### A. Medium-term economic outlook

(Forecast, 2014-18 average)
- GDP growth (percentage change): 5.1
- Current account balance (% of GDP): 5.2
- Fiscal balance: -4.5

### B. Medium-term plan

- **Period:** 2011-15
- **Theme:** Charting development towards a high-income nation

### C. Basic data (in 2012)

- **Total population:** 29 million
- **Population of Kuala Lumpur:** 1.7 million
- **GDP per capita at PPP:** 16,922 (current USD)

**Source:** OECD Development Centre, national sources and IMF.

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## Malaysia

### GDP growth rates (Percentage change)

![GDP growth rates graph]

**Source:** OECD Development Centre, MPF-2014.

### GDP per capita (PPP, current USD)

![GDP per capita graph]

**Source:** IMF and national sources.

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## Composition of exports, 2012

<table>
<thead>
<tr>
<th>Percentage of total exports</th>
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<tbody>
<tr>
<td>Machinery/electrical</td>
</tr>
<tr>
<td>Chemicals and allied industries</td>
</tr>
<tr>
<td>Plastics/rubber</td>
</tr>
<tr>
<td>Vegetable products</td>
</tr>
<tr>
<td>Others</td>
</tr>
</tbody>
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**Source:** Trademap.

## Composition of imports, 2012

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<tr>
<td>Metals</td>
</tr>
<tr>
<td>Transportation</td>
</tr>
<tr>
<td>Others</td>
</tr>
</tbody>
</table>

**Source:** Trademap.

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The Malaysian economy has proved to be resilient at a time of global economic headwinds. Over the medium term, however, there are important long-standing structural issues that may affect its march towards developed country status by 2020.

Such structural problems affect the education system and continue to be a stumbling block in efforts to improve productivity and attract the value-adding high-tech industries that require skilled labour. Small and medium-sized enterprises (SMEs), which contribute so heavily to employment, are especially hard hit as they face difficulties in attracting skilled labour. While the fiscal balance continues to improve, uncertainties in the external environment, coupled with the failure of fiscal reforms to rein in spending on subsidies or implement a goods and services tax (GST), may have an impact on the economy’s public finances.
Malaysia’s medium-term policy challenges and responses

- Improve the quality of education
- Improve the productivity of SMEs
- Widen the tax base and improve tax administration and compliance

POLICY FOCUS
Improve the quality of education

The Malaysian education system has made steady progress. At the time of Independence in 1957, more than half of the population had no formal schooling, while only 6% of children had been educated to secondary level and just 1% to the post-secondary level. Five-and-a-half decades later, education enrolment rates at every education level have risen substantially. In 2011, Malaysia’s enrolment rates reached 94% at primary level and 87% at lower secondary level (forms 1 to 3). The upper secondary level (forms 4 to 5) has seen tremendous improvements in enrolment, too – from a rate of 45% in the 1980s to 78% in 2011 (Ministry of Education, 2012).

Figure 2.5.1. At-a-glance overview of the Malaysian education system


Improved educational access in Malaysia has also been followed by improved educational attainment. From 1950 to 2010, the proportion of the adult population with no schooling declined from 60% to less than 10%, while the share with secondary schooling rose from around 6% to slightly more than 61% (Ministry of Education, 2012).

Educational outcomes have deteriorated

In spite of the significant improvements in access and attainment, the standard of educational outcomes has not been encouraging. International comparisons show that Malaysian student competencies are far from satisfactory. In PISA 2009 Plus,3 Malaysia was placed in the bottom third of the 74 participating countries, below the international and OECD averages.2 The results reveal that students in Singapore; Korea; China; Hong Kong, China; and Shanghai performed as though they had three or more years more schooling than their counterparts in Malaysia.
Another considerable challenge is the disparity in quality between student outcomes in urban and rural areas. Primary school evaluation tests (UPSR) for children in the Malaysian equivalent of grade 9 pointed to a 4 percentage-point gap between urban and rural school outcomes. The results of examinations for the SPM (Malaysian Certificate of Education, approximately grade 11) showed that the gap had doubled to 8 percentage points (Ministry of Education, 2012).

Educational quality affects students’ performance at school and, later as school leavers, in the labour market. A study by the OECD to relate cognitive skills – as measured by PISA and other international instruments – to economic growth found that relatively small improvements in the skills of a nation’s labour force can have very powerful impacts on future well-being. While both basic skills and advanced skills are important for developing countries, only quality education can deliver the advanced skills needed to help a country escape the middle-income trap and move up to high-income status.

The oversupply of graduates suggests that issues related to access may not be critical in Malaysia (Ministry of Higher Education, 2012). A more urgent need is to improve the overall quality of education in Malaysia if it is to keep pace with its regional competitors.

There are 20 public universities and 60 private higher education institutions nationwide and “every year about 180 000 students graduate with diplomas and degrees”, as Malaysia’s Prime Minister observed in his budget speech on 28 September 2012. In May of the same year, the then Deputy Human Resources Minister, Datuk Maznah Mazlan, told Parliament that some 76 200 graduates in Malaysia were unemployed (Ibrahim, 2012). She was drawing attention to a very real problem that receives no media coverage. In general, the perception is that unemployment in Malaysia is due to the unavailability of jobs (UNESCO, 2012).

However, despite the oversupply of graduates, there are jobs that private sector employers have not been able to fill because of the mismatch between industry needs and graduates’ qualifications. The labour market, especially in the private sector, requires more science and technical graduates. Also, new science and technical graduates do not meet industry needs owing to their lack of crucial communication and technical skills and knowledge (Ministry of Higher Education, 2012).

**Improve the quality of teachers**

In 1999, 2003, and 2007 Malaysia took part in the Trends in International Mathematics and Science Study (TIMSS) which assesses achievement in mathematics and science in schools. The country participated as part of its commitment to raising its educational quality and competing with developed nations. In 1999, its results in the TIMSS mathematics and science tests for the eighth grade were well above the international average. In 2007, however, they fell back below that benchmark. In the three types of cognitive skills assessed (knowledge recall, the application of knowledge in solving problems and the ability to reason in working through problems), Malaysian students lagged behind their counterparts from the high-income economies in the region.

Malaysia’s 2007 TIMSS results suggest that, if it is to improve the quality of its secondary education provision, it will need to ensure the continuous training of high-quality teachers who are able to respond to complex educational and social needs.
Table 2.5.1 shows the results of a 2010 study by the National Higher Education Research Institute (IPPTN) into how higher education administrators perceived the quality of teachers in Malaysia. Respondents were asked to judge teachers against four “Dimensions” – fundamental quality, personal quality, citizenship quality, and knowledge and skills – and to rate their performance on a five-point scale in ascending order, where a score of 1 was “very weak” and 5 was “excellent” (Ismail et al., 2010).

Table 2.5.1. Mean scores and standard deviations of teacher quality as perceived by university and teacher education institute administrators in Malaysia, 2010

<table>
<thead>
<tr>
<th>Dimensions</th>
<th>Mean score</th>
<th>Standard deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fundamental quality</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intellectual</td>
<td>3.38</td>
<td>0.59</td>
</tr>
<tr>
<td>Social skills</td>
<td>3.97</td>
<td>0.52</td>
</tr>
<tr>
<td>Communication</td>
<td>3.63</td>
<td>0.65</td>
</tr>
<tr>
<td>Numeracy</td>
<td>3.53</td>
<td>0.51</td>
</tr>
<tr>
<td><strong>Personal quality</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Attitude</td>
<td>3.93</td>
<td>0.70</td>
</tr>
<tr>
<td>Philosophy</td>
<td>3.81</td>
<td>0.71</td>
</tr>
<tr>
<td>Values</td>
<td>3.77</td>
<td>0.71</td>
</tr>
<tr>
<td>Adaptability</td>
<td>3.59</td>
<td>0.64</td>
</tr>
<tr>
<td><strong>Citizenship quality</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Citizen advocacy</td>
<td>3.77</td>
<td>0.68</td>
</tr>
<tr>
<td>Culture worthy</td>
<td>3.49</td>
<td>0.64</td>
</tr>
<tr>
<td>Social diversity</td>
<td>3.87</td>
<td>0.73</td>
</tr>
<tr>
<td><strong>Knowledge and skills</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Teaching, learning and class management</td>
<td>3.89</td>
<td>0.64</td>
</tr>
<tr>
<td>Co-curricular activities</td>
<td>3.62</td>
<td>0.88</td>
</tr>
<tr>
<td>School management</td>
<td>3.88</td>
<td>0.73</td>
</tr>
<tr>
<td>ICT skills</td>
<td>4.42</td>
<td>0.59</td>
</tr>
<tr>
<td>Technical skills related to performance of teachers’ role</td>
<td>3.65</td>
<td>0.59</td>
</tr>
<tr>
<td><strong>Total mean score perceived by higher education administrators</strong></td>
<td><strong>3.88</strong></td>
<td><strong>0.50</strong></td>
</tr>
</tbody>
</table>


It is also noteworthy that of all four main quality dimensions “fundamental quality” had the lowest mean score at 3.64 (0.48 standard deviation). Within that dimension, “intellectual” was the quality rated lowest at 3.38 (with standard deviation of 0.59).

It may be inferred from these results that the teaching profession is not attracting the most able candidates, even though the policy of the Ministry of Education’s teacher training institutes for a number of years has been to attract the best. Teaching is no longer a profession of choice, but one of last resort. Hardly surprising, then, that a 2011 study found that only 50% of teachers delivered their lessons effectively. Put another way, the lessons did not engage students sufficiently. They were passive, delivered like lectures, and focused on achieving surface-level content understanding, rather than higher-order thinking skills (Ministry of Education, 2012).
Policy priority: professional, real-world education driven by political will rather than interference

Many other factors, both within and outside the education system, affect academic standards and outcomes. According to a 2004 OECD study, one common factor in countries that perform well in PISA tests is that the authorities put much effort into improving the education system. In those countries, it enjoys high political priority and is largely independent of the political orientation of the ruling government (OECD, 2004).

Other priorities pursued as part of high-performing countries’ commitment to improving the quality of education include: 4
- a focus on ICT, mathematics and science,
- higher levels of English-language competence,
- closer co-operation between schools and the world of work,
- higher standards in pre-service and in-service teacher training.

Policies to strengthen the Malaysian education system and reverse the sharp fall in standards and outcomes should concentrate on:
- attracting the best candidates and improving the work of currently serving teachers,
- allowing schools greater autonomy in curriculum delivery and learning methods,
- moving the current school funding model to one that is needs-based.

Attract the best candidates and improve the work of incumbent teachers

There should be incentives for the best graduates who have a passion for teaching to join the profession. At the same time, performance-based contractual employment would filter out any recruits who might perform poorly.

Another important measure is to improve the current teacher-training curriculum so that it offers a more even balance between pedagogical content knowledge and teaching skills relevant to life in the 21st century. Reshaping the teacher-training curriculum is a prerequisite for any action to address the supply-side issues of new teachers.

Addressing the quality of currently serving teachers requires distinguishing between teacher quality and teaching quality. Government intervention is noticeably more focused on improving the quality of teachers, with generous grants and study leaves to help teachers upgrade their academic qualifications.

While the quality of teachers is important, greater emphasis should be placed on better teaching standards. One way to do so would be through a systemic reform of current practices in teachers' continuing professional development (CPD) and teacher performance evaluation. The Malaysia Education Blueprint 2013-2025 has made this shift in emphasis, and rightly so. To address the issue of poor-quality teachers, it calls for upgrades in the quality of CPD for teachers, allowing them to focus on their core teaching function, and recommends the implementation of competency and performance-based assessment.

Allow more school autonomy in curriculum delivery and learning methods.

Malaysia’s school and schooling provision accords rural and urban areas the same levels of infrastructure, resources and support to ensure that every child in the public school system receives an equal standard of education. However, despite equity in the
allocation of resources, gaps in student achievements still persist as socio-economic factors outweigh school-related ones.

Addressing school governance can help right this imbalance: schools could be allowed more autonomy in curriculum delivery and learning methods. Schools would thus enjoy greater flexibility in their work to improve student performance through creative, innovative education practices. Schools should be empowered to determine strategies and customise their curricula to incorporate practices that would improve student learning.

**Move the current school funding model to one that is needs-based**

At present, funds for curriculum support and school operations are allocated on a per capita basis (i.e. per enrolled student). Per capita allocation is simple, objective, and relatively easy to administer and monitor. However, Malaysia’s model of equitable public expenditure leaves room for improvement. Many such schools are located in remote, disadvantaged areas and the current funding policy which does not distinguish between urban and rural locations puts them at further disadvantage. The result is an ever-widening of the gap in student outcomes.

### POLICY FOCUS

**Improve the productivity of SMEs**

The *Malaysian Census Report* on SMEs 2011 recorded a total of 645,136 small and medium-sized enterprises operating in Malaysia. They accounted for 97.3% of all business establishments. Census findings also showed that 90.1% of SMEs were in the services sector, 5.9% in manufacturing and 3% in construction. The remainder operated in agriculture (1%) and mining and quarrying (0.1%).

SMEs contributed nearly one-third (32.5%) of GDP in 2011, compared to slightly more than large firms’ two-thirds (67.5%). In the same year, the output of SMEs expanded at a faster pace (6.8% year-on-year) than that of the overall economy (5.1%). Employment in SMEs also grew faster than total employment growth – 3.9% against 3.7%.

By far most Malaysian SMEs do business in the services, generating a total of value added in 2011 that accounted for 20% of national output (Table 2.5.2). Manufacturing sector SMEs come a distant second, contributing just 7.9%.

| Table 2.5.2. Contribution of SMEs to GDP in Malaysia, by key economic activity, 2007-11 |
|-----------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
|                            | 2007            | 2008            | 2009            | 2010            | 2011            |
| Agriculture                | 3.4             | 3.3             | 3.4             | 3.4             | 3.4             |
| Mining                     | 0.1             | 0.1             | 0.1             | 0.1             | 0.1             |
| Construction               | 0.7             | 0.7             | 0.8             | 0.8             | 0.8             |
| Manufacturing              | 8.2             | 7.8             | 7.4             | 7.7             | 7.9             |
| Services                   | 18.2            | 19.1            | 19.9            | 19.8            | 20.0            |
| Plus: Import duties        | 0.1             | 0.2             | 0.2             | 0.2             | 0.3             |
| **Total SME value-added**  | **30.7**        | **31.2**        | **31.7**        | **32.0**        | **32.5**        |

Source: Department of Statistics, Malaysia.
Malaysian SMEs face a number of constraints:
- lower productivity than their counterparts in the more developed nations,
- lower business formation rates than in high-income nations,
- output and employment is concentrated in a relatively small number of firms,
- many operate in the informal sector.

In July 2012, Malaysia launched its SME Masterplan which seeks to boost the contribution of SMEs to GDP from 32% to 41%. The Masterplan’s objectives include:
- raising the productivity of SMEs,
- increasing the SME business formation rate,
- expanding the number of high-growth, innovative companies,
- intensifying entry of SMEs into the formal sector.

SME productivity still lags behind

Malaysian SMEs have outstripped large firms in productivity growth in recent years. In 2010 and 2011, they recorded two consecutive years of positive growth (0.9% and 2.8% respectively), while big firms’ productivity growth was negative in 2010 (down 9.3%) before rebounding in 2011 (0.9%) (SME Corporation Malaysia, 2012a).

The productivity performance of Malaysian SMEs has been attributed to the government’s encouragement of automation and the adoption of information and communication technology (ICT), as well as to capacity building programmes. There is evidence that Human Resources Development Fund (HRDF) training programmes have had a positive impact on SMEs, helping them to increase their value added, investment, labour productivity, and wages.

However, there is no denying that the productivity performance of Malaysian SMEs still lags behind that of large domestic firms. The most recent estimates put the average productivity of SMEs at MYR 50 498 (Malaysian ringgit) per employee, 64% lower than the MYR 140 691 per employee estimated for large firms. The gap is attributable mainly to SMEs’ sizeable employment of unskilled workers in labour-intensive industries across all economic sectors (SME Corporation Malaysia, 2012a).

More importantly, the productivity of Malaysian SMEs is significantly lower than that of their counterparts in the advanced economies. In the United States, for example, SMEs were nearly seven times more productive in 2008 (Figure 2.5.2).

In a rapidly globalising economic environment, Malaysian SMEs may not be able to withstand competition from even foreign-based SMEs. Enter the SME Masterplan, which sets out a vision of SMEs that can effectively compete on the global stage.

One main objective of the SME Masterplan is to raise the productivity of SMEs – a daunting challenge. The findings from a survey of SMEs conducted by the Associated Chinese Chambers of Commerce and Industry of Malaysia (ACCCIM) in 2012 show that nearly one-third (32%) of respondents from agriculture, timber, fishery, farming and the gardening industry indicated that they were innovating to improve productivity. While this sounds like good news, it should be noted that the aggregated results across all sectors reveal that only 11% of respondents stated that the prime purpose of their innovation activities was to improve productivity. This lower percentage also suggests that the largest SME contributors to national GDP by economic activity – services and manufacturing – are not giving productivity enough priority.
However, SMEs cannot really be faulted for not giving enough importance to innovation. They possess inherent traits that may weaken their ability to innovate and advance technologically. These include:

- key decisions made by individuals, owners, or small groups;
- short-term gains more important than long-term vision;
- predominant focus on cutting costs and getting more for less;
- low or no investment in research and development due to lack of funds or skills.

**Inadequate human capital holds back productivity growth**

An inadequately educated and trained work force is a major impediment to business and growth. As mentioned above, one major reason why Malaysian SMEs’ productivity is poorer than that of large domestic firms is the large number of unskilled workers that they employ in labour-intensive industries across all economic sectors.

There is a mismatch between labour supply and demand in Malaysia because the labour supply lacks job readiness. The curricula of Malaysian universities, colleges, technical schools and polytechnics has little industry perspective or up-to-date industry knowledge. The quality of students has suffered.

Even though graduates in Malaysia face unemployment and underemployment, SMEs often have trouble attracting and retaining workers because they cannot pay such high salaries as larger firms. The talent pool in Malaysia has also been dried out by the brain drain, as qualified and highly skilled workers flock overseas to seek better career opportunities. SMEs have suffered more than large firms.

SMEs’ lack of interest in staff training has not helped matters. The ACCCIM 2012 survey of SMEs reveals that only 26% reported that they conducted regular staff training courses, 50% that their training programmes were irregular, and 24% that they provided no training at all. There are various reasons for this. One, according to 33% of
the respondents in the ACCCIM survey, was limited human resources – in other words, sending employees for training disrupted business. Many employers also feared their trained staff would be poached by other firms or that trained employees would leave to join a competitor.

SMEs widely perceive training as a cost and fail to appreciate the long-term benefits of productivity gains. Many also fail to realise that their employees need constant training and skills upgrading if they are order to improve their capacity to innovate. Finally, the simple lack of relevant courses is also a possible reason why SMEs show little interest in training (SME Corporation Malaysia, 2012b).

Some priorities for improving SME productivity

How efficiently a firm converts inputs into outputs determines its productivity. Firm productivity is therefore a reflection of both labour ability and technology. It is shaped chiefly by factors that include the quality and size of the workforce, use of technology, management capabilities, organisational structure and level of capital sufficiency.

The obstacles to higher productivity that SMEs have to contend with include the lack of skilled human capital, new technologies and limited capital resources. They are already covered by Malaysia’s laudable, comprehensive SME Masterplan 2012-2020 and its six focus areas:

1. access to financing
2. innovation and technology adoption
3. human capital development
4. market access
5. legal and regulatory environment
6. infrastructure.

Step up innovation-related activities

As there appears to be a positive relationship between innovation rates and productivity (Hall, 2011), it is important that SMEs should be involved in innovation-related activities. According to the 2012 ACCCIM survey of SMEs, 12% of respondents stated that innovation activities did not matter to them. It may be inferred that the remaining 88% consider that innovation activities are important. This is indeed good news. However, there are obstacles. The two main ones that SMEs must contend with in their innovation-related activities are financing and a grasp of technology. That the SME Masterplan 2012-2020 should include both access to finance and innovation and technology adoption as two of its six focus areas is an encouraging sign.

Raise awareness of the importance of TVET

Results from the same ACCCIM survey also indicate that 62% of respondents face a shortage of workers and have problems hiring. Of those respondent SMEs, 30% face shortages of skilled workers, with sectors such as construction and contracting (59%) and manufacturing (42%) experiencing the most problems in that regard.
To improve the competencies of its workforce and accelerate the supply of skilled labour, Malaysia will need to focus on its technical and vocational education and training (TVET) programmes. Skills gained from TVET programmes seem especially appropriate for SMEs because their levels of technology are lower than those of the highly capital-intensive large firms.

While the government has been trying to raise the skills level of the labour force by broadening access to TVET, the take-up rate has been low. According to Malaysia's Economic Planning Unit, only 10% of students enrol in upper-level secondary technical and vocational education. In OECD countries, the average enrolment rate is 44% (EPU, 2010). The currently low TVET enrolment rates point to huge untapped potential for training which could increase the supply of skilled workers – with SMEs in particular standing to gain. TVET participation rates need to be raised. To that end, there should be campaigns to raise students' and parents' awareness of the benefits of TVET. In this respect, progress is actually being made.

**Action taken to promote and widen TVET take-up**

The Ministry of Education has introduced two pilot vocational colleges (VCs) as part of its efforts to mainstream TVET and allow students to enter vocational streams of study from the age of 15. As part of this initiative, 78 technical/vocational schools are to be converted into VCs with seven additional new VCs in place by 2015. The Ministry of Education will collaborate with other public training institutes as part of its overall plan to enrol 187,000 students by 2015. That number would represent an increase in TVET enrolment of up to 20%, compared with 10% in 2010.

In 2011, the Department of Skills Development, under the purview of the Ministry of Human Resources, launched the SkillsMalaysia campaign to raise interest in TVET. As part of SkillsMalaysia, action has been taken to promote TVET through various media channels and skills competitions at both local and international levels.

Additional initiatives seek to pave clear further-education pathways for TVET graduates. With the establishment of the Malaysian Technical University Network (MTUN) in 2006, graduates of public training institutes are able to pursue their studies at a higher level in four public universities and other selected universities in the technical field.

Malaysia has adapted Germany’s National Dual Training System (NDTS) to enable training programmes to be conducted in accordance with industry needs. Since the scheme started in 2005, it has produced more than 30,000 skilled workers with more than 1,100 companies taking part. Yet that number of companies remains very low, despite the success of the programme in meeting industry’s need for skilled workers. Limited resources and time constraints chiefly account for the lack of SME involvement in the NDTS.

As for the issue of skills mismatches, the government introduced industry lead bodies (ILB) in 2011 to promote closer collaboration between training institutions and industry and to help develop a curriculum that would contribute to narrowing the skills gap. More ILBs will be set up in the future – particularly in critical sectors – in order to foster even closer collaboration between stakeholders in drawing up a quality curriculum.
POLICY FOCUS
Widen the tax base and improve tax administration and compliance

Malaysia’s finances a serious cause for concern

Over-reliance on the oil and gas sector

The largest contributor to tax revenue in Malaysia is the oil and gas industry (Ministry of Finance, 2013), which exposes the budget to the volatility of oil prices. Oil-related revenue from state-owned oil and gas company Petronas alone – in the form of dividends, corporate tax, petroleum income tax (PITA), royalty payments and export duties – ran to 28% in 2012. The country’s over-reliance on Petronas to finance its budget is a source of concern as its oil and gas reserves are limited.

Malaysia has a narrow tax base

Out of a population of about 28 million, slightly more than 12 million make up the labour force, of whom 6.4 million are registered individual taxpayers. However, only 1.8 million pay tax. The same pattern is to be found in the business community. Of the 508 150 registered companies that are supposed to pay tax, only 107 043 actually do so (Ministry of Finance, 2013). In 2012, as Table 2.5.3 shows, taxes collected from individuals and companies accounted for 35.7% of Malaysia’s total revenue.

Table 2.5.3. Federal government revenue in Malaysia, 2012

<table>
<thead>
<tr>
<th>Revenue Type</th>
<th>Amount (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenue</td>
<td>100.0</td>
</tr>
<tr>
<td>Non-tax revenue</td>
<td>26.4</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
</tr>
<tr>
<td>Licence and permits</td>
<td>6.5</td>
</tr>
<tr>
<td>Investment income</td>
<td>17.7</td>
</tr>
<tr>
<td>Non-revenue receipt</td>
<td>0.7</td>
</tr>
<tr>
<td>Direct tax</td>
<td>56.2</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
</tr>
<tr>
<td>Companies</td>
<td>24.7</td>
</tr>
<tr>
<td>PITA</td>
<td>16.3</td>
</tr>
<tr>
<td>Individual</td>
<td>11.1</td>
</tr>
<tr>
<td>Indirect tax</td>
<td>16.7</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
</tr>
<tr>
<td>Excise duties</td>
<td>5.9</td>
</tr>
<tr>
<td>Sales tax</td>
<td>4.6</td>
</tr>
<tr>
<td>Tax revenue</td>
<td>72.9</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance, Malaysia.
Over-reliance on subsidies

In the early years of independence, Malaysia made limited, very selective use of subsidies aimed not at consumption but at production and investment (Thillainathan, 2008). The investment activities that it subsidised heavily included:

- irrigation, which the government provided free of charge to allow double cropped paddy rice production;
- land development and resettlement, with the government waiving the reimbursement of administrative costs from settlers.
- The subsidies extended to paddy farmers and settlers were equitable as the two groups were amongst the country’s poorest. In that respect, some types of subsidies do serve useful purposes.

In later years, Malaysia also directed subsidies at consumption. It began subsidising transport fuel, for example, in 1983 to keep it affordable for ordinary citizens. By making input costs lower, the subsidy indirectly makes goods and services that use transport fuel cheaper (e.g. public transport).

However, subsidies can come at a high cost. They can hinder efforts to reduce budget deficits. They may widen socio-economic gaps because the rich may also benefit if subsidies are not confined to the truly needy. The Ministry of Finance’s Economic Report 2012/2013 estimated that its budget allocation for the fuel subsidy – the largest subsidy – reached MYR 25.2 billion in 2012. That is more than 50% of the federal government’s total development expenditure in 2012 (estimated at MYR 49.8 billion).

Need for reform in tax administration and compliance

Goods and services tax (GST) to broaden the tax base

The spread of value-added tax (VAT), also called goods and services tax (GST), was a very important development in taxation. It is a broad-based consumption tax that over 130 countries have now introduced. In such countries (which include OECD members), it typically accounts for one-fifth of total tax revenue. The recognised capacity of VAT to raise revenue in a neutral and transparent manner has prompted all OECD member countries (except the United States) to adopt it (OECD, 2006c).

As GST is based on consumption rather than income, it spreads the tax burden more evenly and widens the tax base. It would give the federal government wider scope for tax collection as it would help diversify the tax base away from reliance on direct taxation, which accounts for slightly over 56% of total revenues. As sales tax contributes just 4.6% of the government’s total revenue, GST has much potential for helping to bolster the sustainability of Malaysia’s public finances. It could also allow corporate and individual income tax rates to be reduced. Malaysia should introduce GST as soon as possible.

Cut subsidies

To improve spending efficiency the Malaysian government should reduce subsidies. In particular, funds allocated to the transport fuel subsidy could be better used in, for example, human capital development. In 2012, the allocation for education and training was estimated at 16.1% of total development expenditure, and that for health at 4.0%.
Subsidies in their current form are inefficient, with most benefitting middle- and high-income groups, foreigners and businesses. The government needs to confine subsidies to the truly needy and eliminate unproductive tax incentives. It has started to rationalise the system, but implementation is expected to be a long drawn-out affair as the government seeks to contain inflationary pressures and to soften the blow to consumers, businesses, lower-income households, and the rural population.

**Improve tax administration and compliance**

- Improving tax administration and compliance is one plank of the Economic Transformation Programme (ETP). The focus is on reducing the tax gap, which would improve tax collection and help bolster public finances. Measures include:
  - widening field audit and investigation coverage;
  - audit-based control of exporters and importers of liquor and cigarettes in duty-free islands and free commercial zones;
  - improve customs enforcement.

Successful implementation of the measures will however depend on the competence of the responsible officers. Staff competence is critically important in tax administration. In *Principles of Good Tax Administration* (1999) the OECD recommends that tax authorities practice meritocracy and equal opportunity when recruiting, training and promoting employees. It also highlights the need for tax authorities to remunerate employees sufficiently well to attract and retain competent individuals.

Closing the tax gap involves two key measures – reducing the opportunities for evasion and improving compliance. Methods of curbing evasion, which intersect with the goal of improved compliance, should include strengthening third-party reporting requirements and expanding the tax authority's access to reliable third-party data. Third-party information is that provided by, for example, financial institutions. Access to credit and debit card transaction reporting by financial institutions would allow the tax authorities to better target their audits and strengthen enforcement.
Notes

1. Sixty-four economies originally participated in PISA 2009 (see endnote 2). Ten additional partner participants, who were unable to participate within the PISA 2009 project timeframe, participated in the PISA 2009 study on a reduced and delayed timeline in 2010. This is known as the PISA 2009+ project. The PISA 2009+ economies are: Costa Rica, Georgia, India (Himachal Pradesh & Tamil Nadu), Malaysia, Malta, Mauritius, Venezuela (Miranda), Moldova, United Arab Emirates. PISA 2009+ involved testing just over 46,000 students across these ten economies, representing a total of about 1,377,000 15-year-olds (Australian Council for Educational Research, www.acer.edu.au/media/acer-releases-results-of-pisa-2009-participant-economies/).

2. Launched in 1997 by the OECD, the Programme for International Student Assessment (PISA) is an international study to evaluate education systems worldwide every three years. It assesses 15-year-olds’ competencies in the key subjects of reading, mathematics and science.

3. For the past 20 years, TIMSS (Trends in International Mathematics and Science Study) has measured trends in mathematics and science achievement at the fourth and eighth grades. It has been conducted on a regular 4-year cycle since 1995, making TIMSS 2011 the fifth assessment of mathematics and science achievement trends (TIMSS website, http://timssandpirls.bc.edu/).

4. These are some of the Finnish government’s priorities for education in its 1999-2003 plan.

5. The objective of SkillsMalaysia campaign is to raise awareness of the opportunities in skills training and job-related TVET that can contribute towards developing a high-income nation and in making skills training the first choice for school leavers (SkillsMalaysia website, www.skillsmalaysia.gov.my/).
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