for low-income workers. Implementation of the TPPA will reduce restrictions on unionisation, while an employment insurance scheme has been developed to finance reskilling and job search activities but is held up by stakeholder disagreement.

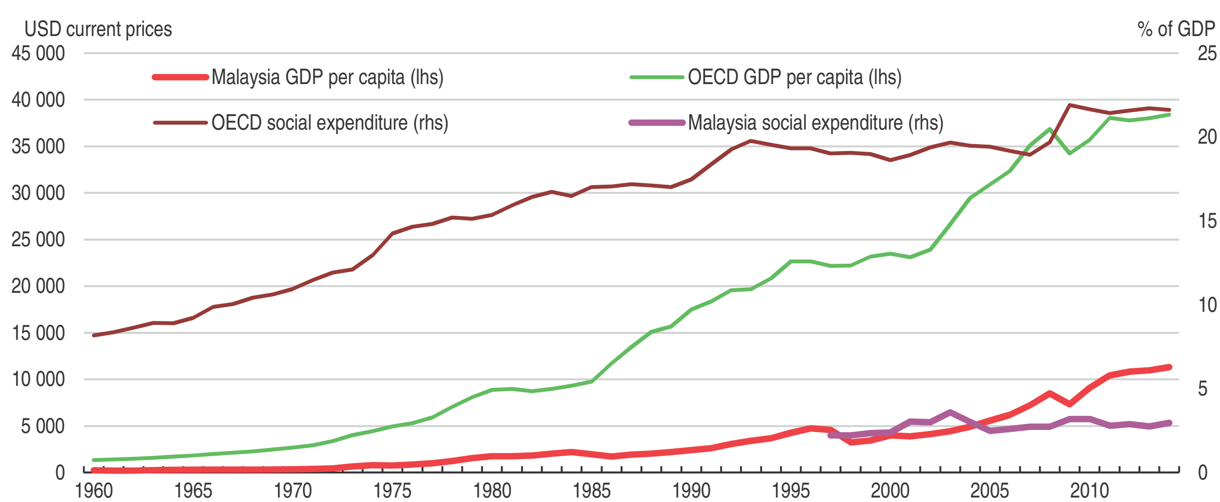
To promote an inclusive and productive labour market, it is key to raise participation rates, especially for women (whose participation rate, at 54% in 2015 remains below the 63% OECD average for 2014). The 11th Malaysia Plan set the target rate for female labour participation at 59% by 2020. The implementation of programmes to encourage female labour participation by providing access to better labour market information and supporting entrepreneurship among women contributed to female labour participation rates increasing from 46% in 2009 to 54% in 2015. To raise the participation rate, a comprehensive set of reforms is required. This includes strengthening family-friendly policies such as better access to quality child care and labour regulation. Reforms promoting flexible working conditions including flexible working hours and work-from-home provide options for raising participation rates, particularly of women.

Providing life-long learning and reskilling opportunities would also facilitate women's return to work. Increasing incentives to encourage the formalisation of informal labour and economic activities are also important, including strengthening enforcement of labour market regulations such as the minimum wage. Government also needs to work more closely with business and migrants to develop a stable longer-term immigration policy consistent with labour market needs. This would include enhancing opportunities for legal permanent migration of both skilled and low-skilled workers where consistent with structural needs, while the hiring of undocumented workers would be further discouraged through strengthened enforcement and penalties.

Strengthening social protection

The absence of an integrated and targeted social protection system in Malaysia is an impediment to inclusive growth. Households benefit from near-universal access to electricity, clean water, healthcare and transport, but income support for disadvantaged persons (such as the unemployed, single parents, disabled and elderly) remains ad hoc, insufficiently targeted and inadequate for ensuring basic living standards. Government expenditure on social protection is lower than in all Southeast Asian countries for which data are available, as well as in all but a handful of countries in the Asia-Pacific region (ADB, 2015). While public expenditure on social protection as a proportion of GDP typically rises in step with GDP per capita, as has been the case for OECD countries, Malaysia's social expenditure as a percentage of GDP has not increased during its development phase (Figure 25). The low level of social protection expenditure is further reflected in the lack of

Figure 25. **Social expenditure in Malaysia has not increased in step with GDP per capita**



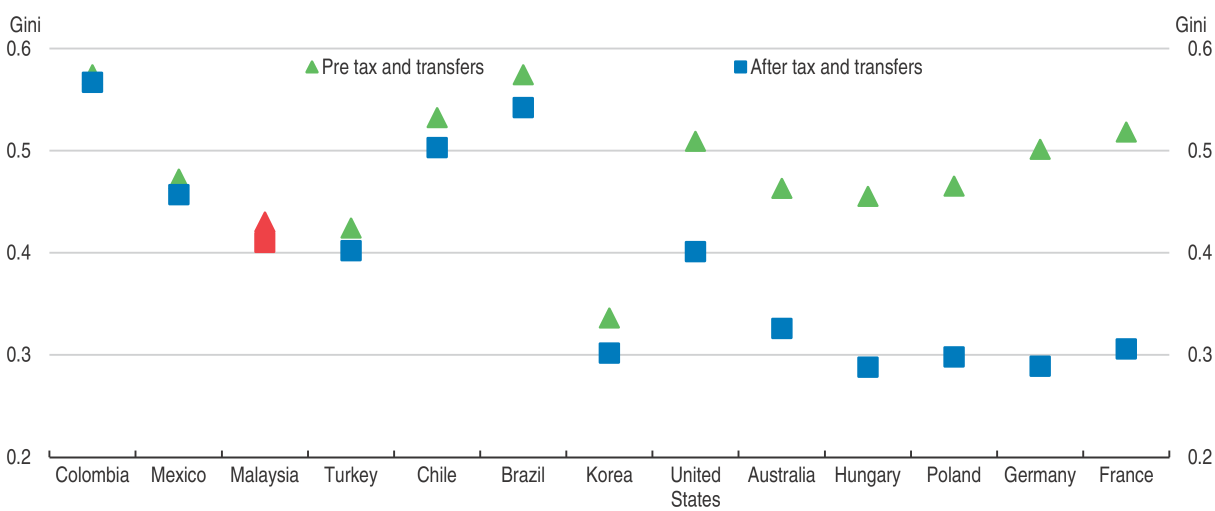
Source: OECD (2016), Social spending (indicator), *http://dx.doi.org/10.1787/7497563b-en*; ADB, Statistical Database System.

StatLink *http://dx.doi.org/10.1787/888933410825*

redistribution of tax revenue to low-income households, with minimal divergence in pre and post-tax and transfers Gini coefficients for income, like in Turkey (OECD, 2012; Figure 26). While civil society makes an important contribution to social expenditure in Malaysia through the collection and distribution of *Zakat* (Islamic compulsory charitable mechanism), increased government expenditure is still necessary.

A key priority is the introduction of an employment insurance scheme that integrates job-matching services, reskilling and income smoothing to prevent a temporary setback from becoming an entrenched disadvantage. The Government has developed an employer-and-employee-funded training and job search focused insurance system based on the Japanese and Korean ones, but the proposed funding model is opposed by the social partners, pointing to the merits of considering financing it through general tax revenue, as in Australia. The overall experience of OECD countries suggests that in practice, employer, employee and government co-financing is often required. More broadly, it is essential that Malaysia develop a comprehensive social protection and income transfer system that provides targeted and timely support to those in need, while retaining strong incentives and facilitation mechanisms to maximise labour market participation. This requires more than filling gaps with new and often contradictory programmes, and calls for undertaking a comprehensive assessment of social protection needs and optimal strategies to meet them. Malaysia is aware of this need and intends to develop such a policy in the near future.

Figure 26. **Malaysia's tax-and-transfer system has little effect on income distribution**



1. 2013 for Korea and the United States, and 2014 for Malaysia and Hungary, 2012 for all others.
2. The Gini coefficient has a range from zero (when everybody has identical incomes) to one (when all income goes to only one person). Increasing values of the Gini coefficient thus indicate higher inequality in the distribution of income.

Source: OECD Income Distribution Database, *http://dx.doi.org/10.1787/data-00654-en*; World Bank (2014), *Malaysia Economic Monitor December 2014: Towards a Middle Class Society*.

StatLink http://dx.doi.org/10.1787/888933410837

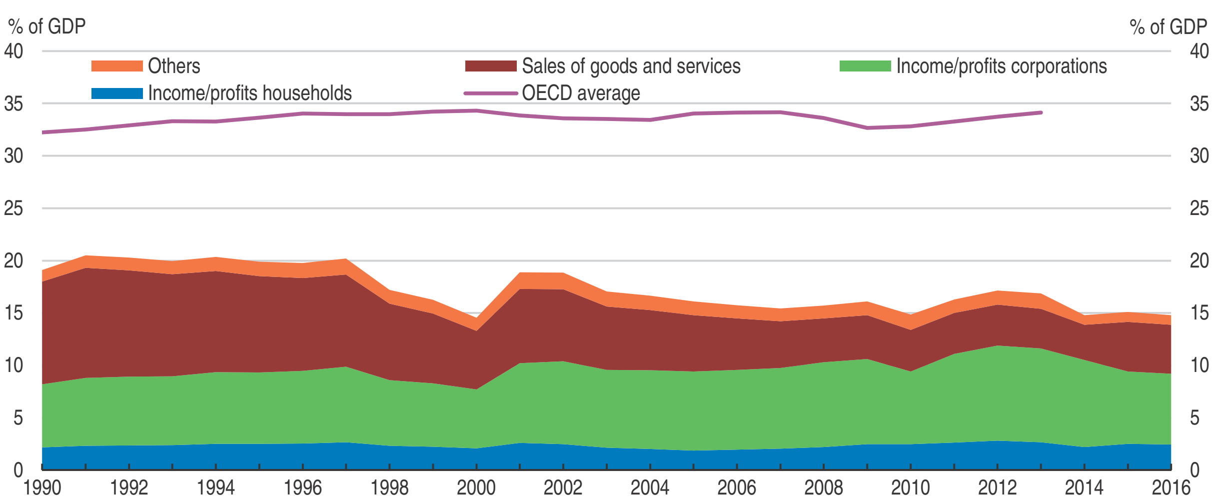
A tax and transfer system that supports inclusive growth

As Malaysia approaches high-income economy status and as its society ages, higher tax revenue will be needed to fund growing fiscal expenditure supporting inclusive growth. However, a substantial recent decline in oil-related revenue amid low global oil prices has reduced overall revenue by around 2% of GDP in 2015 (exclusive of partially offsetting measures). Declining oil-related revenue is the latest contribution to a more concerning longer-term structural decline in the overall tax base. From around 20% of GDP prior to the Asian financial crisis, tax revenue has fallen throughout the 2000s to under 15% of GDP today – less than half the OECD average of over 34% and trending downwards (Figure 27). The introduction of the GST in 2015 was a major step forward but has only partially compensated for the significant long-term decline in indirect tax revenue and more recent declines in oil-related revenue. Reversing this trend in the context of rising cost-of-living pressures and a reliance on private consumption to support moderating growth will be difficult but necessary.

Consumption taxes are potentially quite important to the overall tax mix given the size of the informal household sector, which includes an estimated 1.7 million undocumented foreign workers, and the estimated 350 000 Malaysian residents commuting to work in Singapore. Implementation of the GST has been more successful than anticipated, with a high rate of business compliance boosting collections beyond original projections. The initial rate of the GST, at 6%, is low by international standards (Figure 28). Moreover, the number of exempt or zero-rated items is significant and increasing, which reduces compliance and create distortions (OECD and Korea Institute of Public Finance, 2014). Reducing the number of exempt or zero-rated items and strengthening tax enforcement would help reduce tax leakage in the short term, while consideration could be given to a gradual increase in the rate of the GST over the medium term.

Malaysia's income tax and transfer system does very little to enhance inclusiveness through tax schedule progressivity or redistribution, as evidenced by almost identical before and after tax-and-transfer Gini coefficients (Figure 26). A more progressive personal income tax schedule would complement the development of a comprehensive social protection system in reducing income inequality. Middle-income earners need to become taxpayers, as less than 10% of Malaysians over 15 years old actually pay income tax. Personal income tax is only levied at a very high income threshold compared to the average wage and the informal sector escapes this form of taxation. A combination of higher tax rates and narrower tax bands throughout the schedule are needed to raise the average tax levied on

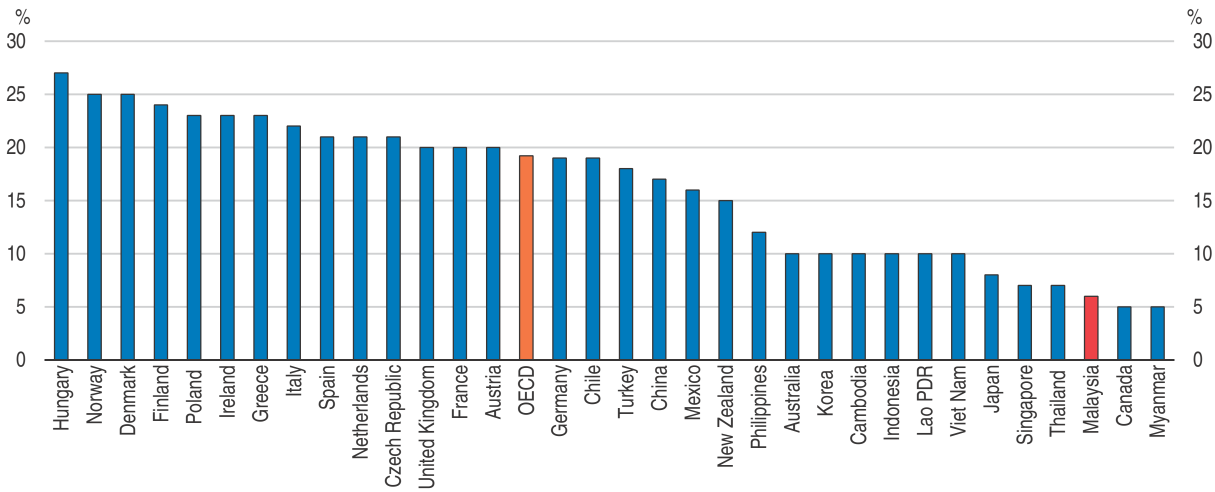
Figure 27. **The share of tax revenue in GDP is low and declining**



Source: OECD (2015a), *Revenue Statistics in Asian Countries 2015: Trends in Indonesia, Malaysia and the Philippines* (for the years 1990-2013), *http://dx.doi.org/10.1787/9789264234277-en*; MOF (2015), *Economic Report 2015-2016* (for the years 2014-16).

StatLink http://dx.doi.org/10.1787/888933410849

Figure 28. **The GST rate is low by international standards**



Source: OECD (2016), Tax database, *http://dx.doi.org/10.1787/tax-data-en*; KPMG (2015), *2015 Asia Pacific Indirect Tax Guide.*

StatLink http://dx.doi.org/10.1787/888933410851

middle- and high-income earners, with exemptions or transfers to avoid increasing the tax burden on low-income households. The top marginal tax rate for very-high-income earners was recently raised to 28% but remains well below top rates of between 45% and 55% in high-income countries, providing scope for further increases that raise revenue while maintaining the country's attractiveness to investors and skilled workers.

Taxes on individual capital income as well as on capital gains, in particular in relation to property, contribute little to the current tax base. Property taxes could also be increased, with ongoing taxes based on the value of the property another potential reform. Additionally, with constitutional responsibility for property taxes with state governments, reform of property taxes could support fiscal decentralisation. Malaysia also lacks an inheritance tax levied on the transfer of a deceased person's assets. Introducing such a tax would not only reinforce the tax base but promote tax progressivity and reduced wealth inequality.

The complexity of the interactions between the recent and the possible additional reforms points to the need for an overall review of the tax base as part of the aforementioned review of medium-term fiscal sustainability.

Malaysia is also working to address issues of international tax avoidance. Malaysia is participating in regional network discussions under the OECD base erosion profit shifting (BEPS) project. A BEPS Action Committee has been established to make headway on this matter, with Malaysia prepared to revise tax legislation in accordance with international standards insofar as these are applicable and relevant to the Malaysian context.

A more sustainable pension system that delivers higher retirement incomes

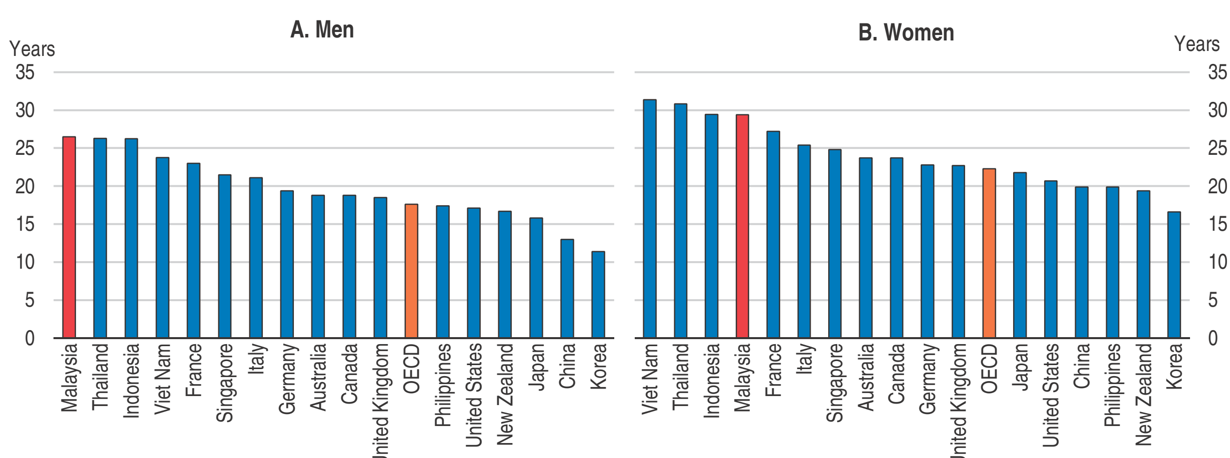
Malaysia has a longstanding dual track pension system comprised of a non-contributory defined benefit scheme for public sector workers (the Malaysian Public Sector Pension Scheme) and a defined contribution system for the private sector (the Employees Provident Fund scheme). The public scheme is funded from consolidated tax revenue, while the Employees Provident Fund (EPF) is the publicly-owned monopoly superannuation fund responsible for managing the contributions of private sector and non-pensionable public sector employees (such as persons hired on a contractual basis). The EPF is one of the world's largest pension funds with MYR 667.2 billion (approximately USD 171 billion or 58% of nominal GDP in 2015) in assets under management as of end-June 2015 (EPF, 2016).

A particular challenge for inclusive growth in transitioning towards high-income country status is balancing growth in consumption and investment today while provisioning for sustainable future living standards. Pension system sustainability requires careful long-term planning in anticipation of expected demographic trends. While Malaysia's population structure is relatively young at present, it can expect to experience rapid ageing, with a projected doubling, from 7% to 14%, of the proportion of the population aged over 65 in just 20 years (World Bank, 2016b); by comparison it took the United Kingdom and the United States 45 and 69 years respectively. Malaysia's rapidly ageing population is already beginning to test the effectiveness of the pension system, with an increasingly unsustainable burden of financing generous public sector pensions and inadequate replacement rates for private sector retirees who lack other forms of social protection. Early access to pension benefits is encouraging earlier-than-optimal retirement, with expected years in retirement for Malaysians well above the OECD average (Figure 29).

With pension expenditure having tripled in the past ten years to reach MYR 18 billion in 2015 (1.6% of GDP) and a long way from peaking due to the burgeoning civil service headcount (up to 1.6 million in 2015 from 0.98 million in 2000), it is crucial to improve the sustainability of the system. Moving new employees into a defined contribution scheme would help limit future pension liabilities to existing and former employees, with legacy benefits paid out of a fully-financed separate fund. For equity reasons, it would be desirable to transfer the new employees into the existing defined contribution scheme for private sector employees. A transparent transition period with a one-off wage increase would help maintain the attractiveness of the public sector.

Meanwhile, concurrent reforms to improve the robustness of the defined contribution system would complement public pension reform and benefit overall retirement income adequacy. The net replacement rate for a Malaysian male of average income was 41% in

Figure 29. **Malaysians can expect a lengthy retirement**

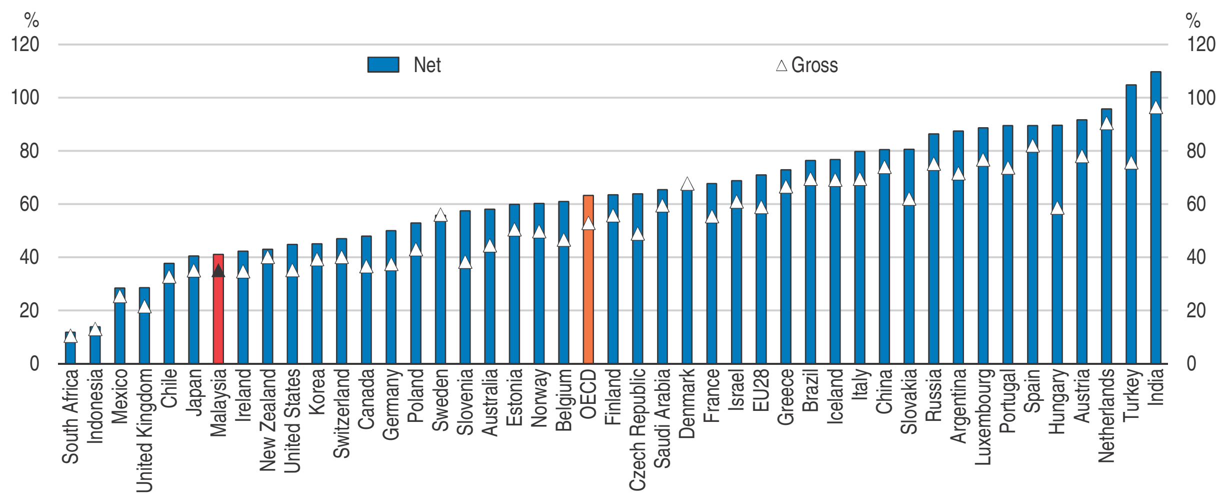


Note: The data for OECD countries and China is for 2014, 2012 for all other countries.
Source: OECD (2013b), *Pensions at a Glance Asia-Pacific 2013*, *http://dx.doi.org/10.1787/pension_asia-2013-en*; OECD (2015c), *Pensions at a Glance 2015*, *http://dx.doi.org/10.1787/pension_glance-2015-en.*

StatLink http://dx.doi.org/10.1787/888933410862

2012, while the net replacement rate for a Malaysian male earning half the level of average income was 40.3% (Figure 30). By comparison, the OECD average for these indicators was 68.3% and 79.5% respectively in 2014, with a replacement rate of around 70% of average income considered a reasonable benchmark for pension system adequacy (OECD, 2015c). EPF data indicates that 70% of 54-year old members would not have enough savings to meet basic retirement needs if they retired at age 55, while half of all retirees exhaust their savings in just five years. Bringing more informal workers into the system, increasing the official retirement and pension access ages in line with improvements in healthy life expectancy, and reducing exemptions for early withdrawal would all help achieve this objective.

Figure 30. **Pension replacement rates are low**



Note: The data are for 2012 for Malaysia and for 2014 for OECD countries.
Source: OECD (2013b), *Pensions at a Glance Asia-Pacific 2013*, *http://dx.doi.org/10.1787/pension_asia-2013-en*; OECD (2015c), *Pensions at a Glance 2015*, *http://dx.doi.org/10.1787/pension_glance-2015-en*.

StatLink http://dx.doi.org/10.1787/888933410874

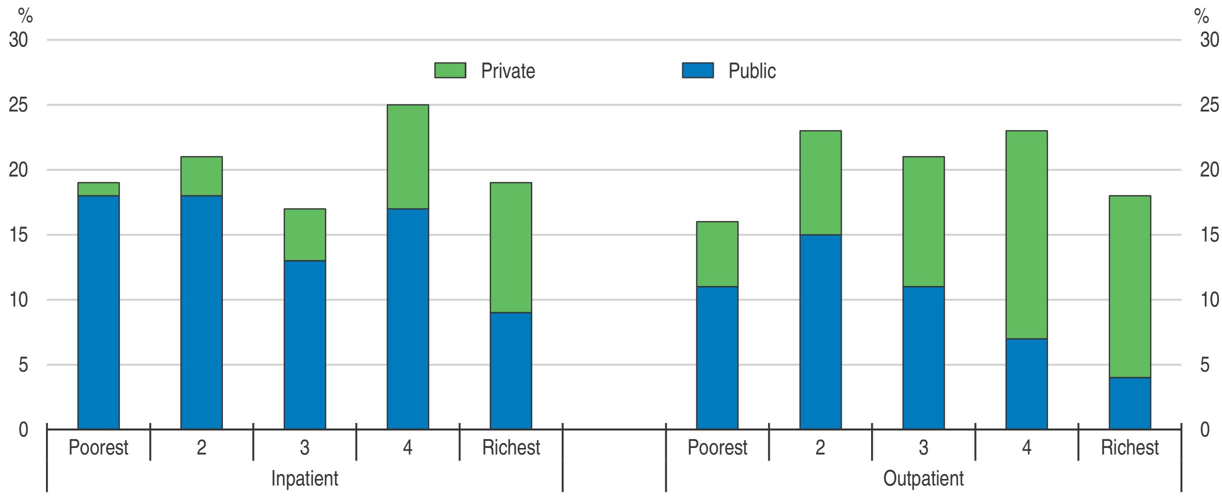
Maintaining universal access to quality healthcare

Maintaining universal access to quality healthcare is important to continued growth in healthy life expectancy and safeguarding a productive workforce. Malaysia's public healthcare system provides universal healthcare at minimal out-of-pocket expense, providing an essential safety net for households otherwise unable to afford medical care. There is also a private healthcare system where the costs of services are paid by the patients themselves, their employers or insurance companies (PEMANDU, 2012). Efforts are made to provide public health services of equal standard irrespective of location, with particular attention paid to accessibility in remote rural areas and availability in increasingly populated urban areas.

However, access to healthcare is becoming increasingly polarised along socio-economic lines. The inexpensive public system is overburdened in urban areas and faces difficulties retaining qualified staff, while high out-of-pocket expenses, low take-up rates of private insurance cover and insufficient investment in skills training prevent further growth in the private system (Figure 31). Inadequate transport infrastructure, low

Figure 31. **Poor households are more reliant on public sector health care services**

As of 2011



Source: IHSR (2013), *Malaysia Health Care Demand Analysis: Inequalities in Healthcare Demand & Simulation of Trends and Impact of Potential Changes in Healthcare Spending.*

StatLink http://dx.doi.org/10.1787/888933410883

economies of scale and low incentives for professionals to work in rural areas hinder the establishment of urban-equivalent facilities in remote areas, reducing system universality.

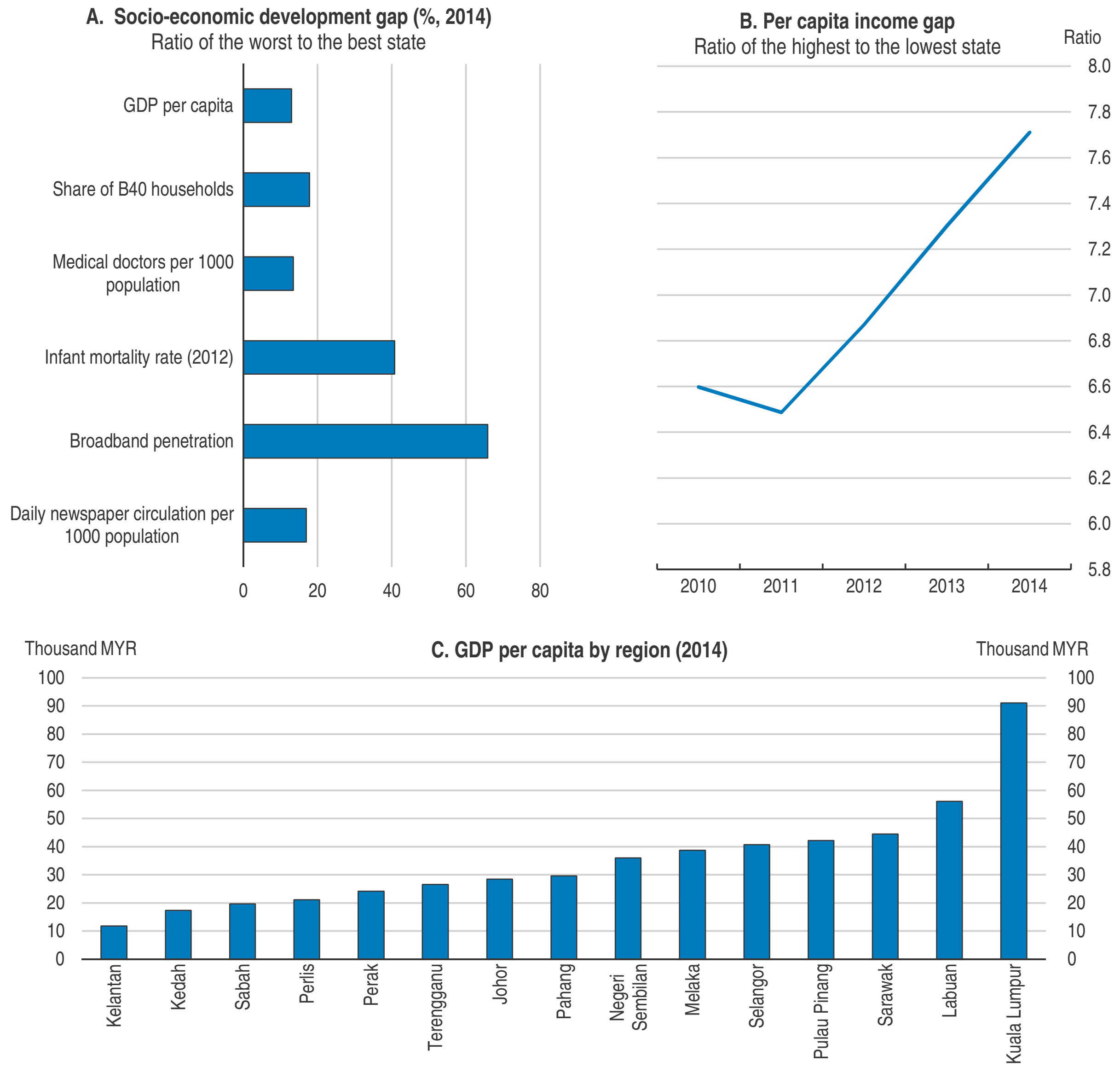
Steps have been taken to ease the burden on the urban public health system and improve access to quality healthcare for low-income urban and rural residents. In urban areas, operational hours of some public outpatient clinics have been extended and "cluster hospital" arrangements introduced to pool resources. Moreover, retention packages have been developed to increase compensation and allow more flexible working arrangements, aiming to encourage medical doctors and specialists to remain in the public system. Mobile clinics have increased accessibility in rural areas ahead of plans to build more permanent facilities in remote communities. Nonetheless, further reforms that would improve the healthcare system include improvements to pre-hospital services and referral systems, simplifying licensing and other regulatory processes, greater autonomy for public hospitals and clinics to improve efficiency and increased incentives to encourage utilisation of private health insurance.

Narrowing the regional development gap

Last but not least, inclusive growth relies on continuing long-standing efforts to reduce inter and intra-regional imbalances and increase inclusivity by attracting investment in economic activities, particularly in rural areas. The socio-economic development gap among states is significant, most notably in terms of relative poverty and healthcare. The income gap between the richer and poorer states has also widened in the past five years (Figure 32).

The government initiative to create five regional economic corridors has encouraged more investment in these areas to spur development based on regional competitive advantages. For example, Sarawak is attracting investment in industries that utilise its rich natural resources, such as focussing on renewable energy. Creating autonomous and sustainable development by encouraging economic activity in rural industries such as

Figure 32. **Increasing development gaps between states**



Source: Department of Statistics, Malaysia; MRRD (2016), *The 2014 Statistics Bulletin*.

StatLink http://dx.doi.org/10.1787/888933410897

agro-based processing activities and eco-tourism is key to narrowing the income gap between urban and rural areas. Realising business potential in rural areas will also require strengthening programmes supporting rural entrepreneurs' access to skills training, in particular e-commerce to link consumers directly with rural entrepreneurs. Further investment to increase urban-rural connectivity, notably in the form of additional roads and telecommunications infrastructure such as broadband that enable rural areas to better access public services and reduce transaction costs of economic activities, alongside investment in education and healthcare services, would benefit inclusiveness.

Overall, further increasing the inclusiveness of growth will require even more difficult but essential changes to Malaysia's policy settings. Providing comprehensive social protection and improved labour market access for vulnerable groups stand out as the most important reform priorities, with substantial tax reform also required to rebalance Malaysia's approach to income redistribution and provide sustainable financing for social expenditure. A more adequate and sustainable retirement income system, reduced pressure on the public healthcare system and measures to boost sustainable regional development will also be fundamental to inclusive growth in the interests of the *"rakyat"* (ordinary people).

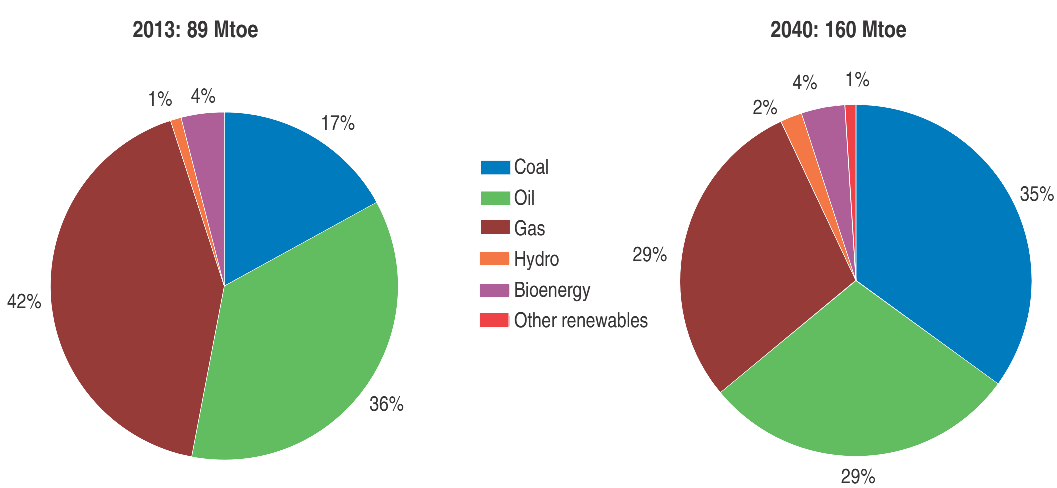
Green growth

The conservation and sustainable use of Malaysia's richly biodiverse and heavily forested environment is critical to the future prosperity of the country and its neighbours. Malaysia recognises the need for environmentally sustainable development and climate change mitigation and has committed to limiting deforestation and reducing its greenhouse gas emissions intensity. Malaysia's intended nationally determined contribution to the COP21 is to a 35% reduction in greenhouse gas emissions intensity by 2030 relative to 2005 levels (2011 levels were 23% lower than 2005), or 45% conditional upon receipt of climate finance, technology transfer and capacity building from developed countries. Continued growth with accompanying increases in energy demand and urbanisation will challenge the effectiveness of Malaysia's green growth strategies, calling for greater use of market mechanisms, stricter environmental standards and improved environmental policy governance.

The challenge of rising energy demand

Significant increases in energy and electricity demand accompanying Malaysia's growth over the coming decades will challenge Malaysia's ability to generate sufficient energy from cleaner sources. According to International Energy Agency projections, energy and electricity demand in Malaysia are expected to grow by 2.2% and 4% per year respectively from 2013 to 2040. In the process, the share of coal – the most CO_2 intensive fuel - is expected to more than double, reaching 35% of total energy demand (Figure 33). The contribution of renewable energy sources is expected to increase from 5% to 7%, but

Figure 33. **Malaysia's energy demand is expected to become more coal intensive**



Source: IEA (2015), *Southeast Asia Energy Outlook 2015.*

StatLink http://dx.doi.org/10.1787/888933410904

the scale and emissions intensity of increased fossil fuel consumption will largely determine Malaysia's success in meeting its COP21 commitments and the Sustainable Development Goals related to energy access and combating climate change.

Prior to 2014, retail energy markets were distorted by price subsidies that encouraged excessive oil, gas and electricity consumption. While the removal of the vast majority of subsidies was a welcome step, they leave a legacy of inefficient energy consumption and minimal demand-side pressure to promote clean energy and appropriately priced environmental externalities. The production side remains distorted by piped gas prices below market rates, while the absence of penalties for producers of fossil fuels has increased the contribution of coal to electricity generation as gas and oil prices are slowly becoming market-driven.

OECD modelling has suggested that introducing a carbon tax with an appropriate redistribution of revenue gains would not only reduce CO_2 emissions but be pro-growth in Malaysia (OECD, 2014). The 11th Malaysia Plan notes that economic instruments such as a green or carbon tax, and reducing emissions from deforestation and forest degradation will be considered, but this has yet to occur.

COP21 commitments have triggered a reassessment of energy planning to ensure it is inclusive and consistent with environmental objectives, rather than exclusively driven by cost minimisation. For the time being, Malaysia relies on a range of measures to promote renewable energy demand and increase energy efficiency standards. In relation to coal, the government intends to regulate the construction of new coal-fired power plants to ensure they use clean coal technologies. More broadly, the creation of the Sustainable Energy Development Agency and the introduction of a feed-in tariff (FiT) scheme for renewable energy, as well as tax incentives to encourage the take-up of such schemes have boosted investment in renewable energy, in particular the installation of solar cells in residential and commercial properties. The FiT scheme has encouraged the addition of over 400 MW to the electricity grid since 2011, with the recent introduction of net metering for households expected to further boost total investment to up to 2000 MW by 2020. However, the success of the scheme has been limited mostly to solar, chiefly due to the relatively attractive initial tariff rates offered. The take-up for biogas, biomass and hydro has been much less than expected. The FiT scheme and energy efficiency more generally would benefit from the deregulation of electricity prices. This would allow for the removal of the cap on the overall take-up of FiT that is maintained to ensure adequate utility profitability and funding for FiT payments.

Malaysia is also increasing energy efficiency standards for buildings, transport fuel and government procurement to support greener industries and consumption. Implementation could involve more ambitious targets and shorter adjustment periods, particularly for government green procurement to lead by example. Education and information initiatives to promote recycling and other sustainable behaviour are also seeking to reduce wasteful behaviour and energy demand, but remain to be fully supported by complementary initiatives. For example, new recycling standards have been enforced by introducing fines for households that fail to separate recyclable rubbish into separate coloured plastic bags. Increasing the proliferation of plastic bags as a means of sorting waste reduces the overall benefits of the policy, while making recycling more convenient outside of households and schools would be more effective in facilitating behavioural change than imposing fines. Similar implementation issues exist for policies in urbanised states such as Penang, Selangor and Kuala Lumpur that have introduced pricing of plastic bags by supermarkets and other grocers, with Selangor only mandating this rule every Saturday.

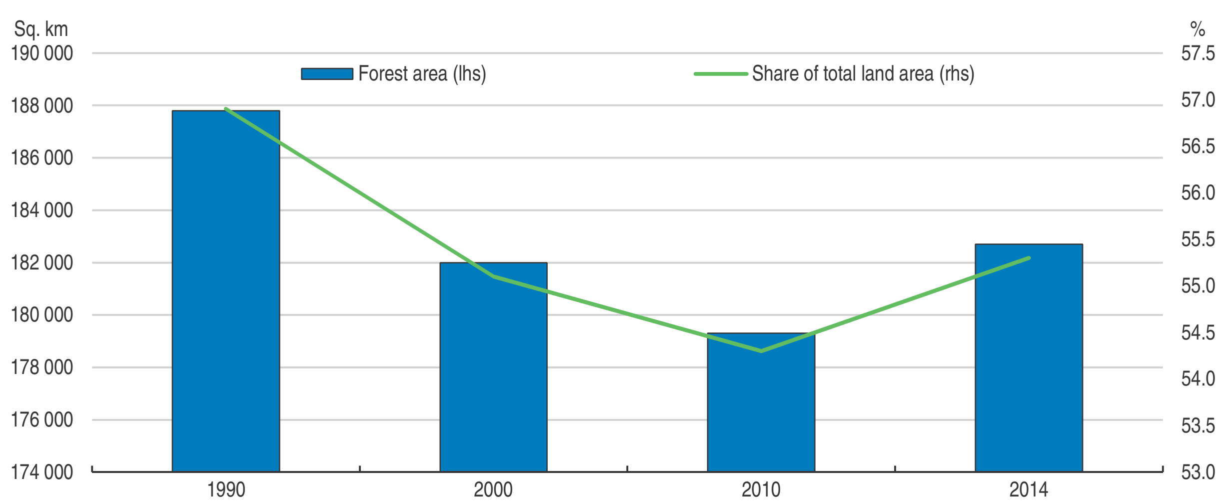
Strengthening regional cooperation will also be crucial to driving efficiency improvements in energy supply, with cross-border integration of power grids increasing energy security and system reliability, and providing a cleaner, more sustainable approach to meeting rising energy demand. In this regard, further support for and progress towards regional integration initiatives will be a priority. Resource sharing initiatives by ASEAN member states are most critical, including the ASEAN Power Grid, Trans-ASEAN Gas Pipeline and LNG regasification terminals (ASEAN Centre for Energy, 2016).

Limiting deforestation and maintaining biodiversity

Malaysia is a megabiodiverse country and harbours a variety of ecosystems, including its rich forests assets. Conservation and sustainable use of these assets while meeting the challenges of rapid development is essential for green and inclusive growth. Engaging indigenous and local communities in conservation efforts and providing alternative livelihoods, such as eco-tourism, while enforcing legal protections for these resources are important to maintain biodiversity.

At the Rio+20 Summit, Malaysia committed to ensure at least 50% of its land area remain forested, with at least 17% of terrestrial and inland water areas, as well as 10% of coastal and marine areas under permanent conservation in accordance with the 2011-20 Aichi biodiversity targets. It is progressing well in meeting these targets, following in the footsteps of Costa Rica by increasing living standards while reversing an earlier decline in total forest cover in recent years (Figure 34). Malaysia is working closely with global partners such as the United Nations Development Programme on projects to improve the planning, management and sustainability of biodiversity in forested areas. Malaysia is currently considering substantial increases to marine protected areas to meet its commitments.

Figure 34. **Malaysia's forest cover is recovering**



Source: Ministry of Natural Resources and Environment and Department of Statistics, Malaysia.

StatLink http://dx.doi.org/10.1787/888933410914

As a leading global producer of palm oil, Malaysia should continue efforts to increase its share of global sustainable palm oil production, which has already reached 21% from zero in 2008 (RSPO, 2016). Malaysia represents around 42% of global sustainable palm oil production, while palm oil more generally is an industry which provides a crucial economic lifeline for many poorer rural households. While generally cooperative with the Roundtable on Sustainable Oil Production (RSPO), the leading global NGO for sustainable palm oil certification, Malaysia introduced its own certification scheme in January 2015. As RSPO has been internationally recognised as the standard for sustainable palm oil trading by both consumers and producers, the Malaysian certification scheme should aim to complement the RSPO rather than compete.

Malaysia's fishing industry operates in one of the world's major fishing areas. Malaysia's capture fisheries are the 15th largest in the world by tonnage (FAO, 2014), and landings grew by close to 15% between 2003 and 2012. Fishing practices in coastal zones involve local fishers operating traditional fishing equipment that is particularly damaging to the natural environment. Prohibitions on some destructive fishing techniques are in place. The Ecosystem Approach to Fisheries management has been introduced in some coastal areas, where most of the fisheries are fully or over-exploited. In 2014, Malaysia announced its intention to ban trawling, one of the most destructive fishing methods, by 2020.

Transport and urbanisation

Malaysia is one of the most urbanised countries in Southeast Asia, with an estimated urban population of almost 75% in 2015, which is growing by around 2.7% per year (World Bank, 2015b). However, Malaysia's urban centres are among the least densely populated in the region, a situation which reflects restrictions on land usage that made residential development relatively unattractive. With Malaysia aiming to develop four major cities (Kuala Lumpur, Johor Bahru, Kuching and Kota Kinabalu) into competitive centres of economic growth, careful urban planning will be required to ensure the increased density of these cities does not compromise broader ambitions for green growth. Urban planning will test the effectiveness of intergovernmental cooperation and the relative prominence afforded to environmental objectives.

The development of the Iskandar Malaysia corridor in the region bordering Singapore is an example of existing efforts to translate urbanisation into a sustainable and low emissions process (OECD, 2015d). It comprises measures to promote green industries, green households and a clean environment, combining green planning and regulation on the supply side with education and efficiency of consumption on the demand side. The federal administrative capital in Putrajaya was also based on the principles of sustainable urban development, with the aim for Putrajaya to become a sustainable low-carbon green city by 2025.

Significant recent investments in the planning and development of public transport infrastructure in major cities also seek to reduce the environmental impact of the urban transport sector, providing an efficient and more affordable alternative to personal transportation. The development of a mass rapid transit system and the extension of existing light rail and bus systems in the Greater Kuala Lumpur/Klang Valley area, together with upgrading of rail infrastructure in the West Coast of Peninsular Malaysia and improved bus systems in other major cities should help reduce very high rates of personal motor vehicle use.

Bibliography

Adalet McGowan, M. and D. Andrews (2016), "Insolvency regimes and productivity growth: A framework for analysis", *OECD Economics Department Working Papers*, No. 1309.

ADB (2013), *Beyond Factory Asia: Fuelling Growth in a Changing World*, Background Paper for the Asian Development Bank 2013 Annual Meeting Governors' Seminar, Asian Development Bank, Mandaluyong City.

ADB (2014), "Asia in Global Value Chains", *Asian Development Outlook 2014 Update*, Asian Development Bank, Mandaluyong City.

ADB (2015), *Key Indicators for Asia and the Pacific 2015*, Asian Development Bank, Mandaluyong City.

APO (2015), *Productivity in the Asia-Pacific: Past, Present and Future*, Asia Productivity Organisation, Tokyo.

ASEAN Centre for Energy (2016), *ASEAN Power Grid*, *www.aseanenergy.org/programme-area/apg* (accessed on 28 April 2016).

Beetsma, R. and X. Debrun (2016), "Fiscal councils: rationale and effectiveness", *IMF Working Papers*, WP/16/86, Washington D.C.

Blöchliger, H. (2015), "Reforming the tax on immovable property: Taking care of the unloved", *OECD Economics Department Working Papers*, No. 1205, OECD Publishing.

Blöchliger, H., D. Bartoli and S. Stossberg (2016), "Does Fiscal Decentralisation Foster Regional Convergence?", *OECD Economic Policy Papers,* No. 17, OECD Publishing, Paris.

BIS (2016), *Basel III Implementation Assessment of Russia and Turkey by the Basel Committee*, BIS Press Release, Basel, Switzerland.

BNM (2015), *Bank Negara Malaysia Financial Stability and Payment Systems Report 2014*, Bank Negara Malaysia, Kuala Lumpur.

BNM (2016a), *Bank Negara Malaysia Annual Report 2015*, Bank Negara Malaysia, Kuala Lumpur.

BNM (2016b), *Bank Negara Malaysia Financial Stability and Payment Systems Report 2015*, Bank Negara Malaysia, Kuala Lumpur.

Caporale, G. et al. (2016), "The bank lending channel in a dual banking system: evidence from Malaysia", *DIW Berlin Discussion Papers*, German Institute for Economic Research. No. 1557, Berlin.

Cornell University, INSEAD, and WIPO (2015), *The Global Innovation Index 2015: Effective Innovation Policies for Development*, Fontainebleau, Ithaca, and Geneva.

Dizioli, A. et al.(2016), "Spillovers from China's Growth Slowdown and Rebalancing to the ASEAN-5 Economies", *IMF Working Paper* 16/170, Washington D.C.

EPF (2016), *EPF Savings and your Retirement*, Employees Provident Fund, Kuala Lumpur.

EPU (2013), *Malaysian Well-being Report 2013*, Economic Planning Unit, Prime Minister's Department, Putrajaya.

EPU (2015), *Eleventh Malaysia Plan*, Economic Planning Unit, Prime Minister's Department, Putrajaya.

ERIA, OECD and ASEAN (2014), *ASEAN SME Policy Index*, OECD Publications, Paris.

Ernst and Young (2015), *World Islamic Banking Competitiveness Report 2016*, Ernst & Young Global Limited.

FAO (2014), *The State of the World's Fisheries and Aquaculture,* Rome.

Gulzar, R. and A. Masih (2015), "Islamic banking: 40 years later, still interest-based? Evidence from Malaysia", *MPRA Paper,* University Library of Munich, Munich.

Hasan, M. and J. Dridi (2010), "The effects of the global crisis on Islamic and conventional banks: a comparative study", *IMF Working Papers*, No. 10/201, Washington D.C.

Hutchinson, F. (2014), "Malaysia's federal system: overt and covert centralisation"*, Journal of Contemporary Asia*, 44:3, 422-442.

IHSR (2013), *Malaysia Health Care Demand Analysis: Inequalities in Healthcare Demand & Simulation of Trends and Impact of Potential Changes in Healthcare Spending*, Institute for Health Systems Research, Kuala Lumpur.

IEA (2015), *Southeast Asia Energy Outlook 2015*, International Energy Agency, Paris.

IMF (2015a), *Malaysia – Technical Assistance Report – Strengthening Outcomes Based Budgeting*, IMF Country Report No. 15/266, Washington D.C.

IMF (2015b), "Structural Reforms and Macroeconomic Performance: Country Cases", *IMF Policy Papers*, Washington D.C.

IMF (2016), *Malaysia – 2016 Article IV Consultation- Press Release; Staff Report; and Statement by the Executive Director for Malaysia*, IMF Country Report No.16/110, Washington D.C.

IMF and World Bank (2014), *Revised Guidelines for Public Debt Management*, Washington D.C.

KPMG (2015), *2015 Asia Pacific Indirect Tax Guide*, *www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Documents/2015-asia-pacific-indirect-tax-country-guide.pdf* (accessed on 28 April 2016)

Malaysian Digest (2015), "Fines to encourage more recycling – Are Malaysians ready?", 10 July, malaysiandigest.com.

MOE (2015), *Malaysia Education Blueprint 2015-2025 (Higher Education),* Ministry of Education, Putrajaya.

MOF(2015), *Economic Report 2015-2016,* Ministry of Finance, Putrajaya.

MOF (2016), *Quarterly Economic Data Fourth Quarter, 2015,* Ministry of Finance, Putrajaya.

MRRD (2016), *The 2014 Statistics Bulletin*, Ministry of Rural and Regional Development, Putrajaya.

NEAC (2010), *New Economic Model for Malaysia*, National Economic Advisory Council, Putrajaya.

OECD (2012), *OECD Economic Survey of Turkey*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/eco_surveys-tur-2012-en*

OECD (2013a), *Southeast Asian Economic Outlook 2013: With Perspectives on China and India,* OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/saeo-2013-en*

OECD (2013b), *Pensions at a Glance Asia-Pacific 2013*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/pension_asia-2013-en*

OECD (2014), *Towards Green Growth in Southeast Asia: OECD Green Growth Studies*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/9789264224100-en*

OECD (2015a), *Revenue Statistics in Asian Countries 2015: Trends in Indonesia, Malaysia and the Philippines,* OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/9789264234277-en*

OECD (2015b), *Implementing Good Regulatory Practice in Malaysia*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/9789264230620-en*

OECD (2015c), *Pensions at a Glance 2015: OECD and G20 indicators,* OECD Publications, Paris. DOI: *http://dx.doi.org/10.1787/pension_glance-2015-en*

OECD (2015d), *Urban Green Growth in Dynamic Asia Project*, OECD, Paris.

OECD (2016a), *Low-Performing Students: Why They Fall Behind and How to Help Them Succeed*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/9789264250246-en*

OECD (2016b), *OECD Education GPS*, *http://gpseducation.oecd.org/Home* (accessed on 28 April 2016).

OECD (2016c), *OECD Reviews of Innovation Policy: Malaysia 2016*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/9789264255340-en*

OECD Tax Database, *www.oecd.org/tax/tax-policy/tax-database.htm*.

OECD and Korea Institute of Public Finance (2014), *The Distributional Effects of Consumption Taxes in OECD Countries*, OECD Tax Policy Studies, No. 22, OECD Publishing. DOI: *http://dx.doi.org/10.1787/9789264224520-en*

PEMANDU (2012), "Snapshot: Healthcare", *Inside Malaysia*, July, Putrajaya.

Petri, P. and M. Plummer (2016), "The economic effects of the Trans-Pacific Partnership: new estimates", *Peterson Institute of International Economics Working Paper Series* 16-2, Washington D.C.

RSPO (2016), *Impacts, www.rspo.org/about/impacts* (accessed on 28 April 2016).

SEDA (2015), "*Malaysia set to record over 2,000 megawatts of RE by 2020*", Sustainable Energy Development Authority, Putrajaya.

SME Corp (2012), *SME Master Plan 2012-2020*, SME Corp Malaysia, Kuala Lumpur.

Standard Chartered Bank (2016), *Asia Leverage: After the boom. www.sc.com/BeyondBorders/asia-leverage/* (accessed on 20 May 2016).

World Bank (2013), *Malaysia Economic Monitor December 2013: High-Performing Education*, Washington D.C.

World Bank (2014), *Malaysia Economic Monitor December 2014: Towards a Middle Class Society*, Washington D.C.

World Bank (2015a), *Ease of Doing Business 2016: Economy Profile 2016 Malaysia*, Washington D.C.

World Bank (2015b), "Malaysia among Most Urbanized Countries in East Asia", *www.worldbank.org/en/news/feature/2015/01/26/malaysia-among-most-urbanized-countries-in-east-asia*.

World Bank (2016a), *Commodity Price Outlook*, April, Washington D.C.

World Bank (2016b), *Live Long and Prosper: Aging in East Asia and Pacific*, Washington D.C.

Thematic chapters

Chapter 1

Boosting productivity

Productivity growth is essential to providing sustainable increases in living standards. Malaysia has reached a development stage where growth needs to be driven more by productivity gains than the sheer accumulation of capital and labour inputs. The 11th Malaysia Plan (2016-20) sets an ambitious labour productivity growth target of 3.7% per year, well above than the 2% average growth recorded from 2011 to 2015. Co-ordinated structural reforms will be necessary to achieve the productivity improvements needed to attain high-income country status. Areas where reforms would deliver the greatest boost to productivity include increasing the quality of education and skills training, spurring innovation, adopting information technology more widely, fostering a well-functioning competition policy framework, improving the functioning of the labour market and the regulatory framework for small and medium-sized enterprises, fostering regional integration and raising public sector productivity.

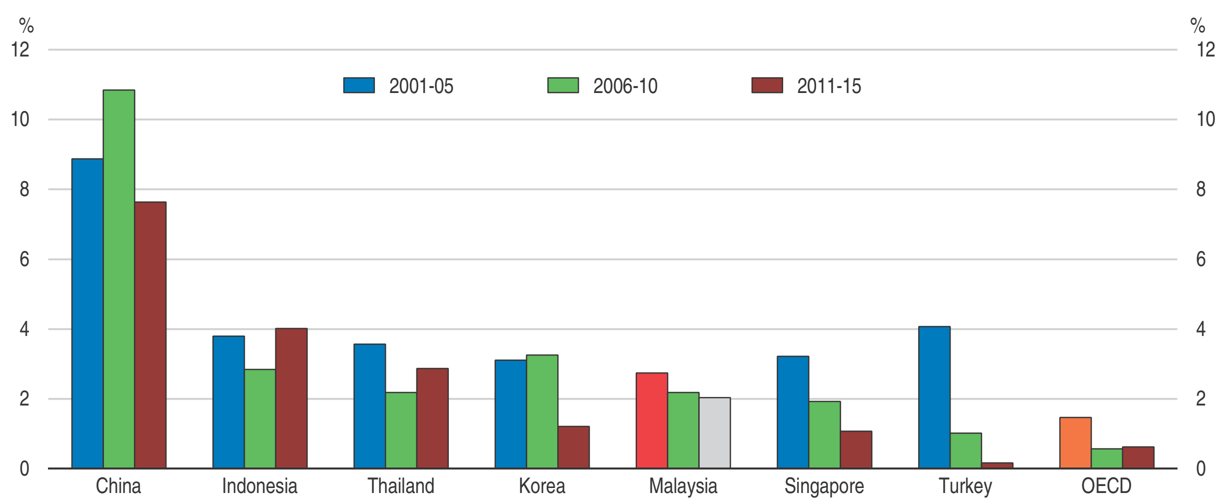
Introduction

Productivity growth in Malaysia averaged 2.3% per year since the first half of the 2000s, helping to raise per capita income to higher middle-income country levels (Figure 1.1). Growth was driven by increasing inflows of foreign direct investment (FDI) and industry restructuring that shifted resources to higher value-added sectors such as electronics and electrical (E&E) and petrochemical (APO, 2015). However, labour productivity has gradually decelerated since 2001, with Malaysia underperforming relative to some of its major regional peers. Factors contributing to this deceleration include a slowdown of capital deepening and global trade growth, and insufficient innovation.

For Malaysia to attain high-income country status, growth needs to be driven more by productivity gains, as opposed to the sheer accumulation of capital and labour inputs. Like in other East Asian emerging economies, productivity gains during Malaysia's early industrialisation period came from the reallocation of underutilised rural labour from the agriculture and mining sectors to the labour-intensive manufacturing sector, supported by capital accumulation and imported technology from increased foreign direct investment (FDI). Malaysia's competitive advantages are changing as labour is fully employed and real wage levels increase, with the price competitiveness of its lower value-added manufactures gradually declining. Gains from imported technology that used to underpin the growth of labour-intensive manufacturing are also contributing less than before as a

Figure 1.1. **Labour productivity growth has declined**

Average of growth of real value added per employee per year



Note: The underlying employment data for Malaysia might underestimate the number of legal and undocumented foreign migrant workers.

Source: OECD calculations based on data provided by national statistical office and OECD (2016), Productivity Statistics (database), *http://dx.doi.org/10.1787/data-00685-en.*

StatLink http://dx.doi.org/10.1787/888933410921

result of intense competition for industry relocation within the region, most notably from China and increasingly the Philippines and Viet Nam. Continuous economic transformation is therefore needed to boost productivity by engaging in more high-technology and knowledge-intensive activities.

The 11th Malaysia Plan sets an ambitious target for labour productivity growth of 3.7% per year from 2016 to 2020, as against an outcome of 2% from 2011 to 2015. This reflects Malaysia's recognition that productivity improvements will be essential to achieving high-income country status. As the Plan suggests, raising productivity requires a comprehensive set of policies to increase human capital development, promote innovation, improve regulatory frameworks and further regional integration by liberalising trade and investment.

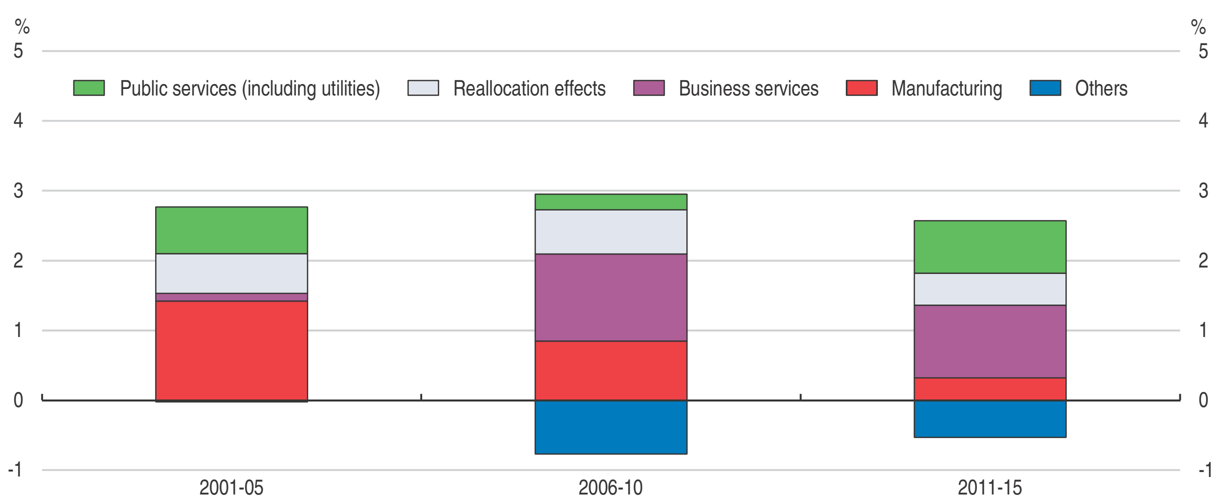
This chapter focuses on the challenges Malaysia faces in raising the contribution of productivity to economic growth. These call for policy reform in areas including strengthening human capital through education and skills training, promoting innovation, enhancing the regulatory framework for SMEs by facilitating exit and entry, furthering regional integration and raising public sector productivity.

Malaysia's productivity performance and outlook

In the first half of the 2000s, productivity growth largely stemmed from the manufacturing sector (Figure 1.2). Slower capital deepening since the early 2000s held back productivity gains in manufacturing. Economy wide, so did a declining share of skilled workers in total employment, from 27.6% in 2010 to 25.7% in 2015 according to the latest Labour Force Survey. Meanwhile, inflows of low-skilled migrant workers increased their share of total employment from 9.5% to 15%.

Figure 1.2. **Labour productivity growth by sectors**

Average growth of real value added per employee per year at 2010 constant prices



1. Due to the changes in the classification of sectors in 2010, data before and after 2010 are not entirely consistent.
2. The underlying employment data for Malaysia might underestimate the number of legal and undocumented foreign migrant workers.
3. Reallocation effects correspond to the impacts of movements of labour between sectors.
4. Others include agriculture, fishery and forestry, mining and quarrying, and construction.

Source: OECD calculations based on data provided by Department of Statistics, Malaysia.

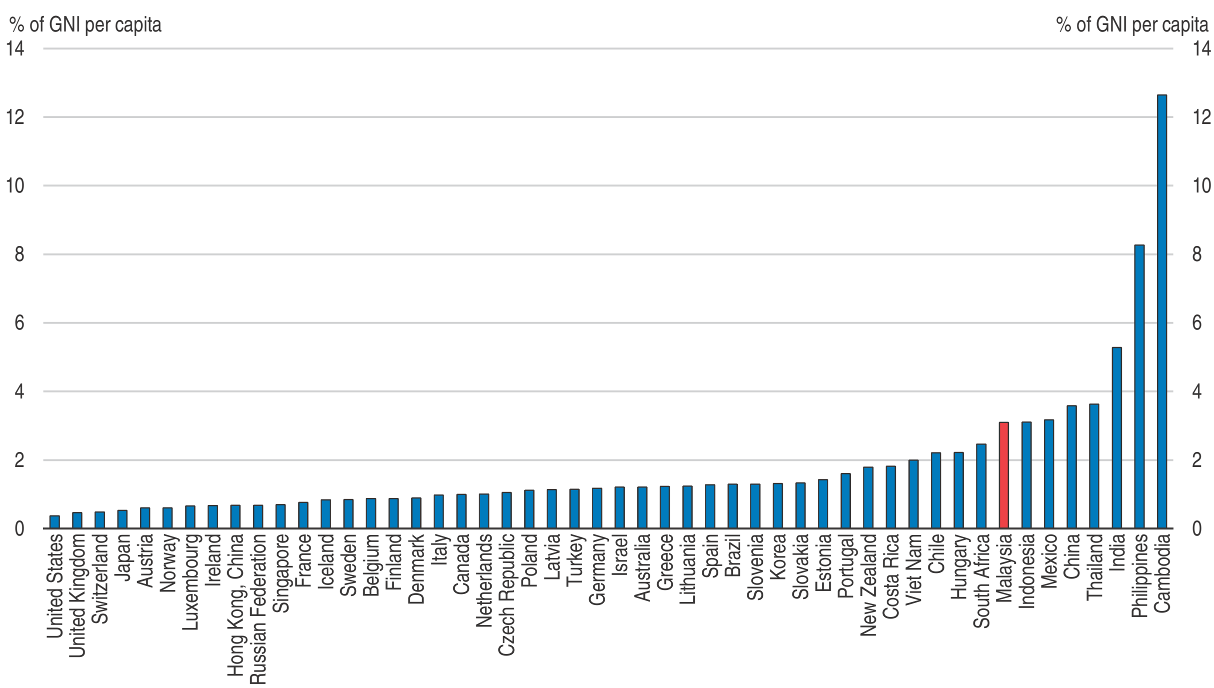
StatLink http://dx.doi.org/10.1787/888933410702

The low level of innovation by domestic firms was another drag on productivity growth. Underlying causes included low innovation capability due to inadequate resources, the underdevelopment of institutional mechanisms to promote commercialisation of innovation, and insufficient development of technology infrastructure (OECD, 2015b). Despite adopting a National Broadband Initiative in 2010 which recognises high-speed Internet broadband as a critical enabler of business innovation, fixed Internet subscriptions remain very low at just 10.1% in 2014 (80th out of 189 countries) despite an overall Internet access rate of 65.5% (ITU and UNESCO, 2016). This reflects the high cost of broadband subscription in Malaysia compared to its regional peers, largely because government-linked Telekom Malaysia's near complete ownership of fibre infrastructure impedes competition (Figure 1.3).

The 11th Malaysia Plan emphasises the need to boost productivity growth in the services sector, recognising its increasing contribution to GDP, employment and exports (Table 1.1). Productivity growth in the services sector between 2011 and 2015 benefited from strong growth in the information and communication, and financial intermediation subsectors (Figure 1.4). During this period, competition laws were implemented and restrictions on foreign investment in 18 services subsectors were lifted, including telecommunications and wholesale and retail trade. However, as the composition of the services sector is currently skewed towards subsectors that rely on low-skilled labour (notably wholesale and retail trade, and hotels and restaurants), overall productivity levels remain low (EPU, 2015a; MPC, 2015).

Industry value added upgrading and the automation of production processes has been slow, limiting productivity growth through changes in outputs produced. Malaysia's

Figure 1.3. **Fixed broadband subscription prices are relatively high**



Source: ITU (2015), *Measuring the Information Society 2015.*

StatLink http://dx.doi.org/10.1787/888933410935

Table 1.1. **Malaysia's ambitious sectoral targets for labour productivity growth**

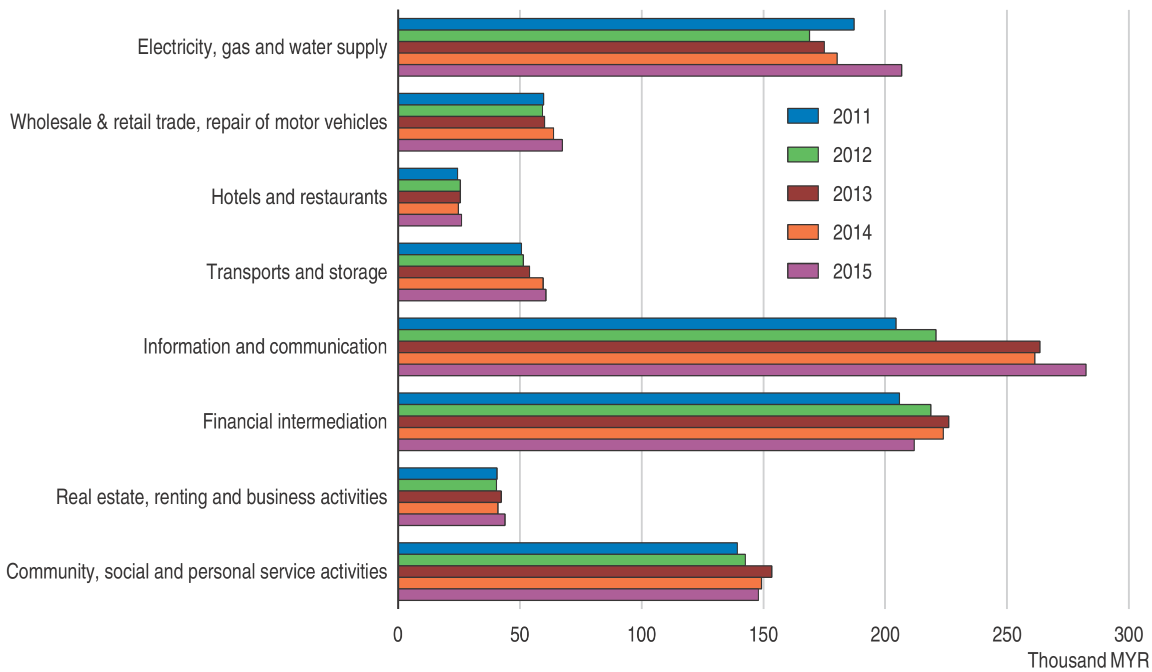
Average annual growth (%)

Sectors	2011-2015	2016-2020
Agriculture	2.2	3.6
Mining and quarrying	1.1	1.1
Manufacturing	0.9	2.6
Construction	9.6	9.6
Services	2.8	4.1

Source: Economic Planning Unit, *Eleventh Malaysia Plan*.

Figure 1.4. **Labour productivity growth in services subsectors**

Value added per employee in 2010 constant prices



Source: OECD calculations based on data provided by Department of Statistics, Malaysia.

StatLink http://dx.doi.org/10.1787/888933410943

contribution to global value chains (GVCs), particularly in manufacturing subsectors such as E&E now faces intense competition from other emerging economies such as China, the Philippines and Viet Nam. The slow transformation toward higher value-added activities has resulted in an overall declining share of Malaysian manufacturing exports in global trade (EPU, 2015b). A shift towards innovation-led growth, as seen in Korea, would help substantially in pursuing industrial upgrading.

Improving the quality of education

Universal access to quality education makes a critical contribution to the development of human capital and labour force productivity, driving medium to long-term gains in economic growth. It also plays a crucial role in promoting inclusiveness, equal opportunity and intergenerational mobility of socio-economic status.

Malaysia's education policy has long focused on inclusiveness, and access to education has improved significantly in recent years. In line with the Millennium Development Goals, it has reached near-universal levels, with primary education enrolment at around 98% in 2015 and pre-school and secondary education enrolment at around 95% and 89% respectively according to Ministry of Education data. Malaysia has successfully addressed prior concerns with female education participation, for the most part exhibiting minimal gender differences in education access and performance levels. Malaysian schools try hard to encourage attendance through engagement with rural communities, under-enrolled schools remain open to ensure access, while numerous programmes cater to special-needs students and student welfare including malnutrition. The recently introduced District Transformation Programme has begun to narrow the urban-rural achievement gap but education outcomes are still influenced by socio-economic status.

Raising the quality of education to produce graduates with job-ready skills is the biggest challenge and potential reform area to boost productivity. Ambitious reforms are already underway in higher education to make the curricula more industry-relevant and to tie institution funding to performance indicators. Considerable efforts are also being made to increase the quality of basic education, including reversing a decline in English language proficiency that is affecting one of Malaysia's competitive advantages within the region by upgrading teachers' skills in this area (World Bank, 2013). Raising education quality would boost Malaysia's attractiveness to investors and skilled workers, increasing the value added of domestic businesses and their global value chain participation while easing concerns with talent migration patterns.

Raising the quality of basic education

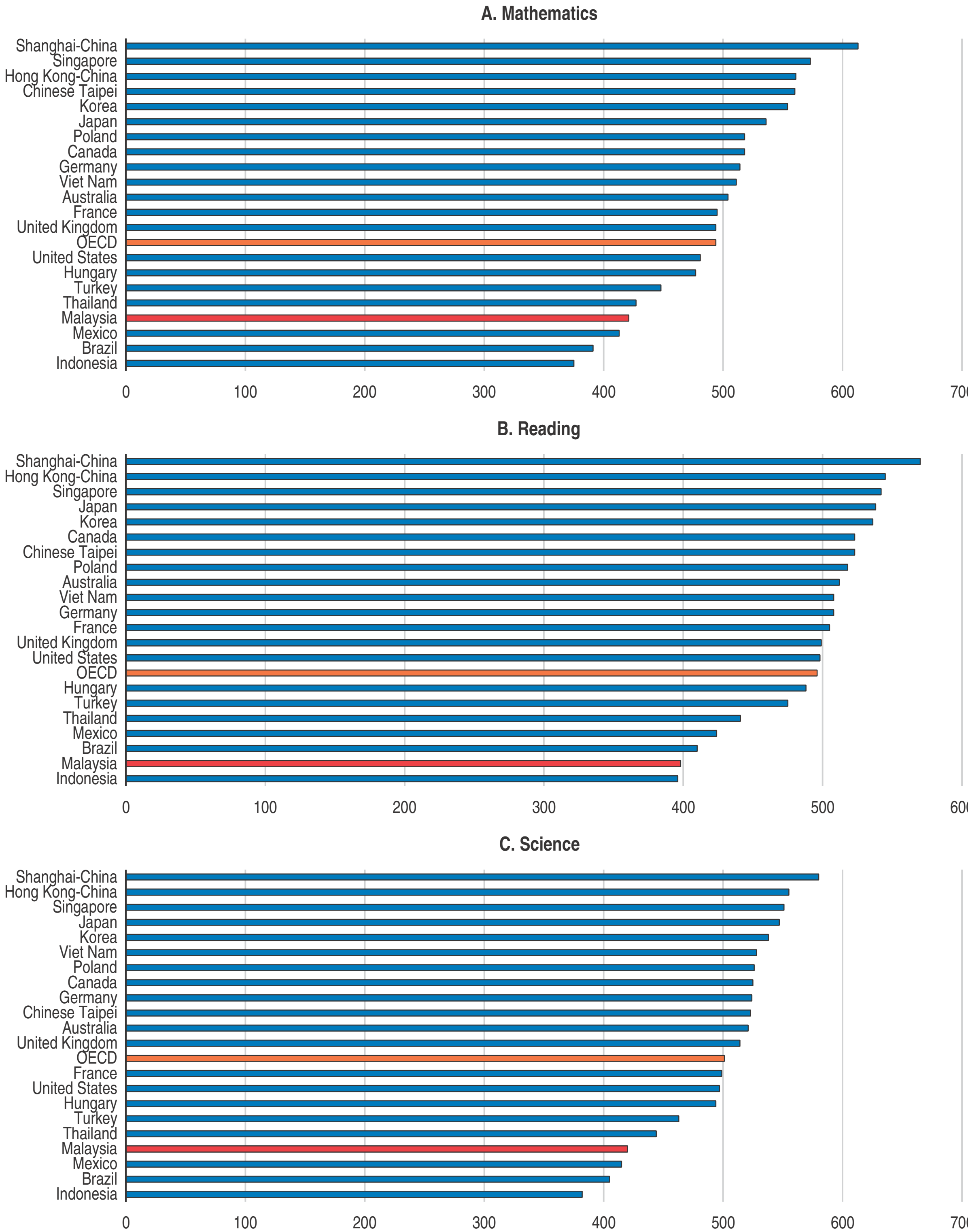
Malaysian students have not performed well on the OECD's benchmark *Programme for International Student Assessment* (PISA) (Figure 1.5). Student scores for mathematics, science and reading were among the lowest of the 65 countries surveyed in 2012, with Malaysia outperformed by less developed regional neighbours such as Viet Nam. Scores for reading and science actually declined between 2009 and 2012, suggesting Malaysia's basic education system was struggling to keep pace with global benchmarks.

The impact of socio-economic differences on student performance is high, with almost 70% of disadvantaged Malaysian students categorised as low performers in mathematics on PISA. This compares to about 30% of advantaged students, with the 40 percentage point differential well above the gaps found in participating Southeast Asian countries and 12 percentage points higher than the OECD average (OECD 2016b, Figure 1.6).

While cognisant of PISA and other international benchmarks, Malaysia introduced its own system of Literacy and Numeracy Screening (LINUS) in 2010 to improve foundational learning for early primary school students. Six-monthly LINUS testing in Bahasa Melayu (Malay language), English and numeracy from first to third grade has helped tailor teaching support to students. According to LINUS results, near-universal basic literacy and numeracy was achieved by the end of third grade. In addition, teaching and national examinations for secondary school students have increasingly incorporated Higher Order Thinking Skills (HOTS), but student outcomes are too recent to make a full assessment.

Figure 1.5. **Student performance on PISA is low**

2012

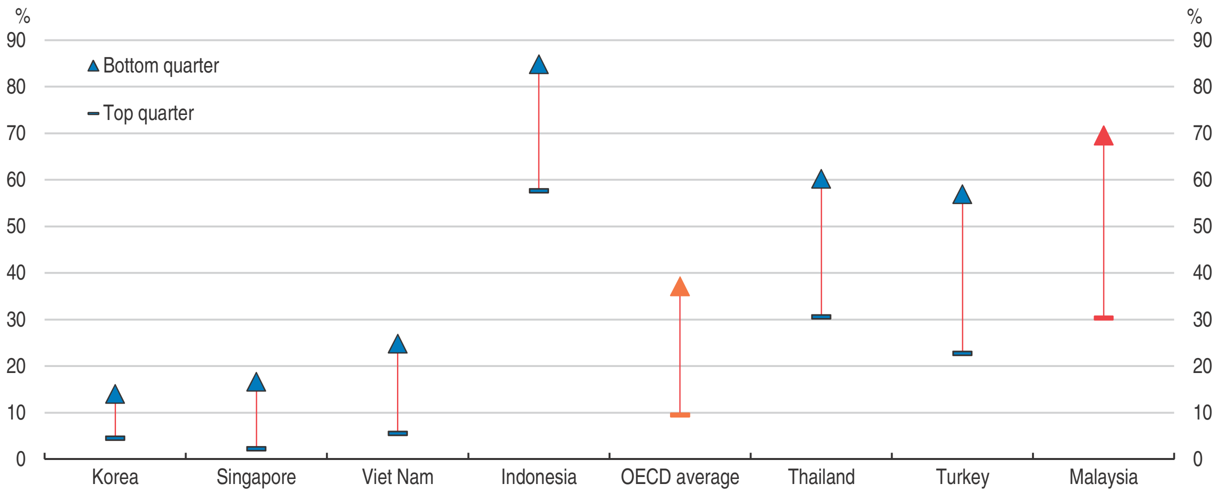


Source: OECD (2016), *PISA: Programme for International Student Assessment*, OECD Education Statistics (database), *http://dx.doi.org/10.1787/data-00365-en*.

StatLink *http://dx.doi.org/10.1787/888933410727*

Figure 1.6. **Socio-economic status affects PISA performance in mathematics**

Percentage of low performers in mathematics by socio-economic quartile



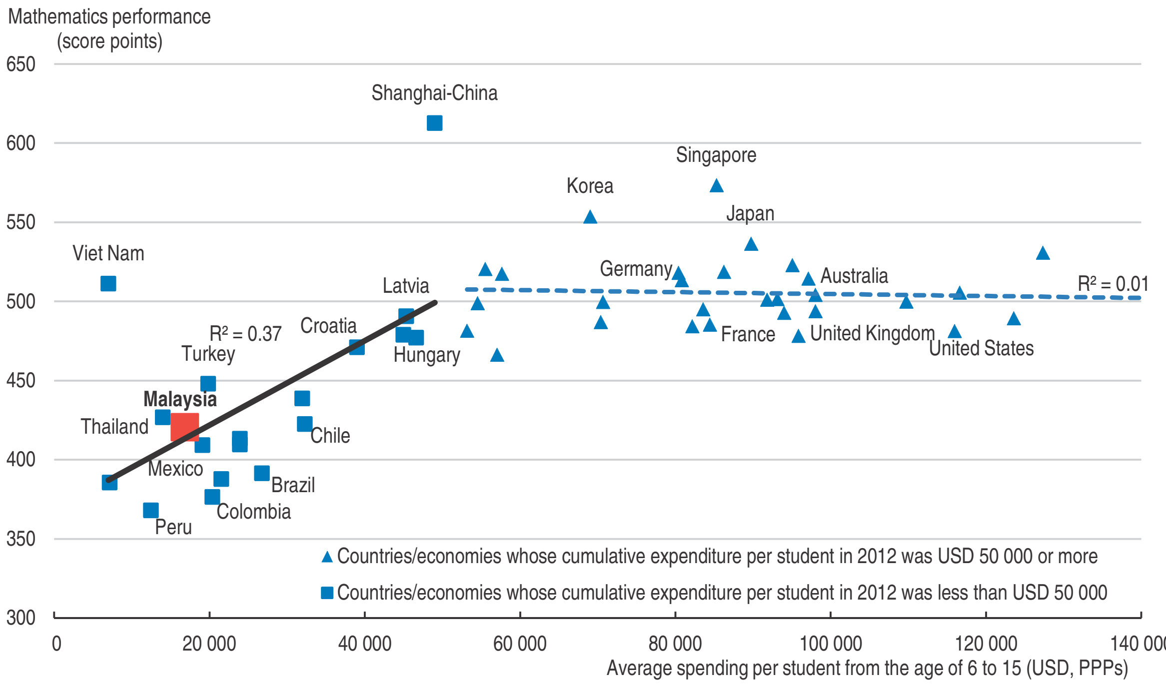
Source: OECD (2016b), *Low-Performing Students: Why They Fall Behind and How to Help Them Succeed*, *http://dx.doi.org/10.1787/9789264250246-en*.

StatLink http://dx.doi.org/10.1787/888933410711

Recent analysis by the OECD and others has identified several factors contributing to the relatively poor education outcomes in Malaysia:

- *Over-emphasis on tertiary education spending relative to primary and secondary education may impact performance* – education and training has commanded around 22% of the national budget in recent years but primary and secondary education spending per student together has been around half that of spending per tertiary student, with PISA results indicating Malaysia first needs to reinforce its basic education system. OECD analysis has found a positive relationship between cumulative education spending up to USD 50 000 per student and PISA scores in mathematics (Figure 1.7).
- *Teachers need more than high salaries to support student outcomes* - despite exceptionally high job satisfaction and self-belief, Malaysian teachers spend comparatively little time on actual teaching (instead dealing with administrative tasks) and report the need for further training in critical information technology skills (*OECD Teaching and Learning International Survey*, 2013). Malaysian teachers are well paid on average relative to their international peers (at almost 2.1 times GDP per capita in 2012, compared to a 1.2 times average for PISA countries), suggesting there are financial incentives available to encourage a career in teaching. That high average salaries have not delivered strong student outcomes may indicate the need for a greater proportion of education funding to be directed to complementary infrastructure, teaching materials and specialised administrative staff.
- *Declining English proficiency of younger teachers is an area of particular concern* – Malaysian teachers are younger on average than in other countries (*OECD Teaching and Learning International Survey,* 2013), which combined with declining rates of English language proficiency in younger generations provides cause for concern (World Bank, 2013). Malaysia's low effective retirement age (discussed further in chapter 2) exacerbates this problem in the short term before professional upskilling of English language teachers takes full effect.

Figure 1.7. **Higher per capita spending on basic education would benefit students**



Source: OECD (2013b), *PISA 2012 Results: What Makes Schools Successful (Volume IV): Resources, Policies and Practices*, *http://dx.doi.org/10.1787/9789264201156-en*.

StatLink http://dx.doi.org/10.1787/888933410950

- *Education is mainly a national government responsibility, which may hamper service delivery* - education systems involve significant complexity and heterogeneity at school and classroom level, which are difficult to manage through centralised control. Malaysia is an outlier among countries participating in the *OECD Teacher and Learning International Survey* in terms of education system centralisation. Schools have minimal decision-making power in regard to hiring and firing teachers, budget formulation and allocation and curriculum choice (*OECD Teaching and Learning International Survey*, 2013).
- *Centralised decision-making inhibits competition, accountability and continuous improvement at school level* – limiting schools' flexibility to respond to parental pressure for improvements, neutralising the competitive pressures and reducing accountability (World Bank, 2013).

Malaysia is responding to many of these concerns through substantial reforms. In addition to changes in the examinations and in benchmarking related to LINUS and HOTS, Malaysia is implementing a revised curriculum based on international benchmarks; a comprehensive framework for teacher evaluation, training and career development; increased use of key performance indicators (KPIs) for teachers and education officials; and investments in digital learning and internet connectivity for schools. Financial support for children of low-income households and programmes to reduce malnutrition have also been expanded in recent years, which aim to reduce the influence of socio-economic disadvantage. For example, the scope of the Supplementary Food Programme, which has long provided recess meals students from poorer families and currently covers around 550 000 students, was to be broadened in 2016.

Raising English language standards has also been a particular focus of recent reforms, in recognition of the need to bolster this critical area of comparative advantage. Reforms seek to improve the standards of English language proficiency through the English Roadmap, to step up professional upskilling of English language teachers under the ProELT programme, to increase international benchmarking of English language proficiency and to elevate English language requirements for graduating students (under the Literacy and Numeracy Screening Programme). The English Enhancement Programme for Secondary Schools established in 2014 provides targeted interventions for "hotspot" schools in need of additional assistance. Also, two additional programmes were implemented in 2016 to increase the usage of English language in schools, the Highly Immersive Programme for creating an immersive English language school environment and the Dual Language Programme for English-language teaching of science and mathematics.

These reforms do target pressing concerns but implementation needs to be monitored and continuously evaluated. Moreover, reforms to increase decentralisation, competition and accountability in the education system are necessary over the long term to maximise incentives for continuous innovation and effective resource utilisation. A strong focus on equity should also be retained, ensuring reforms to improve quality do not exaggerate differences between regions or socioeconomic groups. Implementation of poorly designed KPIs for example, could lead to clustering of good teachers in areas of socio-economic advantage, where students would be expected to perform better.

Graduate employability and labour force skills demand

The OECD Skills Strategy highlights the vital role of education and skills in generating jobs and boosting productivity. Continuous human capital development is critical to increasing Malaysia's competitiveness in attracting investment in higher value-added activities. Overall higher education enrolment increased 70% from 2004 to 2014, with Malaysia third only to Singapore and Thailand among the countries of the Association of South East Asian Nations (ASEAN) in terms of tertiary enrolment rates. Despite producing an increasing number of graduates, higher education in Malaysia is not producing enough job-ready young professionals with the skills required by industry. A 2014 business survey uncovered a serious mismatch between higher education graduate skills and labour force skills demands, with particular deficits in practical training and communication skills (World Bank and TalentCorp, 2014). A mismatch between graduate skills and labour force requirements is contributing to underemployment of graduates in semi-skilled professions and around 25% of graduates are unemployed six months after graduating (MOE, 2015). Regular data collection capturing adult skill levels would help monitor developments in this area, for which Malaysia may wish to consider joining the next round of the OECD Programme for the International Assessment of Adult Competencies.

Improving the quality and appeal of technical and vocational education and training (TVET) in Malaysia has been an ongoing recommendation of the OECD's *Southeast Asian Outlook* series over the past few years, while the *OECD Reviews of Innovation Policy: Malaysia 2016* makes several important recommendations to improve the performance of the higher education sector in producing better science, technology and mathematics graduates (OECD 2013a, 2014a, 2016a, 2016c). Recent reforms have improved collaboration between industry and tertiary educators to align curricula to industry specifications and internationally recognised qualifications, while also increasing opportunities for work placements during and after the completion of studies. Examples include the CEO faculty programme, which involves industry leaders lecturing at public universities, and 2u2i, a new degree programme where students spend two years at university followed by two years in an industry placement. The 11th Malaysia Plan includes the establishment of a single system for coordinating and monitoring TVET adopted by the Malaysian Qualification Agency and the Department of Skills Development. The recent establishment of the Human Capital Council – a high level committee chaired by the Prime Minister – will provide high-level oversight of reforms to address critical human capital needs, including curricula and programme improvements and TVET sector alignment with workforce requirements.

Efforts are also ongoing to increase the appeal of TVET as a pathway to a fulfilling career, both to attract recent school leavers and to improve workforce participation rates through upskilling of unemployed, female and elderly workers, taking inspiration from the experience of countries such as Australia, Austria and Korea that implemented evidence-based and well-targeted skills strategies (OECD, 2013c). The Malaysia Board of Technologists was established in 2015 to assist TVET graduates to become professional technologists and qualified technicians, while also providing an avenue for workforce upskilling through life-long learning opportunities. The role of TalentCorp in providing policy oversight for Malaysia's development and sourcing of demand-driven skills is also increasingly important to reduce labour market skills mismatches (see chapter 2). Moreover, the 1Malaysia Training Scheme (SL1M) has enhanced graduates' employability through collaboration with public and private sector companies in providing soft skills training and industry placement. The scheme targets participants from rural areas, urban poor and low-income households, with participating companies given a double tax deduction incentive on allowances and training expenses. These initiatives are important to increase life-long learning and second-chance opportunities for graduates and adults, to improve their marketable skills.

Increased collaboration with industry will help address skills mismatches in the current labour market but human capital development must not lose sight of longer-term development goals. The focus of collaboration should be improving the quality of tertiary graduates, avoiding an overemphasis on meeting short-term demands that risks reinforcing labour market distortions that impede Malaysia's industrial upgrading and development of skilled jobs (see chapter 2). Ongoing curricula improvements should target the development of future innovators and thought leaders with global employability, sensitive to the changing needs of the Malaysian economy as it continues to develop. This in turn would improve the competitiveness of Malaysia's higher education institutions in attracting talented local and international students, consistent with Malaysia's ambitions to become a regional education hub and to maximise skilled migration (Box 1.1).

Tertiary education reforms must complement further improvements to basic, and in particular secondary education. That higher tertiary sector enrolment rates are not translating into sufficiently qualified graduates not only reflects a need to improve the quality of tertiary education but earlier stages of education, with PISA scores suggesting many secondary school graduates are not sufficiently prepared for tertiary education.

System efficiency – improving student outcomes at current or lower expenditure levels

A high share of government expenditure in Malaysia goes to education, with a commitment to maintain expenditure of at least 16% of the government budget until 2025 (converging on the expenditure floor would represent a significant drop from a share of

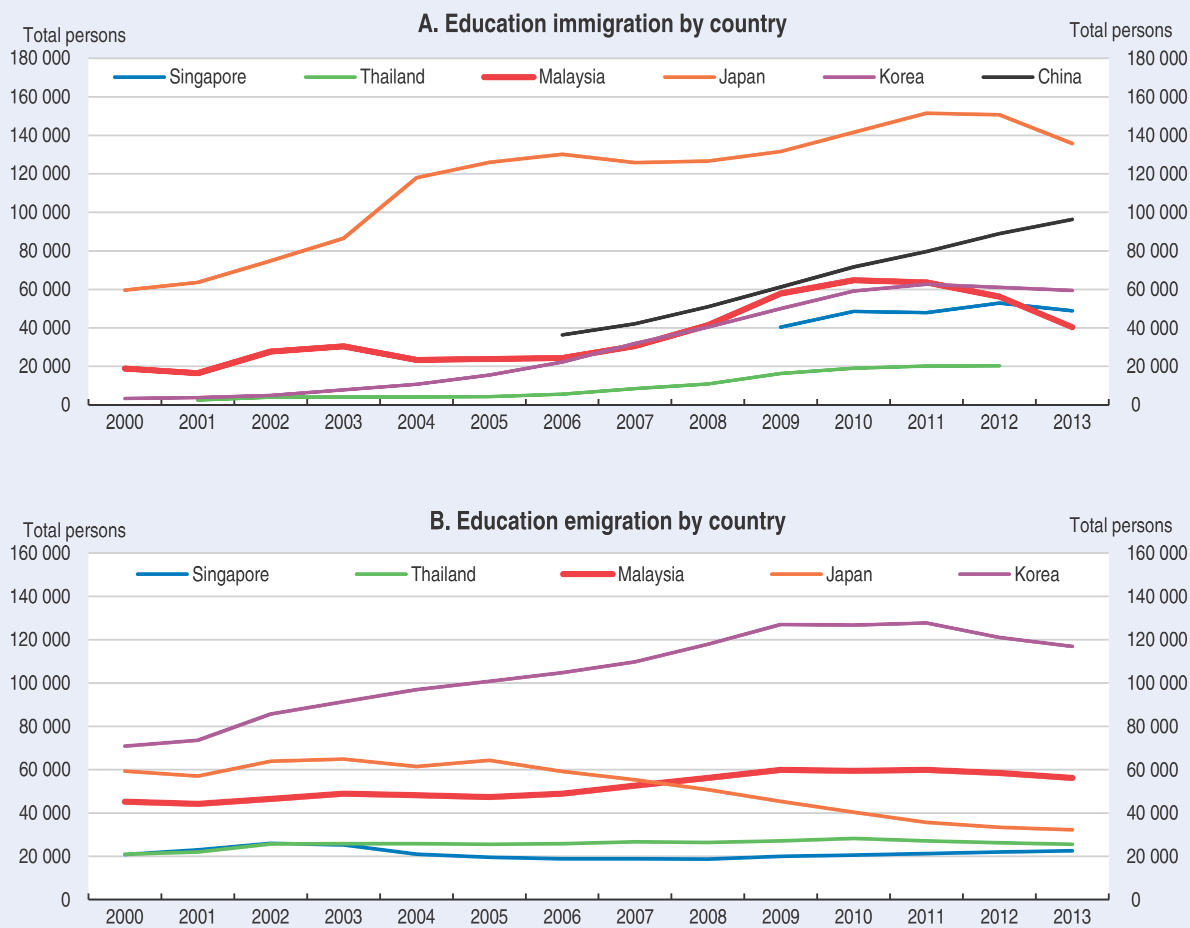
Box 1.1. **Education migration in Malaysia**

Like other middle-income economies, Malaysia seeks to attract or retain highly educated and skilled labour but mainly attracts low-skilled immigrants and sees many educated Malaysians emigrate. Policies towards low-skilled immigration are becoming more and more restrictive as perceptions mount that it puts Malaysian workers at a disadvantage, despite evidence to the contrary (World Bank, 2015). At the same time, a specialised agency (TalentCorp) is tasked to attract skilled workers from overseas, utilising process streamlining and tax incentives to lure expatriate Malaysians back home.

As Malaysia is seeking to become a regional hub for higher education, there are fewer barriers to education immigration than broader immigration. In terms of emigration, Malaysians are encouraged to study overseas in the hope that they will return more educated and skilled. A difficult balance is thus being sought between openness to student migration, increasing restrictions on foreign workers (which detract from post-graduation employment prospects) and providing preferential treatment to returning expatriates above that provided to locals (which may further incentivise skilled locals to leave).

According to the latest UNESCO data, education immigration declined from 2010 to 2013 even as most of its regional competitors experienced growth (Figure 1.8). Education emigration has experienced a similar pattern, although smaller in magnitude. Overall student migration flows (both directions) would have to

Figure 1.8. **Education immigration and emigration flows**



Source: UNESCO (2016), UIS. Stat database.

StatLink http://dx.doi.org/10.1787/888933410961

Box 1.1. **Education migration in Malaysia** *(cont.)*

increase considerably for the country to compete as a regional hub. Indeed, overseas students comprise around 3.3% of Malaysian university enrolments, compared to 24.3% in Australian universities (Australian Education Network, 2016).

Beyond migration data, other evidence suggests that Malaysia's "brain drain" has been exaggerated. International business leaders consider Malaysia the eighth best country in the world in terms of ability to retain talent (World Economic Forum, 2016), while the proportion of patents filed by Malaysians living abroad versus at home is low relative to countries at comparable income levels (The Economist, 2015).

While a more detailed investigation of overall migration policies' effects on education migration is needed to establish concrete links, initial evidence raises questions as to the efficacy of the current approach. To become a regional education hub and converge on developed country education migration patterns, policies recognising the interrelationships between education and labour migration, and the complementarity of education emigration and immigration, warrant further consideration.

around 22% in 2015). However, declining government revenue and the accompanying fiscal consolidation have resulted in significant nominal budget cuts to higher education in particular (for example, the budgets of several public universities were reduced by over 20% in 2016). Efficiency of education expenditure is therefore an increasing priority.

The rationalisation of government expenditure has prompted reforms across the education sector to improve incentives, with the most significant reforms occurring in higher education. Block grants for public higher education institutions are being replaced with performance funding linked to student numbers and research output, while overall funding cuts hope to incentivise these higher education institutions to seek more funding from alternative sources (donations, research collaboration, commercialisation etc.). Institutions will have their funding tied to periodic performance reviews, with increased government monitoring of expenditure efficiency at the institutional level.

Linking block grants to student demand and addressing overreliance on government funding will spur competition among public higher education institutions for funds and improve long-term system sustainability. The scale and complexity of these changes should not be underestimated, however, with realistic expectations on the sequencing of reforms and time required for institutions to adjust particularly necessary in the context of severe short-term reductions in government funding. Malaysia should monitor implementation closely to ensure changes to the funding formula do not compromise necessary improvements to education quality.

The Education Blueprint 2015-25 (Higher Education) also signals reconsideration of student contributions to their own education expenses. Malaysia's higher education funding model is comparable to Scandinavian countries and Turkey, with relatively low fees and high income support (largely student loans, but also various cash payments) minimising student out-of-pocket expenses. While possible reforms to tuition fees remain unclear, reforms to the student loan system will be implemented to make future loan repayments conditional on income. The reforms are aimed at reducing non-compliance with student loan repayments and, more importantly, improving the alignment of student costs with an expected income premium post-graduation. As a further measure to improve expenditure efficiency, Malaysia could use this opportunity to convert cash subsidies and tax deductions for other higher education expenses into additional eligible items under the student loans scheme (thus treating them like tuition fees, as an investment in future earnings to be repaid conditional on future income). Consideration should also be given to how the national identification cards used in the student loans system can assist efforts to formalise the labour force.

Strengthening innovation

As Malaysia seeks to become a high-income country, sustainable long-term growth will depend more and more on the contribution of innovation-driven productivity gains rather than increasing factor inputs. Innovation is central to sustainable growth policies as it drives the competitiveness of industries in international markets and their participation in GVCs, generates improvements in the quality of products and processes (including government) and affects real incomes and social welfare through technology-driven enhancements in living standards.

Particularly since 1996, Malaysia has utilised an increasing range of policy instruments to encourage additional innovation by public institutions (universities and public research institutions) and businesses (focussing on small and medium-sized enterprises – SMEs). However, the proliferation of programmes has resulted in substantial duplication and ineffectiveness and a potential information barrier to accessing government support. Institutional reforms to improve the coherence and coordination of innovation policy will be critical to boosting productivity and Malaysia's global competitiveness.

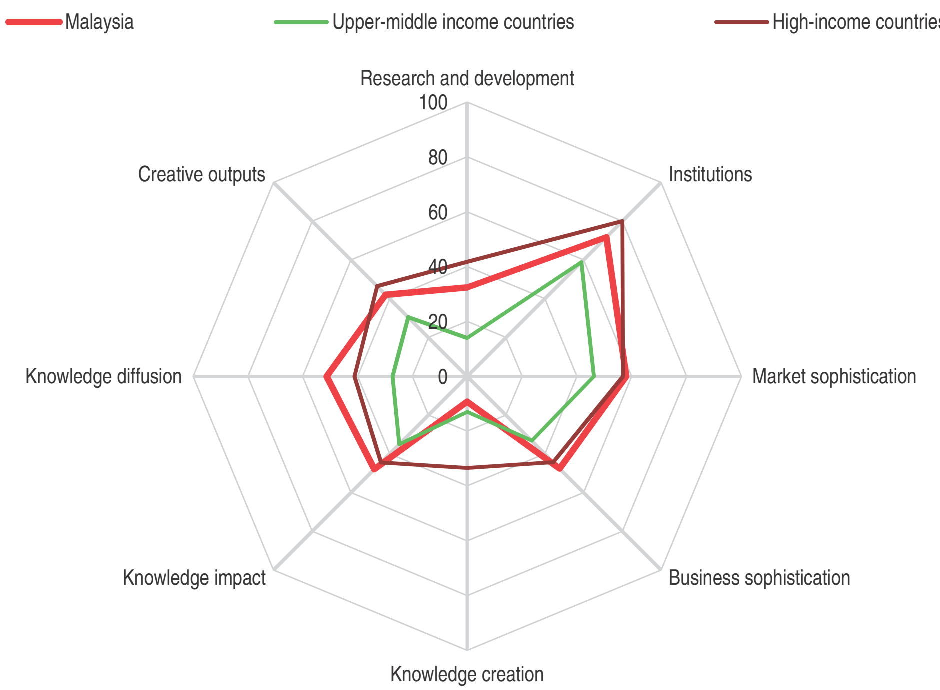
Improved governance arrangements would provide the foundation for the coordination and effective implementation of other innovation system reforms, to foster the innovation capabilities of businesses of all sizes and sectors, strengthen the research capabilities and commercialisation of universities and public research institutes, enhance collaboration between business and researchers, and the development of human capital in areas of core science, technology and innovation (STI) capabilities. Insufficient implementation and a lack of programme evaluation are significantly hindering their effectiveness. The *OECD Reviews of Innovation Policy: Malaysia 2016* provides a comprehensive suite of recommendations in these areas from which the analysis in this section is predominantly drawn (OECD, 2016c).

A simplified innovation governance framework with clear delegation of responsibilities

Malaysia has long recognised the importance of investing in innovation, evidenced by high levels of overall gross (1.1% of GDP) and business (0.7% of GDP) expenditure on research and development (R&D) for its income level. It is a strong innovation performer among upper middle-income countries, particularly on indicators of innovation system inputs (Figure 1.9; Cornell University, INSEAD, and WIPO, 2015; OECD, 2016c). Residents are filing an increasing proportion of patent applications both at home and abroad relative to non-resident applications, indicating some solid returns from efforts to boost home-grown innovation over the past two decades (Figure 1.10).

Innovation plays a role in the strategic planning of many areas of government, with additional agencies and programmes created to address evolving target areas (Figure 1.11). However, commendable initiatives both past and present have been weakened by insufficient coordination, duplication and governance weaknesses that are in urgent need of repair. Establishing a clear, streamlined and coordinated governance structure is essential to improve the orientation and implementation of innovation policy.

Figure 1.9. **Innovation indicators**



Note: Consistent with the source, the categorisation of upper-middle and high-income countries is based on World Bank classification as at July 2013.
Source: Cornell University, INSEAD and WIPO (2015), *The Global Innovation Index 2015: Effective Innovation Policies for Development.*

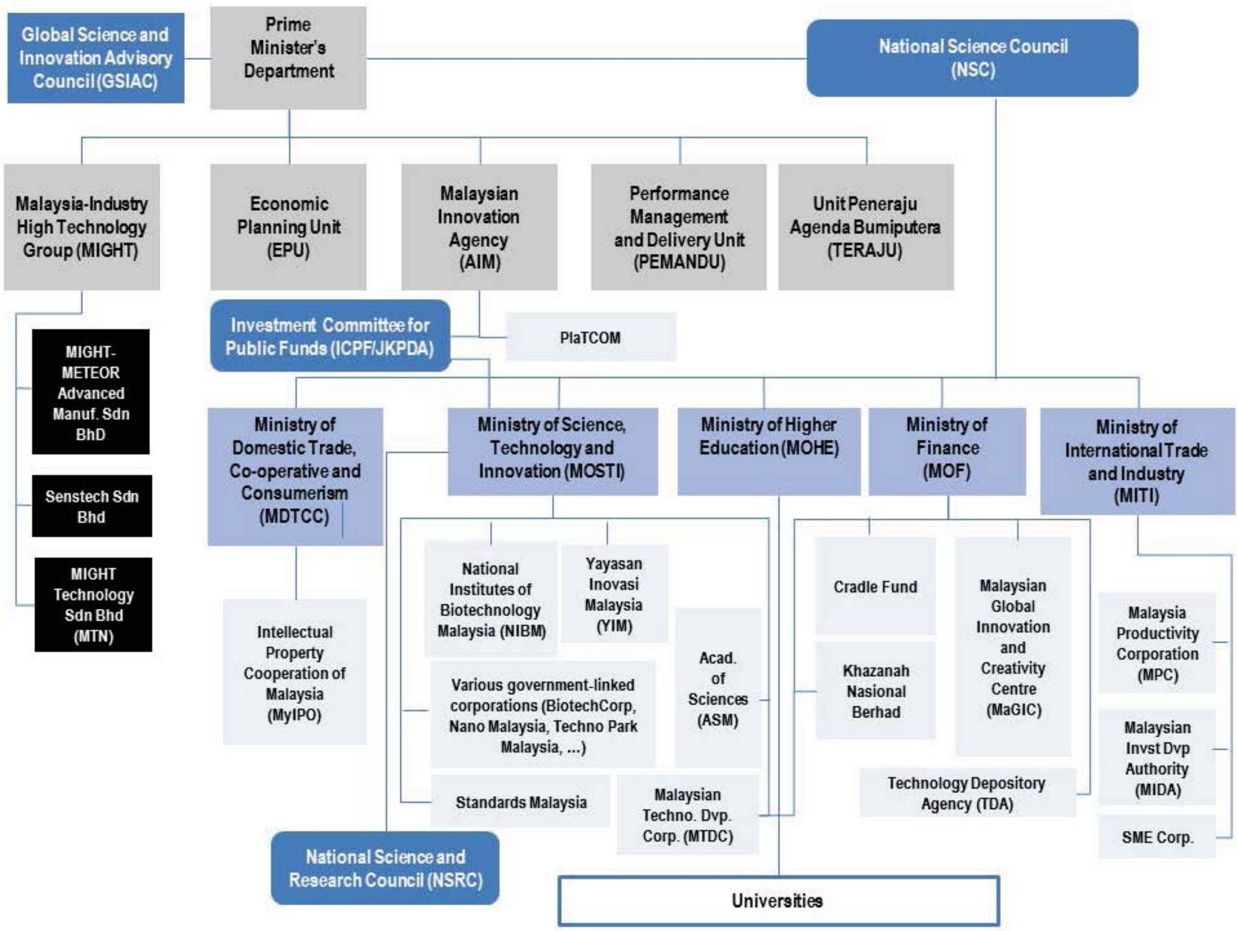
StatLink http://dx.doi.org/10.1787/888933410730

Figure 1.10. **Patent applications by Malaysian residents and non-residents**

Note: A resident application is an application filed with an intellectual property office by an applicant residing in the country in which that office has jurisdiction. A non-resident application is an application filed with a patent office of a given country/jurisdiction by an applicant residing in another country. An application abroad is an application filed by a resident of a given country/jurisdiction with a patent office of another country/jurisdiction.
Source: OECD (2016c), *OECD Reviews of Innovation Policy: Malaysia 2016.*

StatLink http://dx.doi.org/10.1787/888933410745

Figure 1.11. **Innovation governance involves a complex array of actors**



Note: Several other ministries involved in science, technology and innovation related activities are not represented in this figure, such as the Ministry of Energy, Green Technology and Water.
Source: OECD (2016c), *OECD Reviews of Innovation Policy: Malaysia 2016*.

Rationalisation of the innovation governance structure would ensure better coordination across government and with key stakeholders, deliver more stable and accessible funding for innovative activities, improve programme implementation and effectiveness, and provide a single, clearer vision for innovation policy. As a start, the recently established National Science Council (NSC) should be granted the mandate, authority, capabilities and necessary resources to streamline the innovation bureaucracy and programmes. The NSC should be tasked with managing innovation policy orientation with support from key ministries. The establishment of the proposed national Research Management Agency (RMA) with responsibility for the implementation and evaluation of competitive R&D grant schemes would also support the simplification and streamlining of the governance framework.

The challenge for Malaysia's innovation system is not to devise new plans from scratch; rather, it needs to optimise the performance of existing programmes and improve their governance structure. This means putting in place adequate implementation procedures, monitoring and evaluating results in a clear and transparent way and adapting them as necessary. Clarifying the linkages between programmes would further maximise synergies and efficiency in the allocation of resources, while defining their respective roles in the overall innovation agenda.

Strengthening business innovation and harnessing the potential of SMEs

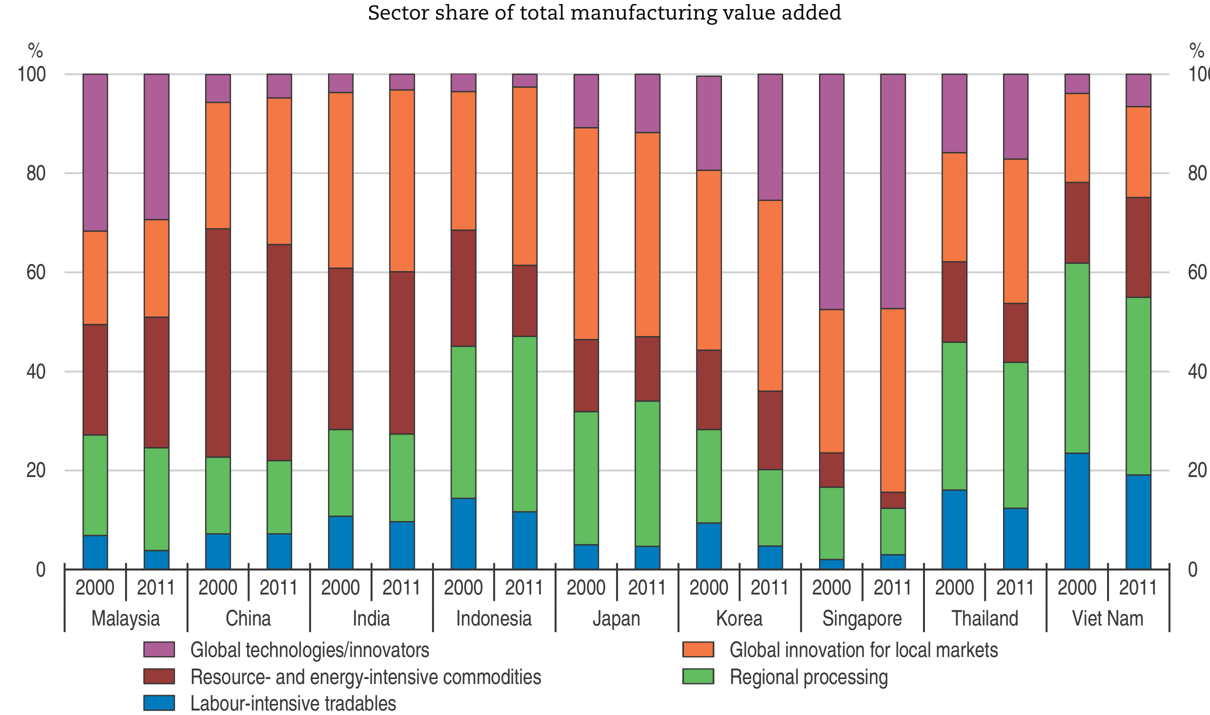
Business enterprises that derive their ongoing competitiveness from innovation, both by cultivating in-house capabilities and through collaboration with experts in universities and research institutions, are fundamental to innovation system performance and the productivity of an economy. Malaysia already compares favourably in some respects, as one of the few developing economies where the business enterprise sector is the main performer and funder of R&D. However, there is a continued need to strengthen the innovation capabilities of Malaysian businesses, especially the smaller firms, which are less prone to undertaking R&D or innovation.

At a time when Malaysian businesses need to be more innovative to counteract rising competition from lower-cost regional competitors, evidence suggests the process of business upgrading has stalled (Figure 1.12). The share of higher-end value-added manufacturing products in total value added has contracted slightly from levels seen in 2000, conceding ground to many of Malaysia's regional competitors. Upgrading in GVCs has been slower in sectors of relative strength (such as E&E) compared to Korea and Chinese Taipei, while the proportion of modern services in Malaysia's exports (while growing) is less than in the Philippines and trails the growth rate in Indonesia.

In addition to the aforementioned governance improvements to increase business access to innovation funding, and increased business-university collaboration (discussed below), more effective arrangements to harness the innovation potential of SMEs, especially in traditional industries, would deliver the largest potential gains. These SMEs often lack the capability to access general government innovation programmes. They

Figure 1.12. **Malaysia's technological upgrading has slowed**

Sector share of total manufacturing value added



Source: OECD (2013a), *Southeast Asian Economic Outlook 2013: With Perspectives on China and India, http://dx.doi.org/10.1787/saeo-2013-en*; Asian Development Bank (2013), *Beyond Factory Asia: Fuelling Growth in a Changing World.*

StatLink http://dx.doi.org/10.1787/888933410757

require proximate, long-term and hands-on support provided by knowledgeable local experts. Malaysia would benefit from emulating the establishment of local innovation centres in countries such as Canada, France or Japan to provide such services which will help minimise the potential for support to become overly interventionist. These centres would build on existing initiatives such as SIRIM-Fraunhofer, Steinbeis, and the Public Private Research Network, which are virtual platforms providing expertise and vouchers for third-party finance but would benefit from dedicated, accessible local expert staff. They could also leverage efforts to increase the availability of innovation finance for SMEs, which includes strengthened engagement with financial institutions, venture capitalists and angel investors and the use of equity crowdfunding platforms. Local innovation centres would thus complement existing initiatives to increase SME commercialisation through the Technology Commercialisation Platform. The government is strengthening its engagement with financial institutions, venture capitalists and angel investors to reduce dependency on government resources to finance SME innovation. Equity crowdfunding platforms have been introduced to increase the range of fundraising options for small firms.

At the opposite end of the size spectrum, Malaysia's large government-linked corporations (GLCs; which represent around 15% of value added and around 30% of stock market capitalisation) are less innovative on average than the private sector. The limited innovation by GLCs is consistent with the experience of other countries (including Singapore), suggesting that GLCs are inherently less innovative than private businesses of equivalent size. The Government could either allow privatisation to drive innovation or utilise its controlling interest in these businesses to reorient their KPIs to include a greater role for innovation and R&D.

More generally, reducing the level of anti-competitive product market regulation has been found by the OECD to be one of the most powerful tools that governments have to raise the level of business R&D spending. Easing anti-competitive product market regulations was also found to raise both the level of patenting and the proportion of firms who are successful innovators and thus innovation overall.

Improving the relevance and recognition of university and public research institute output

Across the tertiary education and research sector, reforms are underway to improve collaboration with industry and increase the business relevance of research and curricula (see the section on education). It will take time for these reforms to deliver improvements to the current dearth of collaboration and increase the attractiveness and practical applicability of university patents to industry. Patent quality is a key concern given the high costs of patenting and renewing intellectual property (within Malaysia and internationally).

Increased commercialisation of research by universities and public research institutes has also become a focal point of efforts to improve its relevance, recognition and financial sustainability. The minimal rate of commercialisation by tertiary institutions does indicate ample room for growth. However, there is no universal benchmark commercialisation rate and large divergence in advanced country experiences.

One focus of reforms so far has been to incentivise commercialisation by reducing overall government funding and linking remaining funding to commercialisation outcomes. While changes to government funding arrangements provide motivation to diversify funding, in the short term it is unlikely to come from commercialisation; this creates risks that universities are unable to finance commercialisation capacity building during this difficult transition. Successful commercialisation depends on sufficiently mature, and often specialised, financial markets willing to provide funding, or financing from governments or universities with limited understanding of markets. Beyond increasing research quality and relevance, a precondition for increased commercialisation is to facilitate the deepening of these markets, often through the establishment of jointly funded public-private partnerships, with investment decision-making solely in private hands. Rather than creating commercialisation rate KPIs for tertiary institutions, it would be more effective to establish commercialisation funds that connect researchers to financial markets, with the government role limited to co-financier and matchmaker.

Simultaneously increasing demands on teaching outcomes (see the section on education) and commercialisation while reducing funding for tertiary institutions increases implementation risks from inadequate prioritisation and sequencing of reforms. The focus on commercialisation should not detract from the traditional contribution of universities to innovation through the development of highly qualified graduates with STI skills.

Further improving the competition framework

Robust competition is an essential driver of productivity and innovation, stimulating businesses to continuously improve their processes, products and services. To be effective, competitive markets require comprehensive competition legislation enforced by an independent competition authority with suitably qualified staff and adequate resources.

Malaysia's competition framework has improved in recent years, with the introduction of the Competition Act 2010 and the creation of the Malaysia Competition Commission (MyCC) in 2011 to enforce the new laws. The Competition Act generally reflects international standards. While acknowledging the relative infancy of the system and difficulties experienced in building institutional capacity, there remain concerns with the competition policy framework related to the independence of the MyCC, the lack of merger control powers and the exemption of certain sectors from the Competition Act.

Enforcement activities are still in their infancy. MyCC is currently undertaking its fourth market review in five years. Few decisions have been made on breaches of the Act, with MyCC having taken four final decisions regarding cartels and yet to conclude any abuse of market dominance cases. The use of fines is low thus far. MyCC needs to intensify its enforcement activities to achieve effective deterrence, increase awareness and build stakeholder confidence in the exercise of its mandate.

Inadequate agency independence and resourcing is affecting regulatory outcomes

Competition agency independence is desirable for a sound and effective competition policy regime (OECD, 2012a). Independence from government and those it regulates increases confidence and trust in the integrity of agency decision-making, while a high level of integrity improves regulatory outcomes (OECD, 2014b). The degree of agency independence also influences legal certainty and the consistent application of rules over time.

MyCC considers itself to be an independent body and maintains institutional separation from other government agencies. However, its independence is not safeguarded by competition legislation and several provisions of these laws indicate a degree of government dependence. Key concerns are:

- *Broad government discretion over the staffing of MyCC* - OECD best practice safeguards the independence of the regulator by ensuring the CEO is appointed by and primarily accountable to the governing body (OECD, 2012b). In Malaysia, the MyCC head and members are appointed by the Prime Minister on the advice of the Minister of Domestic Trade, Co-operatives and Consumerism. In addition "any member of the Commission may, at any time, be revoked by the Prime Minister, if necessary in the interest of the effective and economical performance of the functions of the Commission" (Article 11 of the Competition Act). Such extensive discretionary powers may limit the autonomy of the institution.

  A similar power exists for the Minister to influence the appointment of the CEO "on such terms and conditions as he thinks desirable". This is critical given the CEO's responsibility for the administration and management of MyCC operations and employees.

- *The composition and remuneration of the commissioners* – four of the nine serving commissioners (excluding the chairman) are government representatives, while the remaining five come from business, industry and academia. Commissioners are part-time, receive no remuneration (except for the chairman), but are entitled to allowances determined by the Minister. Together these factors raise potential conflicts of interest. To avoid the latter, OECD best practice suggests stakeholder engagement mechanisms, such as an advisory or consultative committee, are preferable to direct representation on regulatory bodies (OECD, 2012b).

- *Powers of ministerial direction* – the Minister has the power to give MyCC "directions of a general character, consistent with the provisions of the competition laws, and which relate to the performance of MyCC's functions and powers". This power was exercised in March 2015 when the Minister issued a statement providing direction to MyCC for 2015. The Minister is also empowered to direct MyCC to investigate specific suspected infringements of competition law. Such wide-ranging powers allow the Minister to set priorities, influence or directly intervene in MyCC operations, potentially limiting the regulator's independence.

The autonomy and independence of MyCC, along with its capacity to perform its functions, is also limited by the role of the Minister in determining its budget: MyCC's annual budget requires general plus item-by-item approval by the Minister. Furthermore, current funding levels are severely limited, at around eight times less than the competition authority of Indonesia.

Funding restrictions impose both quantity and quality limitations on staffing. MyCC has ten commission members and around 30 technical staff. By comparison, regulators in Thailand and Viet Nam each have 100 staff, Indonesia's has 300, and the newly created Philippines Competition Commission plans to recruit approximately 200. MyCC is keen to develop its capacity to enforce competition law but lacks experienced staff and financial resources, particularly in competition economics with only two economists (GCR, 2016). MyCC has had difficulties in recruiting suitably qualified staff and has struggled to retain the staff it has trained. There have been three CEOs in less than two years, and the last two were high-level officials from the Ministry of Domestic Trade.

Additional functional and financial independence together with increased resourcing are necessary to improve regulatory outcomes and ensure fair competition in Malaysia. If not, competition policy will become increasingly ineffective as “low-hanging” fruit cases are exhausted and anti-competitive conduct becomes more sophisticated.

Exemptions reduce the consistency of competition regulation

Competition in the electricity and piped gas industries, the communications and multimedia sectors, and the aviation sector is governed by separate regulatory bodies. The sectors are governed by the Energy Commission, the Malaysian Communications and Multimedia Commission (MCMC) and the Malaysian Aviation Commission (MAVCOM) respectively under separate sector-based legislation, with those bodies having broad sector-related responsibilities beyond competition policy.

Enforcement by these bodies requires even greater development than for the MyCC. As an example, the MCMC has never brought a single competition case against a telecoms operator, which is remarkable for a sector that in most countries attracts a large share of competition complaints. Additionally, while there is always the potential for inconsistencies in competition policy where different sectors have different regulators, this risk is higher in the communications and media sectors where legal tests and standards differ substantially from the Competition Act provisions. In an effort to improve consistency of approach, MyCC has established a Special Committee of competition regulators. Where the sector regulator does not take action in response to a complaint under its responsibilities, the issue will be raised at the Special Committee. Given the lack of enforcement by the MCMC, this seems to be ineffective. Malaysia should consider harmonising the competition provisions in sector-specific regulation with those of the Competition Act, and ensure adequate resources are being devoted to competition issues in the MCMC, should this sector remain exempt from the Competition Act 2010.

The MAVCOM started operation in March 2016 and has competition powers that go beyond those of the MyCC, as it also has merger control powers (see below). Prior to the transfer of aviation competition regulation to MAVCOM, one of the four infringement decisions of the MyCC was in relation to a market allocation agreement between Malaysia Airways and AirAsia. Considering this history and MAVCOM’s sole responsibility for competition issues in this sector, it is crucial that it has sufficient and specialised means to implement the competition provisions.

In 2013, amendments to the Competition Act exempted the direct upstream commercial activities of the petroleum sector regulated under the 1974 Petroleum Development Act and Regulations. Neither of these Acts contain competition provisions, which effectively exempts the sector from competition law and reiterates the exclusionary rights of the wholly-government-owned oil and gas company, PETRONAS (Teong, 2015). In effect, the legal framework grants PETRONAS status as both a market player and regulator. A clear separation of state ownership functions from regulatory responsibilities in this sector is essential to provide a level playing field and effective competition in the sector (OECD, 2015c).

Enhanced merger review in Malaysia

An effective merger review is an important component of a competition regime, with competition law in almost all countries providing for control of mergers. While mergers can be beneficial to competition, some mergers can result in large costs to consumers and to the economy more generally. Merger control can help prevent consumer harm from transactions that can lead to significant increases in market power, increased prices for consumers and less competitive market structures. It is essential that regulators have the power and skills to effectively investigate and address potential problems, including through merger control powers.

Malaysia is currently the only jurisdiction in ASEAN with a competition law that does not provide for competition merger control. The only exception is contained in the recently introduced Malaysian Aviation Commission Act 2015, which is the first legislative instrument in Malaysia to contain competition merger control provisions. While generally mergers are overseen by the Malaysian Securities Commission, its mandate does not capture competition effects or safeguarding the competitive structures of markets. Malaysia should consider extending merger control to the broader economy through amendments to the Competition Act.

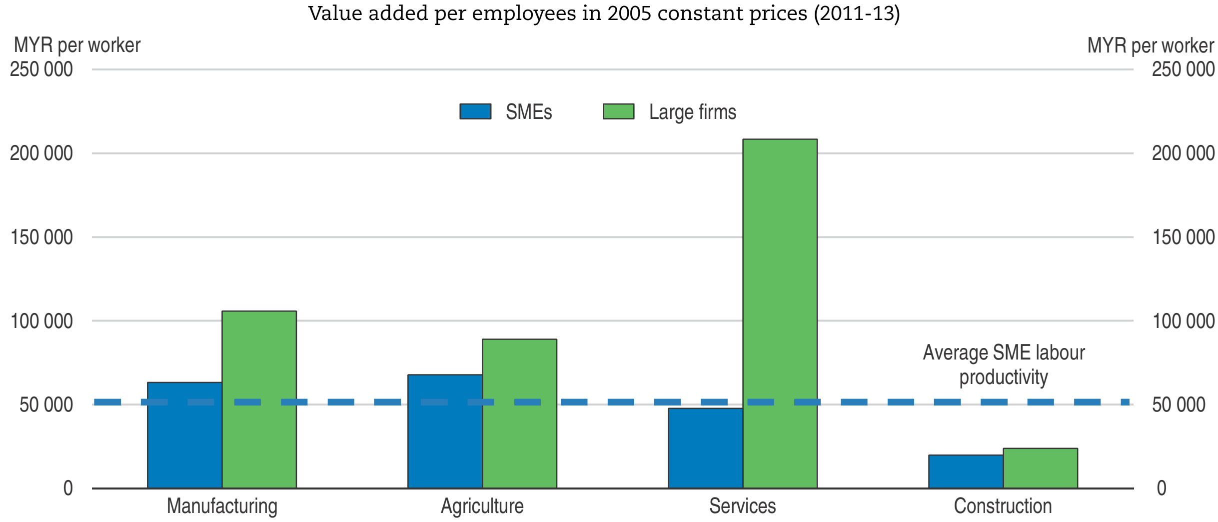
Enhanced regulatory frameworks for SMEs

Good regulatory practice drives productivity gains by effectively allocating resources, promoting fair and robust competition and minimising the compliance burden on business. Cumbersome regulatory requirements are particularly detrimental to SMEs, which have relatively limited resources to deal with red tape. SMEs are critical to competitive and innovative markets and therefore to boosting productivity. In Malaysia, SMEs accounted for 97% of the country's total business establishments in the 2011 economic census, but with a much smaller share of GDP compared to the advanced countries. The 11th Malaysia Plan targets an increase in the SMEs contribution to GDP from 36% in 2015 to 41% in 2020 and in the share of total employment from 59% in 2015 to 62% in 2020.

Like in many OECD countries, labour productivity in SMEs lags behind that of larger firms, particularly in the services sector (Figure 1.13). The relatively large share of SMEs in

Figure 1.13. **SME productivity lags large firms**

Value added per employees in 2005 constant prices (2011-13)



Source: Economic Planning Unit, 11th Malaysia Plan; Department of Statistics, Malaysia, National Accounts Small and Medium Enterprises Year 2013.

StatLink http://dx.doi.org/10.1787/888933410971

subsectors with lower productivity such as wholesale and retail trade, and hotels and restaurants explains some of the productivity gap. However, regulatory barriers and in particular obstacles to entry and exit are also a contributory factors. Where SMEs do outperform larger size firms, they are characterised by competitive advantages in niche, high-brand or high intellectual property content activities, intensive use of ICT, and participation in GVCs (OECD, 2015c).

The SME Masterplan 2012-2020 seeks to promote innovation and productivity-led SME growth through policies encouraging greater innovation and technology adoption, enhancing human capital development, supporting equitable access to finance – in particular providing funds at the start-up stage – and creating a regulatory environment conducive to SME growth (SME Corp, 2012). Greater automation of production processes and business services complemented by increased ICT utilisation is a priority of the Masterplan. Reforms to reduce barriers to firm entry and exit are also mentioned, with action in these areas particularly important to supporting the development of productive SMEs and competitive markets.

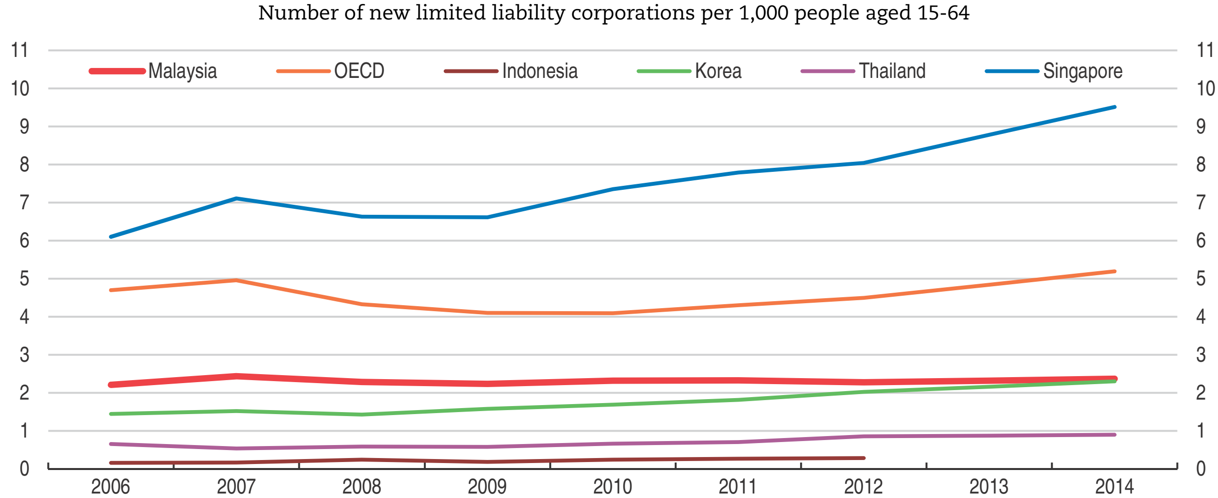
Removing barriers to firm entry

Market turnover is as essential to productivity as technological progress and innovation, enabling the entry of innovative firms and the exit of unproductive and unprofitable businesses (Andrews et al., 2015). In OECD countries, firms less than five years old (regardless of size) accounted for less than a fifth of total non-financial business employment, but generated half of all new jobs over 2010-11. These growth and job creation effects occur largely through innovation, as new firm creation and SME growth increase productivity and bring new or under-utilised resources into use (OECD, 2010, 2013d). In Malaysia, new business entry has stagnated in the past ten years and remains lower than the OECD average and well below neighbouring Singapore (Figure 1.14).

The *ASEAN SME Policy Index* points to the need for several measures that would encourage higher SME entry. These include streamlining firm registration and introducing

Figure 1.14. **New business entry has not increased much**

Number of new limited liability corporations per 1,000 people aged 15-64



Note: 2013 or 2014 data are not available for Indonesia; for the other countries 2013 has been linearly interpolated.
Source: World Bank (2016), World Development Indicators (database).

StatLink http://dx.doi.org/10.1787/888933410767

zero licensing procedures to facilitate entry in services and industry, addressing information failures by increasing support for entrepreneurial education and highlighting the importance of shared learning from entrepreneurial initiatives (ERIA et al., 2014). Services sector liberalisation could also go further, with almost all services sectors still requiring licences to start a business. The criteria for granting licences are often unpublished and subject to significant administrative discretion (EUMCCI, 2015).

A broader examination of barriers to SME competition would also be beneficial to identify unnecessary red tape. *The OECD Competition Assessment Toolkit* provides a methodology for undertaking an assessment of competition barriers, including impediments to the entry and exit of small firms (OECD, 2009).

More accommodative exit policies

Malaysia's overly stringent bankruptcy laws are a major impediment to business regeneration, particularly for SMEs. In the World Bank's *Ease of Doing Business 2016* index, resolving insolvency is the least favourable indicator for Malaysia (Figure 1.15). This reflects an underdeveloped insolvency framework particularly lacking in fair and effective debt reorganisation proceedings for distressed debtors. Creditors can initiate bankruptcy proceedings for debt defaults of as little as MYR 30 000 (around USD 7 500), at which point no possibility of a "second chance" or gradual debt repayment plan exists – the only way to exit bankruptcy proceedings is full debt repayment. Existing laws contain no provision for an automatic discharge from bankruptcy after a set period of time, which is a common feature of insolvency regimes in OECD countries (Adalet McGowan and Andrews, 2016). Therefore, bankruptcy laws in Malaysia provide a strong disincentive to risk-taking and entrepreneurship that disproportionately affects SMEs. Bankruptcy procedures could be further enhanced by introducing a voluntary debt restructuring scheme similar to Chapter 11 bankruptcy laws in the United States. This would facilitate the rescue of viable firms. In addition, bankruptcy processes could be reinforced by introducing out-of-court arbitration procedures to facilitate company restructuring. Automatic discharge of debts after a set period of time should also be introduced.

Figure 1.15. **Resolving insolvency has the largest distance to the frontier**

Note: The gap to frontier is the difference between Malaysia's score and the score of best performing country (=100).
Source: World Bank (2016), Doing Business (database).

StatLink http://dx.doi.org/10.1787/888933410980

Malaysia is considering bankruptcy law reforms that enable a more flexible debt repayment plan, increasing the debt threshold to bankruptcy to MYR 100 000 (around USD25 000) and introducing a voluntary arrangement provision based on practices in the United Kingdom and United States. While this is a good first step, "second chance" provisions remain weak, especially for businesses. Indeed, automatic discharge provisions remain absent, while the increased debt threshold only applies to individual borrowers, not to firms. As such, more comprehensive insolvency reforms are essential to encourage more risk-taking and innovative behaviour from SMEs.

Trade, investment and furthering regional integration

Trade and investment have made essential contributions to Malaysia's development and continue to play a major role in the Malaysian economy. Malaysia's trade-to-GDP ratio of around 134% in 2015 is around 2.3 times the OECD average, while net inflows of FDI are around five times the OECD average as a share of GDP. The integration of businesses into GVCs provides them with exposure to international best practice, frontier technology and competition, with further integration an important driver of future productivity. The challenging external environment requires the country to enhance its competitiveness in attracting global capital, with advancement up the value chain critical to providing skilled employment opportunities.

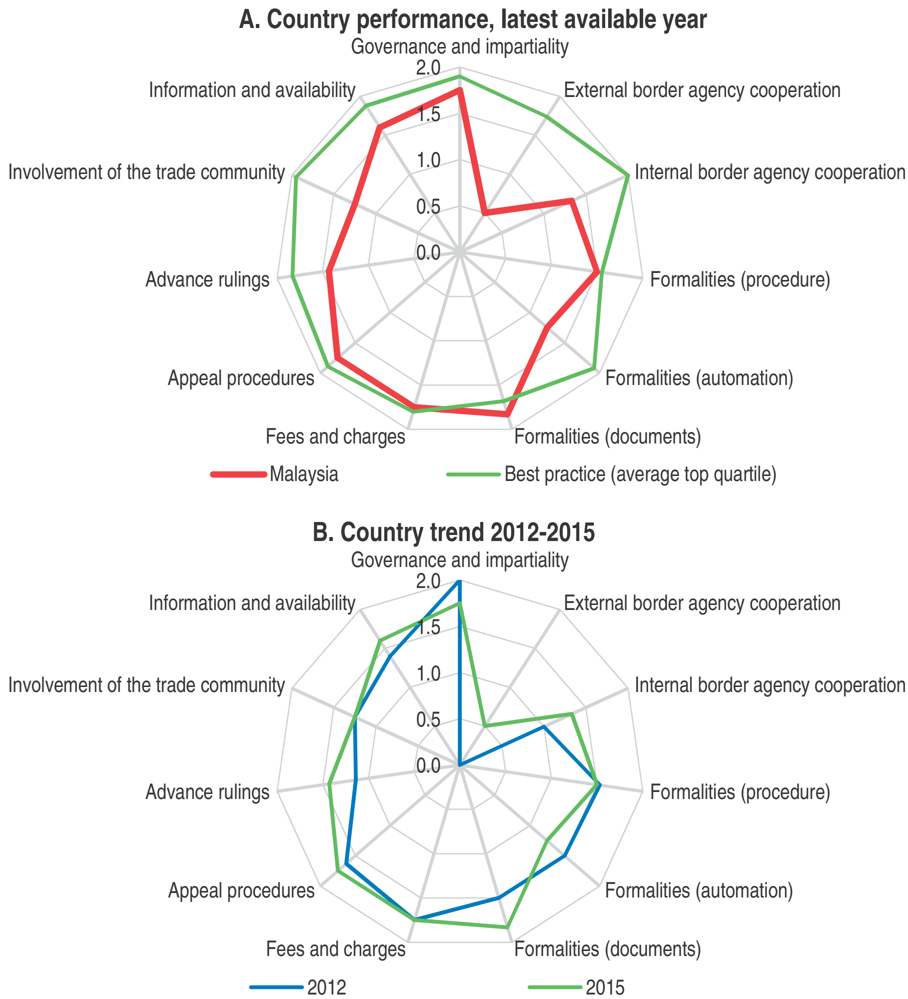
Building on solid trade fundamentals

The economy benefits from its relative openness to trade and its strong business environment, as demonstrated by it being ranked 18th in the World Bank's *Ease of Doing Business 2016* index. Malaysia rates as having above-average openness on the International Chamber of Commerce's *Open Markets Index*, with its specific ratings on trade openness gradually improving in recent years (ICC, 2015). Import tariffs have been gradually reduced through unilateral reductions and trade agreement concessions. The country had a simple average tariff rate of 5.6% in 2013, while actual rates were slightly higher for industrial products and lower for agriculture (WTO, 2014). Further tariff cuts and the elimination of certain non-tariff barriers will come about with the implementation of the Trans-Pacific Partnership Agreement (TPPA) and may result from Malaysia's participation in the Regional Comprehensive Economic Partnership (RCEP) and other trade agreement negotiations if concluded.

The OECD's trade facilitation indicators show that Malaysia performs at or close to best practice in several aspects relating to non-tariff barriers (Figure 1.16). Remaining barriers equate to a potential trade cost of 16.1%, which is slightly better than the ASEAN average (16.9%) but below the average for Asia-Pacific Economic Cooperation (APEC) member economies (14.0%) (OECD, 2015e).

The areas in which Malaysia would gain most from improvements are the automation of formalities and increased availability and accessibility of information through greater use of information and communications technology, the reversal of negative developments in governance and impartiality, and enhanced cooperation with neighbouring and third country border agencies. Many of these issues are focus areas for ongoing work within regional forums such as ASEAN and APEC, where mutually agreed regional improvements will benefit Malaysia over and above unilateral reform.

Figure 1.16. **Trade facilitation indicators frontier**



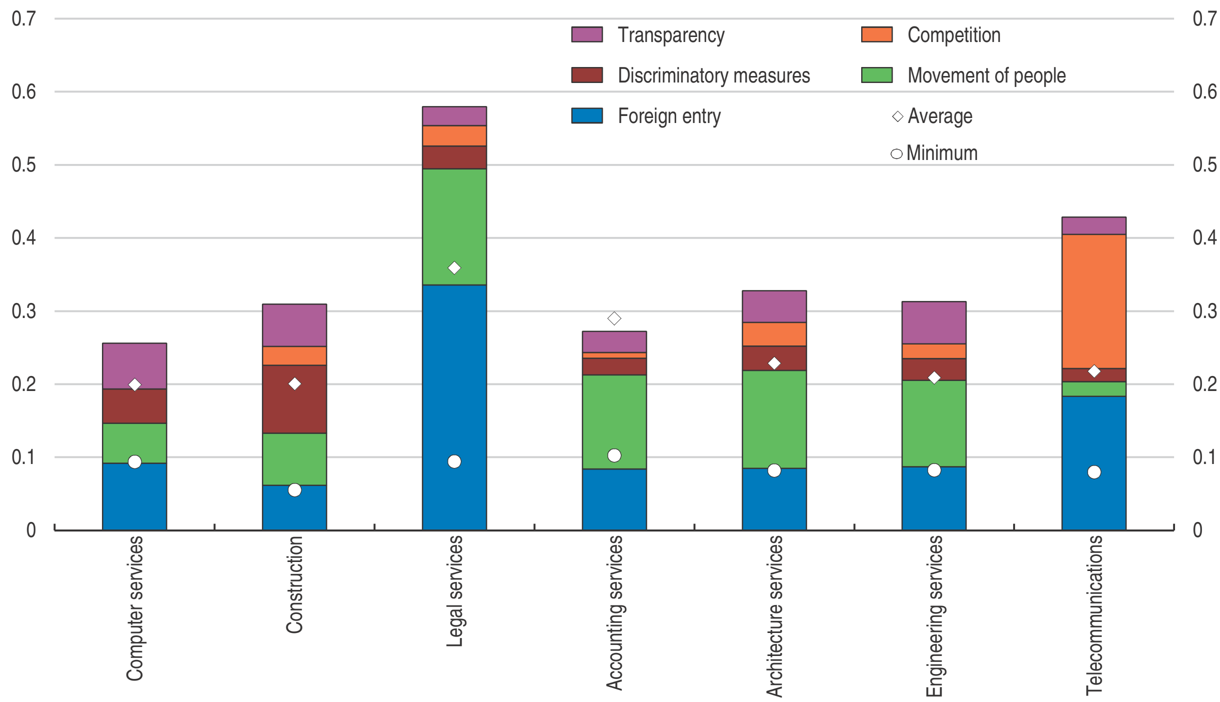
Note: The gap to frontier is the difference between Malaysia's score and the score of best performing country (=2.0).

Source: OECD (2016), Trade facilitation indicators (database), *www.oecd.org/tad/facilitation/indicators.htm.*

StatLink http://dx.doi.org/10.1787/888933410993

The OECD Services Trade Restrictiveness Index (STRI), computed for the first time here, shows that Malaysia has more restrictive regulations than the sample average in six out of the seven sectors covered (Figure 1.17). This is partly due to regulations applying to all sectors of the economy. They include a requirement of local incorporation to operate in Malaysia, residency requirements for board members and restrictions on land acquisition by foreigners. Preferences are given to local suppliers in public procurement markets, and there are time limits for entry of temporary services providers (12 months for contractual and independent services suppliers, and 24 months for intra-corporate transferees). The services with higher STRI scores are those typically subject to a significant level of restrictiveness in many countries, including legal services and telecommunications. Though Malaysia has liberalised its international law market, domestic law remains reserved to national suppliers. In telecommunications, foreign equity participation is limited to 70% and Malaysia also requires pre-approval of investment. Although the regulatory framework for the sector is quite advanced, some pro-competitive measures (e.g. a secondary spectrum trading scheme and number portability for fixed lines) are still lacking.

Figure 1.17. **The STRI for selected sectors**



Note: The STRI indices take values between zero and one, one being the most restrictive. They are calculated on the basis of the STRI regulatory database which contains information on regulation for the 34 OECD Members, Brazil, China, Colombia, India, Indonesia, Latvia, Malaysia, Russia and South Africa. The STRI database records measures on a Most Favoured Nations basis. Preferential trade agreements are not taken into account.

Source: OECD (2016), Services Trade Restrictiveness Index.

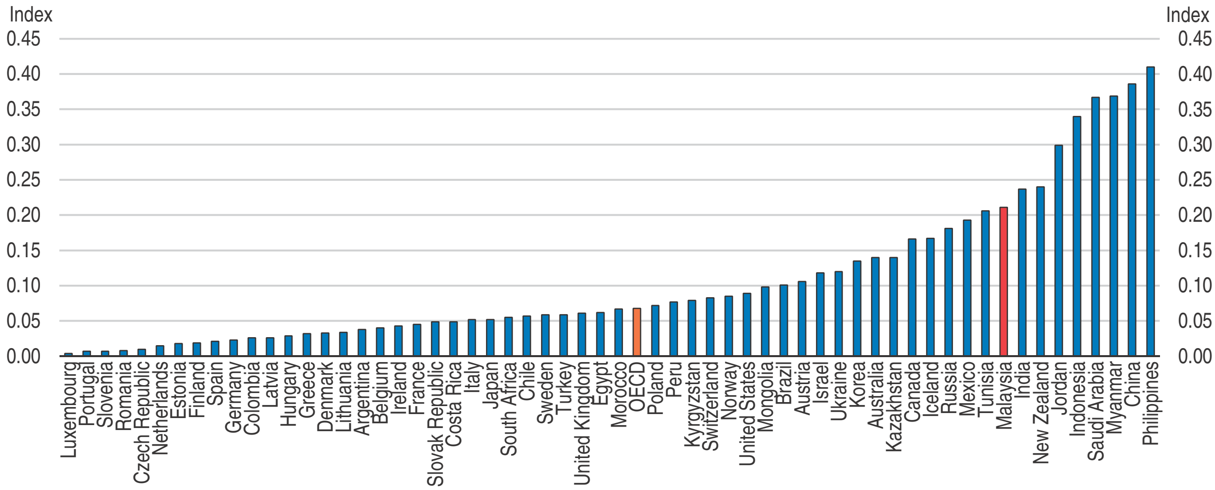
StatLink http://dx.doi.org/10.1787/888933410774

Regaining momentum for liberalising services investment

Malaysia has progressively eased foreign ownership restrictions since 2009, and its share of global FDI inflows has increased to the highest levels since the Asian Financial Crisis (though remaining well below pre-crisis levels). Wholly-foreign-owned businesses have recently been allowed to operate in service sectors such as education, health, tourism and professional services. While among the most open countries in East Asia (in terms of statutory restrictions on FDI), Malaysia remains among the most restrictive countries surveyed by the OECD's *FDI Restrictiveness Index* (Figure 1.18), with liberalisation not having continued as hoped following the *2013 OECD Investment Policy Review* (OECD, 2013e). The review identified continuing restrictions in key service sectors as impediments to investment, with concerns magnified by fragmented and burdensome regulatory procedures such as licencing.

As the services sector accounts for over half of Malaysia's economy, further liberalisation will be increasingly important to maintaining high levels of FDI. Further foreign investment could also deliver additional expertise and international networks to support Malaysian businesses to expand globally, while also improving knowledge of investment opportunities in emerging industries for which local expertise may be insufficient. Liberalisation would also boost competition and productivity in these industries.

Figure 1.18. **FDI restrictiveness index 2015**



Source: OECD (2016), *OECD FDI Regulatory Restrictiveness Index* (Edition 2015), OECD International Direct Investment Statistics (database), *http://dx.doi.org/10.1787/671274a5-en*.

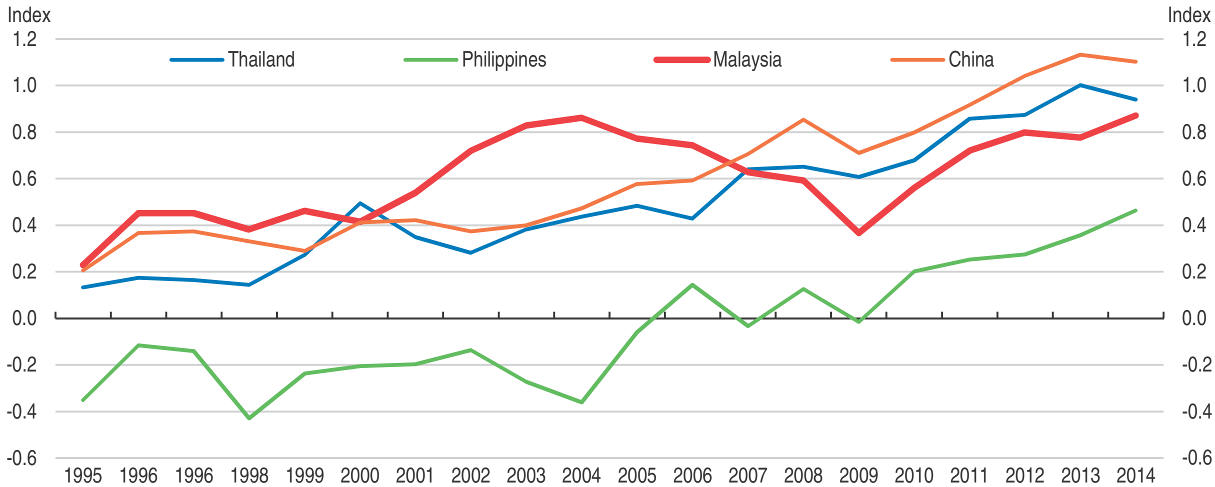
StatLink http://dx.doi.org/10.1787/888933411008

Increased participation in global value chains

GVCs are increasingly central to trade and investment patterns, particularly in an ever-more integrated Asia-Pacific region. Participation in GVCs provides Malaysian businesses, especially in E&E – Malaysia's largest export sector accounting for 36% of gross exports in 2015 - with opportunities to increase their productivity through production economies of scale, increased efficiency and sophistication through specialisation, and access to advanced business practices and technology. While the measurement of GVC participation remains difficult, available evidence suggests Malaysia's contribution has been relatively strong, consistent with its aforementioned openness to trade and ease of doing business. *The OECD-WTO GVC participation index* rates Malaysia's participation well above both developed and developing country averages, though it appears overly concentrated in "backward linkages" (where imports of intermediate products are used in exports) typically associated with lower value added contributions (WTO, 2016). More recent estimates suggest Malaysia's participation was as high as 2.7% of global and 5.2% of Asia's GVC trade between 2009 and 2013 (Arudchelvan and Wignaraja, 2015), making it the fourth most active Asian economy in GVC trade behind China, Japan and Korea.

As Malaysia moves towards high-income status, its participation in GVCs needs to become increasingly sophisticated to claim a higher share of value added and maintain competitiveness as labour costs rise. On some indicators, improvements in absolute performance have been slow relative to its regional competitors, creating risks to Malaysia's future competitiveness. For example, Malaysia's Economic Complexity Indicator dropped sharply in the second half of the 2000s, when the E&E sector suffered from the sharp fall in demand for personal computers, falling behind China and Thailand in absolute terms while losing ground to the Philippines (Figure 1.19) (Centre for International Development, 2016). Malaysia's ranking has recovered since 2010, as firms adjusted to supplying components for mobile devices, but further gains are needed to recover the ground lost to its competitors. Similarly, as noted above, Malaysia's share of high value-added manufacturing in GVCs has contracted slightly since 2000.

Figure 1.19. **Malaysia has lost some ground with respect to export diversity and complexity against regional GVC competitors**



Note: The Economic Complexity Indicator ranks how diversified and complex a country's export basket is. A country is considered "complex" if it exports a large number of highly complex products, as represented by a higher indicator value.
Source: Centre for International Development (2016), *Atlas of Economic Complexity*.

StatLink http://dx.doi.org/10.1787/888933411012

Continuing to enhance regional integration

Malaysia is geographically and geopolitically well situated to benefit from ongoing efforts to increase the regional connectivity of trade, investment, people and markets. Its proximity to the global centre of developing economy growth, particularly that of China and India, and its membership of ASEAN, APEC and their associated institutions present Malaysia with a wealth of regional expansion opportunities. Participation in regional fora and trade agreement negotiations can also be an important driver of structural reform.

The launch of the ASEAN Economic Community (AEC) at the end of 2015 marked a milestone for the regional grouping, which pursues regional integration through mutually agreed liberalisation and cooperation. It has made substantial progress in areas including the almost complete elimination of tariffs between members (96% of tariff lines have been eliminated across the region, including 99.2% of tariffs from the six most developed economies including Malaysia), harmonisation of trade-related technical standards, mutual recognition and movement of skilled labour, and the collective negotiation of trade and investment agreements (ASEAN, 2015a). However, key areas of particular relevance to Malaysia remain outside of plans for further integration (ASEAN, 2015b). For example, Malaysia could push for region-wide liberalisation of investment in services, a regional framework for investment attraction to reduce the provision of costly investment incentives, and enhanced cooperation on unskilled labour migration.

The agenda of the broader APEC grouping also presents complementarities to Malaysia's trade and investment policy objectives. APEC facilitates high-level dialogue between leaders and senior officials from economies with diverse development levels and experiences, enhancing policy outcomes through shared learnings and mutually agreed aspirational targets. APEC's recent focus on the inclusiveness of growth and development shares many complementarities to the issues of interest to Malaysia (APEC, 2016). As discussed below, for Malaysia as a party to both the TPPA and RCEP, the APEC aspiration of a Free Trade Area of the Asia Pacific (FTAAP) is expected to advance the regional economic integration agenda.

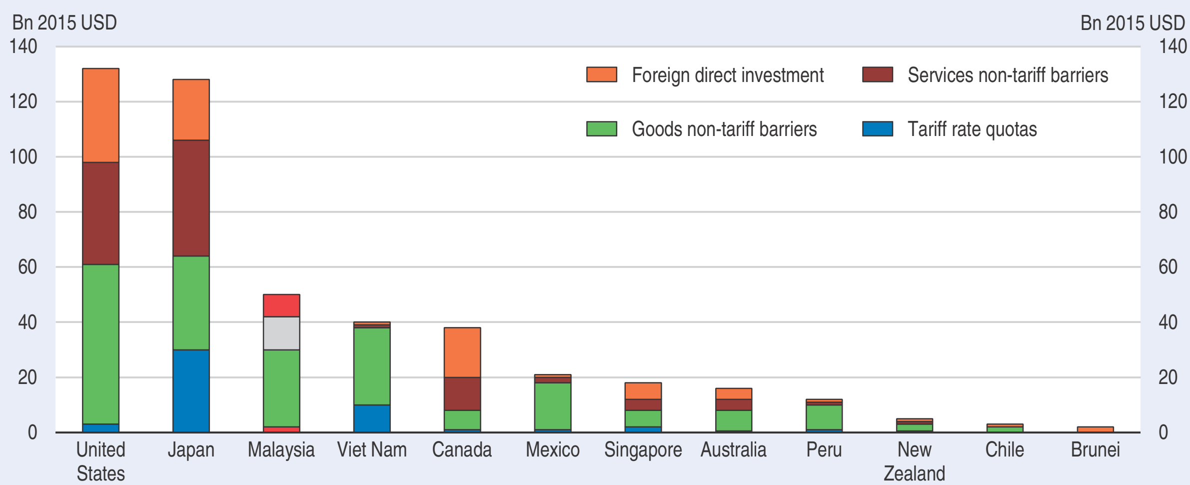
Box 1.2. **Benefits to Malaysia of regional trade agreements**

Like many other countries, Malaysia supports multilateral trade liberalisation through the World Trade Organization but is taking the pragmatic approach of also negotiating regional and bilateral agreements. The free trade area under the AEC and the recently concluded (but not yet implemented) TPPA are the most significant to date, respectively representing 27% and 38% of Malaysia's merchandise trade in 2015. The future conclusion of RCEP (62%) and/or the FTAAP (77%) would cover a larger proportion of Malaysia's trade.

The TPPA is a comprehensive agreement capturing both traditional facets of economic integration (such as the removal of trade and investment barriers) and issues such as the digital economy, government procurement, labour rights, state-owned enterprises, intellectual property rights and the environment. Malaysia's involvement is predicted to provide substantial economic benefits over the medium term, with a projected 7.6% increase on baseline real income by 2030 (Petri and Plummer, 2016). Reflecting Malaysia's already low tariff schedule, benefits will mostly come from the removal of non-tariff barriers and additional FDI (Figure 1.20).

Figure 1.20. **The Trans-Pacific Partnership Agreement will boost Malaysian real incomes mainly through behind-the-border liberalisation**

Real income effect in 2030, billion USD, 2015 constant prices



Source: Petri and Plummer (2016), "The economic effects of the Trans-Pacific Partnership: New estimates", *Peterson Institute of International Economics working paper series* 16-2.

StatLink http://dx.doi.org/10.1787/888933410781

The TPPA will require Malaysia to adhere to stricter standards in important areas such as association of labour, government procurement, state-owned entreprises (SOEs) and competition policy. It is hoped that TPPA implementation will provide impetus for structural reforms that go beyond minimum requirements, in particular to remove competition barriers in sectors where SOEs remain dominant. This would amplify the growth and productivity benefits of the TPPA for Malaysia. As the TPPA membership does not include Malaysia's main trading partner (China) or several ASEAN countries, Malaysia would gain further by making progress with similar liberalisation vis-à-vis non-members (either unilaterally or through further agreements such as RCEP).

Boosting public sector productivity

A productive public sector is key for economic progress. It enables markets to efficiently provide goods and services, and minimises the diversion of resources away from less productive uses. The efficient delivery of public services, including education, healthcare, social protection and basic infrastructure, is fundamental in promoting inclusive growth.

Malaysia's 1.6 million employee public sector workforce represented a 16.1% share of total employment in 2014, higher than many of its neighbours and close to the OECD average (Figure 1.21A). In many respects, Malaysia does have a productive public sector. It outperforms advanced economy averages across the spectrum of the World Bank's Worldwide Governance Indicators and the government efficiency component of the World Economic Forum's *Global Competitiveness Report* (Figure 1.21B, C). Malaysia's relatively strong performance reflects ongoing reforms under the Government Transformation Programme (GTP), launched in 2010, in conjunction with the 10th Malaysia Plan (2011-2015) and the Economic Transformation Programme (ETP). The plans prioritised the streamlining of regulatory frameworks, reduced business licensing requirements and promoted information technology use by government agencies (Box 1.3). The Malaysia Productivity Corporation (MPC) was put in place as the key-coordinator agency across the government for improving regulatory governance. Its achievements include the Modernising Business Licensing (MBL) initiative, the Reducing Unnecessary Regulatory Burden initiative, implementation of a regulatory impact assessment (RIA) system that assesses the positive and negative effects of proposed regulations at an early stage of policy-making, and guidelines on effective public consultation. As ratified in the National Policy on Development and Implementation of Regulation and a Guideline on Public Consultation Procedures, RIA and public consultation are becoming increasingly embedded into the policy-making process to improve the quality of evidence-based policy making (OECD, 2015g).

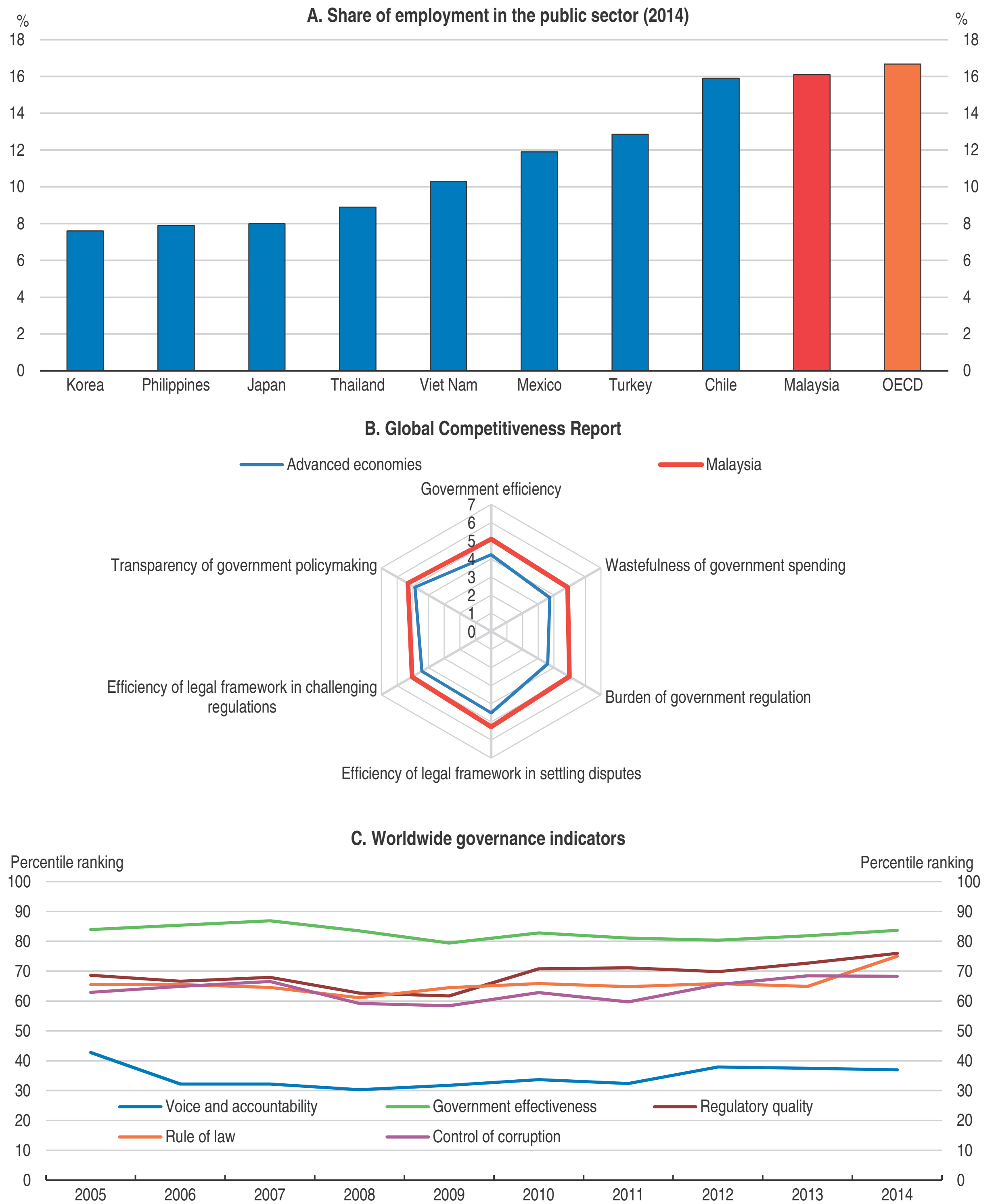
Even so, Malaysia's public sector can be further improved, particularly by improving public service delivery, rationalising the roles and functions of ministries, empowering state and local authorities, reviewing programme and performance evaluations, enhancing public procurement, and better incentivising officials. Beyond the MPC, multiple institutions and actors are working towards improving the efficiency and effectiveness of the public sector at the federal, state and local level. Connecting and appropriately sequencing the reforms in these areas would increase the productivity of the public sector in particular and the Malaysian economy in general.

Empowering agencies by aligning and streamlining responsibilities

Malaysia's federal government agencies are typically required to formulate, implement and monitor government policies to meet the needs of stakeholders. The remit and duties of the agencies have evolved over time with those needs, sometimes resulting in fragmentation and duplication of responsibilities and resources. This has impeded the efficient and effective delivery of public services.

Successful national precedents exist for improving policy coordination and delivery where multiple agencies share responsibilities or interests. These include the Special Task Force to Facilitate Business (PEMUDAH), a joint effort between the government and the private sector established under the Prime Minister's Department in 2007 to improve government-business collaboration in reducing the regulatory costs for business.

Figure 1.21. **Malaysia's public sector is large but its governance compares well internationally**



1. The share of public sector employment in panel A includes all government sector employment plus employees of publicly-owned resident enterprises and companies, operating at central, state (or regional) and local levels of government.
2. Panel B scales ranges from 0 (lowest performer) to 7 (best performer).
3. Panel C is percentile rankings among 235 countries/territories, with 100 representing the top performing country.

Source: ILO, ILOSTAT (database); World Economic Forum, *Global Competitiveness Report 2015-2016*; World Bank, Worldwide Governance Indicators (database).

StatLink http://dx.doi.org/10.1787/888933410798

PEMUDAH's achievements have been reflected in Malaysia's improved rankings in the World Bank's *Doing Business*, with working groups established to improve individual indicators (OECD, 2015g). At an operational level, Malaysia has established one-stop agencies for SMEs (SMECorp Malaysia) and labour market skills matching (the TalentCorp) (OECD, 2013e, 2016a).

Notwithstanding these successful cases, there remains ample scope to improve public service delivery by rationalising duplicative agency efforts and clarifying agency responsibilities. While the aforementioned successful examples have improved service delivery, they have added to the crowded agency structure. Some 44 agencies and 10 ministries are involved in initiatives to support STI activities, with 14 agencies under eight ministries providing grants to support R&D alone (OECD, 2016c). A whole-of-government strategy would help address the challenges in institutional arrangements (OECD, 2015g). Careful deliberation and clear identification of the roles and responsibilities for these new agencies is key to ensuring the avoidance of duplicative roles and to further enhancing the institutional landscape, while avoiding unnecessary expansion of government size. As noted earlier, the proposal in this case is to establish the National Science Council (NSC) as the lead institution in streamlining the innovation bureaucracy and programmes. Thus, to ensure effective rationalisation of these agencies, commitments by the highest levels of government providing strategic prioritisation will help.

Malaysia has a centralised governance structure, with federal government delivery of a broader range of public services than other federations. Empowerment of state and local government agencies through decentralisation, in tandem with measures strengthening governance and enhancing transparency would improve policy adaptation to local conditions and increase the accountability of local government.

Improvement of performance evaluation is a precondition for identifying progress in public sector productivity. The GTP introduced clear and quantifiable KPIs for ministers and the heads of government agencies to evaluate performance against National Key Result Areas and Ministerial Key Result Areas. The KPIs focus on quantifiable outcomes that improve the evaluation of agency performance in implementing government policies. However, the scheme involves comparatively little assessment of performance in reforming and developing policies, and provides only minor policy input to the government. A more comprehensive KPI framework covering all agency functions would minimise the risk that agency focus is inadvertently narrowed.

Effective programmes and procurement processes

Stakeholder involvement in policy-making could be further improved in Malaysia, as reflected in its low performance on the voice and accountability indicator (Figure 1.21C). Stakeholder engagement is a routine part of the development of annual budgets and five-year development plans, and nationwide public engagement activities have occurred in implementing major policies such as the GST and minimum wage. Enhanced public consultation with private businesses and foreign investors, trade unions, civil society organisations and the public, may result in better-designed policies and help achieve swifter and more effective implementation. While consultation between ministries, the federal government and state governments, and between government and the private sector has improved under the GTP, more can be done. In October 2014, the Government published a *Guideline on Public Consultation Procedures* to provide principles for officials undertaking public consultation. A circular has been issued making it a mandatory requirement across government. Consulting and engaging more actively with citizens and civil society organisations will generate new ideas and feedback on policies and services. More transparent and efficient policy making based on the rule of law enhances both the quality and compliance with public policies, which can in turn promote inclusive socio-economic development.

As well, there is room to improve evaluation and monitoring of government programmes and strategic plans. Regular performance evaluation including independent performance audits, as is done in most OECD countries (OECD, 2015h), would enhance planning and programme effectiveness. Effective public governance requires sustained monitoring and reassessment of programmes by continually engaging with affected stakeholders. A recent survey indicated that firms are not well consulted when new laws and regulations are developed that impact the business environment (AMCHAM, 2015).

Malaysia is undertaking reforms to its budget processes that are expected to better align spending and programme outcomes. It is working towards the implementation of outcome-based budgeting and has introduced a medium-term fiscal framework to improve longer-term expenditure prioritisation. These measures should improve accountability and the identification of underperforming programmes, thereby supporting broader efforts to improve public sector efficiency through KPIs.

The composition of programmes and degree of government intervention in industry and markets also needs to evolve as the country continues to develop. Programmes propping up specific industries should be replaced with investment in technology, innovation, markets and skills. Reducing red tape and the discretion of officials would also galvanise private-sector-led growth, improving market-based incentives and minimising opportunities for rent-seeking, anti-competitive behaviour and corruption. The 11th Malaysia Plan foreshadows greater co- or self-regulation, notably in the telecommunications, education and consumer-related areas.

Public procurement of goods, services and investment in infrastructure by the government represent a substantial part of government expenditure. In 2015, 8% of GDP was spent on public procurement across all levels of government. Streamlined public procurement processes maximise value for taxpayer money, ensuring optimal use of public revenues. Procurement processes need to be fair, predictable and open to competition from all firms who wish to submit bids. Lack of transparency promotes "middlemen" who increase procurement costs and heightens the risks of corruption (MACC, 2016). Competition and transparency in the design and implementation of public procurement are called for.

Collusion by potential bidders in public procurement processes can be particularly detrimental to the effective use of public funds. Indeed, bid rigging in public procurement is a type of cartel that has the potential to cause great harm as the higher costs paid by the government for goods and services are passed on to citizens in the form of higher taxes, fewer services, and less or poorly constructed infrastructure (OECD, 2011a). Malaysia has stated its intention to tackle bid rigging in public procurement, as a priority area for the MyCC stated by the Minister of Domestic Trade. Thus far no bid rigging cases have been brought by MyCC, even though these efforts have helped identify cases of corruption associated with procurement tenders. The absence of bid rigging cases contrasts with the experience of Japan, Korea and Indonesia, for instance, where many cases of bid rigging have been brought by competition authorities with significant sanctions and penalties attached (OECD, 2014b).

Efforts to build MyCC's capacity to detect, identify, investigate and prosecute cases would be beneficial. MyCC could also increase the range of government agencies it collaborates with to help detect bid rigging and collusion involving procurement officers. More broadly, Malaysia may wish to consider the *OECD Recommendation on Fighting Bid Rigging in Public Procurement* that calls for assessing public procurement laws and practices at all levels of government in order to promote more effective procurement and reduce the risk of bid rigging in public tenders.

Moreover, procurement methods should not only reduce the possibility of bid rigging but also facilitate the participation of SMEs, both domestic and foreign. This may be done by breaking down large tenders into lots, allow for joint bidding of SMEs and simplifying processes, for example (see the *OECD Guidelines on Fighting Bid Rigging*).

Furthermore, this approach should be extended to GLCs as organisers of tenders as any bid rigging practices concerning public procurement can impact how level a playing field is. Its application in this context is limited to cases where one of the bidders itself is a GLC or if the public procurer distorts the procurement process to favour an incumbent GLC, or national champions or other favoured companies. Either way, the procuring authority has a responsibility to stop anticompetitive practices and such responsibility should be included in codes of conduct or ethics in order to assure integrity in the public procurement process (*OECD Guidelines on Corporate Governance of State-Owned Enterprises 2015*).

A holistic framework for incentivising the public service

Numerous factors influence the productivity of public service employees. These include recruitment and retention policies, training and education opportunities, performance (and underperformance) management, remuneration and conditions, career progression and mobility, organisational values and culture, and supporting infrastructure facilities.

The recent focus under the GTP has been the introduction and ongoing refinement of quantifiable KPIs to support regular performance reviews of high-ranking officials (an example of the performance review is provided in Table 1.2). Performance against KPIs directly influences rewards, remedial actions and possible termination. The Performance Management and Delivery Unit (PEMANDU), established under the Prime Minister's Department, oversees the delivery of these KPIs and monitors outcomes. Staffed by both government and private sector officials, PEMANDU is mandated to provide independent performance reviews of ministers and heads of government agencies to the Prime Minister, with the results scrutinised by a third party (typically an audit firm). Performance evaluations utilising KPIs will be expanded to cover the next level of senior government officers by 2019. Performance evaluation should be expanded to a larger number of officials.

Table 1.2. **An example of performance review by KPI**

KPI target and actual output in the comprehensive rural development programme (1AZAM)

No.	KPI	Target	Actual	% achieved
1.	Number of 1AZAM participants monitored at the minimum of six months after implementation	32 300	33 368	103
2.	Number of existing 1AZAM participants who increased their income by MYR 300 for any three months	28 900	24 646	85
3.	Number of 1AZAM participants in Financial Literacy Programme	32 300	28 528	88
4.	Number of 1AZAM projects in collaboration with NGOs and corporate sector	36	46	128
5.	Number of 1AZAM community/group based programmes	77	77	100
6.	Ensure 100% updates in *eKasih* (1AZAM website)	100%	100%	100
7.	Number of graduated 1AZAM participants who obtained micro-credit loan	500	555	111
	Total			102

Source: PEMANDU (2015), *Government Transformation Programme Annual Report 2014*.

The further extension of KPIs to the rest of the public service would be beneficial in improving performance management processes. Similar benchmarks are commonly used in the private sector and already exist in some quasi-government agencies such as PETRONAS, Bank Negara Malaysia and Khazanah Nasional (the sovereign wealth fund). A comprehensive performance management system, with KPIs capturing expected outcomes and behaviours, would improve consistency, transparency and fairness in performance evaluation. Better linking performance management to rewards, penalties and career progression would incentivise healthy competition among staff, replacing opaque decision-making and a hierarchical culture with an expectation of procedural fairness (OECD, 2005, 2011b). This would not only incentivise existing workers to increase their productivity; it would also make public services jobs more attractive to talented workers.

Box 1.3. **Best practices of the OECD countries in the evaluation of public sector productivity**

Measuring public sector productivity forms the cornerstone of assessing the progress of productivity-enhancing reform. However, in order to properly measure productivity of the public sector it is necessary to measure and eventually quality-adjust both inputs and outputs. While input measurement is usually perceived as more concrete, less consensus exists about how to define and measure government outputs. Nevertheless, an increasing number of OECD countries are undertaking efforts to measure output with a focus on individual services (education and health) and are exploring measurement of other government services.

The best practices of OECD countries in evaluating the productivity of the public sector include those of the United Kingdom, Australia, Denmark, New Zealand and the Netherlands. The UK Public Sector Efficiency Group of the Cabinet Office has recently published a report on public sector efficiency, from the twin viewpoints of technical efficiency and allocative efficiency. The former evaluates the outputs of the policy and the latter focuses on the outcome or desired impacts of the policy on the economy and society. The analysis of the Group has broken down public sector activity into three types of services: transactional (benefit administration and tax collection), back office (human resource management and finance) and front line (schools, health, police, social care, etc.) (UK Public Sector Efficiency Group, 2015). Australia has a Productivity Commission which provides detailed information on the measurement of public sector inputs, outputs, and outcomes on an annual basis, consistent with the Atkinson recommendation (Atkinson, 2005). In September 2014, Denmark moved to direct-output measurement of public goods and services in line with 2002 EU recommendations (Statistics Denmark, 2016). In 2008, New Zealand conducted a feasibility study assessing the practical aspects of measuring non-market outputs (Statistics New Zealand, 2010), and in 2015 the Netherlands published a report comparing public sector inputs, outputs, and outcomes across 36 countries, using data from OECD/Eurostat surveys (Goderis ed. 2015).

A detailed example of these initiatives comes from the UK Public Sector Efficiency Group. It estimated productivity in the education sector using as output measures the total number of full-time equivalent students in publicly funded schools, quality-adjusted by the average score of the General Certificate of Secondary Education in that year. On the input side, an aggregate of labour input, purchased goods and services and government consumption (including both central and local government) was used. According to their findings, productivity in the education sector measured as the ratio of output per unit of input has increased, driven by rising educational performance and reduced staff costs.

Other recent measures aimed at boosting productivity include introducing more flexible work arrangements, increased use of contracts to attract talented workers, and across-the-board remuneration increases. Public service remuneration was increased through the reclassification of pay grades, particularly aimed at increasing salaries for low-income public servants. These changes came into effect on 1 July 2016 in line with an upward revision of the minimum wage for private sector workers. The 2016 budget also announced the provision of a one-off special payment to all public servants.

These measures each contribute to increasing the relative attractiveness of working for the public service but fall short of a comprehensive and considered approach to understanding the drivers of public service productivity. An independent review covering all aspects of public service productivity is needed to develop a robust and exhaustive framework. A possible follow-up, in-depth OECD Regulatory Reform Review of Malaysia would be a step in this direction (see also the forthcoming inaugural *OECD Southeast Asia Government at a Glance*).

Main recommendations to boost productivity

Improving the quality of education

Key recommendations

- Follow through with the revised school curricula based on international benchmarking and the improvements to teacher evaluation, training and upskilling.
- Increase the collaboration of tertiary institutions with industry to deliver job-ready graduates, with a focus on vocational education and training.

Further recommendations

- Increase decentralisation, competition and accountability in the education system to maximise incentives for continuous innovation and effective resource utilisation.
- Monitor the impact of basic education reform implementation on student access and equality.
- Better align labour and education migration policies to support the development of a higher education hub.

Strengthening innovation

Key recommendation

- Streamline innovation system governance through clear mandates for the National Science Council and Research Management Agency.

Further recommendations

- Create local innovation centres to boost SME innovation.
- Spur government-linked company innovation and R&D through privatisation or key performance indicators.

Main recommendations to boost productivity *(cont.)*

Further improving the competition framework

Key recommendations

- Enhance the independence, staffing and financial resources of the regulator.
- Expand merger control powers to all sectors.

Further recommendation

- Improve the consistency of competition policy across exempt sectors.
- Undertake an assessment of barriers to SME competition to identify and remove unnecessary red tape.

An enhanced regulatory frameworks for SMEs

Key recommendations

- Amend insolvency laws to facilitate the rescue of viable firms.
- Introduce out-of-court insolvency procedures.

Further recommendation

- Streamline firm registration and introduce zero licensing procedures in services and industry.

Furthering trade, investment and regional integration

Key recommendation

- Pursue further trade and investment liberalisation to boost services sector growth and competition.

Boosting public sector productivity

Key recommendation

- Commission an independent review of public sector productivity.

Further recommendations

- Regularly evaluate strategic plans and programmes through independent audits and regulatory impact assessments.
- Expand performance benchmarks to a larger number of officials, with clear links to rewards, penalties and career progression.
- Improve alignment of responsibilities by reducing agency duplication and decentralising certain functions.
- Reinforce efforts to tackle bid rigging and other barriers to effective public procurement.

Bibliography

ADB (2013), *Beyond Factory Asia Fuelling Growth in a Changing World*, Background Paper for the Asian Development Bank 2013 Annual Meeting Governors' Seminar, Asian Development Bank, Mandaluyong City.

Adalet McGowan, M. and D. Andrews (2016), "Insolvency regimes and productivity growth: A framework for analysis", *OECD Economics Department Working Papers*, No. 1309.

AMCHAM (2015), *2015 ASEAN Business Outlook Survey Malaysia Country Report*, American Malaysian Chamber of Commerce, Kuala Lumpur.

Andrews, D., C. Criscuolo and P. Gal (2015), "Frontier firms, technology diffusion and public policy: Micro evidence from OECD countries", *OECD Productivity Working Papers,* No. 2, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/5jrql2q2jj7b-en*.

APO (2015), *Productivity in the Asia-Pacific: Past, Present and Future*, Asia Productivity Organisation, Tokyo.

Arudchelvan, M. and G. Wignaraja (2015), "SME Internationalization through Global Value Chains and Free Trade Agreements: Malaysian Evidence", *ADBI Working Papers*, No. 515, Asian Development Bank Institute, Tokyo.

ASEAN (2015a), *A Blueprint for Growth - ASEAN Economic Community 2015: Progress and Key Achievements*, ASEAN Secretariat, Jakarta.

ASEAN (2015b), *ASEAN Economic Community Blueprint 2025*, ASEAN Secretariat, Jakarta.

APEC (2016), *APEC Outcomes and Outlook 2015/2016*, Asia Pacific Economic Cooperation, Singapore.

Atkinson, T. (2005), *Atkinson Review: Final report. Measurement of Government Output and Productivity for the National Accounts*, Palgrave, London.

Australian Education Network (2016), *International Student Numbers at Australian Universities, www.australianuniversities.com.au/directory/international-student-numbers* (accessed on 19 April 2016)

Centre for International Development, Harvard (2016), *Atlas of Economic Complexity. http://atlas.cid.harvard.edu/rankings/country/* (accessed on 1 June 2016)

Cornell University, INSEAD, and WIPO (2015), *The Global Innovation Index 2015: Effective Innovation Policies for Development*, Fontainebleau, Ithaca, and Geneva.

EPU (2015a), "Transforming Services Sector", *Eleventh Malaysia Plan Strategy Paper* 18, Economic Planning Unit, Prime Minister's Department, Putrajaya.

EPU (2015b), "Energising Manufacturing Sector", *Eleventh Malaysia Plan Strategy Paper 19*, Economic Planning Unit, Prime Minister's Department, Putrajaya.

EPU (2015c), *Eleventh Malaysian Plan*, Economic Planning Unit, Prime Minister's Department, Putrajaya.

ERIA, OECD and ASEAN (2014), *ASEAN SME Policy Index 2014*, OECD Publications, Paris. *www.oecd.org/globalrelations/regionalapproaches/ASEAN%20SME%20Policy%20Index%2014.pdf*

EUMCCI (2015), *EU-Malaysia Business: EUMCCI Trade Issues and Recommendations 2015,* EU-Malaysia Chamber of Commerce and Industry, Kuala Lumpur.

GCR (2016), "A conversation with Tuan Ragunath Kesavan", *Global Competition Review*, 4 March. *http://globalcompetitionreview.com/features/article/40623/a-conversation-tuan-ragunath-kesavan* (accessed on 15 May 2016)

Goderis, B. ed (2015), *Public Sector Achievement in 36 Countries: A Comparative Assessment of Inputs, Outputs and Outcomes,* The Netherlands Institute for Social Research, The Hague.

ICC (2015), *ICC Open Markets Index 2015*, International Chamber of Commerce, Paris.

ITU (2015), *Measuring the Information Society 2015*, ITU, Geneva, Switzerland. *www.itu.int/en/ITU-D/Statistics/Documents/publications/misr2015/MISR2015-w5.pdf* (accessed on 1 June 2016)

ITU and UNESCO (2016), *The State of Broadband 2015*, ITU, Geneva, Switzerland. *www.broadbandcommission.org/publications/Pages/SOB-2015.aspx*.

MACC (2016), "Initiatives for Change", Malaysia Anti-Corruption Commission, *www.sprm.gov.my/index.php/en/130-ace/1044-problem-areas-initiatives-for-change* (accessed on 29 May 2016)

MOE (2013), *Malaysia Education Blueprint 2013-2025 (Preschool to Post-Secondary education),* Ministry of Education, Putrajaya.

MOE (2015), *Malaysia Education Blueprint 2015-2025 (Higher Education),* Ministry of Education.

MPC (2015), *22nd Productivity Report 2014/2015*, Malaysia Productivity Corporation, Petaling Jaya.

OECD (2005), *Performance-related Pay Policies for Government Employees*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/9789264007550-en*

OECD (2009), *Recommendation of the OECD Council on Competition Assessment*, OECD Council, OECD Publishing, Paris.

OECD (2010), *SMEs, Entrepreneurship and Innovation*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/9789264080355-en*

OECD (2011a), *Competition and Procurement - 2011: Key Findings,* OECD Publications, Paris.

OECD (2011b), *Government at a Glance 2011*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/gov_glance-2011-en*

OECD (2012a), *Recommendation of the Council on Regulatory Policy and Governance*, OECD Council, OECD Publishing, Paris.

OECD (2013a), *Southeast Asian Economic Outlook 2013*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/saeo-2013-en*

OECD (2013b), *PISA 2012 Results: What Makes Schools Successful (Volume IV): Resources, Policies and Practices,* OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/9789264201156-en*

OECD (2013c), Developing *Skills in Central Asia through Better Vocational Education and Training Systems*, OECD Publications, Paris.

OECD (2013d), *OECD Science, Technology and Industry Scoreboard 2013: Innovation for Growth*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/sti_scoreboard-2013-*

OECD (2013e), *Investment Policy Review: Malaysia*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/9789264194588-en*

OECD (2014a), Economic *Outlook for Southeast Asia, China and India 2014*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/23101113*

OECD (2014b), OECD (2014), *The Governance of Regulators,* OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/9789264209015-en*

OECD (2015a)*, OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2015 Edition,* OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/9789264244160-en*.

OECD (2015b), *Boosting Malaysia's National Intellectual Property System for Innovation*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/9789264239227-en*

OECD (2015c), *Entrepreneurship at a Glance 2015*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/entrepreneur_aag-2015-en*

OECD (2015d), *Annual Report on Competition Policy Developments in Indonesia*, OECD Publishing, Paris. *www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DAF/COMP/AR(2015)41&docLanguage=En*

OECD (2015e), *Trade Facilitation Indicators: ASEAN*, OECD Publishing, Paris. *www.oecd.org/tad/facilitation/oecd-tfi-asean-july-2015.pdf*.

OECD (2015f), *Trade Facilitation Indicators: Asia-Pacific Economic Cooperation*, OECD Publishing, Paris. *www.oecd.org/tad/facilitation/oecd-tfi-apec-july-2015.pdf*.

OECD (2015g), *Implementing Good Regulatory Practice in Malaysia*, OECD Publishing, Paris. *http://dx.doi.org/10.1787/9789264230620-en*

OECD (2015h), *Government at a Glance 2015*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/gov_glance-2015-en*

OECD (2016a), *Economic Outlook for Southeast Asia, China and India 2016: Enhancing Regional Ties*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/saeo-2016-en*

OECD (2016b), *Low-Performing Students: Why They Fall Behind and How To Help Them Succeed*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/9789264250246-en*

OECD (2016c), *OECD Reviews of Innovation Policy: Malaysia 2016*, OECD Publishing, Paris.

OECD Teaching and Learning International Survey (2013), OECD Education GPS. *http://gpseducation.oecd.org/Home*.

OECD FDI Regulatory Restrictiveness database. *http://stats.oecd.org/Index.aspx?datasetcode=FDIINDEX#*.

PEMANDU (2015), *Government Transformation Programme Annual Report 2014*, Performance Management and Delivery Unit, Prime Minister’s Department, Putrajaya.

Petri, P. and M. Plummer (2016), “The economic effects of the Trans-Pacific Partnership: New estimates”, *Peterson Institute of International Economics working paper series* 16-2, Washington D.C.

SME Corp (2012), *SME Master Plan 2012-2020,* SME Corp, Malaysia, Kuala Lumpur.

Statistics Denmark (2016), *General Government Output and Productivity 2008-2014,* Copenhagen.

Statistics New Zealand (2010), *Measuring Government Sector Productivity in New Zealand: a feasibility study*, Wellington.

Teong, V. (2015), "The Competition Act 2010—Issues and development since coming into force", *ERIA Discussion Paper Series*.

The Economist (2015), *Who's Brains are Draining? Daily Chart 1 July*, *www.economist.com/blogs/graphicdetail/2015/07/daily-chart*.

The Malaysian Insider (2014), "Viewpoint: Procurement and integrity - The way forward", *www.fz.com/content/viewpoint-procurement-and-integrity-way-forwarday-forward#ixzz49gJveijH*.

UK Public Sector Efficiency Group (2015), *Public Sector Efficiency: Final report from the cross-Whitehall analysts' group,* Government Economic Service, London.

World Bank (2011), *Malaysia Economic Monitor April 2011: Brain Drain*, Washington D.C.

World Bank (2013), *Malaysia Economic Monitor December 2013: High-Performing Education*, Washington D.C.

World Bank (2015), *Malaysia Economic Monitor December 2015: Immigrant Labour*, Washington D.C.

World Bank (2016), *Doing Business 2016: Measuring Regulatory Quality and Efficiency*, World Bank, Washington, DC.

World Bank and TalentCorp (2014), *Trends in Graduate Employability. www.talentcorp.com.my/facts-and-figures/matching-talents-to-jobs*.

World Economic Forum (2016), *Global Competitiveness Report 2015-16*, Geneva.

WTO (2014), *Trade Policy Review: Malaysia*, World Trade Organisation, Geneva.

WTO (2016), *Country Profile: Malaysia,* World Trade Organisation, Geneva.

OECD Economic Surveys: Malaysia
Economic Assessment

Chapter 2

Fostering inclusive growth

Malaysia has followed a comparatively equitable development path, largely eliminating absolute poverty and greatly reduced ethnic inequality. Income and wealth inequality have gradually declined since the mid-1970s. With the "people economy" at the centre of Malaysia's ambition to become a high-income country by 2020, the focus is shifting to the challenges of relative poverty and achieving sustainable improvements in individual and societal well-being through inclusive growth. This shift would be aided by reforms in several policy areas where Malaysia may compare favourably within its region but less so relative to OECD countries. This includes reforms to increase access to quality education, provide comprehensive social protection, raise the labour force participation of women and older persons, maintain universal access to quality public healthcare, improve pension system sustainability and adequacy and move towards a tax and transfer system that does more for inclusiveness.

Introduction

Growth can be more inclusive by pursuing policies that enable improvements in a country's living standards while sharing gains more equitably across the population. Inclusive growth incorporates a focus on relative - not just absolute - income and wealth inequality, and on well-being, which depends on both monetary and non-monetary conditions, such as access to quality education, employment, housing and healthcare.

From a highly unequal society on attaining independence in 1957, Malaysia has substantially reduced inequality and poverty through decades of strategic planning with stability and inclusiveness at their core. The New Economic Policy (1971-90) sought growth with equity and national unity, tackling poverty by creating jobs for all Malaysians irrespective of race while seeking to reduce ethnic identification with particular economic activities. The National Development Policy (1991-2000) continued to emphasise the need for growth while increasing the focus on human capital development and the eradication of hard-core poverty. The National Vision Policy (2001-2010) continued earlier policies around the vision of becoming a fully developed nation by 2020, aiming to build a competitive nation with an equitable, unified and resilient society. Most recently, the New Economic Model (since 2010) set targets for achieving high income status, inclusiveness and sustainability, with the Government and Economic Transformation Programmes and the 10th and 11th Malaysia plans providing whole-of-government reform blueprints towards achieving this vision.

Making growth more inclusive is fundamental to Malaysia's efforts to become a high-income country, with the "people economy" at the centre of its development vision. Having eradicated all but a few pockets of absolute poverty through decades of strong economic growth, Malaysia's focus is shifting to the challenges of relative poverty and sustainable improvements to individual and societal well-being. Accordingly, the 11th Malaysia Plan prioritises policies that enhance well-being with a particular focus on increasing the living standards of the bottom 40% of households by income (B40).

The following section provides an overview of the current state of inclusive growth in Malaysia. The subsequent ones identify priority areas where further reforms would enhance well-being. This chapter complements the productivity-boosting reforms discussed in Chapter 1, with many of these reforms also beneficial to fostering inclusive growth. Reforms that provide universal access to quality education and skills training provide an obvious example, and so do reforms that enhance innovation, competition and SMEs. Innovative businesses exhibit higher employment growth that benefits both high- and low-skilled workers. A robust competition environment spurs innovation and facilitates the entry and expansion of new businesses (de Mello and Dutz, 2012). Openness to trade and investment and strong competition policies can increase the availability of lower priced essential goods and services for lower-income households, such as food, clothing and telecommunications. In many respects therefore, productivity and inclusiveness enhancing policies go hand-in-hand.

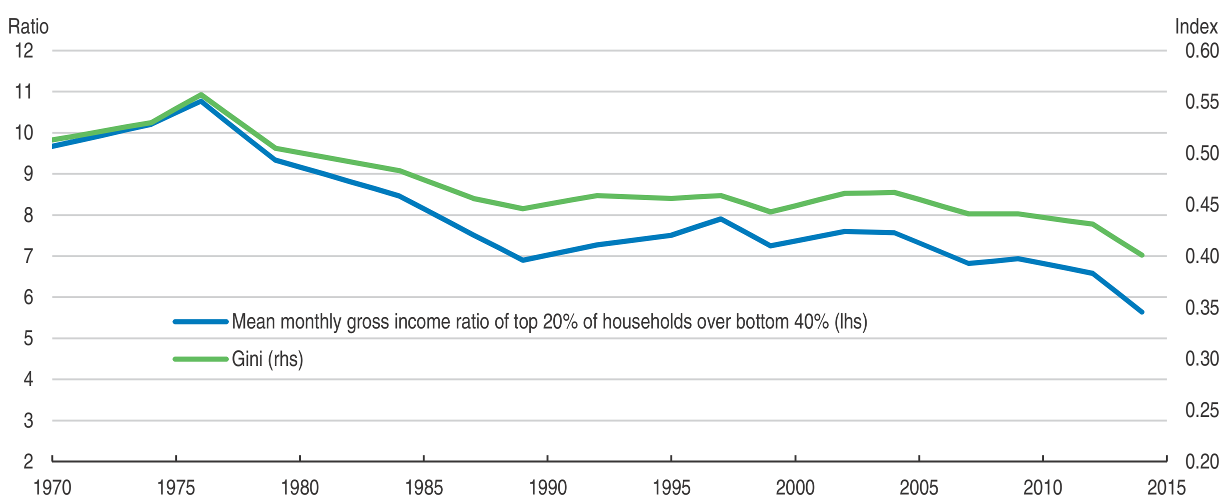
Poverty, income and wealth inequality

Malaysia's sustained rapid real GDP growth of 6.4% per annum from 1970 to 2015 reduced the incidence of absolute poverty from 49.3% to 0.6% (World Bank, *World Development Indicators*). Some challenges remain, with higher rates of absolute poverty in rural areas (1.6%), for children under 15 (1.7%) and for particular ethnic groups (Orang Asli 34%; Bumiputera Sabah 20.2% and Bumiputera Sarawak 7.3%) still a focus of poverty reduction efforts, with programmes providing food, financial aid and skills training. Income inequality has gradually reduced from very high levels, with low-income households and previously disadvantaged ethnic groups benefiting more than proportionately. The income share of the top 20% of households compared to the B40 has declined substantially over this period, at a faster rate than Malaysia's overall Gini coefficient for household income (Figure 2.1).

Malaysia remains very unequal in terms of wealth distribution. Estimates suggest that 53% of Malaysian households had zero financial assets in 2009, with ethnic Malay median financial wealth of just one ringgit (Muhammed Abdul Khalid, 2014). These estimates also indicate that some 92% of household wealth was concentrated in property, consistent with high rates of home ownership in Malaysia (76% of Malaysian households owned their home in 2014).

As absolute poverty in Malaysia has been reduced to low levels, relative poverty provides a more important benchmark for poverty eradication. The relative income poverty rate (based on an unadjusted 50% of median income) has come down to 15.6% in 2014 from 17.4% in 2007, which is above the OECD average but below the level in a comparable country such as Turkey (Figure 2.2A). Inequality is particularly stark along regional lines, with a near eightfold difference in income inequality between the richest and poorest states (Figure 2.2B and Figure 2.18 further down). Very small (single-person) and large (six-person) households appear particularly vulnerable to relative poverty, with education completion, urbanisation, broadband connectivity, and labour force participation among the factors associated with regional differences in relative poverty (Nixon, 2016). Multidimensional indicators of inequality, such as healthcare, education and information availability, also display ample regional variation.

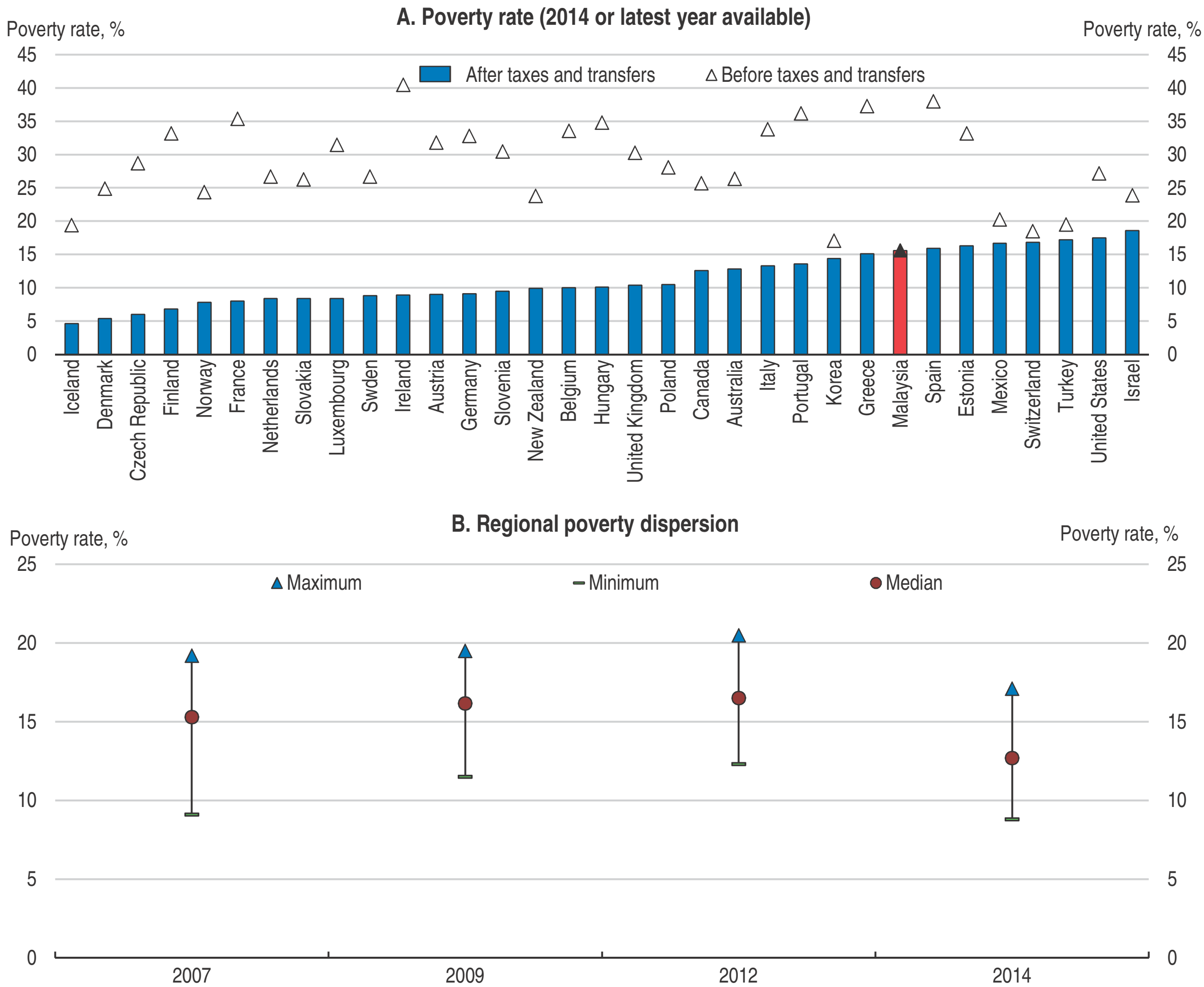
Figure 2.1. **Income inequality has declined**



Source: Department of Statistics, Malaysia.

StatLink http://dx.doi.org/10.1787/888933410802

Figure 2.2. **Relative poverty indicators**



Note: In Panel A, the data for Malaysia is based on relative poverty before taxes and transfers, with the rate after taxes and transfers assumed to be the same, consistent with the minimal redistributive effects of the tax and transfer system (see Figure 2.9below).
Source: OECD (2016), OECD Income Distribution Database, *http://dx.doi.org/10.1787/data-00654-en*; Department of Statistics, Malaysia.

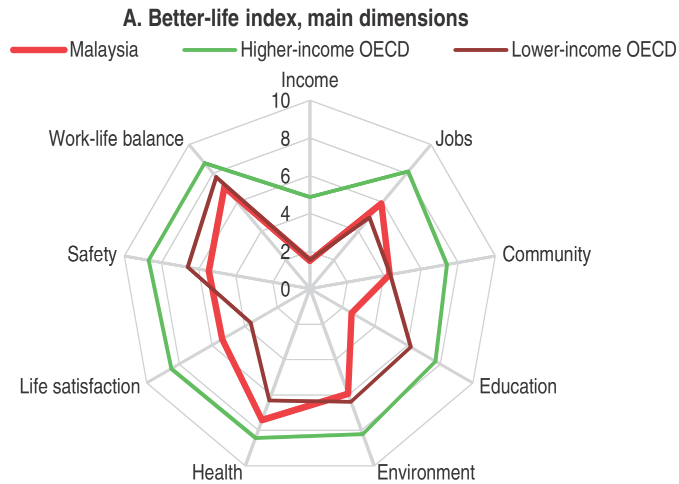
StatLink *http://dx.doi.org/10.1787/888933411026*

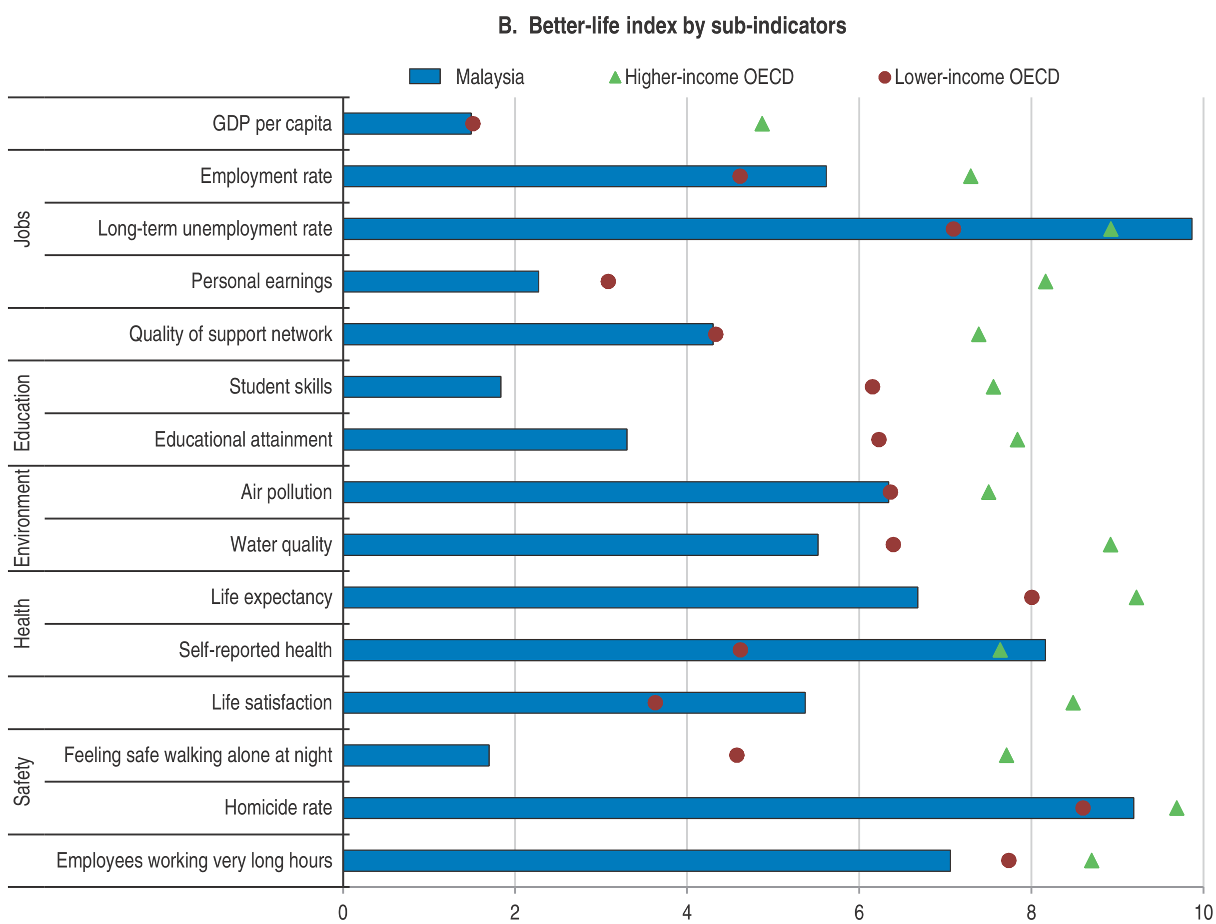
The differences across space and groups in recent cost of living pressures also suggest the need to focus not only on the rural poor in less developed states but also on urban low-income households. In 2015, inflation was almost two percentage points lower in relatively wealthy Kuala Lumpur than in poorer Sabah and Labuan, while inflation for households in the lowest income quintile was up to 0.6% higher (BNM, 2015). The absence of household income data for this period makes it difficult to determine if households in areas of higher inflation have benefited from compensatory adjustments in income; however, differences in local cost-of-living increases may be contributing to regional inequality.

Broader measures of inclusive growth and well-being

The OECD *Better Life Index* provides an overall snapshot of living standards within a country as a measure of the inclusiveness of growth. Malaysia scores well on some indicators, in particular long-term unemployment (Figure 2.3). However, the index illustrates Malaysia's relative weakness in areas such as educational attainment and skills,

Figure 2.3. **Well-being indicators point to further opportunities to foster inclusive growth**





1. Due to data availability, the indicators used in the OECD Better Life database are not necessarily identical with this exercise. Therefore, the high and low-income OECD data does not always correspond to the data in the OECD Better Life database.
2. In panel A, indicators are normalised to range between 10 (best) and 0 (worst) according to the following formula: (indicator value – minimum value) / (maximum value - minimum value) x 10. In panel B, a simple ranking of the OECD countries is applied.
3. OECD high/bottom income countries are countries belonging to the top/bottom 30% income quintiles of the OECD member countries.

Source: OECD (2016), Better Life Index (database), *www.oecdbetterlifeindex.org*; national sources; UNESCO, UIS. Stat database.

StatLink *http://dx.doi.org/10.1787/888933410617*

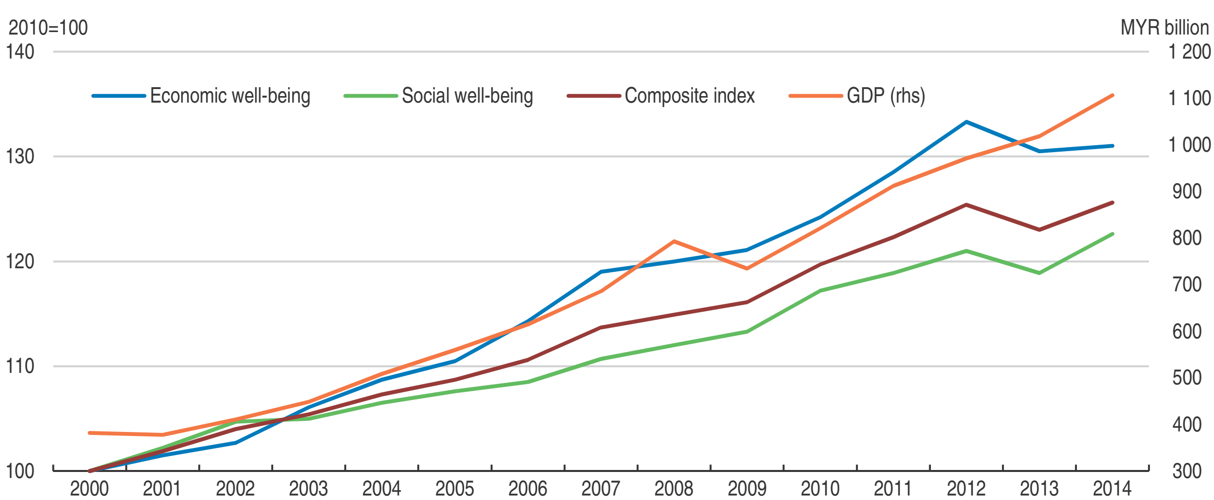
as well as personal earnings. Improving education quality and skills training is essential to raise lifetime earning potential and social mobility while promoting social cohesion and well-being over the longer term. The index also highlights the need to further improve healthcare to increase healthy life expectancy. Maintaining universal access to quality medical services, particularly in rural areas and for low-income urban residents, would help narrow the life-expectancy gap with advanced countries.

The World Economic Forum's *Inclusive Growth and Development Report 2015* broadly confirms the findings of the OECD *Better Life Index* (WEF, 2015). Malaysia performs strongly compared with other middle-income countries for its income level in areas such as the provision of basic services (food, drinking water and electricity), home ownership, financial inclusion, employment, corruption perceptions and the quality and access to healthcare. However, the report identifies several areas of poor performance relative to other middle-income countries, in particular education outcomes, healthcare costs, labour force participation (especially women and elderly persons), pollution and social welfare.

Malaysia has created its own well-being index drawing on indicators specific to its circumstances and priorities (Figure 2.4). The index captures aspects of inclusiveness similar to those embodied in the OECD *Better Life Index* but uses different indicators to represent these, determined by data availability rather than policy targets (see Annex 2.1 at the end of this chapter). The index tracks improvements over time rather than providing an internationally comparable frontier approach. It suggests that between 2000 and 2014, most improvement has occurred in areas such as housing, transport, leisure, education, income and distribution; while improvement has been more modest in areas such as health, environment and family. The decline in index values for 2013 reflects short-lived dips in areas such as housing, culture and social participation, but also more significant downward trends in working life, environment and family life – with index values for the latter two having almost reverted back to the 2000 baseline.

Divergence between the evolution of economic and social well-being and GDP growth over the period reflects the incorporation of indicators that can be weakly or even

Figure 2.4. **Malaysian Well-being Index growth relative to GDP**



Source: EPU (2013), *Malaysian Well-being Report 2013*.

StatLink http://dx.doi.org/10.1787/888933411037

negatively correlated with GDP. Examples include environmental variables such as air quality and waste generation, family variables including the dependency ratio, household debt, divorce rates and reported crime, and economic well-being measures such as average working hours and education attainment rates. Also, the index lacks a reference point against which outcomes can be assessed. Assessing the evolution of the index against domestic goals (such as expected index growth based on policy targets) and international benchmarks would be beneficial. Increased timeliness and frequency of index reporting would also support Malaysia's efforts to foster inclusive growth.

Nonetheless, Malaysia's continued use of both domestic and international indicators of well-being will help develop reforms supporting inclusive growth. Since its introduction in 2013, the index has been used to identify areas in need of reform and develop new policies. Examples of initiatives prompted by the introduction of the index include the Smart Partnership Towards Sustainable Environment programme to raise environmental awareness, the 1Malaysia Family First Movement (1MFF) and Smartstart to reinforce family values and provide guidance for young families, and the Belia Mahir 1Malaysia programme providing vocational courses to young Malaysians.

A more inclusive labour market

Malaysia has a strong record of full employment that has benefited social well-being and inclusiveness. However, so far labour market deficiencies have prevented low unemployment from delivering the expected higher returns to work and skilled employment opportunities befitting a high-income economy.

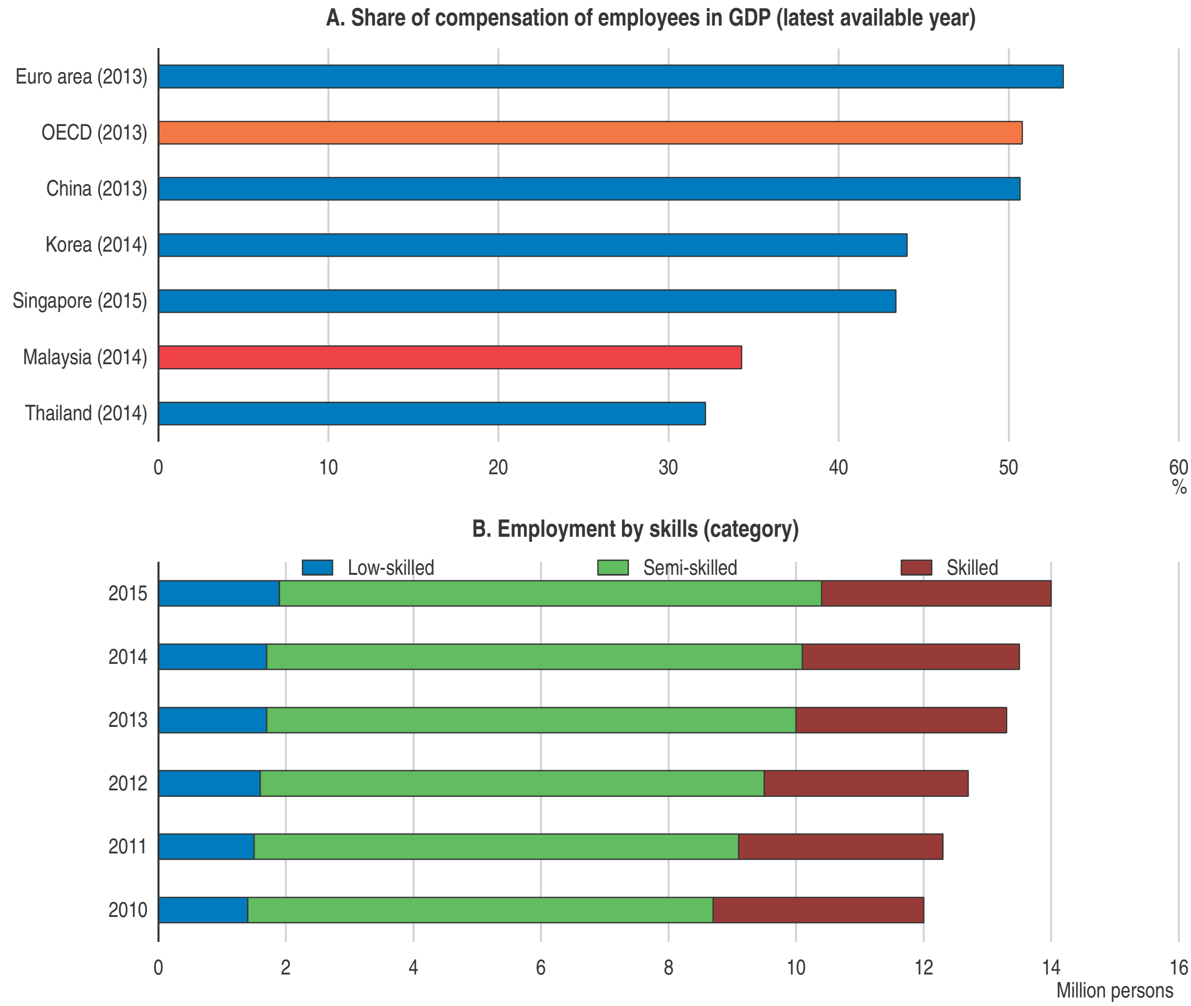
Employee safety nets that are standard in many high-income countries are underdeveloped in Malaysia, which has a new but incompletely enforced minimum wage, no employment insurance scheme, a lack of industry-based skills training, and a low unionisation rate. This exerts a drag on the promotion of inclusive and productive labour markets, hindering industrial transformation from labour-intensive low-skilled activities toward a more high-skilled, high-productivity economy. High-skilled job creation has not kept pace with tertiary graduation rates, contributing to outflows of skilled labour abroad. Addressing the low participation rates of women, youth and old people in particular would increase inclusiveness and productivity. Labour market reforms would raise returns to work, increase participation rates, and facilitate the transformation to high-skilled and high-productivity activities.

Active labour market policies can help harness the productive potential of the population and contribute to economic growth, social cohesion and the sustainability of the social protection system. To this end, the government needs to maintain the motivation of jobseekers to actively pursue employment while also improving their employability and expanding their opportunities to be placed and retained in appropriate jobs (OECD, 2015a).

Addressing labour market imbalances that limit employee returns

Returns to work remain comparatively low in Malaysia, as reflected in a much lower share of employee compensation in GDP than in OECD countries (Figure 2.5A). Slow growth of skilled job creation is contributing to this (Figure 2.5B). Low relative returns to labour limit the inclusiveness of labour markets by discouraging participation and delivering excessive benefits to capital holders.

Figure 2.5. **The wage share is relatively low and skilled job creation has lagged**



1. Skilled employment includes managers, professionals, technicians and associated professionals.
2. Semi-skilled employment includes clerical support workers, service and sales workers, skilled agricultural, forestry and fishery workers, craft and related trades workers, and plant and machine-operators and assemblers.
3. Low-skilled employment is for the remaining elementary occupations.

Source: OECD (2016), OECD National Accounts Statistics (database), *http://dx.doi.org/10.1787/data-00001-en*; national statistics offices; EPU (2015a), "Labour Market for an Advanced Nation", *The Eleventh Malaysia Plan Strategy Paper No. 8*; EPU (2015b), *Eleventh Malaysia Plan*.

StatLink http://dx.doi.org/10.1787/888933411042

A minimum wage was introduced in 2013, applying to both Malaysian national and migrant workers. In 2009, around 34% of private sector workers earned less than MYR 700 (USD 175) per month, below the MYR 800 (USD 200) national poverty line income. The introduction of the minimum wage was estimated to have increased the wages of roughly 3.2 million private sector workers, or approximately 30% of the total workforce, though a systematic assessment of beneficiaries has not been carried out post implementation (UNDP, 2013; BNM 2013). The decline in relative poverty between 2012 and 2014 may reflect a positive impact of the minimum wage (Figure 2.2B). Rates are determined every two-three years by a consultative council comprising government, employer association and union representatives. As of 1 July 2016, the monthly rate was raised to MYR 1 000 (USD 250) for Peninsular Malaysia and MYR 920 (USD 240) for the states of Sabah and Sarawak. The minimum for Peninsular Malaysia stood at 57% of the median wage in 2014.

However, enforcement seems to be uneven and the number of minimum wage beneficiaries may be overestimated, with legislative loopholes being exploited to convert existing benefits into wages and weak enforcement for undocumented migrant workers (MOHR, 2016; ILO, 2016).

The 11th Malaysia Plan includes a commitment to establish a National Wage Index, to be compiled under the aegis of the Ministry of Human Resources, to serve as a guide for employers in determining wage levels for employees. Indicative wage levels will be based on employee qualifications, skills and productivity. The index will not reduce the flexibility of employers to set wages on the basis of market demand and supply, but is meant to increase recognition among employers of the need to regularly adjust wages to reflect the increased skills and experience of their employees. Implementation of the index will require agreement between the government and employer and employee representatives on methodology (through the National Wages Consultative Council).

Reforms have also sought to reduce labour market skills mismatches through increased tertiary sector cooperation with industry and the creation of TalentCorp. Established in 2011 as an agency under the Prime Minister's Department, TalentCorp co-ordinates labour market and skills-development policies under the Talent Roadmap 2020. Policies aim to facilitate demand-driven, inclusive and productive labour markets through reskilling programmes to reduce skills gaps, information and job-matching services to reduce youth unemployment, initiatives to enhance female labour participation and the attraction and retention of foreign talent, including Malaysians working abroad. Education sector reforms to address supply-side constraints, such as the shortage of job-ready graduates, are discussed in Chapter 1.

The introduction of an employment insurance scheme is also an ongoing reform priority and an essential element of a well-functioning labour market. In OECD countries, such insurance schemes encourage labour mobility and risk-taking, provide temporary income smoothing and facilitate job-search and retraining to minimise time out of the workforce. They can also provide an incentive for formalisation in countries where the informal sector remains significant. A proposed scheme is currently being debated, with consensus among stakeholders yet to be reached (see below the section on social protection).

The 11th Malaysia Plan incorporates planned revisions to labour legislation to address rigidities that prevent more flexible working hours and make dismissal processes tedious and repetitive. This includes allowing disputes on dismissals that cannot be resolved by conciliation to be referred automatically to the industrial court for arbitration. The experience of OECD countries in the past decade demonstrates the benefits of less rigid dismissal processes, which increase incentives to hire new workers and enhance the overall flexibility of the labour market to appropriately reward productivity. Recent OECD country experience also highlights the importance of accompanying reforms to provide adequate employment insurance and effective re-employment services (OECD, 2013a).

Malaysia's low trade union membership rate at 9.4% in 2013 compared with an average of 17% for OECD countries (ILO data) is also indicative of labour market imbalances that limit returns for workers. Impediments to the formation of unions and their rights to influence remuneration and conditions contribute to this, though implementation of the Trans-Pacific Partnership agreement (TPPA) is expected to require major improvements in this area. Indeed, TPPA signatories are required to ensure compliance with the 1998 ILO

Declaration on Fundamental Principles and Rights at Work and its Follow-Up. The principles and rights include the freedom of association in forming labour unions and collective bargaining, and the elimination of employment discrimination. Alongside these expected changes, a modest Trade Union Development Programme has been introduced to increase worker understanding of collective bargaining and encourage union creation. These reforms will improve the balance between the protection of employees and the promotion of a flexible labour market.

Raising labour participation rates of women, youth and older people

Another priority for creating a more inclusive labour market is to raise the labour participation rates of women, youth and older people – groups which have ample room to contribute toward raising the overall participation rate. Across OECD countries, the gender employment gap has narrowed, with increased labour participation of women the result of rising education attainment and increased use of family-friendly policies (OECD, 2015b). In Malaysia, participation rates for these groups remain relatively low compared to other Southeast and East Asian countries and the OECD average (Figure 2.6A and B).

The labour participation rate of women decreases with age from 25-29 years old in Malaysia, displaying a single-peak curve. This contrasts with the M-shaped participation profile of countries such as Japan and Korea, where participation rates rise anew after falling at the time of childbirth (Figure 2.6C). Prior to 2010, female labour participation rates remained stubbornly low at around 46%. Reforms since then have contributed to it increasing to 54% in 2015, with the 11th Malaysia Plan targeting 59% by 2020. The government is encouraging female labour participation by providing better labour market information, improving access to jobs through the 1Malaysia Support for Housewives and Flexworklife programmes, and supporting entrepreneurship among women through Women Entrepreneurial Incubator (*Azam Niaga*) and 1Nita programmes. Women's participation also benefits from the Career Comeback programme and Resourcing and Retention grants (which provide financial incentives for employers to hire returning workers) and the flexWorkLife.my portal increasing awareness of flexible working arrangements. To achieve the 59% target rate, the government will be strengthening its family-friendly employment strategy, including better access and affordability to quality childcare facilities and early childhood education. It will also be undertaking labour market reforms promoting flexible working conditions, including flexible working hours and work-from-home options. Such family-friendly strategies and labour market reforms have proven to be effective in OECD countries. Providing life-long learning and reskilling opportunities would also facilitate women's return to work. Malaysia's particular challenge is to raise the participation rate of middle-aged and older women. Women of these generations have lower average levels of educational attainment, thus programmes that provide re-skilling opportunities and hiring incentives for employers are necessary to facilitate their re-entry.

Although the overall unemployment rate is low, at around 3% in recent years, unemployment of youth aged 15-24 approached 11% in 2015, accounting for 61% of total unemployment. The share of unemployed persons with tertiary degrees has risen steadily to close to 34% in 2015 (Figure 2.7A). Unemployed women with a tertiary degree have become one of the largest groups of unemployed (Figure 2.7B).

Higher unemployment rates among the highly-educated youth can largely be attributed to skill mismatches and a lack of work experience. To achieve the 11th Malaysia

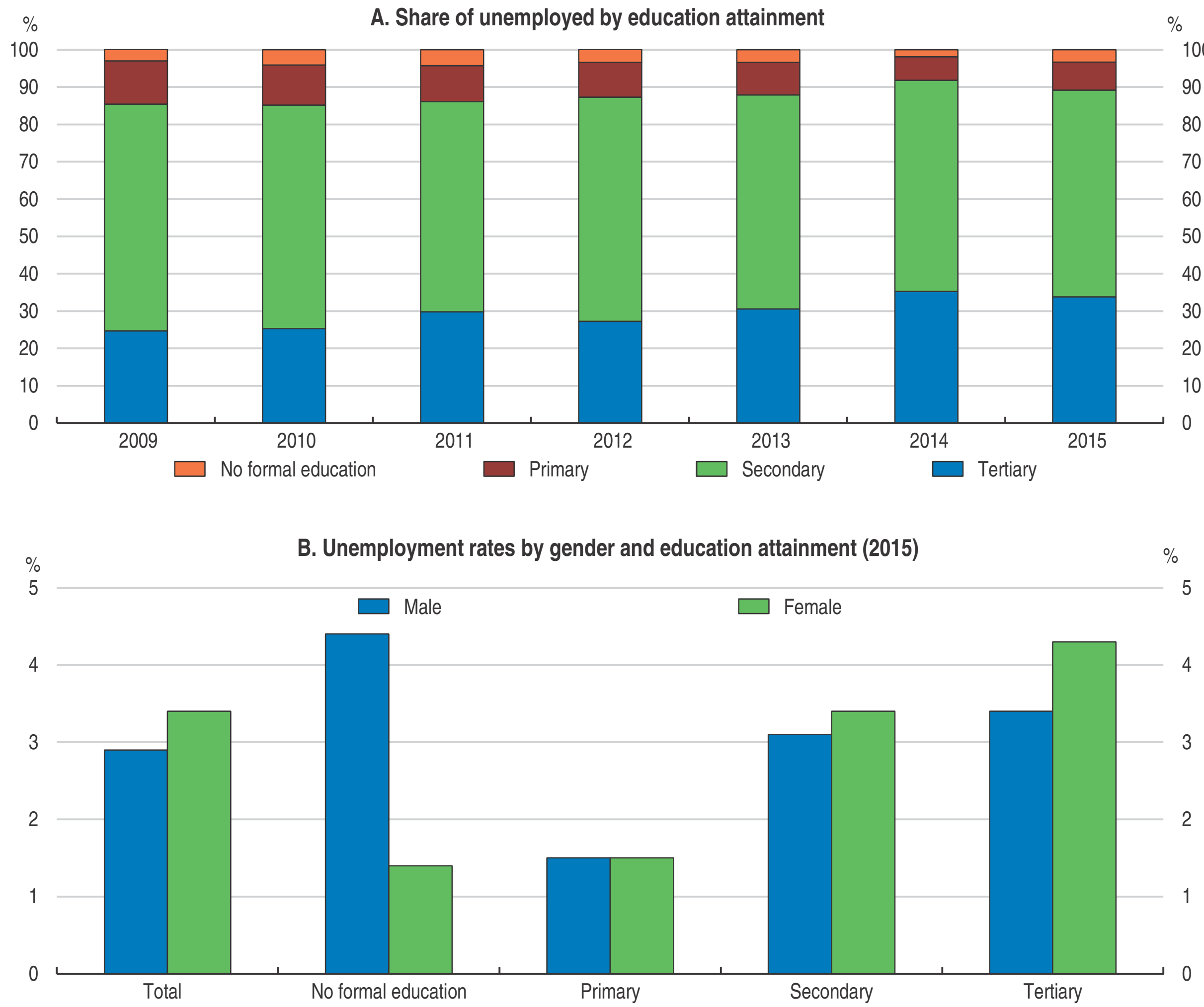
Figure 2.6. **Labour participation rates are relatively low**

Note: In panel B, data for Malaysia is 2015 and 2014 for all others.

Source: ILO, ILOStat database; OECD, Labour force statistics database, *http://dx.doi.org/10.1787/lfs-lfs-data-en*.

StatLink *http://dx.doi.org/10.1787/888933410819*

Figure 2.7. **Unemployment rates by education attainment and gender**



Source: Department of Statistics, Malaysia.

StatLink http://dx.doi.org/10.1787/888933411052

Plan target for youth unemployment of below 8% by 2020, the successful implementation of reforms to improve skills training, job matching and the industry relevance of tertiary qualifications will be critical (see Chapter 1). The government also offers a programme, Transit home, aimed at high-risk children and youth to improve their employability including entrepreneurship, education and skills training as well as providing emotional and psychological support to return into society.

Stronger minimum wage enforcement and effective policies for migrant workers

While the introduction of a minimum wage in 2013 has lifted wages for numerous low-paid workers, many workers are not benefiting from increased legal protections. The informal sector (defined as firms which are not registered with the authorities) accounted for 1.4 million workers or 11.5% of employment in the non-agricultural sector in 2015, according to the Informal Sector Workforce Survey Report (DOS, 2016).

Strengthening the enforcement of the minimum wage is essential to its ongoing effectiveness. As regards employers, the promotion of business registration associated with the introduction of the Goods and Services Tax (GST) in 2015 has encouraged the formalisation of firms that previously operated in the shadow economy. Further formalisation can be promoted through outreach programmes to raise awareness and regulatory reform to reduce the costs of business registration and licencing (see Chapter 1). Complementary initiatives to increase spot checks and auditing of compliance with minimum wages and other labour-related regulations would also assist. Stronger penalties for non-compliance may act as a deterrent (the maximum penalty per worker is equivalent to less than one year of minimum wages).

Enforcement could also be strengthened through incentives and opportunities for workers to assist government compliance activity. In the absence of a strong union presence in Malaysia, awareness of and access to complaints procedures or government tip lines is not widespread among low-skilled, low-income workers. Government regulators need to be proactive in raising awareness and engaging with workers who otherwise may struggle to find them, in particular foreign workers, whose livelihood is under the comprehensive power of their employer by virtue of Malaysia's employer-responsibility system for the recruitment and care of foreign workers (although legal foreign workers are less likely to experience mistreatment).

More broadly Malaysia needs to rectify its approach to labour migration policies that for two decades have focussed on immediate business needs rather than longer-term settlement. While business-oriented temporary worker programmes provide flexibility as part of an overall immigration policy mix, the sole focus on temporary workers should be revisited to reduce the business stranglehold on low-skilled labour policy. This would encourage migrants to cooperate with government as legal temporary workers and potential future permanent residents where consistent with long-term labour market needs (ILO, 2016) (Box 2.1).

Box 2.1. **An immigration policy befitting a high-income inclusive country**

The 11th Malaysia Plan includes a commitment to develop a comprehensive immigration and employment policy for foreign workers – a reform that is essential for Malaysia to become a high-income and inclusive society. Effective implementation of Malaysia's TPPA commitments and minimum wage laws also depends on improving the rights of foreign workers. Promoting high value-added industries and Malaysia as an education hub requires policies to attract and retain talented people, which are linked to broader immigration policies.

Like other middle-income economies, Malaysia seeks to attract or retain highly educated and skilled labour but mainly attracts low-skilled immigrants and sees many educated Malaysians emigrate. Policies towards low-skilled immigration are becoming increasingly restrictive as perceptions increase that it puts Malaysian workers at a disadvantage, despite evidence to the contrary (World Bank, 2015). The 11th Malaysia plan introduced the first-ever cap on all foreign migrant workers at 15% of the total workforce by 2020. At the same time, a specialised agency (TalentCorp) is tasked to attract skilled workers from overseas, utilising process streamlining and tax incentives to lure expatriate Malaysians back home. Yet high and low skilled labour cannot be completely divorced from each other, with the overall immigration environment a potential influence on skilled labour and business decision-making.

Box 2.1. An immigration policy befitting a high-income inclusive country *(cont.)*

To attract high-skilled labour, TalentCorp helps match skilled migrants to employment opportunities, cuts through red tape and provides one-stop services for skilled migrants living and working in Malaysia. Eligible skilled migrants are provided with a range of benefits that provide stability and certainty, including a ten-year pass to live and work in the country, flexibility to move from one employer to another, eligibility for their spouse to work, and a clearer path to permanent residency for themselves and family members. Tax incentives are also provided but are likely to be little more than sweeteners relative to these incentives. Immigration of high-skilled workers is low volume, uncontroversial and for some industries benefits from mutual recognition of planned qualifications within ASEAN.

In contrast, policies regarding low-skilled foreign workers are high volume and politically charged, resulting in migration being more difficult to manage. Registered foreign workers accounted for 17% of total employment in 2014, while the share is estimated to be 27% if undocumented foreign workers are taken into account. Indeed, 2.5 million unregistered foreign workers applied for regularisation in 2011 (OECD, 2012a). A large portion of registered foreign workers were engaged on a short-term basis in the manufacturing (36%), agriculture (23%) and construction (20%) sectors, reflecting restrictions on employment in many services sectors. Approximately one-third of the agricultural, manufacturing and construction workforce are migrants (ILO, 2016). Official planning documents, domestic commentators and to some extent industry see an enduring reliance on informal low-cost and low-skilled foreign workers as contributing to slower than desirable industrial upgrading and lower wage growth, though a causal link is difficult to substantiate.

As noted previously, policies to align domestic and foreign worker rights through minimum wages and conditions are welcome but incompletely implemented and enforced (ILO, 2016). In addition to the 15% quota on migrant workers, increasingly high levies on migrant workers have further sought to reduce incentives to hire these workers and provide a financial barrier to prospective employers of migrants. The government attempted to drastically increase levies in early 2016, but has reduced the size of the hike following protests from employers. Malaysia has also bolstered regulations covering the employment and conditions of foreign workers, although the minimum wage does not apply to domestic helpers, who are mostly foreign workers. It has set up a single-window system for employers to apply for worker permits to encourage formalisation and has strengthened laws against the employers of undocumented foreign workers. However, these measures do not appear to have been effective in managing migration patterns or community attitudes to foreign workers.

The limited effectiveness of existing measures is not surprising, as they fall short of a considered approach to immigration policy underpinned by well-aligned incentives and penalties. Frequent policy changes provide little certainty for prospective migrants or businesses and only serve to exacerbate challenges in facilitating cooperation from either stakeholder. The absence of a clear path to permanent migration for low-skilled workers and a compliance system overly dependent on business disempowers government and migrants and provides opportunities for business exploitation. Further government commitments to introduce a strict liability concept, whereby employers of foreign workers are fully responsible for migrant recruitment and welfare, may further exacerbate these concerns and consolidate business dominance over immigration policy. Ineffective management of community attitudes to immigration is also not endearing the cooperation of migrant and business stakeholders. Malaysia should urgently fulfil its commitment to develop a comprehensive immigration and employment policy for migrant workers to provide stability, certainty and coherence to immigration policy.

Strengthening social protection

Malaysia's success in alleviating poverty, a major target under the 1971 New Economic Policy, has been achieved despite the absence of an integrated and comprehensive social protection system. Households benefit from near-universal access to electricity, clean water, healthcare and transport, but income support for disadvantaged persons (such as the unemployed, single parents, disabled and elderly) remains ad hoc, insufficiently targeted and inadequate in providing basic living standards. Achieving inclusive growth not only requires providing meaningful employment but protecting people who are unable to work. For Malaysia to achieve its aspiration of becoming a high-income country, a key priority is to develop a comprehensive social protection system that provides targeted and timely support to those in need, while retaining strong incentives and facilitation mechanisms to maximise labour market participation.

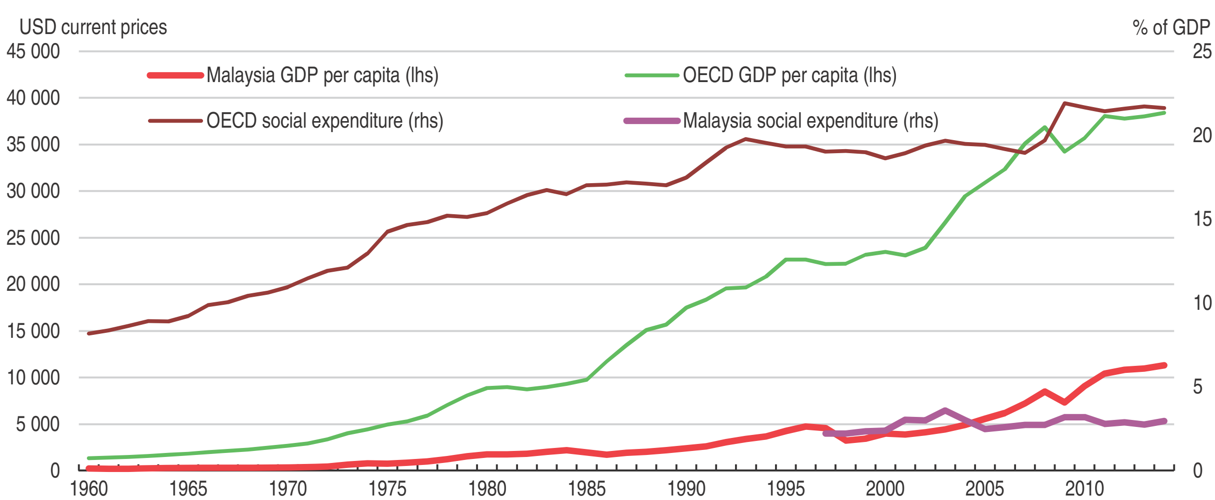
Malaysia's social protection expenditure is low for its development stage

Malaysia's social protection expenditure is lower than in all Southeast Asian countries for which data are available and than in all but a handful of countries in the Asia-Pacific region (ADB, 2015). Public expenditure on social protection as a proportion of GDP typically rises in step with GDP per capita, as has been the case for OECD countries. This has not been the case in Malaysia (Figure 2.8).

The low level of social protection expenditure is further reflected in the low redistributive power of the tax-and-transfer system: pre and post-tax and transfer Gini coefficients for income barely differ, like in Turkey (OECD, 2012b; Figure 2.9).

Subsidies that artificially kept down fuel, food and transport prices were by far the largest transfer to households prior to their substantial removal in 2014 (amounting to around MYR 24 billion or 2.4% of nominal GDP in 2013). Pension payments to retired civil servants are now the largest transfer, benefiting a small set of comparatively well-off households. Neither of these are a transfer that targets social welfare to low-income households.

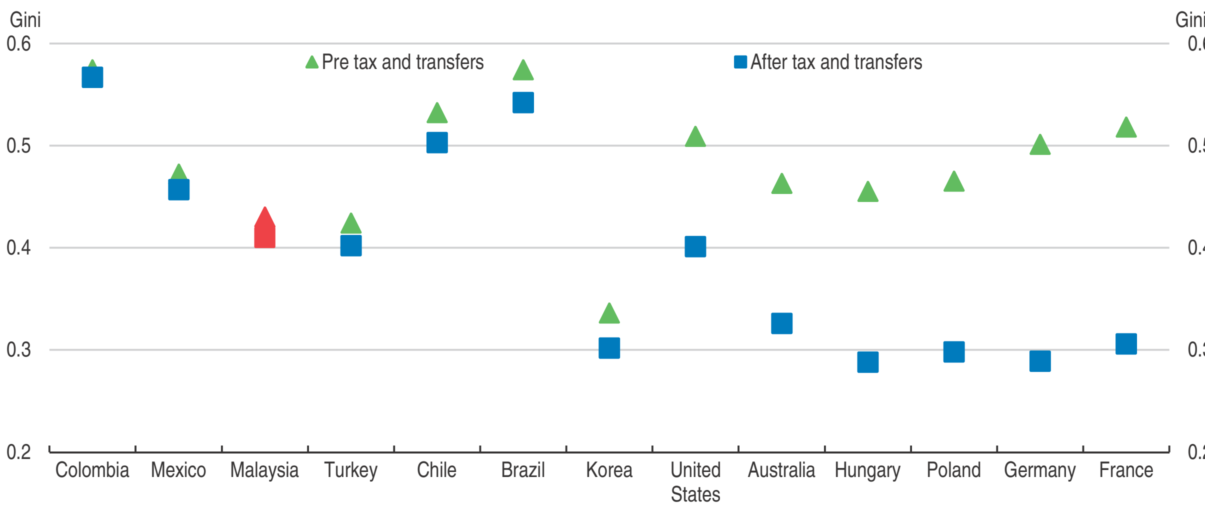
Figure 2.8. **Social expenditure in Malaysia has not increased in step with GDP per capita**



Source: OECD (2016), Social spending (indicator), *http://dx.doi.org/10.1787/7497563b-en*; ADB, Statistical Database System.

StatLink http://dx.doi.org/10.1787/888933410825

Figure 2.9. **Malaysia's tax-and-transfer system has little effect on income distribution**



1. 2013 for Korea and the United States and 2014 for Malaysia and Hungary, 2012 for all others.
2. The Gini coefficient has a range from zero (when everybody has identical incomes) to one (when all income goes to only one person). Increasing values of the Gini coefficient thus indicate higher inequality in the distribution of income.

Source: OECD (2016), OECD Income Distribution Database, *http://dx.doi.org/10.1787/data-00654-en*; World Bank (2014), *Malaysia Economic Monitor December 2014: Towards a Middle Class Society.*

StatLink http://dx.doi.org/10.1787/888933410837

A key priority is the introduction of an employment insurance scheme that integrates job-matching services, reskilling and income smoothing to prevent a temporary setback from becoming an entrenched disadvantage. The government has proposed an employer-and-employee-funded Employment Insurance System based on the set-up in Japan and Korea, but the proposed funding model is opposed by the social partners, pointing to the merits of considering financing it through general tax revenue, as in Australia. The overall experience of OECD countries suggests that in practice, employer, employee and government co-financing is often required. The proposed scheme would provide the unemployed with allowances for job placement and retraining and early re-employment incentives. While suitable for Malaysia's immediate need to improve support for the temporarily unemployed, a more comprehensive scheme that also includes temporary income smoothing payments would further reduce financial barriers to re-employment and overall income inequality. It would also encourage increased productivity by providing a safety net for entrepreneurial risk-taking and labour mobility.

Fragmentation of programmes and institutions results in poorly targeted support

Social expenditure is highly fragmented, being provided through a multitude of small-scale, specific-purpose programmes by a diverse range of ministries. The Ministry of Women, Family and Community Development is the lead agency for social support programmes targeting extreme poverty and workforce participation support for disabled persons and women. Social support for farmers, subsidised diesel for fishermen and rice rations for poor families are provided by the Ministry of Agriculture and Agro-based Industry, support programmes and incentives for poor students by the Ministry of Education, medical support through the Ministry of Health and so on. The introduction of cash payments for families under the BR1M (1Malaysia People's Aid) programme has added the Ministry of Finance as an additional direct stakeholder in social expenditure. At the same time, the "eKasih" database developed to improve the registration and targeting of social welfare recipients is maintained within the Implementation Coordination Unit under the Prime Minister's Department. The implementation of the proposed employment insurance scheme would add the Ministry of Human Resources to an increasingly disjointed social protection system that is prohibitively difficult for potential recipients to navigate.

Key pillars among the range of social support programmes are 1AZAM, the eKasih database and BR1M. 1AZAM is a flagship programme focused on providing income-generating opportunities for low-income households, reducing their reliance on government support. It typifies Malaysia's employment-oriented approach to social welfare (which includes providing higher income support to employed than unemployed disabled persons) and represents a successful example of inter-agency collaboration to tackle pockets of poverty (particularly in rural areas). The eKasih database is a critical enabler of social protection targeting, supporting the identification of impoverished households and connecting them with assistance programmes. Continued efforts to improve the database will support the effectiveness of social protection policy-making and programme implementation. Since 2012, the BR1M programme has provided cash payments to lower-income households to ease cost-of-living pressures. While increasing each year, the BR1M programme allocation of MYR 5.9 billion in 2016 is far smaller, though better targeted, than the value of the discontinued fuel and food subsidies. Into its fifth year, the BR1M programme remains ad hoc and irregular in its payment arrangements, providing little financial certainty for low-income households while jarring with the employment emphasis of other programmes. A more considered approach to BR1M and social protection programmes more broadly is needed to improve the consistency of objectives, programme targeting and the overall impact on reducing disadvantage.

Beyond government, civil society makes an important contribution to social expenditure in Malaysia. As the size of this contribution increases, the effectiveness of Islamic institutions supporting the collection and distribution of *Zakat* and collaboration with government will be critical to optimising overall social expenditure (Box 2.2).

Towards a comprehensive social safety net

It is essential that Malaysia develop a comprehensive social protection and income transfer system that provides targeted and timely support to those in need, while retaining strong incentives and facilitation mechanisms to maximise labour market participation. This requires more than filling gaps with new and often contradictory programmes, and calls for undertaking a comprehensive assessment of social protection needs and optimal strategies to meet them.

Experience suggests there is no one-size-fits-all approach to social protection systems, which need to be suited to country circumstances. However, a well-designed system would complement the strong incentives to engage in productive employment that exist in Malaysia, while supporting inclusiveness through income redistribution and employment facilitation mechanisms for low-income households, unemployed, sick, disabled and elderly persons.

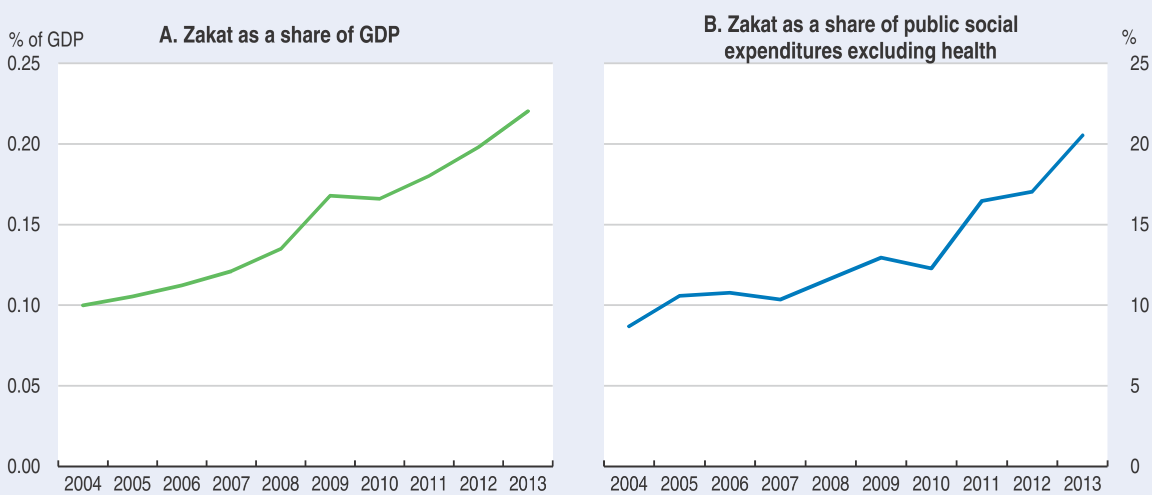
Setting up such a system will require an initial scoping study to map existing programmes and comprehensively identify the vulnerable in need of social protection, including an analysis of the determinants of vulnerability and the needs of affected

Box 2.2. The contribution of *Zakat* to social expenditure in Malaysia

One of the five fundamental obligations of Islam is that Muslims contribute a proportion of their income and wealth to a compulsory charitable mechanism called *Zakat*, with funds redistributed to households as supplementary income to alleviate poverty. Every Malaysian state has its own institution responsible for collecting *Zakat* and making redistributions in accordance with its own *Zakat* poverty line, which is determined on a similar income basis to government poverty lines.

The contribution of *Zakat* to social expenditure has increased significantly in recent years, in absolute terms and in proportion to GDP (Figure 2.10). Importantly from the perspective of expenditure consistency and timeliness, the growth in *Zakat* collections is not proportional to GDP but holds up well during times of economic turbulence, when it is most needed. In 2013, *Zakat* represented over 20% of the level of government social spending excluding health, making it a major contributor to Malaysia's overall social expenditure.

Figure 2.10. **Zakat has been expanding rapidly**



Note: Social expenditure in Panel B includes central government expenditure on social security and welfare and zakat expenditure.
Source: Department of Awqaf, Zakat and Hajj (JAWHAR); ADB (2016), Statistical Database System.

StatLink http://dx.doi.org/10.1787/888933411060

Recent growth in the size of collections has prompted additional research evaluating the effectiveness of *Zakat* as a social expenditure mechanism (Johari et al., 2015). While effective in alleviating poverty by supplementing the income of benefiting households by as much as 30%, studies have identified numerous ways to increase *Zakat* collections, distributional targeting and the professionalism of institutional governance. Among priority areas for improvement are delays in the distribution of funds, the need for modern collection methodologies (such as internet banking) and disbursement for income-generation activities (rather than income supplements).

Greater collaboration between state-level *Zakat* centres, state and federal governments could further assist in reducing duplication and the effective targeting of assistance to impoverished households. Localised *Zakat* administration can help identify and address local needs but lacks the redistributive capacity of national administration. Indeed, *Zakat* collections and therefore redistributions are significantly higher in wealthier states, limiting the ability to target pockets of poverty in poorer states. The development of a national social protection system should maximise complementarities between government expenditure and the increasingly significant role of *Zakat*.

persons. The end goal is a single strategy with implementation supported by clear institutional responsibilities and capacity, including in relation to the ongoing monitoring and evaluation of system performance. Malaysia could utilise global best practice toolkits such as the Inter Agency Social Protection Assessments toolkit (ISPA, 2016) and draw lessons from the OECD Development Centre's work to develop social protection systems in the region (OECD, 2016). ISPA provides a framework for countries to analyse the strengths and weaknesses of the overall social protection system, including policies, programmes and administration. It provides a platform for collaboration between government agencies to develop a common vision for social protection systems and ensure a consistent, inter-agency approach to system development, implementation and evaluation.

A comprehensive social protection system would complement the implementation of other policy priorities identified in this assessment. For example, income smoothing for unemployed persons would be conducive to formalisation of the labour force, allowing for improved targeting of employment facilitation and retraining programmes, a broader income tax base, and increased innovation and entrepreneurship by lowering the potential cost of risk-taking.

A tax and transfer system that supports inclusive growth

Malaysia's tax and transfer system can do more for inclusive growth, with overall tax collection and redistribution both low by OECD and global standards. As Malaysia approaches high-income country status and as its society ages, higher tax revenue will be needed to fund growing fiscal expenditure.

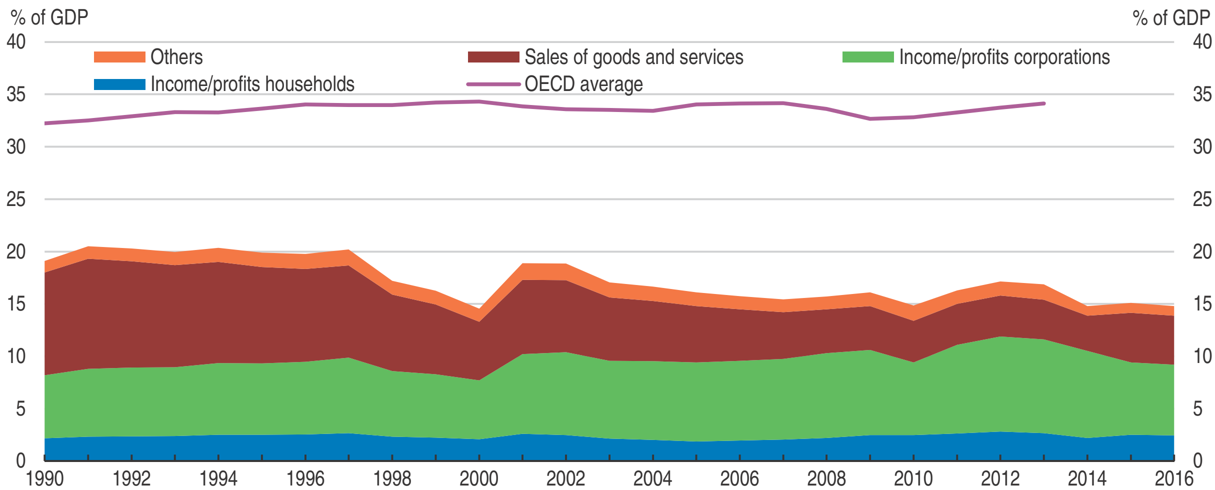
Low global oil prices together with an increasingly services sector and domestic demand driven economy have prompted a prudent rebalancing of Malaysia's revenue base, but further reforms are needed to improve medium-term fiscal sustainability. Reforms are needed to increase the overall tax base, improve the balance of its composition and provide additional resources for programmes promoting inclusive growth. The complexity of the interactions between the recent and the possible additional reforms points to the need for an overall review of the tax base as part of a broader review of medium-term fiscal sustainability.

Reversing the decline in revenue collection

Low global oil prices have seen oil-related revenue decline substantially in recent years, with its share in overall revenue estimated to have halved between 2014 and 2016, to under 15%. Declining oil-related revenue is the latest contribution to a more concerning longer-term structural decline in the overall tax base. From around 20% of GDP prior to the Asian Financial Crisis, tax revenue has fallen throughout the 2000s to around 15% of GDP today (Figure 2.11). Tax revenue as a share of GDP is less than half the 34% OECD average and trending downwards. This evolution contrasts with the experience of other countries with rising income levels.

Faced with declining oil-related revenue, Malaysia has mainly acted on the spending side to achieve fiscal consolidation. Nonetheless, some difficult tax reforms have been implemented to reduce the rate of revenue decline, including the introduction of the GST in April 2015 as well as an increase in the top marginal income tax rate from 25% to 28%. Intensifying popular concerns with rising cost-of-living pressures have more recently

Figure 2.11. **The share of tax revenue in GDP is low and declining**



Source: OECD (2015a), *Revenue Statistics in Asian Countries 2015: Trends in Indonesia, Malaysia and the Philippines*, *http://dx.doi.org/10.1787/9789264234277-en* (for the years 1990-2013); MOF (2015), Economic Report 2015-2016 (for the years 2014-16).

StatLink http://dx.doi.org/10.1787/888933410849

reversed the momentum for tax reform, prompting an expansion of the number of exempt or zero-rated GST items and a series of new income and corporate tax deductions.

Additional revenue is necessary to support medium-term fiscal sustainability and make room for increased spending on social protection, healthcare, infrastructure and communications technology in rural areas and green growth. Malaysia's recently adopted medium-term fiscal framework will need to incorporate a sustainable revenue trajectory that appropriately funds reform priorities.

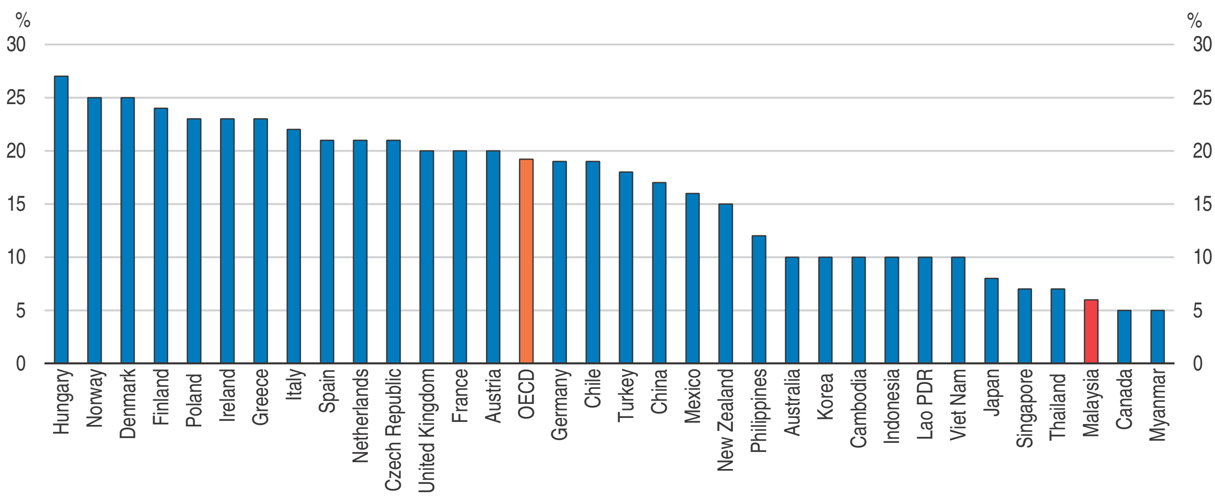
Indirect taxes and the GST in perspective

Indirect tax collections have declined over the past 25 years, with the revenue increase from the recently-introduced GST providing only a partial offset. Sales tax revenue as a proportion of GDP is less than half the early 1990s levels (Figure 2.11). Malaysia's opening to trade through the gradual reduction of tariffs and duties provide a partial explanation. However, despite an increasing share of consumption in GDP since the late 1990s, a combination of reduced tax rates and rising tax evasion has caused an erosion of the indirect tax intake. Reversing this trend in the context of rising cost-of-living pressures will be difficult but necessary.

Consumption taxes are potentially quite important to the overall tax mix given the size of the informal household sector, which includes an estimated 1.7 million undocumented foreign workers, and to tax around 350 000 Malaysian residents commuting to work in Singapore. Implementation of the GST has been more successful than anticipated, with a high rate of business compliance boosting collections beyond original projections. Recent research on OECD countries also indicates that greater use of simple, broad-based consumption taxes can be beneficial in reducing compliance costs and distortions to consumption decisions arising from differential rate systems, while also being proportional or slightly progressive when measured as a percentage of household expenditure (OECD/Korea Institute of Public Finance, 2014).

In fact, there is ample scope for the GST to raise further revenue. The initial rate of 6% is low by regional and broader international standards (Figure 2.12), while increasingly extensive exemptions have reduced its effectiveness. For some zero-rated goods, the introduction of the GST has actually resulted in a decline in the tax rate with the concurrent repeal of the preceding sales tax. There is ample room for a gradual series of increases to bring Malaysia's GST rate into line with regional peers and OECD countries. Reducing the number of exempt or zero-rated items and strengthening tax enforcement would help reduce tax leakage in the short term, while consideration could be given to a gradual increase in the rate of the GST over the medium term.

Figure 2.12. **The GST rate is low by international standards**



Source: OECD (2016), Tax database, *http://dx.doi.org/10.1787/tax-data-en*; KPMG (2015), *2015 Asia Pacific Indirect Tax Guide*.

StatLink http://dx.doi.org/10.1787/888933410851

A more progressive income tax system with a broader base

Malaysia has traditionally sourced a large proportion of tax revenue from corporate income and profits taxes, in particular through taxes on profitable state-owned oil companies (Figure 2.11). Declining oil revenue in recent years has rendered this model unsustainable and highlighted the need to diversify the tax base. Opportunities still exist to adjust corporate tax settings where these would support broader industrial and environmental objectives.

Besides, Malaysia's income tax and transfer system does very little to enhance inclusiveness through tax schedule progressivity or redistribution, as evidenced by almost identical before and after tax and transfer Gini coefficients (Figure 2.9). A more progressive income tax schedule would complement the development of a comprehensive social protection system in reducing income inequality.

Middle-income earners need to become taxpayers, with less than 10% of Malaysians over 15 years old actually paying income tax. That personal income tax is only levied at a very high income threshold compared to the average wage and the size of the informal sector are both part of the explanation. A combination of higher tax rates and narrower tax bands throughout the schedule would raise the average tax levied on middle and high-income earners, while exemptions or transfers could be used to protect low-income households.

The top marginal tax rate for very-high-income earners was recently raised to 28% but remains well below top rates of between 45% and 55% in higher-income OECD countries (OECD Tax Database). Combined with significant tax incentives for high-income returning expatriates – who may be eligible for a flat 15% income tax rate for five years - income taxes levy too small a contribution from Malaysia's richest. Raising the highest marginal tax rate further could contribute to raising average taxes on high-income earners, while the generosity and effectiveness of tax incentives offered to encourage expatriates to return should be reviewed in terms of costs and benefits.

Taxes on capital income as well as on capital gains, in particular in relation to property, contribute little to the current tax base. The high proportion of home ownership, while in some ways supportive of inclusive growth, suggests incentives to invest (including low tax rates) are skewing household investment towards property. Even minor increases in taxes on capital income and gains from property could raise significant revenue given the size of the potential base, while at the same time improving the progressivity of the tax system. Property taxes are also underutilised, with ongoing taxes based on the value of the property another possible means to achieve similar objectives. Additionally, with constitutional responsibility for property taxes with state governments, reform in this area could support fiscal decentralisation.

Malaysia also does not levy inheritance, estate or gift taxes. There is a clear case on distributional grounds for taxing wealth transfers on death as a means of reducing long-run inequality, both by reducing and dispersing wealth holdings and increasing equality of opportunity. Despite their merits, inheritance taxes are underutilised globally, with low rates and numerous exemptions typical where they exist. France and Belgium provide examples of successful systems, and yield fiscal revenue of around 0.5% of GDP (Brys et al., 2016). Inheritance taxes can be designed as a tax on the donor's estate or on the recipients, with inheritance taxes on the recipient the most consistent with inclusive growth. Differentiated rates could be applied depending on the relation between the donor and the recipient, with a minimum amount of the inherited wealth typically exempt from tax. An accompanying gift tax is often utilised to minimise avoidance of the inheritance tax through pre-death transfers, with appropriate exemptions to prevent non-avoidance related gifts from bearing a tax burden (for example, for gifts made more than five years before death). Introducing taxes on the transfer of wealth under these circumstances would not only reinforce the tax base but promote tax progressivity and reduce wealth inequality (Brys et al., 2016).

Malaysia is also working to address issues of international tax avoidance. Malaysia is participating in regional network discussions under the OECD base erosion and profit shifting (BEPS) project, with the Malaysian Inland Revenue Board currently undertaking a review of tax legislation in light of the BEPS project. A BEPS Action Committee has been established, with Malaysia prepared to revise tax legislation in accordance with international standards to the extent such standards are applicable and relevant to the Malaysian context.

A more sustainable pension system that delivers higher retirement incomes

Malaysia has a longstanding dual-track pension system consisting of a non-contributory defined benefit scheme for public sector workers (the Malaysian Public Sector Pension Scheme) and a defined contribution system for the private sector (the Employees Provident Fund scheme). The public scheme is funded from consolidated tax revenue, while the Employees Provident Fund (EPF) is the publicly-owned monopoly superannuation fund responsible for managing the contributions of private sector and non-pensionable public sector employees (such as persons hired on a contractual basis). The EPF is one of the world's largest pension funds with MYR 667 billion (approximately USD 171 billion or 58% of GDP in 2015) in assets under management as of mid-2015 (EPF, 2016).

A particular challenge for inclusive growth in transitioning towards high-income country status is balancing growth in consumption and investment today while provisioning for sustainable living standards in the future. The rapidly ageing population is already beginning to test the effectiveness of Malaysia's pension system: the burden of financing generous public sector pensions is increasingly unsustainable and replacement rates for private sector retirees who otherwise receive little systematic support through other social protection programmes are inadequate. Reforms to strengthen the fiscal sustainability of the public scheme and increase the adequacy of retirement living standards under the private scheme are increasingly necessary.

A more sustainable approach for public service pensions

Like a number of OECD countries, Malaysia has an increasingly unsustainable public sector pension system that offers more generous retirement incomes than afforded to private sector workers. Workers retiring after 30 or more years of service receive a guaranteed ongoing pension equal to 60% of their final salary (excluding allowances), a lump-sum worth more than two years' salary and free or subsidised medical benefits for life. This implies a more-than-adequate effective replacement rate of around 80% of final salary. Pensions are financed through general tax revenue – including the anticipated contribution of Retirement Fund Incorporated established in 2007 to invest a portion of government funds set aside for pensions - and employees do not explicitly contribute a portion of their salary to fund the scheme.

With pension expenditure having tripled in the past ten years to reach MYR 18 billion in 2015 (1.6% of GDP) and a long way from peaking due to the burgeoning civil service headcount (up to 1.6 million in 2015 from 0.98 million in 2000), a more sustainable system is urgently needed. Moving new employees into a defined contribution scheme would help limit future pension liabilities to existing and former employees, with legacy benefits paid out of a fully-financed separate fund. For equity reasons, it would be desirable to transfer the new employees into the existing defined contribution scheme for private sector employees. A transparent transition period with a one-off wage increase would help maintain the attractiveness of the public sector, compensating for the effective reduction in overall benefits. This in turn necessitates creating a dual-track system for all existing employees; that is, maintaining existing pension benefits based on salary net of contributions, while creating a defined contribution account, the balance of which would be deducted from the lump-sum calculation under existing pension rules. While the one-off wage increase would not affect disposable income and therefore would not be expected to have a significant impact on consumption, the transition would involve an increase in upfront government expenditure on pensions (through the commencement of explicit contributions) that should be assessed against the expected gains from reducing future liabilities. Reforms for public employees should also be complemented by concurrent reforms to increase the robustness of the defined contribution system (discussed below).

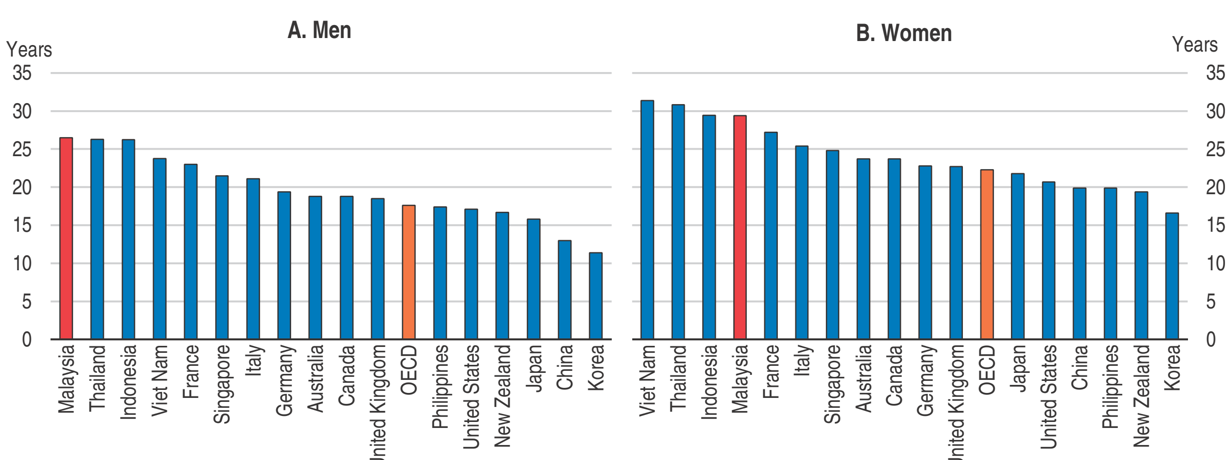
Raising the effective retirement age to account for rapid population ageing

Pension system sustainability requires careful long-term planning in anticipation of expected demographic trends. While Malaysia's population structure is relatively young at present, it can expect to experience rapid ageing, with a projected doubling from 7% to 14% of the proportion of the population aged over 65 in just 20 years (World Bank, 2016) – by comparison it took the United Kingdom and the United States 45 and 69 years respectively. On current trends, Malaysia could expect to reach aged nation status (where the share of the population over 60 years old exceeds 15%) around 2030-35, with the next 15-20 years critical to developing a sustainable pension and broader social protection system for elderly persons.

As life expectancy continues to increase and an increasing proportion of the population spend more time in higher education before entering the workforce, all else remaining equal, a decreasing number of working years would be expected to fund a longer retirement. Malaysia will face something similar to the experience of high-income OECD countries, where system sustainability and the adequacy of replacement rates will come under substantial strain in the absence of forward planning.

Malaysians can already expect a long retirement compared to residents of both OECD countries and countries in the region (Figure 2.13). Despite being raised by five years in 2013, Malaysia's official retirement age of 60 remains below the OECD average of 64 in 2014. Moreover, by not simultaneously adjusting upward the withdrawal age for private sector

Figure 2.13. **Malaysians can expect a lengthy retirement**



Note: The data for OECD countries and China is for 2014, 2012 for all other countries.
Source: OECD (2013b), *Pensions at a Glance Asia-Pacific 2013*, *http://dx.doi.org/10.1787/pension_asia-2013-en*; OECD (2015c), *Pensions at a Glance 2015*, *http://dx.doi.org/10.1787/pension_glance-2015-en*.

StatLink http://dx.doi.org/10.1787/888933410862

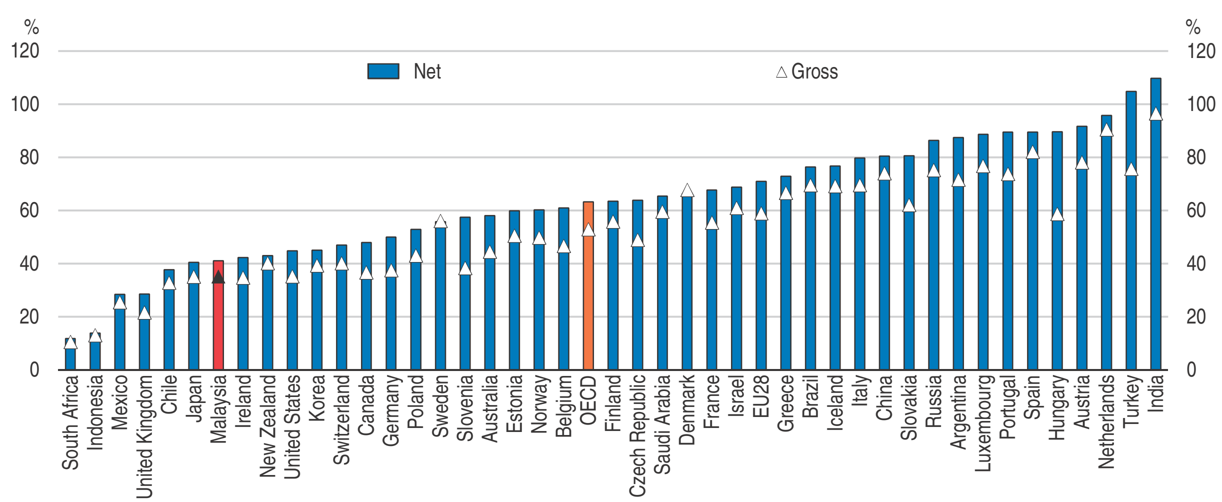
workers under the EPF, the effective retirement age remains at 55. Malaysia should consider an immediate alignment of the EPF withdrawal age with the retirement age with transitional arrangements for current or imminent retirees, while developing a broader strategy to progressively raise its official retirement age and the EPF withdrawal age in line with expected changes in healthy life expectancy. Consultation between the EPF and its members on withdrawal age increases indicates that changes will need be done cautiously and effectively communicated, as individual awareness of retirement adequacy is low.

Options to improve replacement rates

The net replacement rate for a Malaysian male of average income was 41% in 2012, while the net replacement rate for a Malaysian male earning half the level of average income was 40.3% (OECD, 2013b). By comparison, the OECD average for these indicators was 68.3% and 79.5% respectively in 2014, with a replacement rate of around 70% of average income considered a reasonable benchmark for pension system adequacy (OECD, 2015d) (Figure 2.14). EPF data indicates that 70% of 54-year old members would not have enough savings to meet basic retirement needs if they retired at age 55, while half of all retirees exhaust their savings in just five years. System immaturity is not an issue for Malaysia's longstanding retirement system; it is the system settings that are delivering inadequate retirement incomes, with B40 households especially vulnerable. Replacement rates under the private sector scheme would not be expected to reach OECD levels in the absence of reforms.

The generous provision permitting early withdrawals ahead of the official retirement age and for certain current consumption activities (housing, education, medical and religious reasons), undermines a system designed to provide for retirement income. Compared to lowering mandatory contribution rates by 30% - equivalent to the share of contributions that can be withdrawn before age 55 - the system of early withdrawals adds

Figure 2.14. **Pension replacement rates are low**



Note: The data are for 2012 for Malaysia and for 2014 for OECD countries. The source publications assume investment returns of 3.5% per annum for Malaysia, whereas a 3% per annum return was assumed for OECD countries.

Source: OECD (2013b), *Pensions at a Glance Asia-Pacific 2013*, *http://dx.doi.org/10.1787/pension_asia-2013-en*; OECD (2015c), *Pensions at a Glance 2015*, *http://dx.doi.org/10.1787/pension_glance-2015-en*.

StatLink *http://dx.doi.org/10.1787/888933410874*

bureaucracy and limits consumption opportunities for low-income households post-retirement. Tightening the system for early withdrawals would boost system integrity and ultimately improve replacement rates.

Furthermore, replacement rates lack progressivity, implying that the pension system does relatively little to boost the retirement incomes of low-income workers. The aforementioned reforms to improve the progressivity of income distribution pre- and post-retirement would also contribute to Malaysian replacement rates converging to OECD standards.

In addition, reliance on a single, publicly-owned fund for the investment of pension contributions appears to be lowering replacement rates through lower average investment returns. As a public institution, the EPF's mandate contains investment restrictions that limit its ability to maximise returns, resulting in an investment strategy that is conservative by global standards (51% of total investment is in fixed-income products including Malaysian Government Securities). Since 2013, tax exemptions have been offered to encourage individuals to invest in Private Retirement Schemes outside of the EPF, but the take-up rate has been low. Further efforts to open the pension market to competition from alternative providers and to liberalise restrictions on EPF investment would improve replacement rates over the long term.

High contribution rates contribute to informality, low saving and reduced consumption growth

Mandatory contributions to the EPF for the majority of private-sector workers ordinarily amount to 23-24% of wages: an 11% employee contribution plus a 12-13% employer contribution. The employee contribution was temporarily reduced to 8% until the end of 2017 as a 2016 Budget revision measure to boost short-term growth, but employees can choose to opt out of the reduction.

Malaysia's usual mandatory contribution rate is above the OECD average of 20.3% in 2014 and towards the upper end of pension contribution rates in the Asia-Pacific region. Malaysia's high contribution rates are in part a product of its overall approach to taxes, transfers and social expenditure, with the pension system required to do more heavy lifting than in many countries. Although there is no single global standard rate, with the optimal contribution level depending on the particular circumstances of the country, Malaysia's contribution rates are high for its income level. According to one global pension system indicator, which compares the adequacy, sustainability and integrity of pension systems, the top three ranked countries have rates of 13.4% (Denmark), 20.9% (Netherlands) and 9.5% (Australia) (Mercer and Australian Centre for Financial Studies, 2015).

At around 60%, Malaysia's low pension coverage rate as a proportion of its labour force indicates that high contribution rates may be deterring the entrance of workers into the formal sector. Labour force formalisation would improve the effectiveness of government policies including tax and social welfare, with lower pension contribution rates for low-income workers one way to realign incentives to encourage formalisation. As a benchmark for pension coverage, Malaysia could seek convergence with the OECD average of around 86% in 2014.

The low rate of household saving may also indicate that contribution rates are too high for the current level of household income. Household saving averaged around 1.5% of disposable income in 2013 or -5.8% if mandatory contribution rates are excluded, indicating that Malaysian households are borrowing heavily against their deferred income. While EPF returns have exceeded average borrowing costs since 2009, the cost of servicing these debts may ultimately exceed the returns on pension earnings. Evaluating whether contribution rates are appropriate in balancing current and future consumption needs should also form part of discussions on pension reform, subject to broader consideration of complementary policies for social protection.

Maintaining universal access to quality healthcare

An accessible healthcare system that supports increasing healthy life expectancy is not only integral to well-being and inclusiveness, but is a necessary condition for a productive labour force. Malaysia's significant investment in public healthcare has complemented broader initiatives to alleviate poverty in tackling premature mortality. This has contributed to life expectancy increasing from 64.6 years in 1966 to 74.7 in 2014. Although Malaysia's life expectancy is still below the OECD average, it performs as well as the top 30% of OECD member countries in terms of the quality of self-reported health. Over the same period, improved maternal and child healthcare has markedly reduced infant mortality per 1000 live births from 75.5 to 6.6.

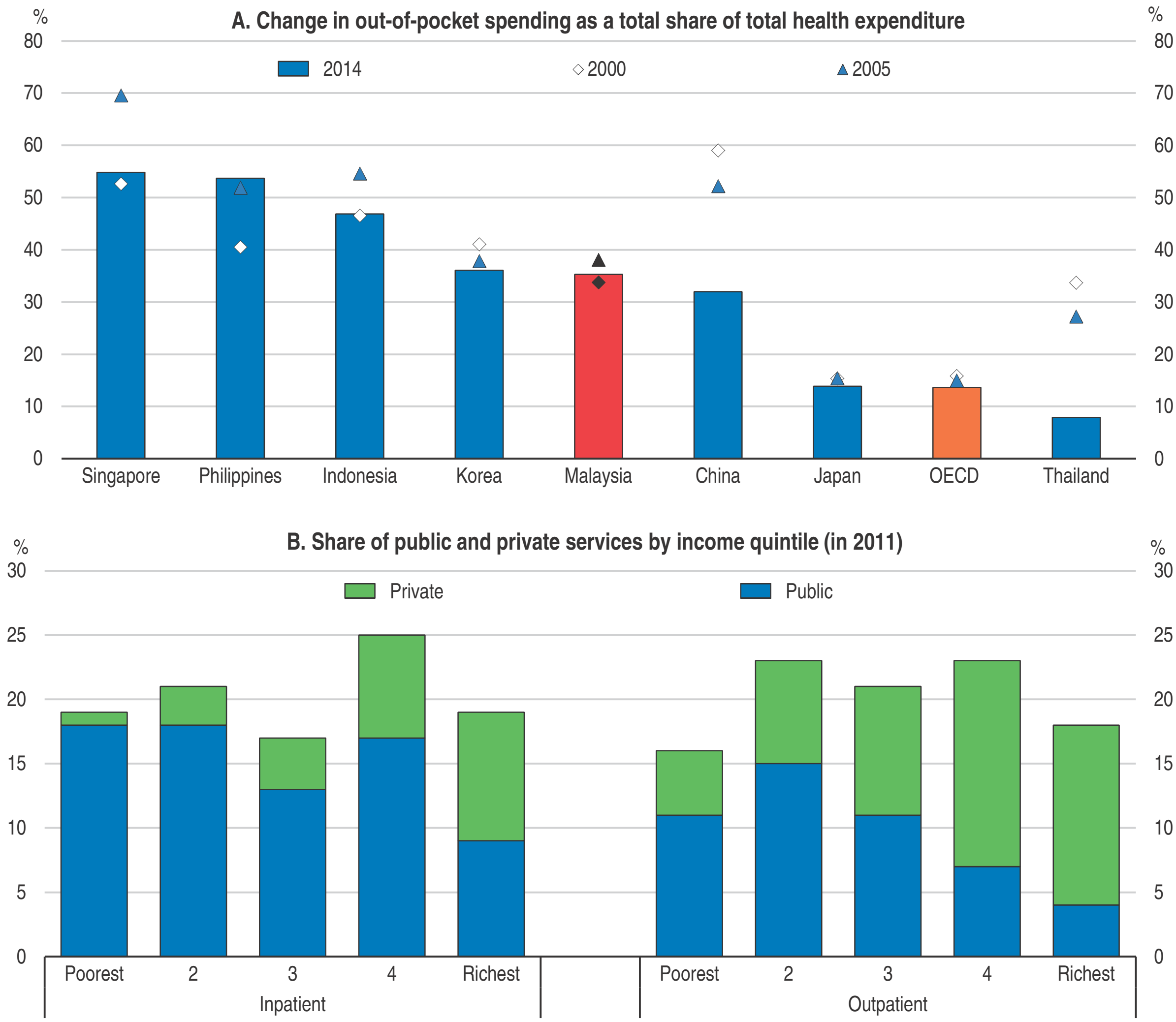
Malaysia provides universal healthcare through a heavily subsidised public system, supplemented by private healthcare for people who can afford it. Public system patients pay a nominal sum for treatment, while fees for private healthcare services are paid fully out-of-pocket by the patients themselves, their employers, or insurance companies (PEMANDU, 2012). The public share of healthcare expenditure was 55% in 2014, while the respective shares of private system patients' out-of-pocket expenditure and private insurance were 79% and 14% of private healthcare expenditure, as private health insurance markets have low saturation.

Addressing the increasing burden on the public system

High out-of-pocket expenditure for healthcare – representing 35% of total healthcare expenditure as of 2014 compared to an OECD average of 14% – is contributing to polarisation in the provision of healthcare services by socio-economic status (Figure 2.15). Use of private services increases with household income, while dependence on public services increases the poorer the household. This is especially the case for inpatients, who require more intensive care, as opposed to outpatients, who require mainly primary care. Access to highly-subsidised public healthcare ensures low incidences of catastrophic and impoverishing expenditures or deferral of medical treatment for financial reasons; however, it is resulting in an overburdening of the public health system.

Many medical specialists have been leaving the public system to take better remunerated positions in the private system, creating shortages of critical staff. On one estimation, almost 70% of medical specialists are in the private sector, but only 30% of complicated cases requiring specialists are managed there (Syed, 2014). This lopsided allocation of medical specialists has led to rising incidences of overcrowding, long waiting times, delayed consultation and late admission for emergency cases (EPU, 2015c). It also reduces the inclusiveness of healthcare as private facilities are typically located in wealthier urban areas.

Figure 2.15. **Poor households are more reliant on public-sector health care services**



Source: WHO Global Health Expenditure (database); IHSR (2013), *Malaysia Health Care Demand Analysis: Inequalities in Healthcare Demand & Simulation of Trends and Impact of Potential Changes in Healthcare Spending.*

StatLink http://dx.doi.org/10.1787/888933410883

Malaysia has taken steps to ease the burden on the urban public health system and improve access to quality healthcare for low-income urban residents. The operational hours of some public outpatient clinics have been extended to increase access to primary care, catering to the irregular working hours of the urban poor. The government has also introduced "cluster hospitals" arrangements whereby facilities in the same geographical location pool resources to better manage patient flows. Retention packages have been developed to increase compensation and allow for flexible working arrangements as an incentive for medical doctors and specialists to remain in the public system.

Limited access remains an impediment to equitable universal healthcare in some rural areas. Inadequate transport infrastructure, low economies of scale and low incentives for professionals to work in rural and remote villages are among the challenges to the establishment of urban-equivalent facilities in remote areas. Nonetheless, mobile clinics in the form of "flying doctors" and vehicle, boat and bus equivalents help provide services in these areas and connectivity to urban facilities. Malaysia continues to plan for the appropriate infrastructure and technologies necessary to ensure the optimal and equitable provision of health services in these communities.

The private system also suffers from a shortage of qualified professionals, most acutely with respect to qualified nurses. In contrast to the migration of doctors to the private system, many trained nurses have shifted to public hospitals attracted by better compensation packages and training opportunities. Private hospitals find it difficult to send their nurses for post-basic training due to a shortage in training capacity (MPC, 2015). Despite the shortage of nurses in the private sector, 8 000 nursing graduates mainly from private colleges remained unemployed in 2012 due to a lack of necessary skills, in particular communication skills, and inadequate training. As most government hospitals have their feeder colleges, they are unable to employ graduates from the private nursing colleges. Most private hospitals prefer to hire graduates from public universities, who are perceived to have the necessary academic and employability skills (Nalini, 2014). To narrow skills and job mismatches, an integrated and well-structured programme encompassing universities, the government, and public and private medical institutions is required, as is a long-term view of skills training and a more flexible regulatory framework including with respect to labour conditions. For this purpose, the government and private colleges offer post-basic training course for private-sector nurses.

Enhancing the sustainability of the healthcare system

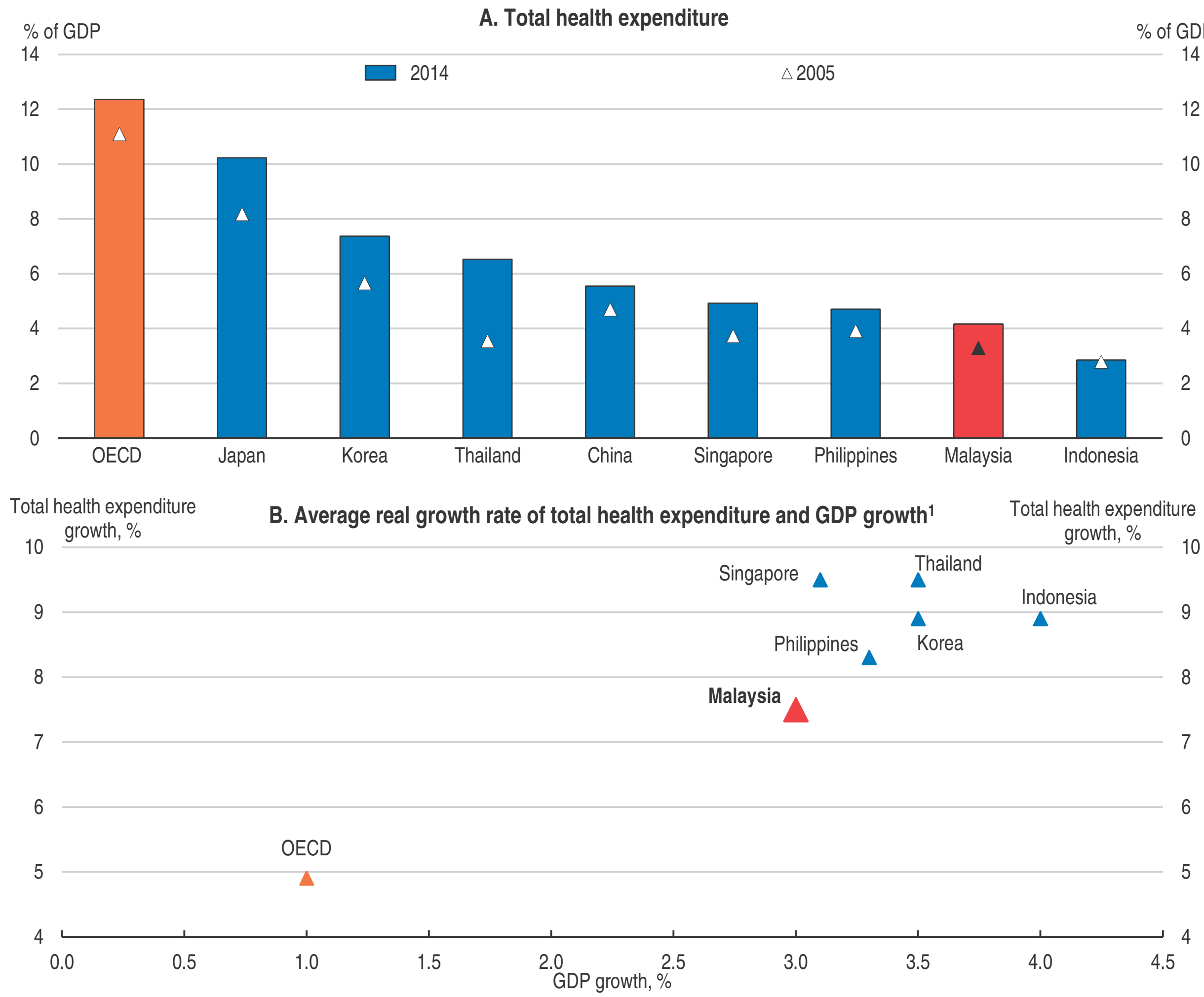
Malaysia's total expenditure on health amounted to 4% of GDP in 2014, below other Southeast Asian countries and the OECD average (Figure 2.16A). However, healthcare spending has outpaced GDP since 2000 and is expected to increase in line with rising living standards, technological development and the acceleration of population ageing (Figure 2.16B). Research on OECD and BRIICS countries has shown that while income and ageing effects account for a large share of rising health expenditure, health policies and institutions can help contain costs and provide opportunities to increase efficiency (OECD, 2013c).

Enhancing effectiveness and efficiency will be key to ensuring the longer-term sustainability of the healthcare system. Strengthening preventive health provision through primary care would reduce recourse to more costly hospital care. Achieving high-quality primary care is a key priority in nearly every OECD country, given the increasing prevalence of chronic illnesses, quicker discharges from hospitals and rising public expectations of seamless, co-ordinated care. Establishing an integrated primary care system employing the "family doctor" concept, which provides multi-disciplinary services including risk factor identification, risk intervention packages and clinical management of diseases, is one way to achieve this goal. Further efficiency gains could be achieved by implementing domiciliary healthcare in a community setting to cater to patients requiring long-term nursing care upon early discharge from hospital.

Simplifying and streamlining the regulatory framework would also deliver efficiency gains. Streamlining licence renewal and accreditation of medical institutions could reduce transaction costs (EPU, 2015c; MPC, 2015). Allowing public-sector hospitals greater autonomy in the allocation of resources would also increase efficiency gains and better adapt healthcare services to local conditions.

Consistent with the ambitions of the Ministry of Health's ICT Strategic Plan 2016-2020, increased use of information and communications technology (ICT) systems would

Figure 2.16. **Healthcare expenditure in Malaysia**



1. Per capita compound growth rate from 2000 to 2014, at 2011 USD PPP prices.

Source: World Bank (2016), World Development Indicators (database); WHO (2016), Global Health Expenditure (database).

StatLink http://dx.doi.org/10.1787/888933411075

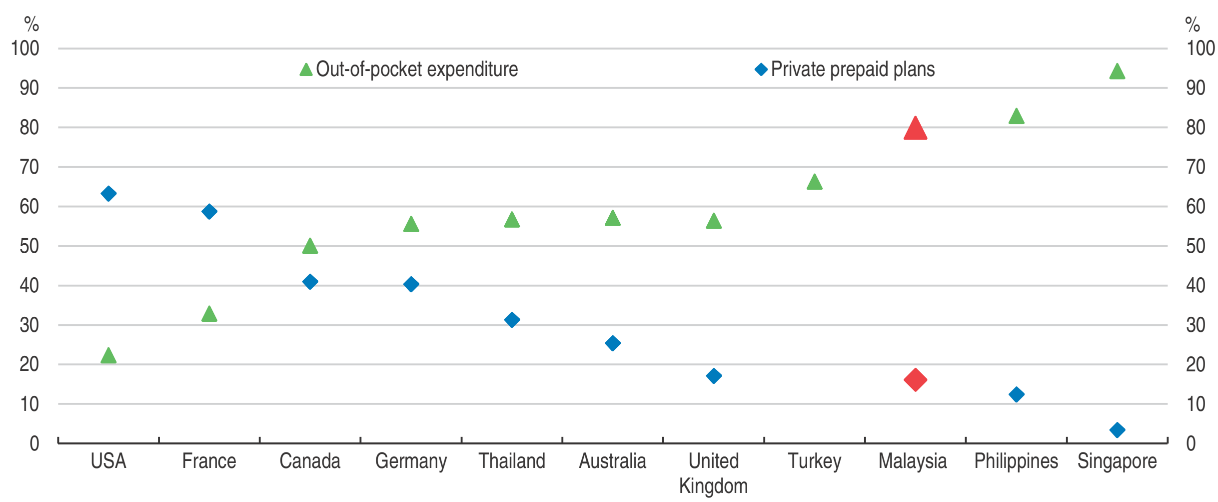
promote efficiency gains by enabling televisual primary care consultations (tele-primary care) and integrating the management of patients' health-related information (lifetime health records). Utilising the existing National Registration Identity Card (MyKad) system in implementing the lifetime health record system would deliver efficiency gains by exploiting synergies.

Reforming the financing structure to ensure sustainability of the healthcare system has long been a government target (OECD, 2015e). Attempts to introduce a public healthcare insurance system have not met with agreement among stakeholders, despite intensive debates regarding cost sharing and the impact on quality and access to the services (Leng and Hong, 2014). Irrespective of whether public healthcare insurance is utilised in the future, rising healthcare costs accompanying population ageing will need to be accounted for in fiscal planning (Lee, 2015).

In principle, private health insurance could make a greater contribution to managing rising healthcare costs, reducing the burden on the public healthcare system and driving improvements in preventive care. In practice, private health insurance is voluntary in Malaysia, with a low uptake so far resulting in a modest overall contribution to health expenditure and high out-of-pocket expenses for private healthcare (Figure 2.17). Tax relief for premiums have sought to raise the contribution of private health insurance with limited success, but as household incomes continue to rise renewed efforts could have more success. The scarcity of net taxpaying households suggests a levy, such as a surcharge on high-income individuals who do not take out private health insurance, would have a stronger incentive effect than tax relief. High-income households would thereby contribute to either private healthcare through insurance or to government revenue to fund the public system. An expanded private insurance market may also help promote preventive care, as insurance providers in countries such as the United States and Australia encourage utilisation of free or subsidised preventive health services to reduce future expenses.

Figure 2.17. **Private insurance could fund a higher share of health expenditure**

% of total private health expenditure



Source: *Source*: Global Health Observatory, World Health Organisation data repository.

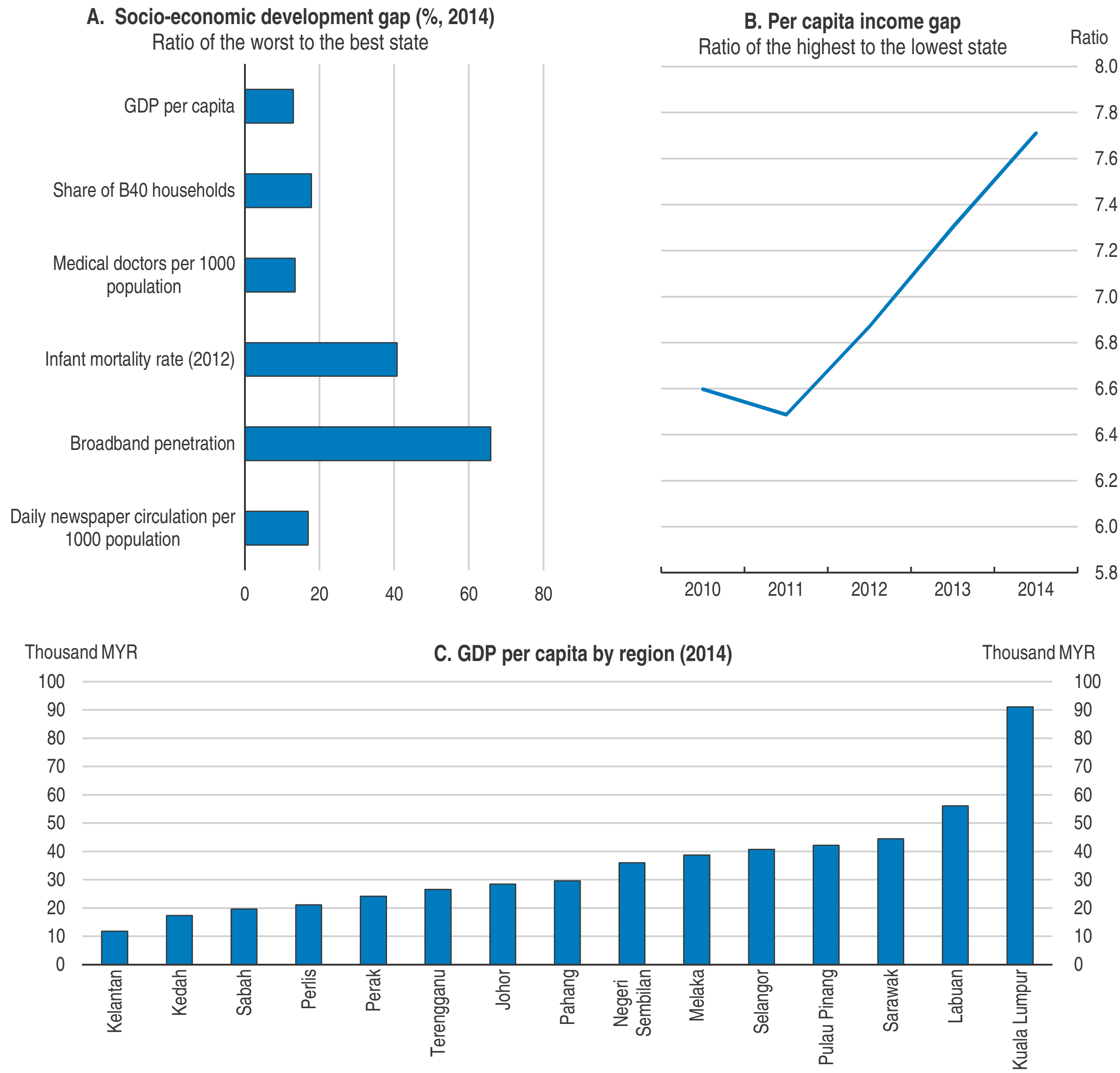
StatLink http://dx.doi.org/10.1787/888933411082

Narrowing the regional development gap

Malaysia's rapid and relatively inclusive development since independence has achieved impressive reductions in overall inequality. However, despite lower regional inequality being a priority of Malaysia's economic and social development strategy, regional differences remain large and have been widening in recent years. In 2014, the per capita GDP of Malaysia's richest state was almost eight times that of the poorest, having widened significantly since 2011 (Figure 2.18A). More broadly, the socio-economic development gap is substantial, most notably in terms of relative income inequality, healthcare and access to information (Figure 2.18B).

Regional inequality reflects the combination of historical, geographical and socio-economic factors that have favoured the development of western Peninsular Malaysia. These richer states have benefited from their location on global trade routes, with trade and investment facilitating the rapid development of industry and commerce. Growth in eastern Peninsular Malaysia and the Borneo Island states has relied more on primary

Figure 2.18. **Increasing development gaps between states**



Source: Department of Statistics, Malaysia, and MRRD (2016), *The 2014 Statistics Bulletin*.

StatLink http://dx.doi.org/10.1787/888933410897

industries, with slower development of infrastructure and human capital. These states are dominated by mountainous terrain or dense tropical rainforests, with challenging geography and low population density creating impediments to the efficient provision of public services. Despite these challenges, Malaysia has achieved near universal supply of reliable electricity and water supply and is making significant investments in improving transport and telecommunications infrastructure, education and healthcare. Even so, more can be done to further reduce regional differences.

The 9th Malaysia Plan (2006-10) created five regional economic corridors focused on attracting additional investment and creating jobs in target industries based on regional comparative advantages. Federal government financial incentives and streamlined regulatory approvals are offered to fast-track private sector investment and infrastructure improvements. Between 2011 and 2014, the corridors have attracted almost MYR 175 billion in investment and created 427 000 jobs (Table 2.1). The 11th Malaysia Plan increased the focus on programmes to raise skills training and entrepreneurship, while also improving the targeting of support to the needs of each economic corridor. For example, in the East Coast Economic Region, the entrepreneurship development programme is targeting women and youth to address relatively high unemployment of these persons in the region. The Sabah Development Corridor programme is providing skills training to upgrade agro-based industry and tourism with an aim to exploit rich natural endowments. The Iskandar Economic Development Zone has utilised investment liberalisation to develop target industries, becoming an emerging hub for sectors such as higher education and medical tourism (attracting patients from neighbouring countries for high-quality, private sector care at competitive prices).

Recent policy priorities issues include raising rural well-being and stimulating economic activities utilising land and natural resources. Initiatives are ongoing to develop rural infrastructure, increasingly in collaboration with non-government organisations and private companies, and government-linked corporations that provide financial contributions to these projects as contributions to corporate social responsibility. Although income inequality and differences in access to public services such as education, medical services and basic infrastructure between urban and rural areas have narrowed since the 1970s (EPU, 2015d), targeted support to improve education and healthcare services are still required as a basis for improving well-being. As discussed in Chapter 1, targeted educational support for students from socio-economically disadvantaged backgrounds, who are more numerous in rural areas, would invigorate social mobility and enhance overall education outcomes.

As noted in the preceding section on healthcare, responding to the acceleration of ageing in rural areas, improving access to quality medical care and strengthening preventive and primary care is also necessary to improve well-being in rural communities. This could contribute to narrowing life expectancy gaps vis-à-vis advanced economies.

To narrow the income gap, it is necessary to create a resilient economic structure in rural areas by promoting rural economic activities and decent employment opportunities (EPU, 2015d). Only 8.9% of the rural population attained tertiary education in 2015. The unemployment rate for rural women with a tertiary degree was 7.4% in 2015, substantially higher than the 3.8% rate for their urban counterparts. Encouraging agro-based processing activities and eco-tourism that utilise regional assets offers business opportunities in rural areas. Enhancing connectivity such as road and broadband internet with urban areas enlarges business opportunities for rural enterprises and should continue to be central to reducing regional inequality. To realise the business potential fully the government needs

Table 2.1. **Investment and job creation in regional economic corridors in 2011-14**

Regional corridor	Committed investment (MYR bn)	Realised investment (MYR bn)	Jobs created
Iskandar Malaysia	90.4	47.1	320 100
Northern Corridor Economic Region	51.7	51.7	63 500
East Coast Economic Region	55.4	22.9	23 000
Sabah Development Corridor	96.7	44.5	15 200
Sarawak Corridor of Renewable Energy	12.9	8.3	5 300
Total	**307.1**	**174.5**	**427 100**

Source: Economic Planning Unit, Eleventh Malaysia Plan.

to implement a programme to support rural entrepreneurs through skills training, in particular for e-commerce, which contributes to linking consumers directly with rural entrepreneurs.

Innovation by rural SMEs will also be critical to boosting regional equality. The Inclusive Innovation programme under the SME Masterplan aims to empower the B40 by promoting the transformation of communities, including through technical financial and management support to microenterprises in rural areas. Harnessing the innovation potential of rural entrepreneurs will help create globally competitive SMEs from all parts of Malaysia and develop creative solutions to regional development problems. Private sector initiatives such as iCube – which provides a dynamic co-working space, financial and expert support for local young entrepreneurs in Kuching (Sarawak state) – also play a critical role in maximising the growth potential of regions.

Main recommendations to foster inclusive growth

A more inclusive labour market

Key recommendation

- Promote flexible work arrangements and invest more in early childhood care, lifelong learning and reskilling.

Further recommendations

- Align tertiary and vocational education and training to labour market needs to continue to reduce skills mismatches.
- Address minimum wage implementation and enforcement problems.
- Remove onerous dismissal procedures.
- Remove barriers to union formation and involvement in workplace rights issues.
- Work more closely with business and migrants to develop a stable longer-term immigration policy consistent with labour market needs.

Strengthening social protection

Key recommendation

- Develop a comprehensive social protection system, including by implementing an employment insurance scheme.

Further recommendations

- Improve social policy consistency, programme targeting and the overall impact on reducing disadvantage.
- Expand employment insurance to include temporary, unconditional income support.

A tax and transfer system that supports sustainable inclusive growth

Key recommendations

- Undertake an independent review of expenditure and revenue needs.
- Over the medium term, consider gradually reducing exemptions and then raising the rate of the goods and services tax, and increasing the progressivity of income tax.

Main recommendations to foster inclusive growth *(cont.)*

A more sustainable pension system that delivers higher retirement incomes

Key recommendations

- Increase pension access ages in line with improvements in healthy life expectancy and reduce exemptions for early withdrawal.
- Enrol future public employees in the defined contribution scheme covering private sector employees.

Further recommendations

- Further efforts to increase pension market competition and liberalise restrictions on the Employees Provident Fund's investment strategy.
- Evaluate the effect of contribution rates on workforce informality, household saving and retirement incomes.

Maintaining universal access to quality healthcare

Further recommendations

- Relieve the burden on the public system by addressing skills training deficits, improving flexible labour conditions and increasing collaboration across the sector.
- Improve expenditure efficiency to ensure sustainability amid population aging through expanded primary care, lower transaction costs, increased expenditure autonomy for hospitals, increased use of information and communications technology and incentives for private insurance.

Narrowing the development gap

Key recommendation

- Improve social services, transport, and broadband connectivity in remote areas.

Bibliography

ADB (2015), *Key Indicators for Asia and the Pacific 2015*, Asian Development Bank, Mandaluyong City, *www.adb.org/sites/default/files/publication/175162/ki2015.pdf*

Asian Development Bank Statistical Database System *https://sdbs.adb.org/sdbs/*.

BNM (2013), *Annual Report 2012*, Bank Negara Malaysia, Kuala Lumpur.

BNM (2015), *Annual Report 2015*, Bank Negara Malaysia, Kuala Lumpur.

Brys, B. et al. (2016), "Tax Design for Inclusive Economic Growth", *OECD Taxation Working Papers*, No. 26, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/5jlv74ggk0g7-en*

de Mello, L. and M. Dutz (eds.) (2012), *Promoting Inclusive Growth: Challenges and Policies*, OECD Publishing, Paris, DOI: *http://dx.doi.org/10.1787/9789264168305-en*

DOS (2016), *Informal Sector Workforce Survey Report Malaysia 2015,* Department of Statistics, Putrajaya.

EPF (2016), *EPF Savings and Your Retirement*, Employees Provident Fund, Kuala Lumpur. *www.kwsp.gov.my/portal/documents/10180/154418/BOOK_-_EPF_Saving_and_Your_Retirement__CS5__25032015.pdf*

EPU (2013), *Malaysian Well-Being Report 2013*, Economic Planning Unit, Prime Minister's Department, Putrajaya.

EPU (2015a), "Labour Market for an Advanced Nation", *The Eleventh Malaysia Plan Strategy Paper No. 8,* Economic Planning Unit, Prime Minister's Department, Putrajaya.

EPU (2015b), *Eleventh Malaysia Plan,* Economic Planning Unit, Prime Minister's Department, Putrajaya.

EPU (2015c), "Achieving Universal Access to Quality Healthcare", *The Eleventh Malaysia Plan Strategy Paper No.*5, Economic Planning Unit, Prime Minister's Department, Putrajaya.

EPU (2015d), "Transforming Rural Areas to Uplift Wellbeing of Rural Communities", *The Eleventh Malaysia Plan Strategic Paper No.* 4, Economic Planning Unit, Prime Minister's Department, Putrajaya.

IHSR (2013), *Malaysia Health Care Demand Analysis: Inequalities in Healthcare Demand & Simulation of Trends and Impact of Potential Changes in Healthcare Spending*, Institute for Health Systems Research, Kuala Lumpur.

ILO (2016), *Review of Labour Migration Policy in Malaysia,* International Labour Organisation Regional Office for Asia-Pacific, Bangkok.

ISPA (2016), *Inter Agency Social Protection Assessments*, *http://ispatools.org/*.

Johari, F. et al. (2015), "A Review on Literatures on Current Zakat Issues: An Analysis Between 2003-2013", *International Review of Research in Emerging Markets and the Global Economy,* Vol. 1, Issue 2.

KPMG (2015), *2015 Asia Pacific Indirect Tax Guide www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Documents/2015-asia-pacific-indirect-tax-country-guide.pdf*

Lee, P.O. (2015), "What lies ahead for Malaysian healthcare?", *ISEAS Economics Working Paper*, Institute of Southeast Asian Studies, Singapore.

Leng, C.H. and P.H. Hong (2014), "'1 Care' and the politics of healthcare in Malaysia", in M. Weiss (ed) *Routledge Handbook of Contemporary Malaysia*, Routledge, New York.

MOF (2015), *Economic Report 2015/16*, Ministry of Finance, Putrajaya.

Mercer and Australian Centre for Financial Studies (2015), *Melbourne Mercer Global Pension Index 2015*, Melbourne, Australia *www.globalpensionindex.com/wp-content/uploads/Melbourne-Mercer-Global-Pension-Index-2015-Report-Web.pdf*

MOHR (2016), Minimum wage portal, Ministry of Human Resources, Putrajaya. *http://minimumwages.mohr.gov.my/?lang=en* (accessed on 25 May 2016)

MPC (2015), *22nd Productivity Report 2014/2015*, Malaysia Productivity Corporation, Petaling Jaya.

MRRD (2016), *The 2014 Statistics Bulletin,* Ministry of Rural and Regional Development, Putrajaya.

Muhammed Abdul Khalid (2014), *The Colour of Inequality: Ethnicity, Class, Income and Wealth in Malaysia*, MPH Publishing, Kuala Lumpur.

Nalini, A. et al. (2014), "Unemployment among graduate nurses in Malaysia: a case study", *Asian Social Science*, Vol. 10, No. 9, Canadian Centre of Science and Education, Toronto.

Nixon, S. (2016), "Relative poverty in Malaysia: regional differences and variance by household size", *OECD Economics Department Working Papers,* forthcoming.

OECD (2012a), *International Migration Outlook 2012*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/migr_outlook-2012-en*.

OECD (2012b), *OECD Economic Survey of Turkey*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/eco_surveys-tur-2016-en*.

OECD (2013a), *OECD Employment Outlook 2013*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/empl_outlook-2013-6-en*.

OECD (2013b), *Pensions at a Glance Asia-Pacific 2013,* OECD Publishing, Paris. DOI: http://dx.doi.org/10.1787/pension_asia-2013-6-en

OECD (2013c), "What future for health spending?", *OECD Economics Department Policy Notes*, No. 19. *www.oecd.org/economy/health-spending.pdf*

OECD (2015a), *All on Board: Making Inclusive Growth Happen*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/9789264218512-en*

OECD (2015b), *OECD Employment Outlook 2015*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/empl_outlook-2015-*

OECD (2015c), *Revenue Statistics in Asian Countries 2015: Trends in Indonesia, Malaysia and the Philippines*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/9789264234277-en*.

OECD (2015d), *Pensions at a Glance 2015*, OECD Publications, Paris, *http://stats.oecd.org/Index.aspx?DataSetCode=PAG*.

OECD (2015e), *Fiscal Sustainability of Health Systems: Bridging Health and Finance Perspectives*, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/9789264233386-en*

OECD (2016), *The EU Social Protection Systems Programme*, *www.oecd.org/dev/inclusivesocietiesanddevelopment/social-protection.htm*.

OECD Income Distribution Database *http://stats.oecd.org/Index.aspx?DataSetCode=IDD*

OECD and Korea Institute of Public Finance (2014), "The Distributional Effects of Consumption Taxes in OECD Countries", *OECD Tax Policy Studies,* No. 22, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/9789264224520-en.*

OECD Social Spending indicator, OECD Publishing, Paris. DOI: *http://dx.doi.org/10.1787/7497563b-en* (accessed on 12 April 2016)

OECD Tax Database *www.oecd.org/tax/tax-policy/tax-database.htm*

PEMANDU (2012), "Snap Shot: Healthcare", *Inside Malaysia*, July, Putrajaya.

Syed, Mohamed Alijunid (2014), "Health policy in Malaysia: three central policy issues", *News Across Asia*, Vol. 3, No.1, *www.ispor.org/consortiums/asia/Health-Policy-in-Malaysia-3-Central-Policy-Issues.pdf*

The Star (2015) *Ahmad: Paying GST can help in nation building*, 19 February, *www.thestar.com.my/news/nation/2015/02/19/ahmad-paying-gst-can-help-in-nation-building*

UNDP (2013), *Malaysia Human Development Report*, United Nations Development Programme, Kuala Lumpur.

WEF (2015), *The Inclusive Growth and Development Report 2015*, Geneva, Switzerland.

World Bank (2014), *Malaysia Economic Monitor December 2014: Towards a Middle Class Society*, Washington, D.C.

World Bank (2015), *Malaysia Economic Monitor December 2015: Immigrant Labour*, Washington D.C.

World Bank (2016), *Live Long and Prosper: Aging in East Asia and Pacific*, Washington D.C.

ANNEX 2.1

Malaysian Well-being Index values and sub-indicators

Values

Components	Index value in 2012 (base year 2000 = 100)	Index value in 2013	Preliminary index value in 2014
Economic well-being	**133.3**	**130.5**	**131.0**
Transport	136.9	134.3	135.7
Communications	136.2	130.3	132.8
Education	132.9	133.4	135.7
Income and distribution	131.8	131.2	136.5
Working life	128.6	123.1	114.4
Social well-being	**121.0**	**118.9**	**112.6**
Housing	136.9	132.8	144.5
Leisure	131.4	129.9	135.9
Governance	128.1	129.5	132.5
Public safety	125.6	126.2	134.2
Social participation	120.6	111.9	116.3
Culture	120.3	110.6	119.0
Health	114.1	118.6	118.0
Environment	107.3	104.5	103.4
Family	104.6	105.7	100.1
Overall	**125.4**	**123.0**	**125.6**

Sub-indicators

Economic well-being

Income and distribution
- Real Gross National Product per capita (+)
- Gini coefficient for disposable income (-)
- Incidence of absolute poverty (-)

Education
- Pre-school participation rate (+)
- Primary school participation rate (+)
- Secondary school participation rate (+)
- Tertiary participation rate (+)
- Literacy rate (+)
- Percentage of graduate teachers in primary schools (+)
- Percentage of graduate teachers in secondary schools (+)
- National Average Grade (Malaysian school examinations) (+)
- Number of lecturers with PhD (+)
- Primary education completion rate (+)
- Secondary education completion rate (+)

Transport
- Road Development Index - incorporates the length of the road network, land area and population (+)
- Private motorcars & motorcycles (per '000 population) (+)
- Road length per capita (km) (+)
- Rail ridership (million) (+)

Communications
- Fixed and mobile telephone line subscriptions (per '000 population) (+)
- Internet subscribers (per '000 population) (+)
- Number of hotspot locations (+)
- Number of domain names (per '000 population) (+)

Sub-indicators

Economic well-being

Working life
- Trade disputes (-)
- Days lost due to industrial action ('000) (-)
- Industrial accidents (-)
- Average working hours (-)

Social well-being

Housing
- Percentage of low-cost housing units to bottom 40% (+)
- Percentage of households with treated water (+)
- Percentage of households with electricity (+)
- Percentage of households with garbage collection services (-)
- Crowdedness (no. of persons per room) (-)

Leisure
- No. of households with paid TV subscription ('000) (+)
- Domestic hotel guests (per '000 population) (+)
- Recreational parks visitors (per '000 population) (+)
- Cinema goers (per '000 population) (+)

Governance
- Percentage of corruption cases prosecuted out of total arrests by Malaysian Anti-Corruption Commission (+)
- Number of e-payment transactions (million) (+)
- Percentage of cases solved by the Public Complaints Bureau (+)
- Percentage of income tax returns filed electronically (+)

Public safety
- Crime rate (per '000 population) (-)
- Road accidents (per '000 vehicles) (-)

Social participation
- Percentage of registered voters (per population aged 21 years and above) (+)
- Number of registered non-profit organisations (per '000 population) (+)
- Number of registered residents associations (+)
- Membership in RELA (volunteer security organisation) and RakanCop (policy community programme) (per '000 population)(+)

Culture
- Membership of public libraries (per '000 population)(+)
- Number of Istana Budaya (an entertainment show) visitors (per '000 population) (+)
- Number of museum visitors (per '000 population) (+)
- Number of Kompleks Kraf (a handicraft attraction) visitors (per '000 population)(+)

Health
- Life expectancy at birth (+)
- Non-communicable disease cases (per '000 population) (-)
- Infant mortality rate (per 1,000 live births) (-)
- Maternal mortality rate (per 100,000 live births) (-)
- Number of hospital beds (per '000 population) (+)
- Doctor to population ratio (-)
- Hospital waiting time for out-patients (minutes) (-)

Environment
- Air quality (% of station with API<50) (+)
- Water quality (% of clean river monitored) (+)
- Percentage of forested land (+)
- Quantity of scheduled waste generated (tonnes/year)/population (-)
- Average maximum temperature per annum (°C) (-)

Family
- Divorce rate (% of population aged 18 and above) (-)
- Domestic violence cases reported to police (per '000 population) (-)
- Juvenile crime cases (% of population aged 10 -18) (-)
- Mean monthly household gross income (RM) (+)
- Household debt per capita (RM) (+)
- Dependency ratio (-)

Source: EPU (2013), Malaysian Well-Being Report 2013.

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The OECD is a unique forum where governments work together to address the economic, social and environmental challenges of globalisation. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

The OECD member countries are: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The European Union takes part in the work of the OECD.

OECD Publishing disseminates widely the results of the Organisation's statistics gathering and research on economic, social and environmental issues, as well as the conventions, guidelines and standards agreed by its members.

OECD PUBLISHING, 2, rue André-Pascal, 75775 PARIS CEDEX 16
(10 2016 19 1 P) ISBN 978-92-64-26262-1 – 2016

OECD Economic Surveys

MALAYSIA

ECONOMIC ASSESSMENT

SPECIAL FEATURES: PRODUCTIVITY; INCLUSIVE GROWTH

Most recent editions:

Australia, December 2014
Austria, July 2015
Belgium, February 2015
Brazil, November 2015
Canada, June 2016
Chile, November 2015
China, March 2015
Colombia, January 2015
Costa Rica, February 2016
Czech Republic, June 2016
Denmark, May 2016
Estonia, January 2015
Euro area, June 2016
European Union, June 2016
Finland, January 2016
France, March 2015
Germany, April 2016
Greece, March 2016
Hungary, May 2016
Iceland, September 2015
India, November 2014
Indonesia, October 2016
Ireland, September 2015
Israel, January 2016
Italy, February 2015
Japan, April 2015
Korea, May 2016
Latvia, February 2015
Lithuania, March 2016
Luxembourg, March 2015
Mexico, January 2015
Malaysia, November 2016
Netherlands, March 2016
New Zealand, June 2015
Norway, January 2016
Poland, March 2016
Portugal, October 2014
Russian Federation, January 2014
Slovak Republic, November 2014
Slovenia, May 2015
South Africa, July 2015
Spain, September 2014
Sweden, March 2015
Switzerland, November 2015
Turkey, July 2016
United Kingdom, February 2015
United States, June 2016

Consult this publication on line at ***http://dx.doi.org/10.1787/eco_surveys-mys-2016-en***.

This work is published on the OECD iLibrary, which gathers all OECD books, periodicals and statistical databases. Visit ***www.oecd-ilibrary.org*** for more information.

Volume 2016/Supplement 1
November 2016

OECD*publishing*
www.oecd.org/publishing

ISSN 0376-6438
2016 SUBSCRIPTION
(18 ISSUES)

ISBN 978-92-64-26262-1
10 2016 19 1 P

9 789264 262621