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Malaysia's economic success story and challenges

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MALAYSIA'S ECONOMIC SUCCESS STORY AND CHALLENGES

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**By Vincent Koen, Hidekatsu Asada, Stewart Nixon,
Mohamed Rizwan Habeeb Rahuman and Abu Zeid Mohd Arif**

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ABSTRACT/RESUMÉ

Malaysia's economic success story and challenges

Malaysia has sustained over four decades of rapid, inclusive growth, reducing its dependence on agriculture and commodity exports to become a more diversified, modern and open economy. GDP per capita is now higher than in a number of OECD economies, while poverty and income inequality have declined considerably. Growth has also been remarkably resilient in the face of external shocks. Going forward, the Malaysian government's 11th Malaysia Plan (2016-20) emphasises the need for greater inclusiveness. Continued, gradual fiscal consolidation is a key policy priority, building on earlier energy and food subsidy rationalisation and on the introduction of a goods and services tax. So is continued prudent monetary and financial policy. Further reforms are needed for Malaysia to become a high-income nation around 2020: productivity growth needs to be reinvigorated through various structural reforms while growth needs to become more inclusive.

This Working Paper relates to the 2016 *OECD Economic Assessment of Malaysia* (www.oecd.org/eco/surveys/economic-survey-malaysia.htm).

JEL Classification: E20; E50; F1; G3; G15; H11; H20; H30; H50; H60; I0; J0; K210; O1; O40; P48.

Keywords: ASEAN, commodities, competition, monetary policy, education, employment, fiscal consolidation, productivity, green growth, inclusive growth, inequality, innovation, insolvency, macro-prudential, migration, pension, regional development, SMEs, skills, structural reform, trade, tax, TVET

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Succès et défis économiques de la Malaisie

La Malaisie a connu plus de quatre décennies de croissance rapide et inclusive, réduisant sa dépendance à l'égard de l'agriculture et des exportations de matières premières, pour devenir une économie plus diversifiée, moderne et ouverte. Le PIB par tête est désormais plus élevé que dans un certain nombre d'économies de l'OCDE, alors que la pauvreté et les inégalités de revenu ont considérablement reculé. La croissance s'est également montrée résiliente face aux chocs externes. Pour l'avenir, le 11ème plan du gouvernement malaisien (2016-2020) souligne l'importance d'une plus grande inclusion. La poursuite graduelle de la consolidation budgétaire est une priorité majeure, dans la foulée de la rationalisation des subventions énergétiques et alimentaires et de l'introduction d'une taxe sur les biens et services. La continuation d'une politique monétaire et financière prudente en est une autre. La Malaisie doit réformer plus avant pour devenir un pays à haut revenu autour de 2020: diverses réformes sont nécessaires pour stimuler la croissance de la productivité et pour une croissance plus inclusive.

Ce Document de travail se rapporte à l'Évaluation économique de l'OCDE de la Malaisie 2016 (www.oecd.org/eco/surveys/economic-survey-malaysia.htm).

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Mots-clés : ASEAN, matières premières, concurrence, politique monétaire, éducation, emploi, consolidation budgétaire, productivité, croissance verte, croissance inclusive, inégalités, innovation, insolvabilité, macro-prudentiel, migration, développement régional, PMEs, compétences, réformes structurelles, commerce, impôts, apprentissage professionnel

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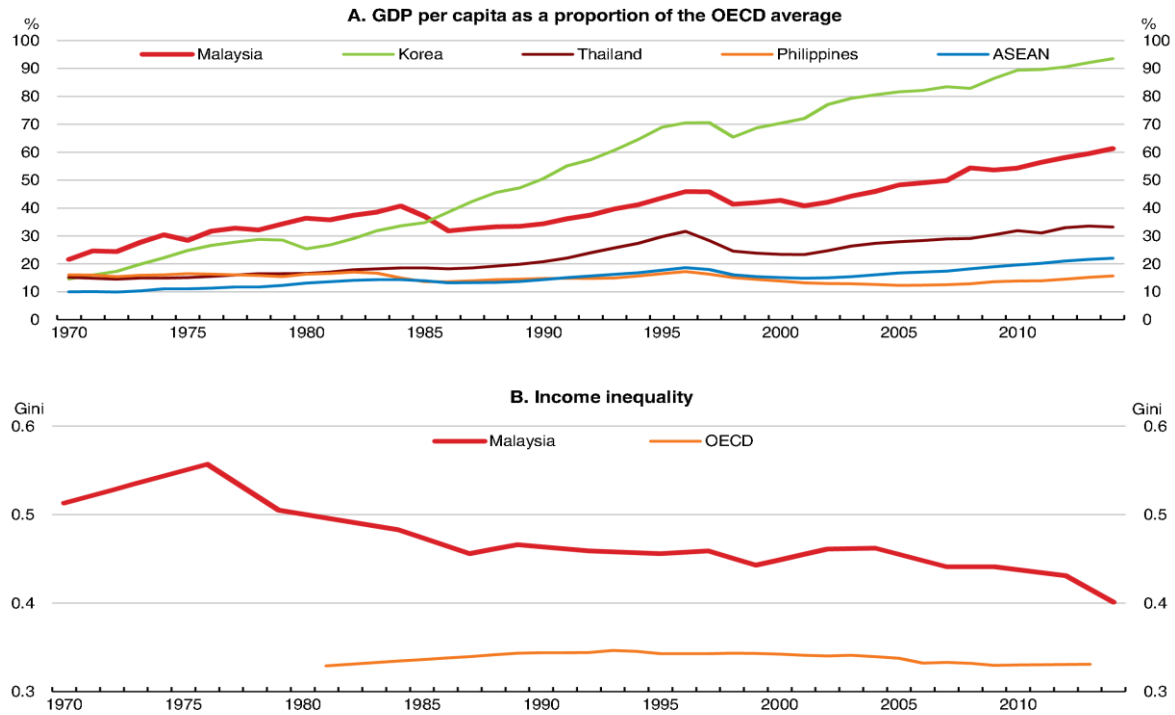
MALAYSIA'S ECONOMIC SUCCESS STORY AND CHALLENGES

By Vincent Koen, Hidekatsu Asada, Stewart Nixon,
Mohamed Rizwan Habeeb Rahuman and Abu Zeid Mohd Arif[1]

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 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).

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).

[1] The authors worked in the OECD Economics department at the time of writing. The authors thank Malaysian officials, members of the Economic and Development Review Committee, Alvaro Pereira, Balázs Egert, Mohamed Rizwan Habeeb Rahuman and Abu Zeid Mohd Arif from the Economics Department, Faisal Naru from Public Governance and Territorial Development, Lynn Robertson and Ruben Maximiano from Directorate for Financial and Entreprise Affairs, Massimo Geloso Grosso and Kazuhiro Sugie from Trade and Agriculture Directorate, Gernot Hutschenreiter and Philippe Larrue from Directorate for Science Technology and Innovation for their valuable comments. Special thanks are due to Thomas Chalaux for research and statistical assistance and to Mercedes Burgos and Sisse Nielsen for technical preparation.

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.

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 the first OECD Economic Assessment of Malaysia relating to maintaining resilient growth, boosting productivity and fostering inclusive growth (Table 1, OECD, 2016d).

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.

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

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

	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	• *Strengthen governance by creating a research management agency.* • *Enhance demand-driven research by*

	OECD key recommendation	Objectives featuring in the 11th Malaysia Plan
	Agency.	*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.	• *Establish the Malaysian Aviation Commission to regulate competition and mergers in this sector.*
	• Amend insolvency laws to facilitate the rescue of viable firms. Introduce out-of-court insolvency procedures.	
	• 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.*

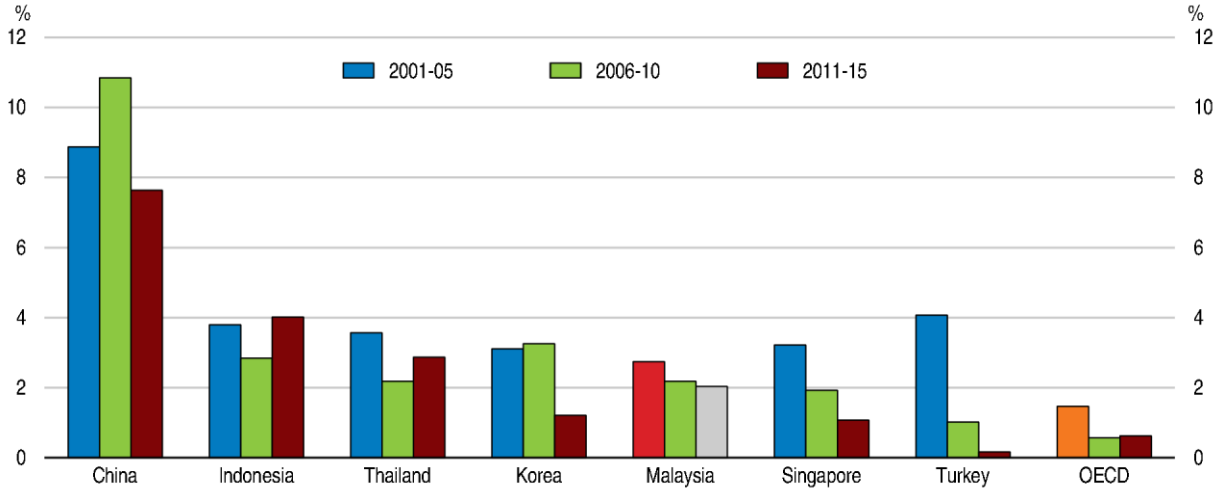
Source: EPU (2015), Eleventh Malaysia Plan and OECD (2016d), Malaysia 2016: Economic Assessment.

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).

Figure 2. Labour productivity growth has declined

Average growth of real value added per employee per year



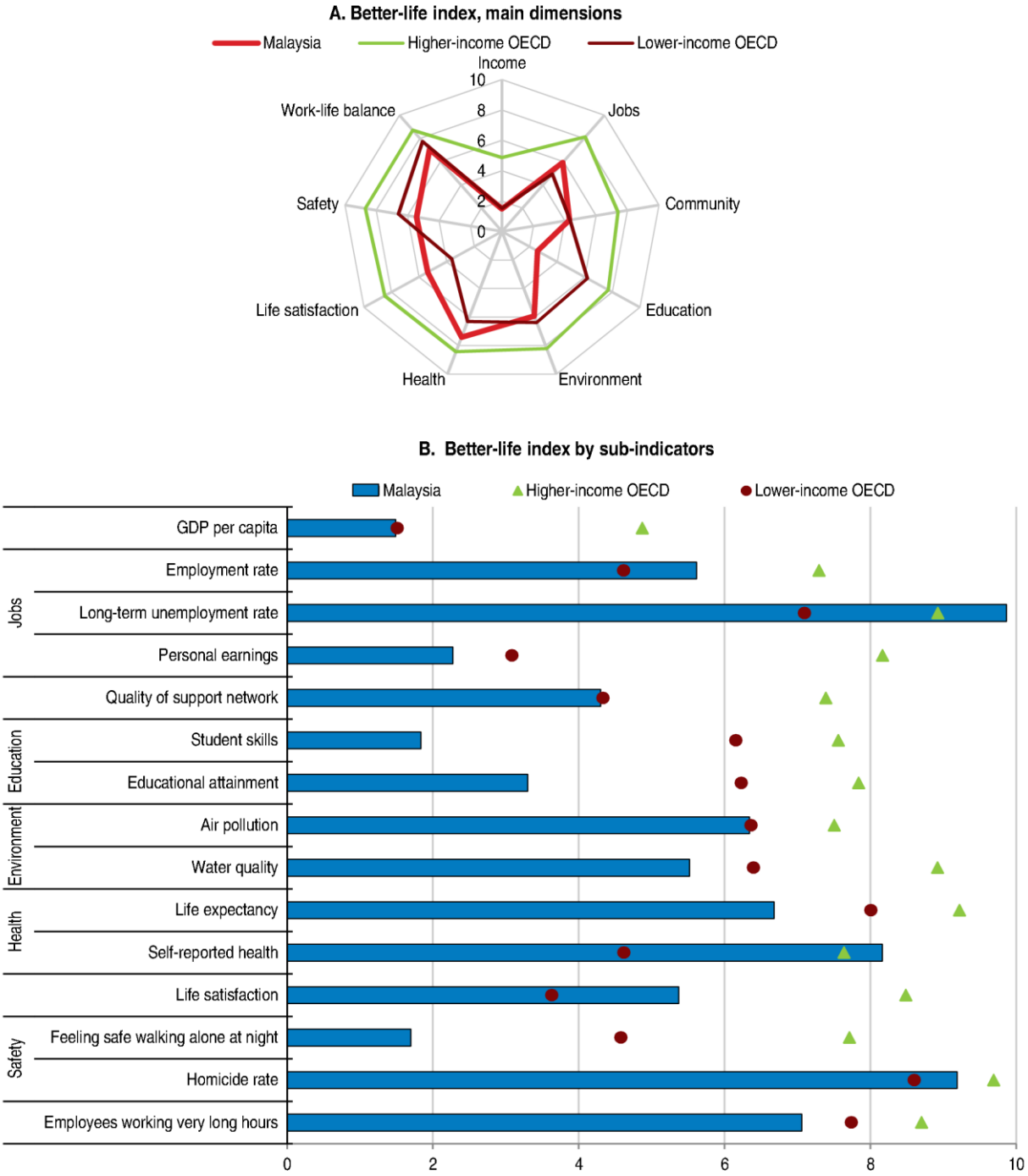
Note: The underlying employment data for Malaysia might underestimate the number of legal and undocumented foreign migrant workers.

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*.

Against this backdrop, the first OECD Economic Assessment of Malaysia recommended the following:

- *Pushing ahead with structural reforms would reinforce economic resilience and sustainable growth.* While growth is expected to remain resilient despite global headwinds, monetary 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 (OECD, 2016d).

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 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).

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

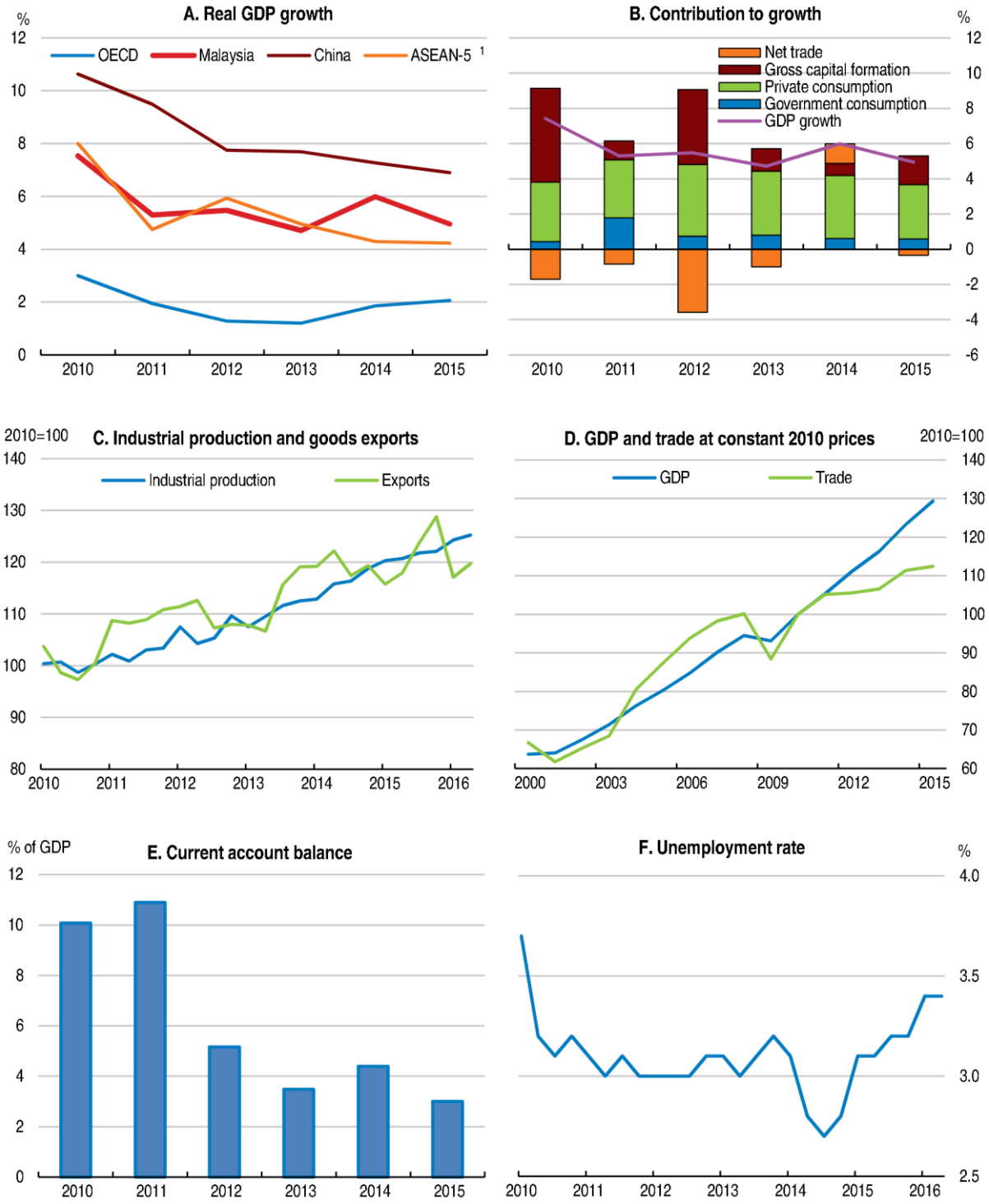
Growth remained strong in 2015, at 5%, despite slowing global growth and a sharp fall in commodity prices (Figure 4.A). Sound macroeconomic fundamentals, disciplined fiscal policy and prudent monetary policy underpin Malaysia's resilience. Notwithstanding the boost to price competitiveness imparted by 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 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 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.

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.

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.

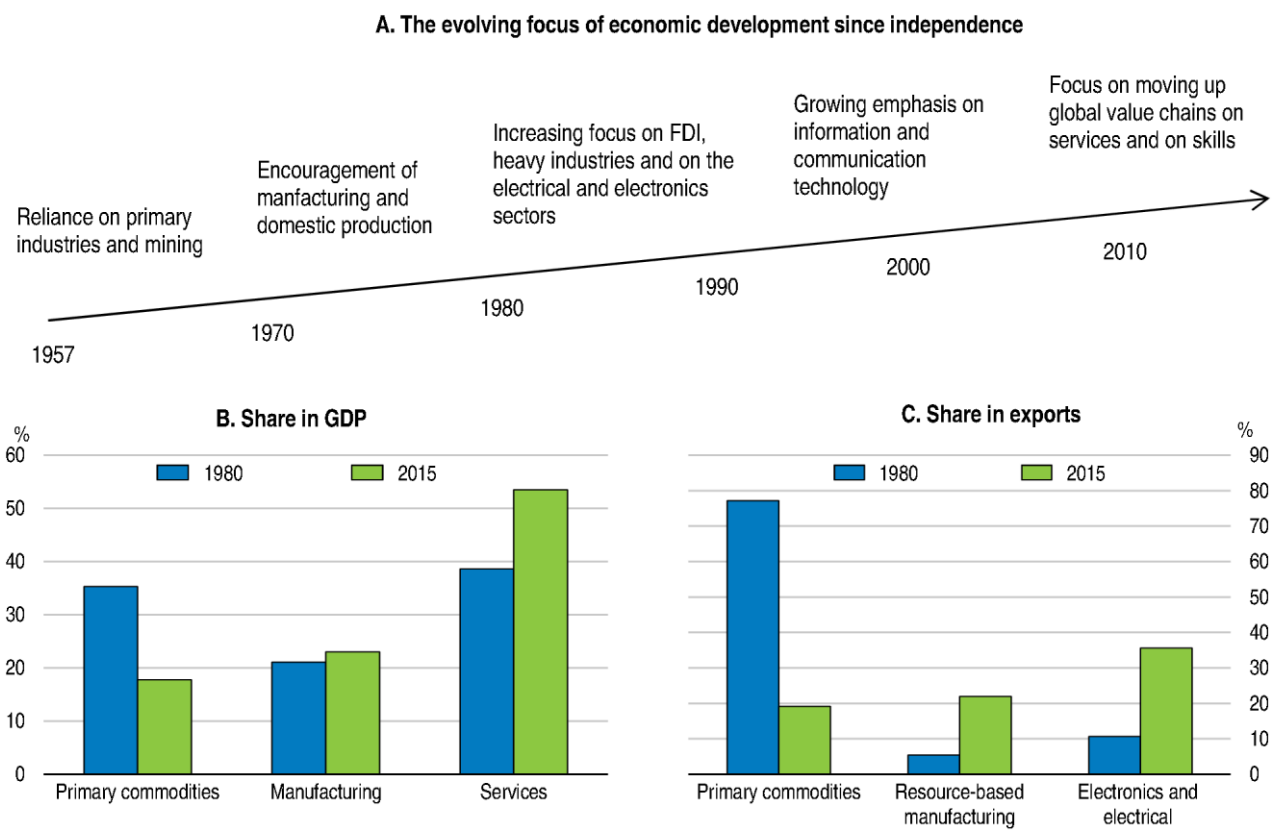
Source: OECD Economic Outlook database, *http://dx.doi.org/10.1787/9572784d-en*; Department of Statistics, Malaysia; Bank Negara Malaysia; Ministry of Finance, Malaysia; World Bank (2016a), *Commodity Price Outlook, April.*

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.

Figure 5. Malaysia's economic development



Source: Department of Statistics, Malaysia.

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).

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

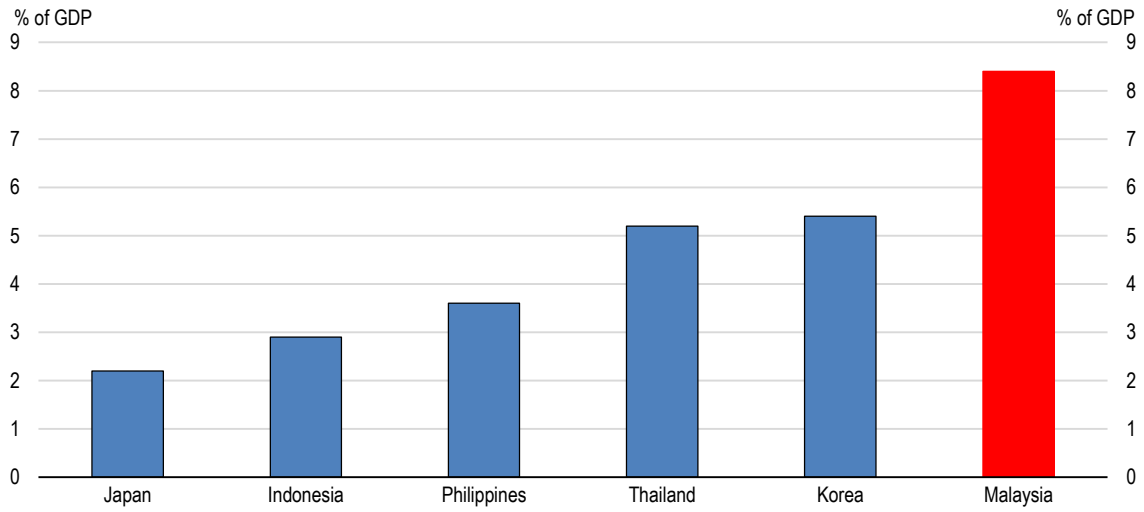
Export partners	Share
Singapore	13.9
China	13.0
European Union (28 countries)	10.1
Japan	9.5
United States	9.4
Thailand	5.7
Hong Kong, China	4.7
Indonesia	3.7
Korea	3.2
Import partners	**Share**
China	18.9
Singapore	12.0
European Union (28 countries)	10.2
United States	8.1
Japan	7.8
Thailand	6.1
Chinese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

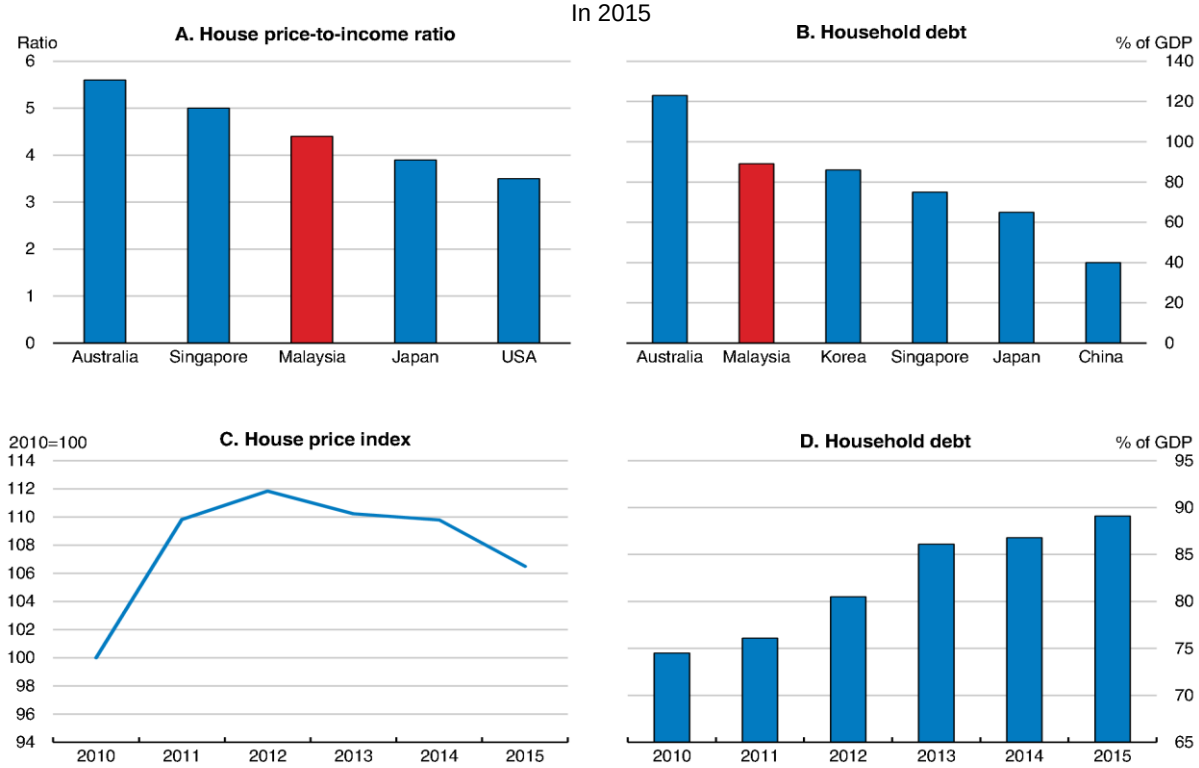
2011



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.*

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.

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.

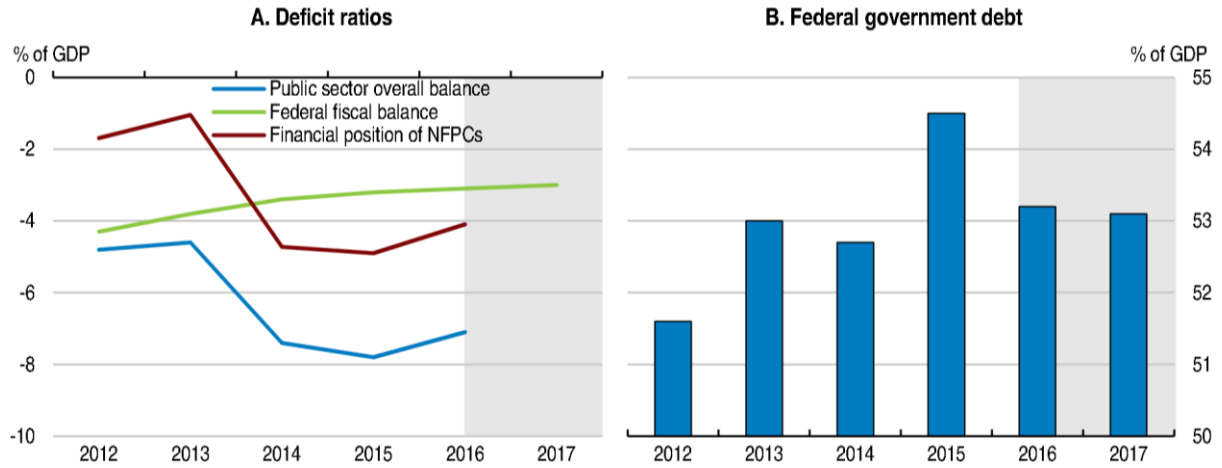
Fiscal consolidation

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).

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.

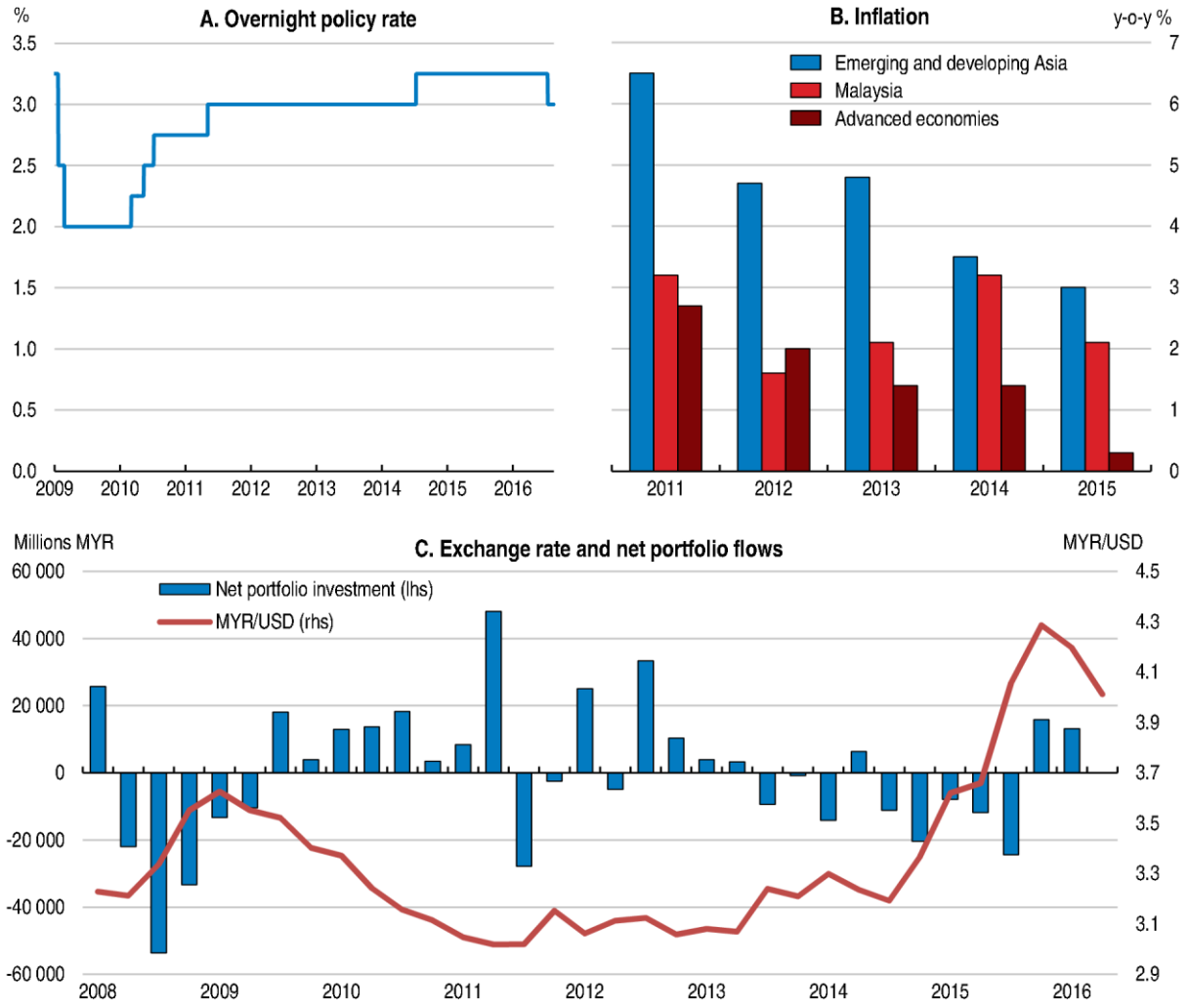
Reducing distortive outlays to the aforementioned sectors will help make room for raising spending on social protection, especially to provide a safety net for disabled, unemployed and elderly persons unable to be gainfully employed. Additional expenditure on healthcare will also be required as Malaysia's 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 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.

Figure 9. Monetary policy indicators



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

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).

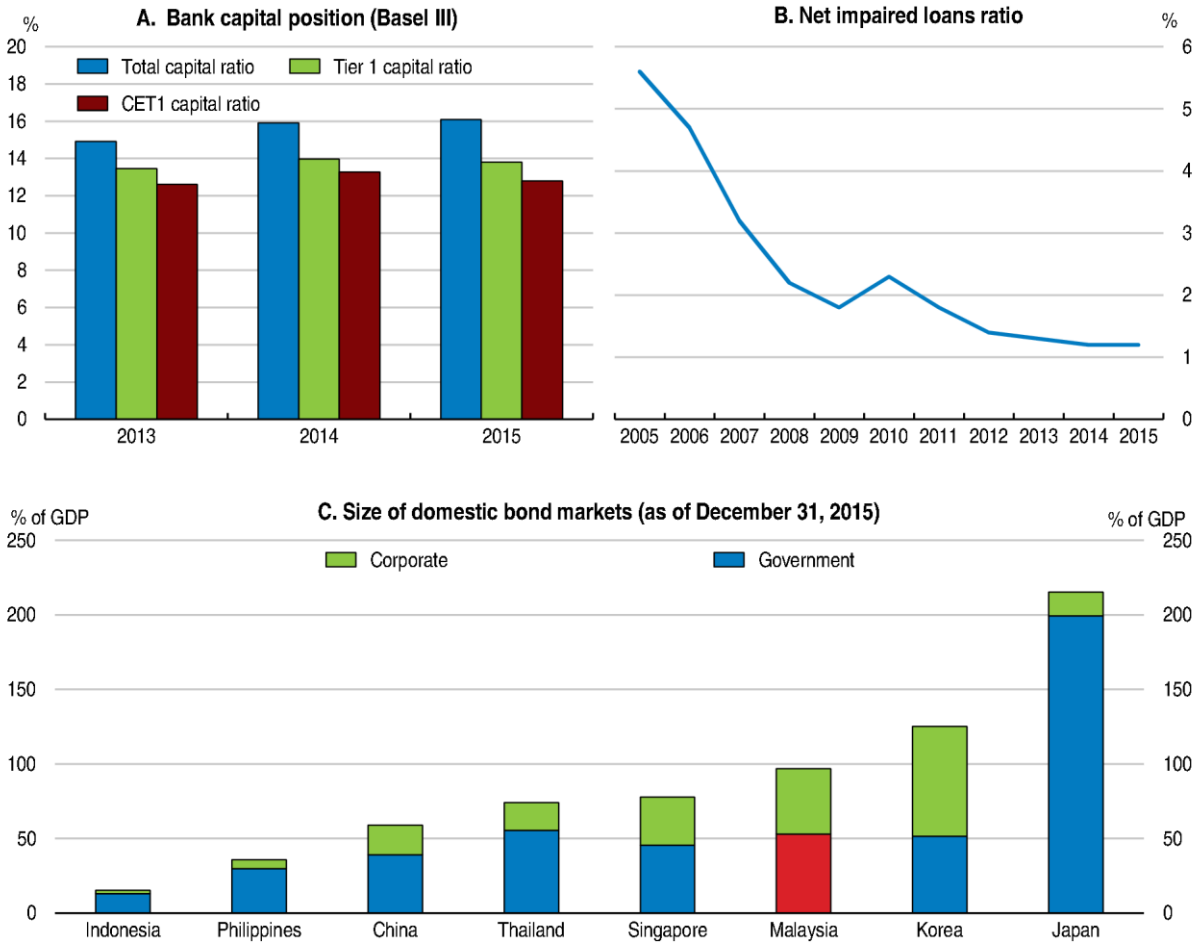
Malaysia has the third-deepest bond market in Asia after Japan and Korea, including a healthy private debt securities market (Figure 10.C). Malaysia is also the world leader in the issuance of Islamic bonds. The well-developed and diversified bond market has served as a cheaper and more durable alternative 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.

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.

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).

Box 3. Islamic finance in Malaysia

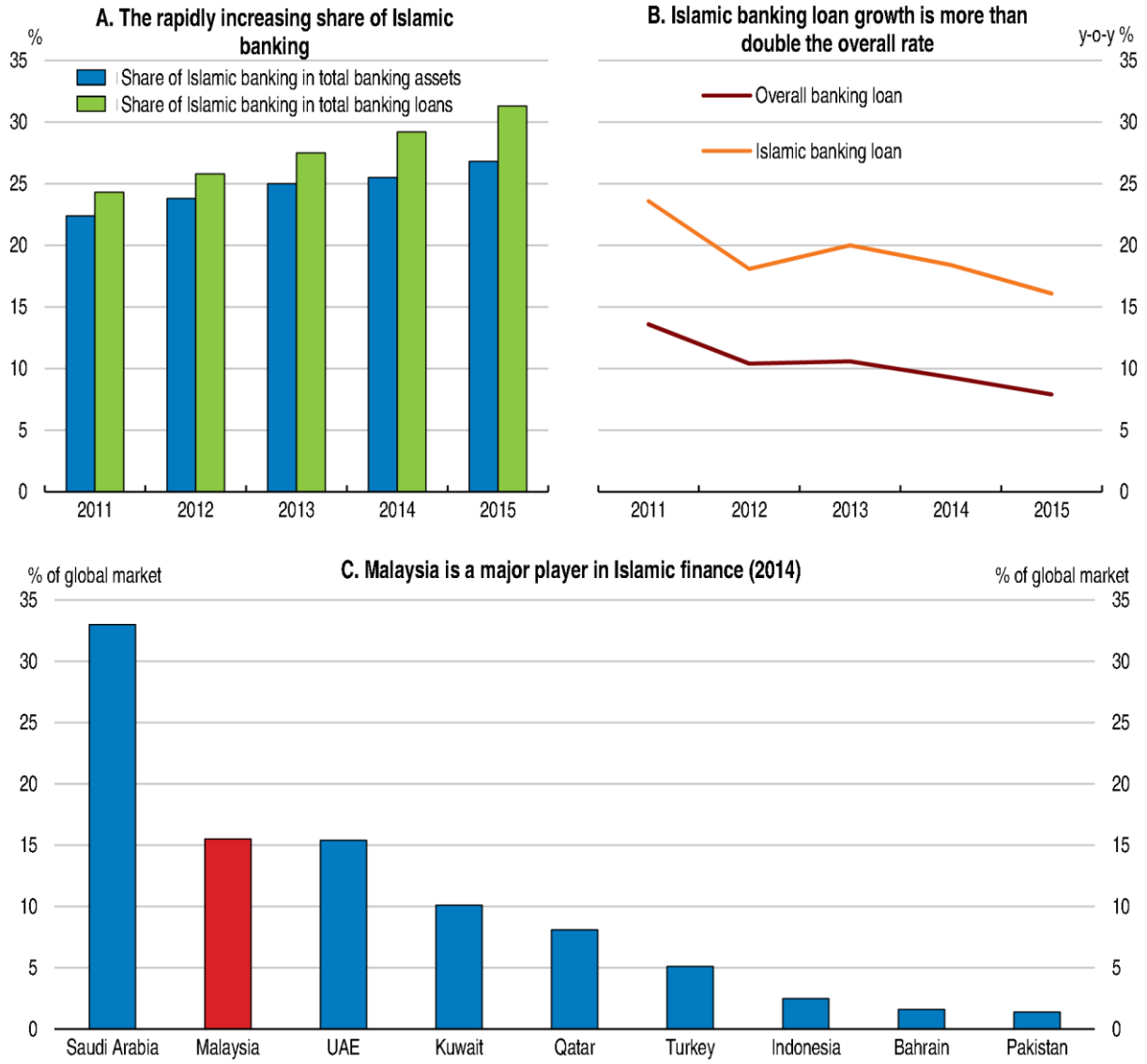
Islamic finance operates according to the principles of Islamic law, which prohibits usury and promotes risk-sharing and participatory asset-backed financing. The development of Islamic finance in Malaysia began with the creation of Bank Islam in 1983. A decade later, Islamic banking activities were 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.

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 *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.

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.*

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.

Boosting productivity to achieve high-income country status

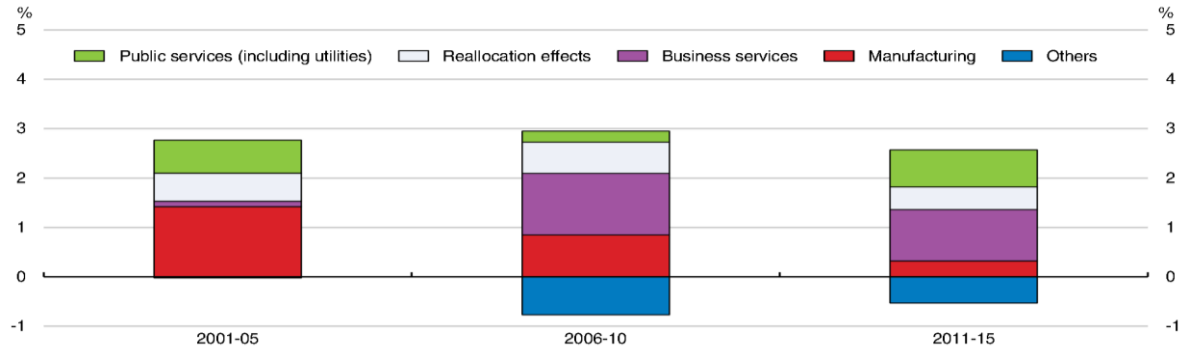
Productivity growth in Malaysia averaged 2.3% per year since the first half of the 2000s, helping to lift per capita income to higher middle-income country levels. Growth was driven by increased inflows of foreign direct investment and industry restructuring that shifted resources to higher value-added 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 capital development, promotion of innovation, improvement in the regulatory framework and regional integration through trade and investment liberalisation.

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.

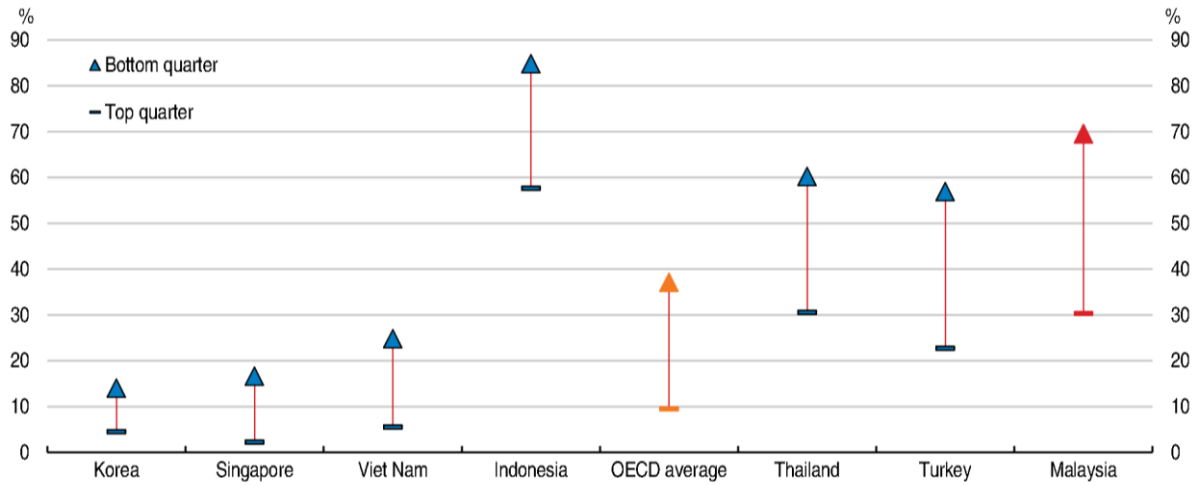
Improving the quality of education

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, 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.

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.

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.

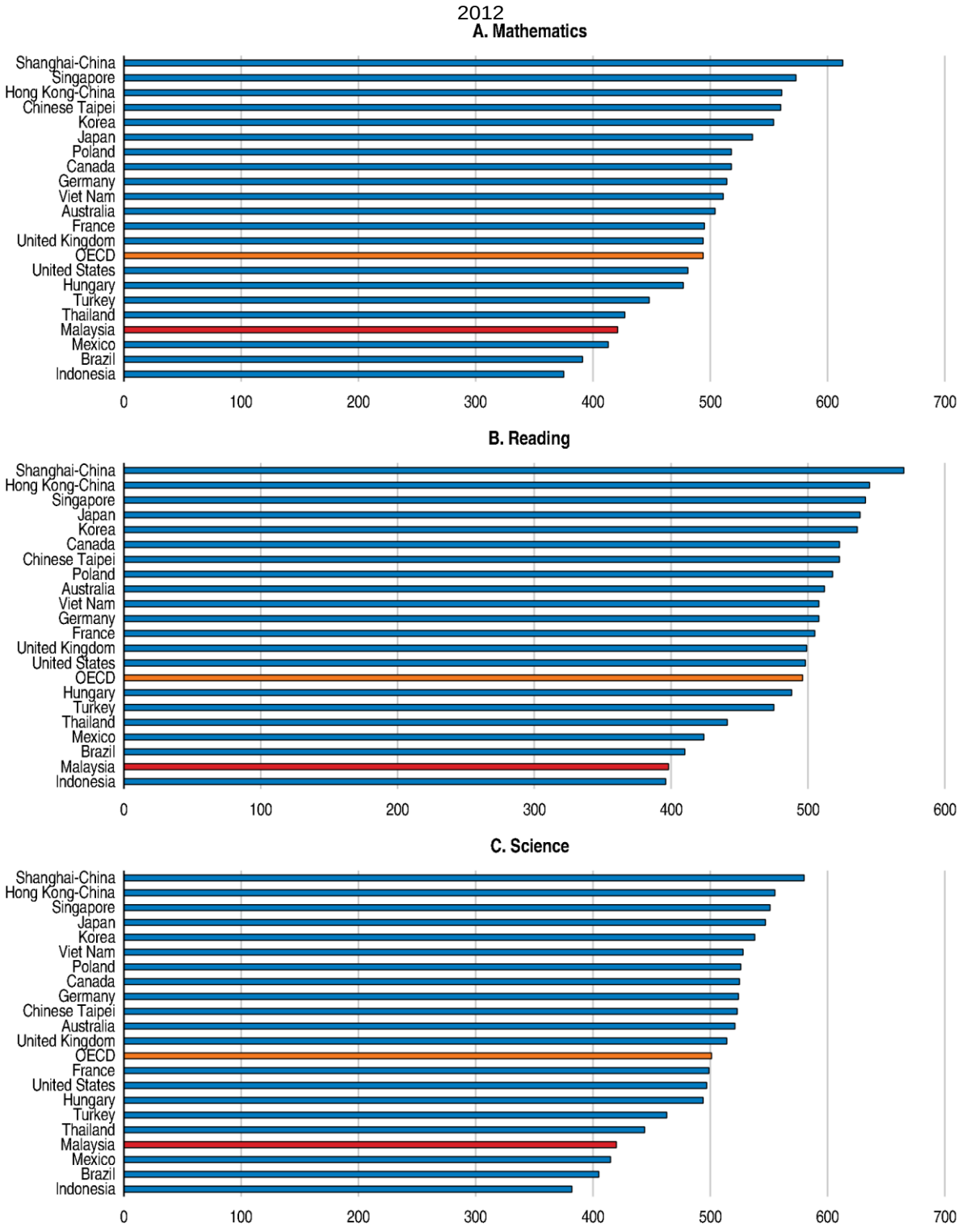
Strengthening innovation

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.

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.

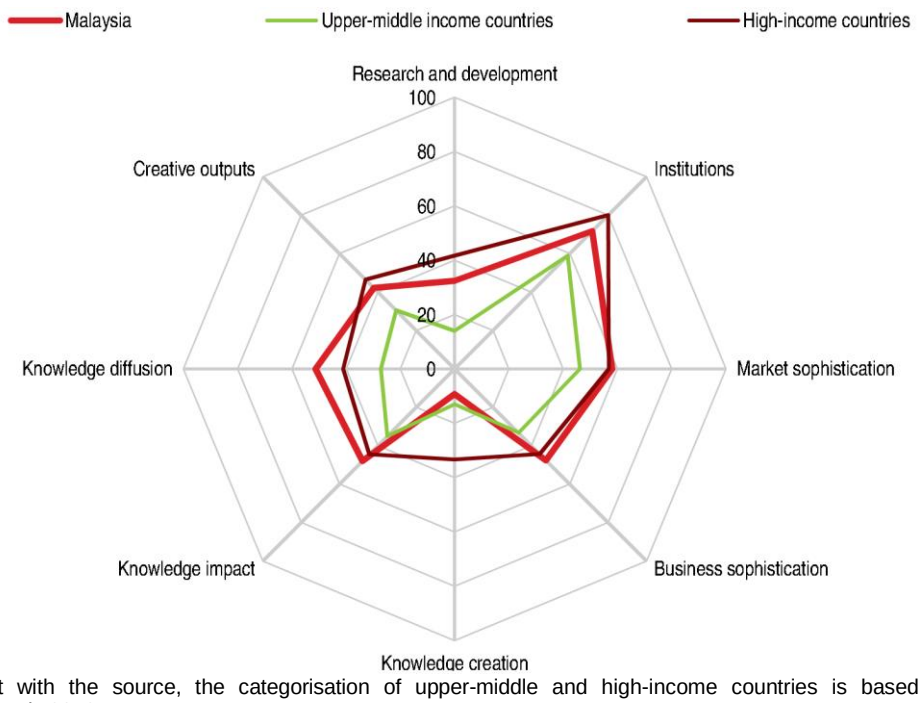
Figure 14. Student performance on PISA is low



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

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.

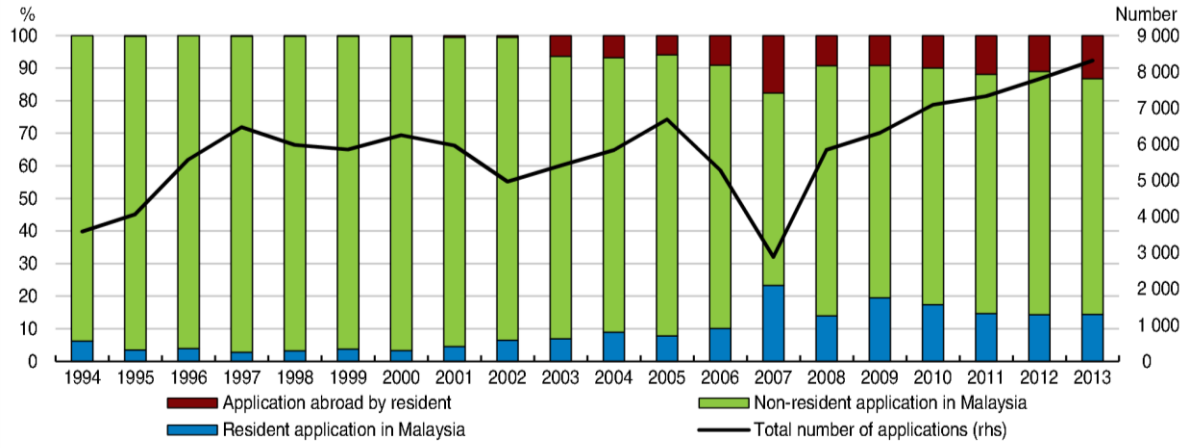
Figure 15. Innovation indicators



Note: Consistent with the source, the categorisation of upper-middle and high-income countries is based on World Bank classification as at July 2013.

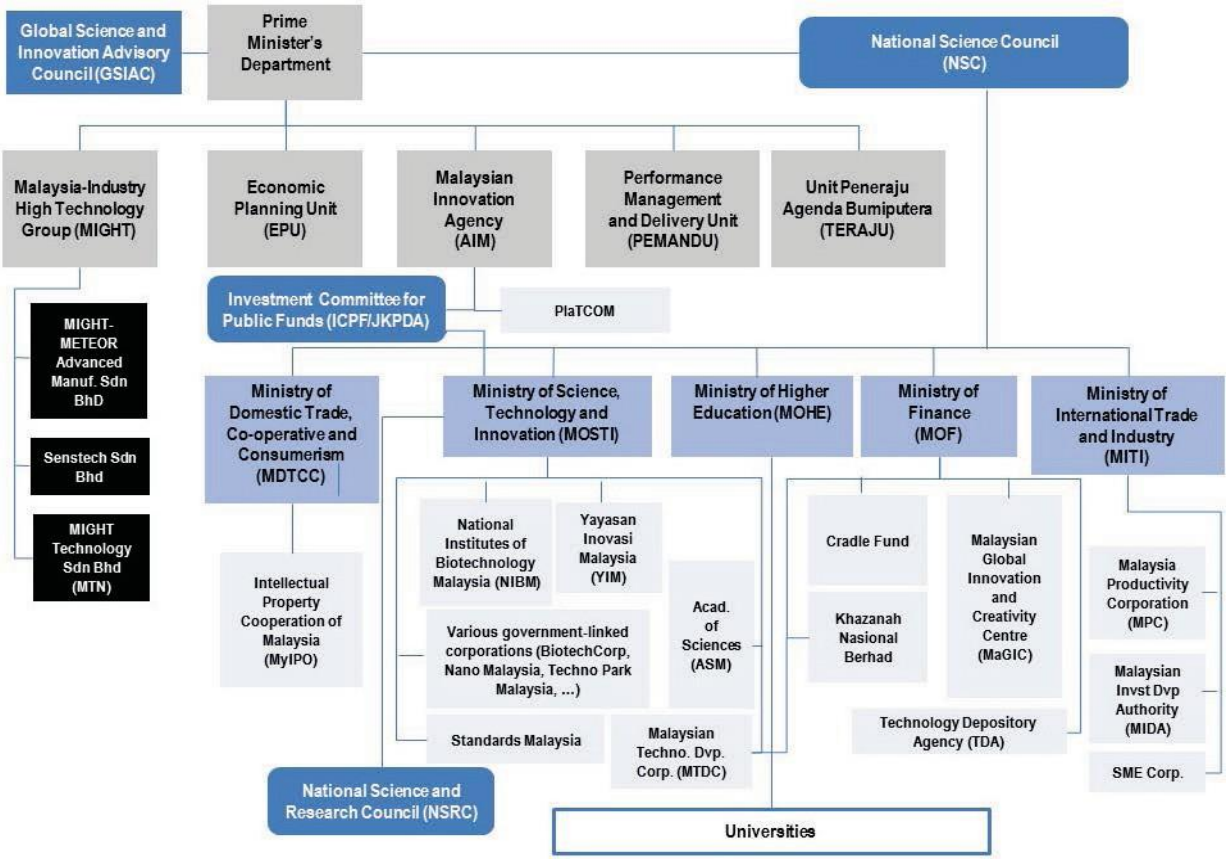
Source: Cornell University, INSEAD and WIPO (2015), *The Global Innovation Index 2015: Effective Innovation Policies for Development*.

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



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

Figure 17. Innovation governance involves a complex array of actors



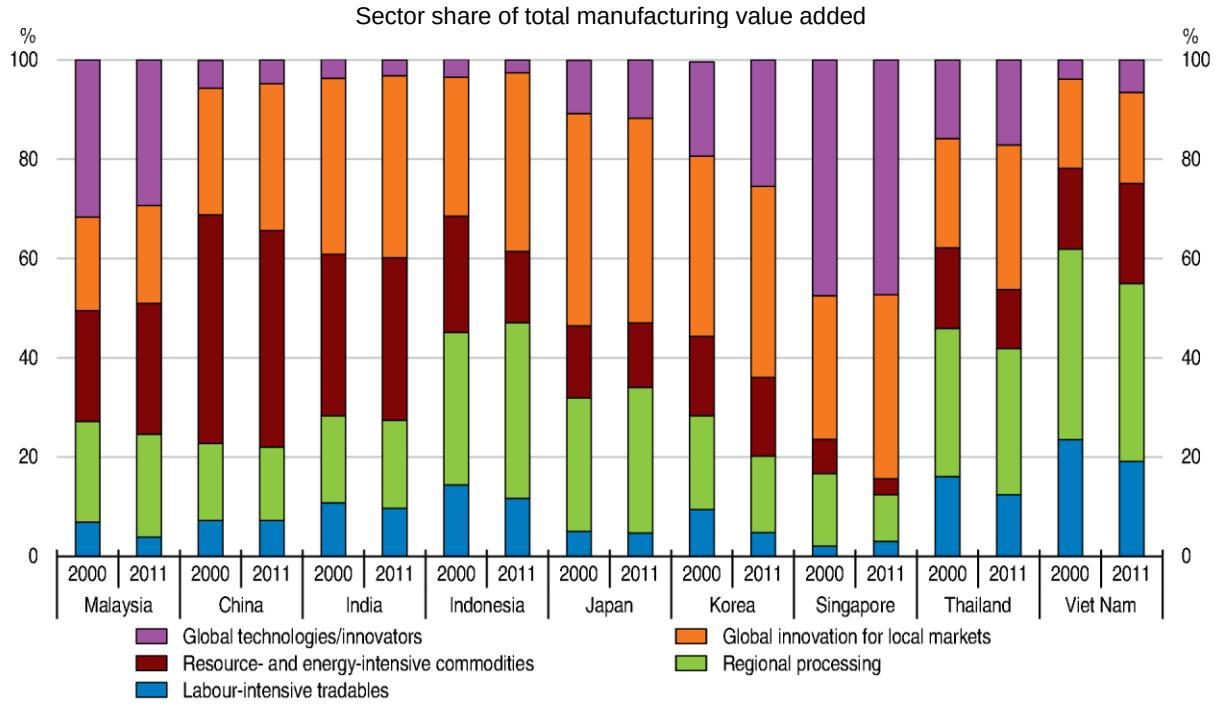
Note: Several other ministries involved in science, technology and innovation related activities are not represented in this figure, such as the Ministry of Energy, Green Technology and Water.

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



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*.

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, 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.

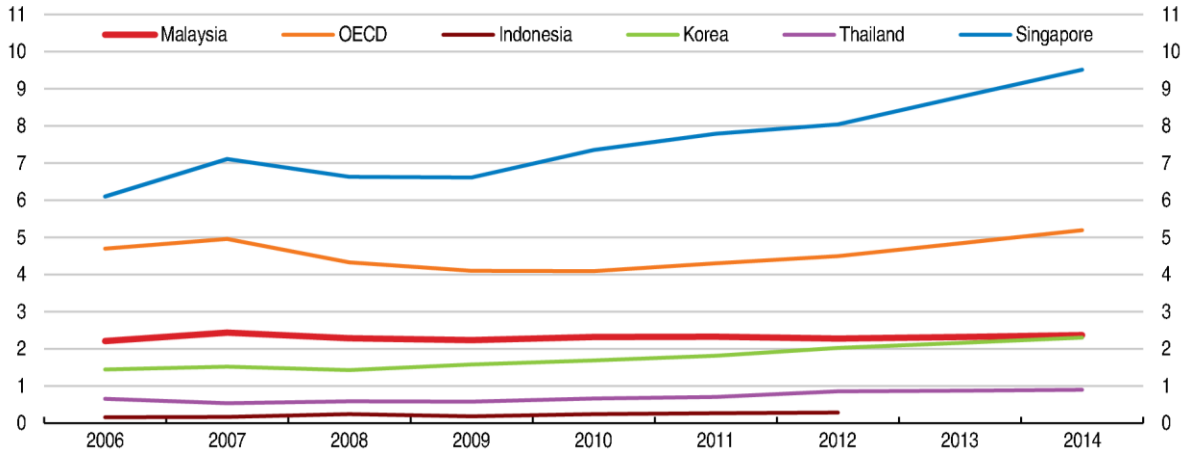
Furthering trade, investment and regional integration

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.

Figure 19. New business entry has not increased much

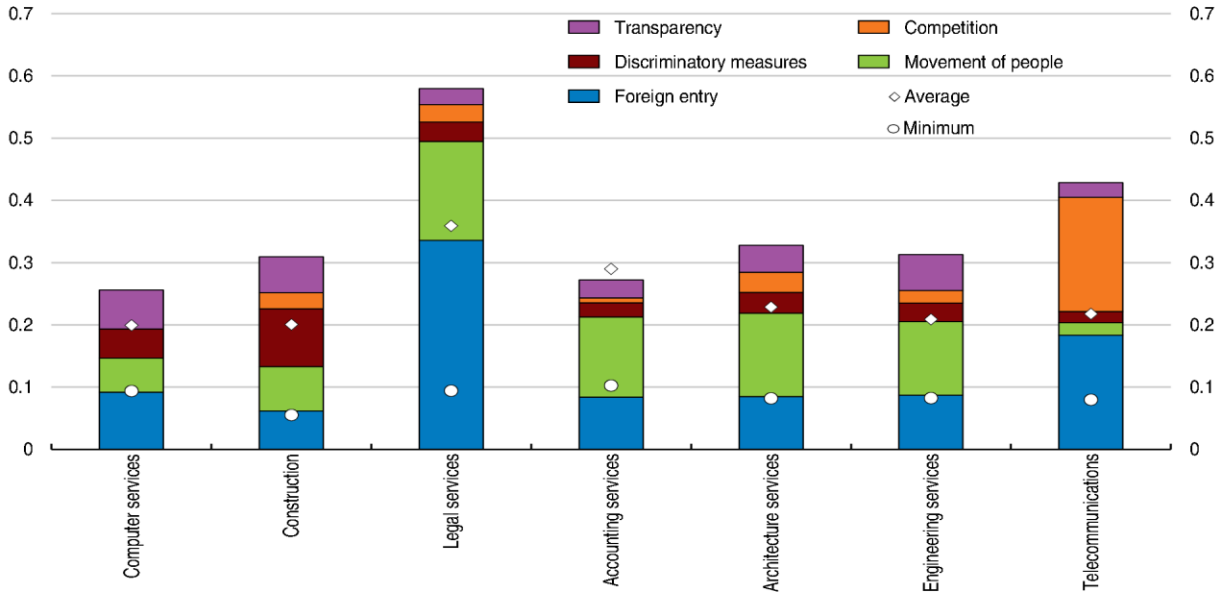
Number of new limited liability corporations per 1 000 people aged 15-64



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).

Figure 20. The STRI for selected sectors



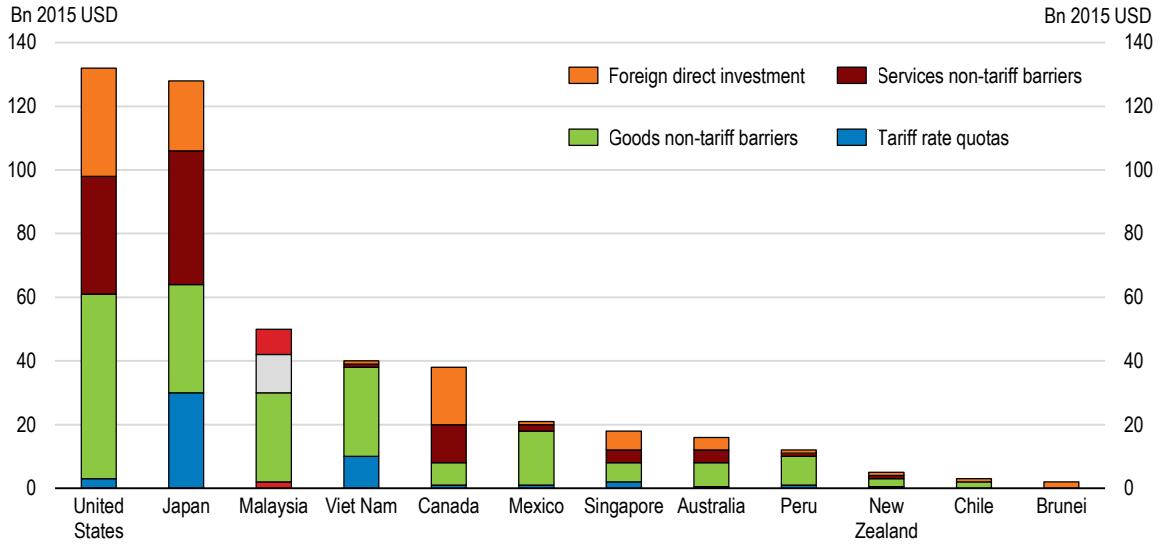
Note: The STRI indices take values between zero and one, one being the most restrictive. They are calculated on the basis of the STRI regulatory database which contains information on regulation for the 34 OECD Members, Brazil, China, Colombia, India, Indonesia, Latvia, Malaysia, Russia and South Africa. 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.

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.

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



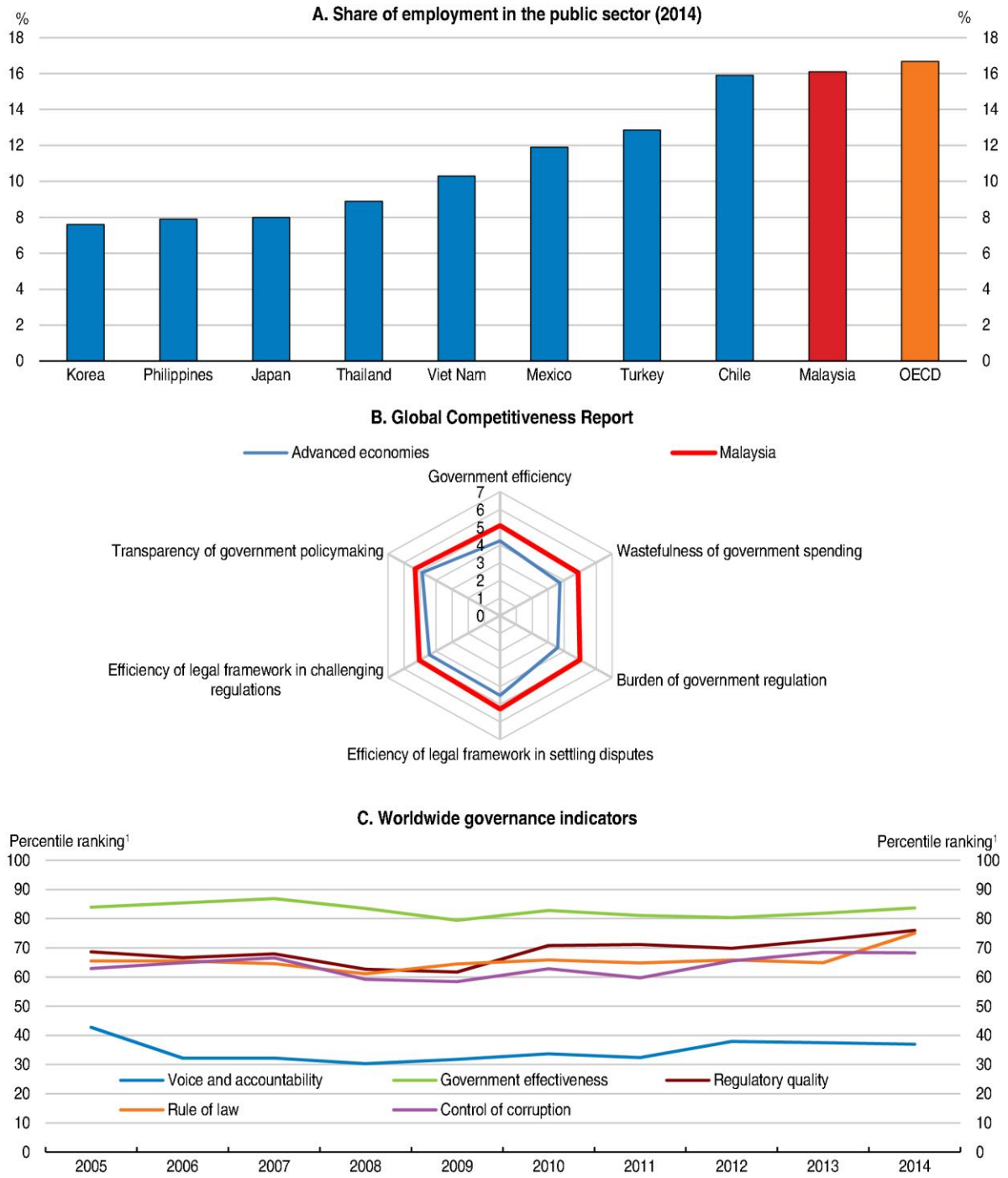
Source: Petri and Plummer (2016), "The economic effects of the Trans-Pacific Partnership: new estimates", *Peterson Institute of International Economics Working Paper Series* 16-2.

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 requirements and promote information technology use by government agencies.

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).

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.

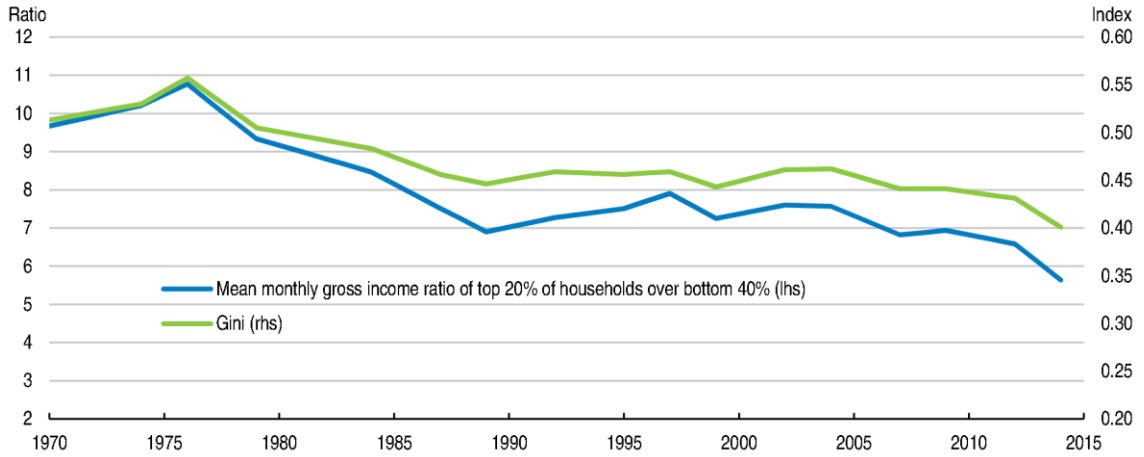
While each of these measures would contribute to increasing public sector productivity, a more comprehensive and detailed assessment would be beneficial to understanding the drivers of public service productivity. An independent review covering all aspects of public service productivity and programme 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).

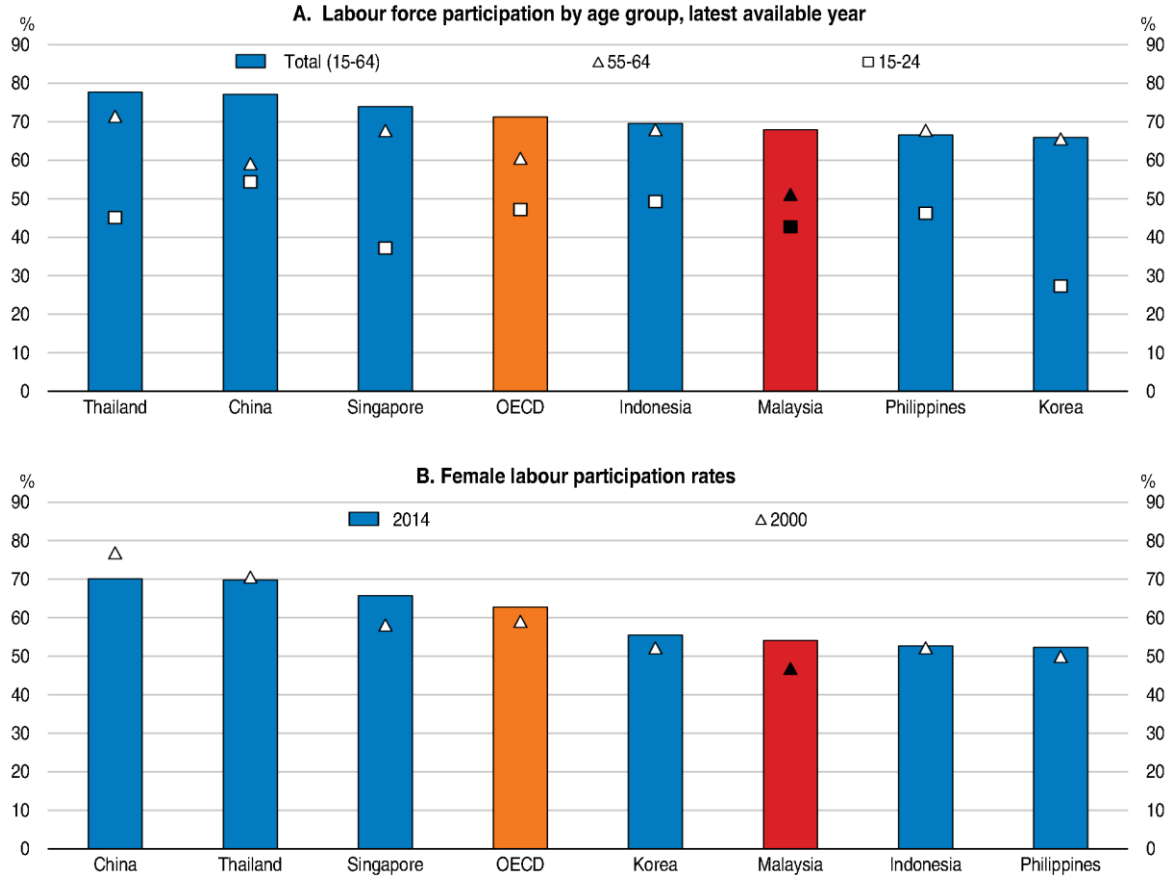
Figure 23. Income inequality has declined



Source: Department of Statistics, Malaysia.

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 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*.

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 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.

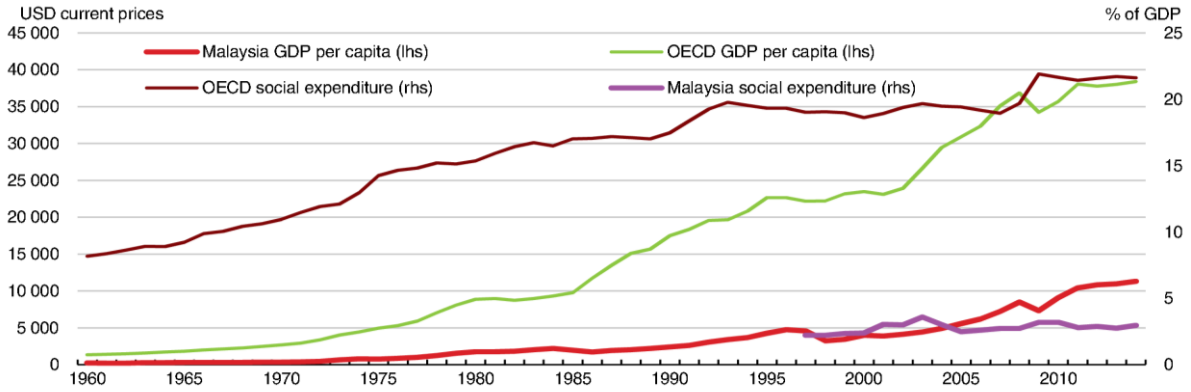
Providing life-long learning and reskilling opportunities would also facilitate women's return to work. Increasing incentives to encourage the formalisation of informal labour and economic activities are also important, including strengthening enforcement of labour market regulations such as the minimum 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 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.

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.

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.

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.

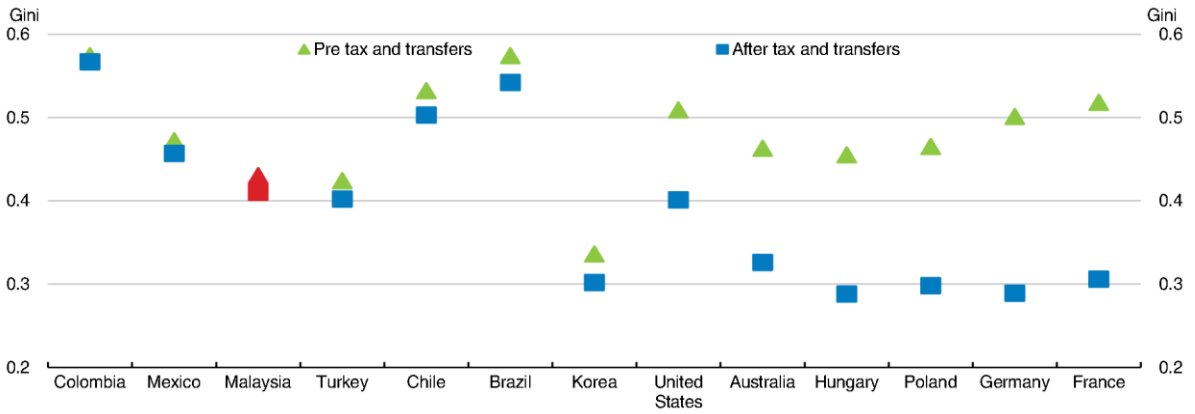
Malaysia's income tax and transfer system does very little to enhance inclusiveness through tax schedule progressivity or redistribution, as evidenced by almost identical before and after tax-and-transfer Gini coefficients (Figure 26). A more progressive personal income tax schedule would complement 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 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.

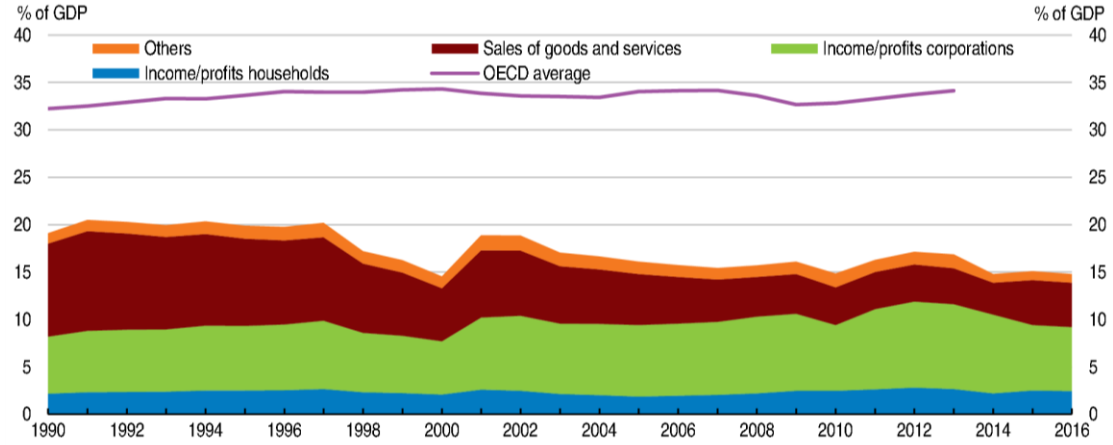
Figure 26. Malaysia's tax-and-transfer system has little effect on income distribution



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.

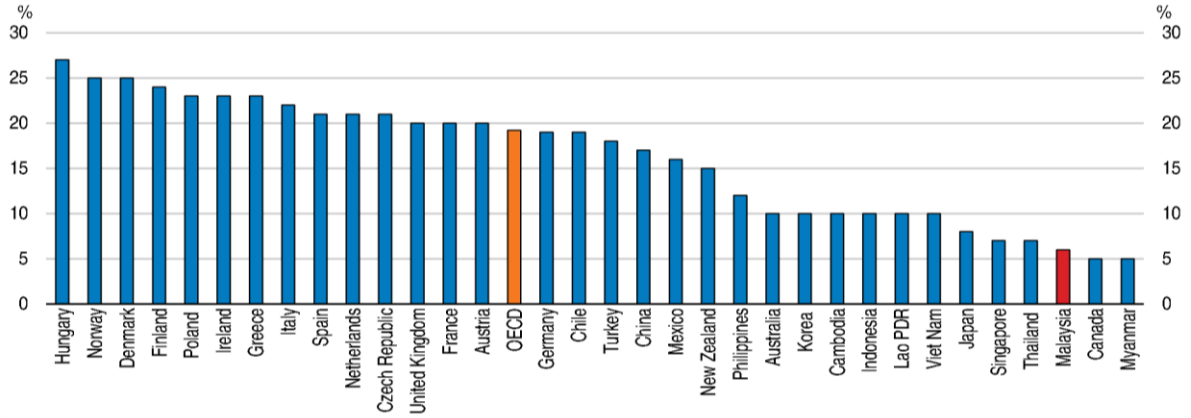
Source: OECD Income Distribution Database, http://dx.doi.org/10.1787/data-00654-en; World Bank (2014), *Malaysia Economic Monitor December 2014: Towards a Middle Class Society*.

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).

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.

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).

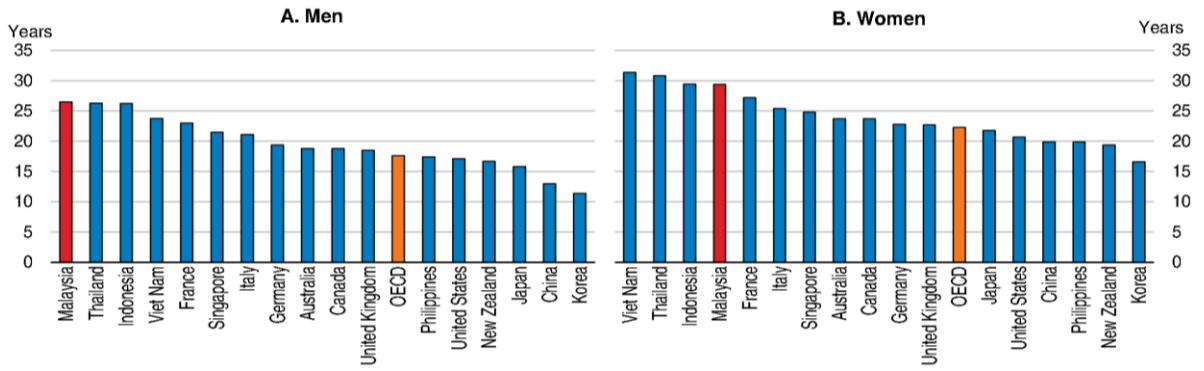
A particular challenge for inclusive growth in transitioning towards high-income country status is balancing growth in consumption and investment today while provisioning for sustainable future living standards. Pension system sustainability requires careful long- term planning in anticipation of expected 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 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 29. Malaysians can expect a lengthy retirement



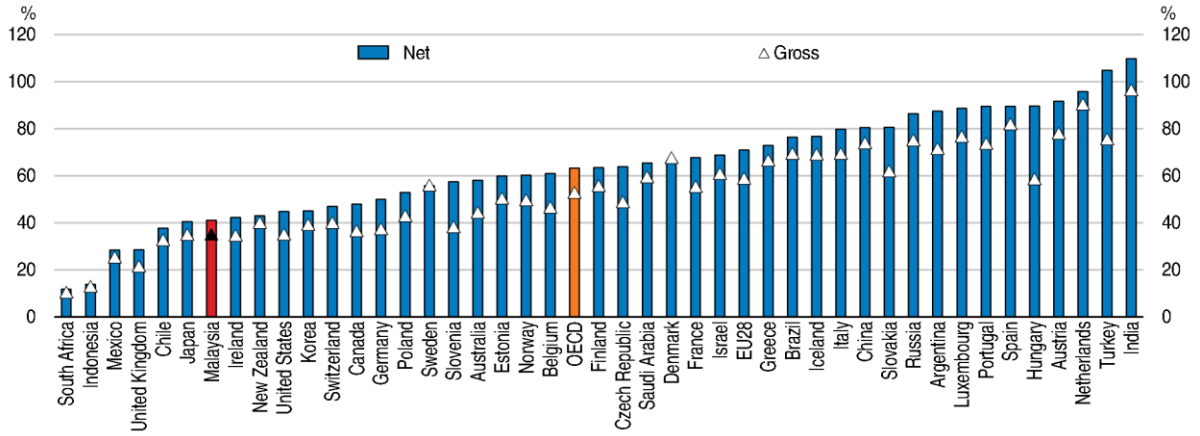
Note: The data for OECD countries and China is for 2014, 2012 for all other countries.

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*.

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.

Figure 30. Pension replacement rates are low



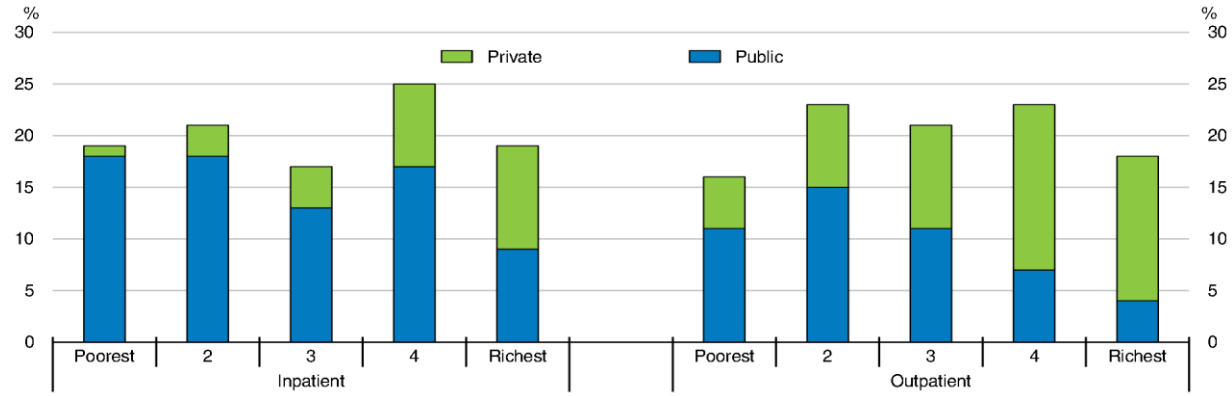
Note: The data are for 2012 for Malaysia and for 2014 for OECD countries.

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*.

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 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.

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.

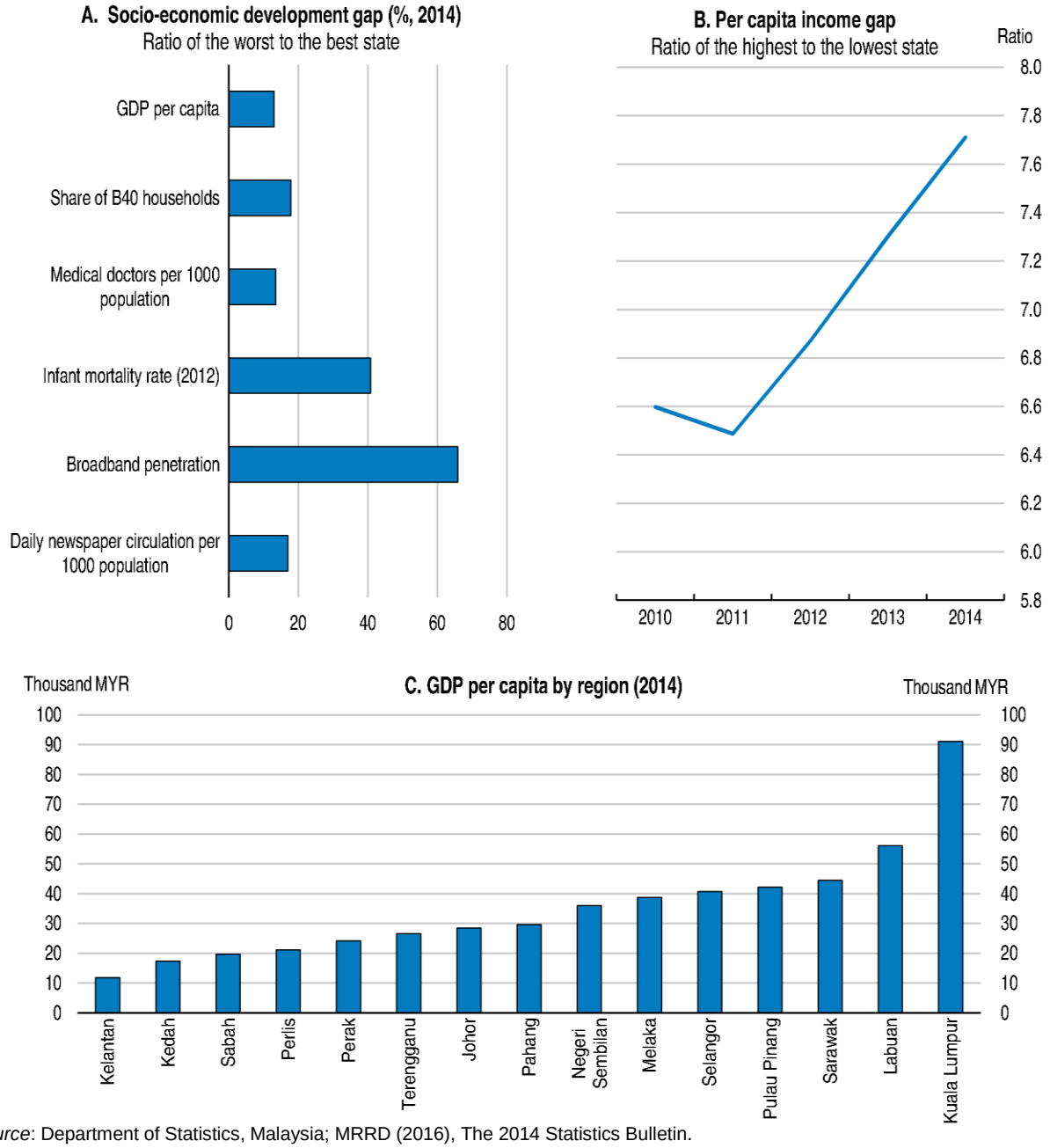
Steps have been taken to ease the burden on the urban public health system and improve access to quality healthcare for low-income urban and rural residents. In urban areas, operational hours of some public outpatient clinics have been extended and "cluster hospital" arrangements introduced to pool resources. 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).

Figure 32. Increasing development gaps between states



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

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 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

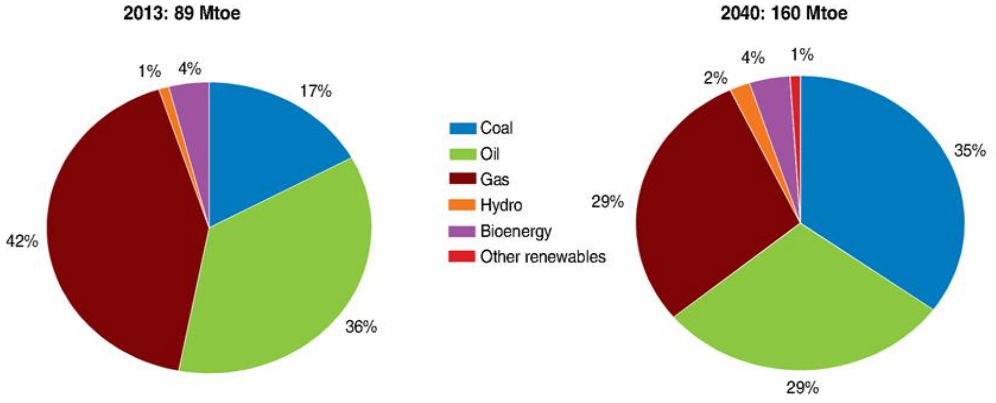
The conservation and sustainable use of Malaysia's richly biodiverse and heavily forested environment is critical to the future prosperity of the country and its neighbours. Malaysia recognises the need for environmentally sustainable development and climate change mitigation and has committed to limiting 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 CO2 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 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.

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



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

OECD modelling has suggested that introducing a carbon tax with an appropriate redistribution of revenue gains would not only reduce CO2 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).

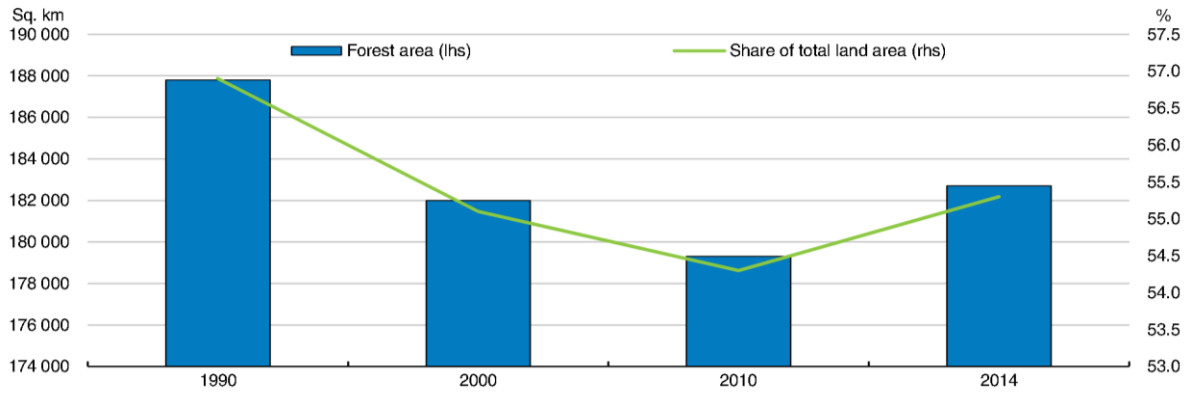
Limiting deforestation and maintaining biodiversity

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.

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.

Figure 34. Malaysia's forest cover is recovering



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

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.

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