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Fostering inclusive growth in Malaysia

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Vincent Koen

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ECONOMICS DEPARTMENT

FOSTERING INCLUSIVE GROWTH IN MALAYSIA

ECONOMICS DEPARTMENT WORKING PAPERS No. 1371

By Stewart Nixon, Hidekatsu Asada and Vincent Koen

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ABSTRACT/RESUMÉ

Fostering inclusive growth in Malaysia

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

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

JEL classification: E20; H20; H50; I0; J0; P48.

Keywords: healthcare, inclusive growth, inequality, labour market, participation, pensions, regional development, social protection, tax, transfer

Promouvoir une croissance inclusive en Malaisie

La Malaisie a suivi une trajectoire de développement comparativement équitable, éliminant largement la pauvreté absolue et réduisant considérablement l’inégalité ethnique. Les inégalités de revenu et de patrimoine ont diminué graduellement depuis le milieu des années 70. « L’ économie du peuple » étant au cœur de l’ambition de la Malaisie de devenir un pays à revenu élevé d’ici 2020, les efforts portent de plus en plus sur le défi de la pauvreté relative et sur la réalisation de progrès durables en matière de bien-être individuel et sociétal grâce à une croissance inclusive. Cette transition serait favorisée par des réformes dans plusieurs domaines où la Malaisie se compare favorablement par rapport aux pays de la région mais moins bien par rapport aux pays de l’OCDE. Cela inclut des réformes pour un meilleur accès à une éducation de qualité, une protection sociale plus complète, une participation plus grande des femmes et des personnes plus âgées au marché du travail, un accès universel à des soins de santé de qualité, ainsi que pour améliorer la viabilité et l’adéquation du système de retraite et aller vers un système de taxation et de transferts plus inclusif.

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).

Classification JEL: E20; H20; H50; I0; J0; P48.

Mots-clés : Santé, croissance inclusive, inégalité, marché du travail, participation, retraites, développement régional, protection sociale, impôt, transfert

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FOSTERING INCLUSIVE GROWTH IN MALAYSIA

By Stewart Nixon, Hidekatsu Asada and Vincent Koen¹

Introduction

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

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

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

The following section provides an overview of the current state of inclusive growth in Malaysia. The subsequent ones identify priority areas where further reforms would enhance well-being. This paper complements the productivity-boosting reforms, with many of these reforms also beneficial to fostering inclusive growth (Asada et al., 2016). Reforms that provide universal access to quality education and skills training provide an obvious example, and so do reforms that enhance innovation, competition and SMEs. Innovative businesses exhibit higher employment growth that benefits both high- and low-skilled workers. A robust competition environment spurs innovation and facilitates the entry and expansion of new businesses (de Mello and Dutz, 2012). Openness to trade and investment and strong competition policies can increase the availability of lower priced essential goods and services for

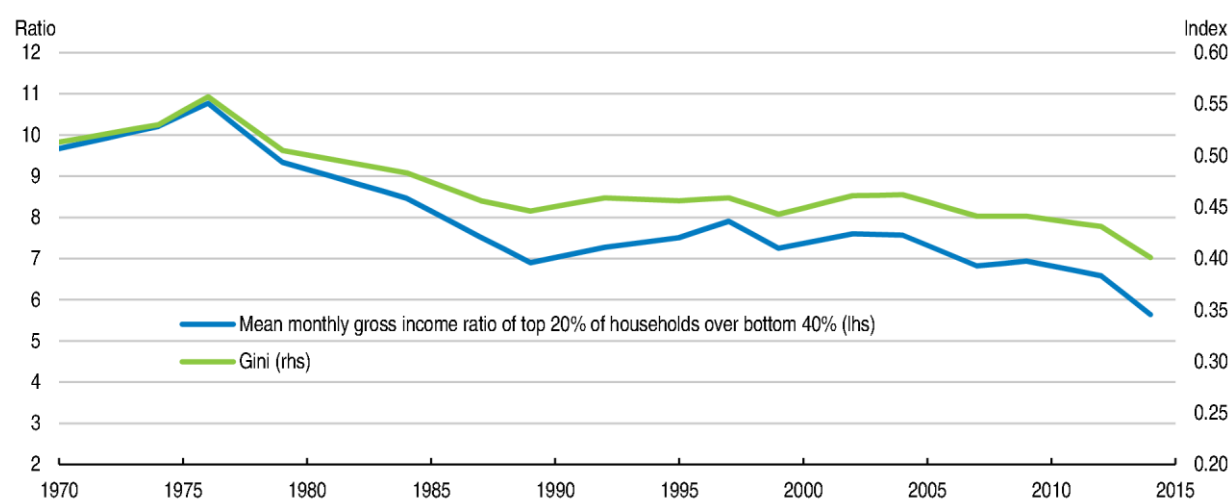
¹ The authors worked in the OECD Economics department at the time of writing. The authors thank Malaysian officials, members of the Economic and Development Review Committee, Alvaro Pereira, Mohamed Rizwan Habeeb Rahuman, Abu Zeid Mohd Arif from the Economics Department and Faisal Naru from Public Governance and Territorial Development 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.

lower-income households, such as food, clothing and telecommunications. In many respects therefore, productivity and inclusiveness enhancing policies go hand-in-hand.

Poverty, income and wealth inequality

Malaysia's sustained rapid real GDP growth of 6.4% per annum from 1970 to 2015 reduced the incidence of absolute poverty from 49.3% to 0.6% (World Bank, *World Development Indicators*). Some challenges remain, with higher rates of absolute poverty in rural areas (1.6%), for children under 15 (1.7%) and for particular ethnic groups (Orang Asli 34%; Bumiputera Sabah 20.2% and Bumiputera Sarawak 7.3%) still a focus of poverty reduction efforts, with programmes providing food, financial aid and skills training. Income inequality has gradually reduced from very high levels, with low-income households and previously disadvantaged ethnic groups benefiting more than proportionately. The income share of the top 20% of households compared to the B40 has declined substantially over this period, at a faster rate than Malaysia's overall Gini coefficient for household income (Figure 1).

Figure 1. Income inequality has declined



Source: Department of Statistics, Malaysia.

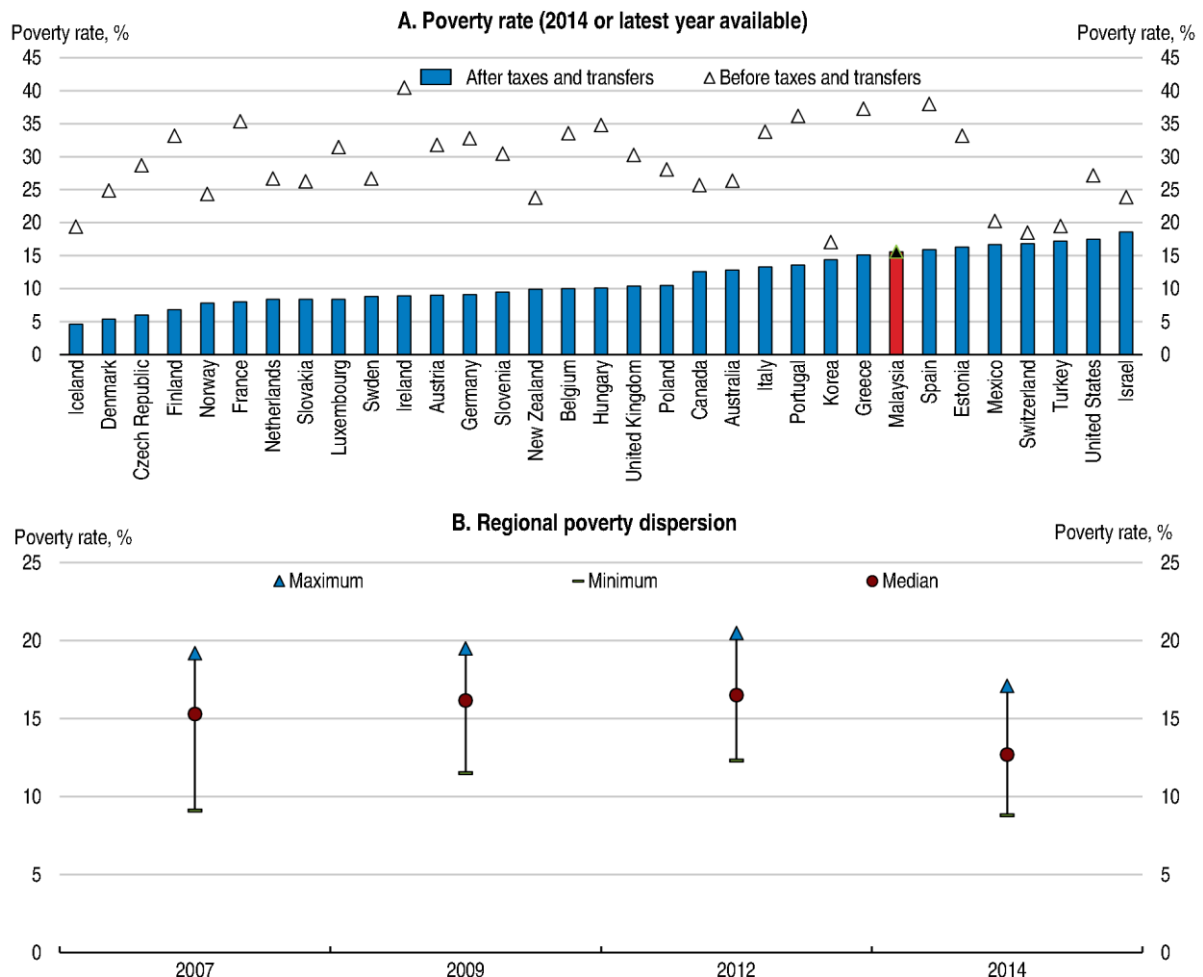
Malaysia remains very unequal in terms of wealth distribution. Estimates suggest that 53% of Malaysian households had zero financial assets in 2009, with ethnic Malay median financial wealth of just one ringgit (Muhammed Abdul Khalid, 2014). These estimates also indicate that some 92% of household wealth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

As absolute poverty in Malaysia has been reduced to low levels, relative poverty provides a more important benchmark for poverty eradication. The relative income poverty rate (based on an unadjusted 50% of median income) has come down to 15.6% in 2014 from 17.4% in 2007, which is above the OECD average but below the level in a comparable country such as Turkey (Figure 2.A). Inequality is particularly stark along regional lines, with a near eightfold difference in income inequality between the richest and poorest states (Figure 2.B and Figure 18 further down). Very small (single-person) and large (six-person) households appear particularly vulnerable to relative poverty, with education completion, urbanisation, broadband connectivity, and labour force participation among the factors associated with regional differences in relative poverty (Nixon, 2016). Multidimensional indicators of inequality, such as healthcare, education and information availability, also display ample regional variation.

The differences across space and groups in recent cost of living pressures also suggest the need to focus not only on the rural poor in less developed states but also on urban low-income households. In 2015,

inflation was almost two percentage points lower in relatively wealthy Kuala Lumpur than in poorer Sabah and Labuan, while inflation for households in the lowest income quintile was up to 0.6% higher (BNM, 2015). The absence of household income data for this period makes it difficult to determine if households in areas of higher inflation have benefited from compensatory adjustments in income; however, differences in local cost-of-living increases may be contributing to regional inequality.

Figure 2. Relative poverty indicators



Note: In Panel A, the data for Malaysia is based on relative poverty before taxes and transfers, with the rate after taxes and transfers assumed to be the same, consistent with the minimal redistributive effects of the tax and transfer system (see Figure 9 below).

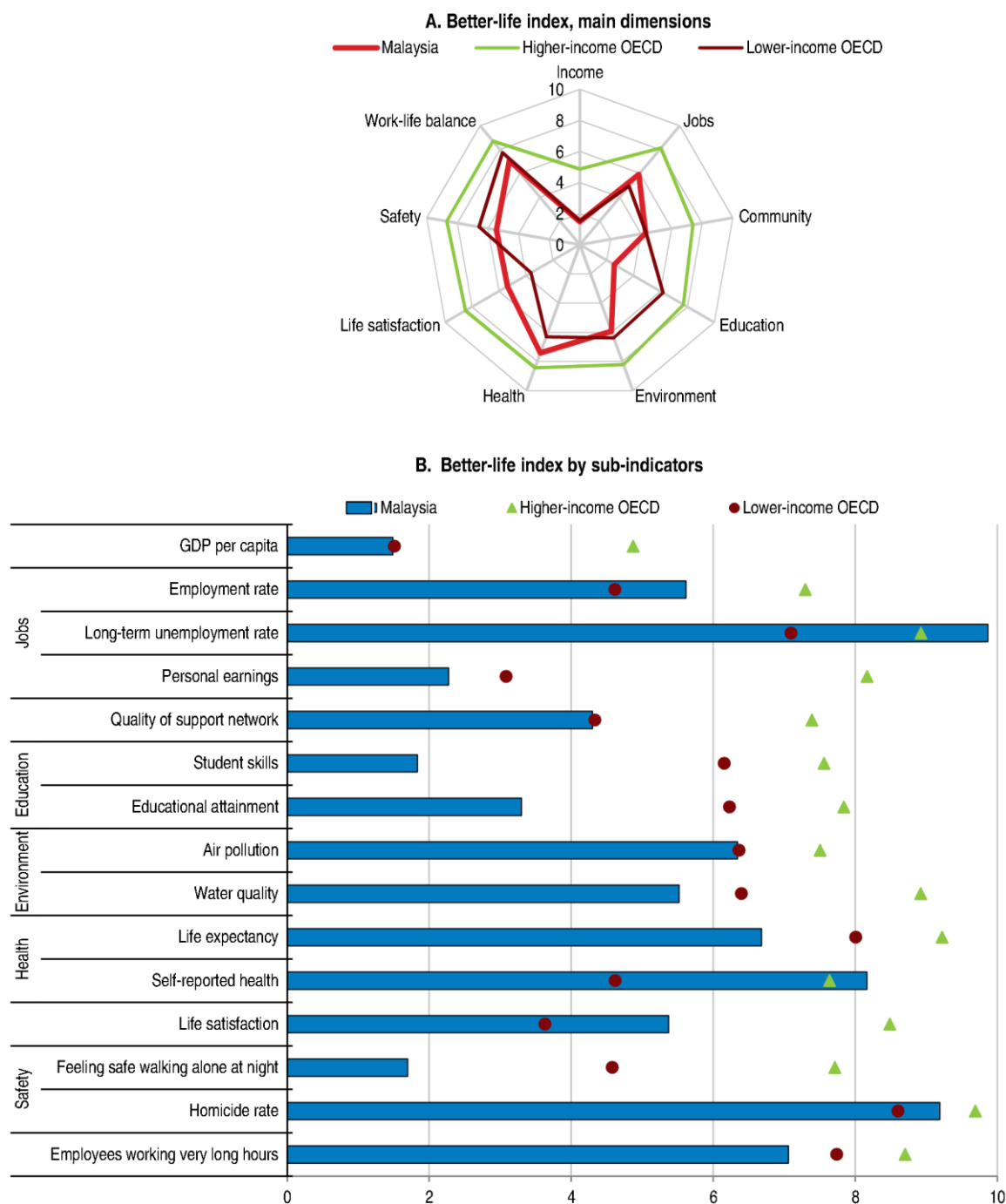
Source: OECD (2016), OECD Income Distribution Database, <http://dx.doi.org/10.1787/data-00654-en>; Department of Statistics, Malaysia.

Broader measures of inclusive growth and well-being

The OECD *Better Life Index* provides an overall snapshot of living standards within a country as a measure of the inclusiveness of growth. Malaysia scores well on some indicators, in particular long-term unemployment (Figure 3). However, the index illustrates Malaysia's relative weakness in areas such as educational attainment and skills, as well as personal earnings. Improving education quality and skills training is essential to raise lifetime earning potential and social mobility while promoting social cohesion and well-being over the longer term. The index also highlights the need to further improve healthcare to increase healthy life expectancy. Maintaining universal access to quality medical services,

particularly in rural areas and for low-income urban residents, would help narrow the life-expectancy gap with advanced countries.

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 high and low-income OECD data does not always correspond to the data in the OECD Better Life database.

2. In panel A, indicators are normalised to range between 10 (best) and 0 (worst) according to the following formula: $(\text{indicator value} - \text{minimum value}) / (\text{maximum value} - \text{minimum value}) \times 10$. In panel B, a simple ranking of the OECD countries is applied.

3. OECD high/bottom income countries are countries belonging to the top/bottom 30% income of the OECD member countries.

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

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

Malaysia has created its own well-being index drawing on indicators specific to its circumstances and priorities (Figure 4). The index captures aspects of inclusiveness similar to those embodied in the OECD *Better Life Index* but uses different indicators to represent these, determined by data availability rather than policy targets (see Annex 1 at the end of this paper). The index tracks improvements over time rather than providing an internationally comparable frontier approach. It suggests that between 2000 and 2014, most improvement has occurred in areas such as housing, transport, leisure, education, income and distribution; while improvement has been more modest in areas such as health, environment and family. The decline in index values for 2013 reflects short-lived dips in areas such as housing, culture and social participation, but also more significant downward trends in working life, environment and family life – with index values for the latter two having almost reverted back to the 2000 baseline.

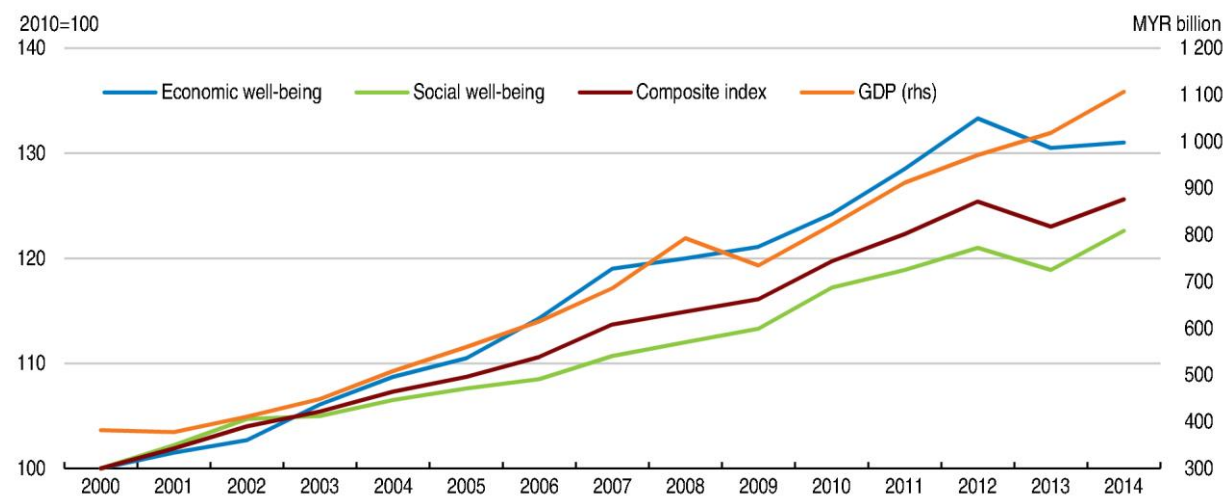
Divergence between the evolution of economic and social well-being and GDP growth over the period reflects the incorporation of indicators that can be weakly or even negatively correlated with GDP. Examples include environmental variables such as air quality and waste generation, family variables including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

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

A more inclusive labour market

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

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

Figure 4. Malaysian Well-being Index growth relative to GDP

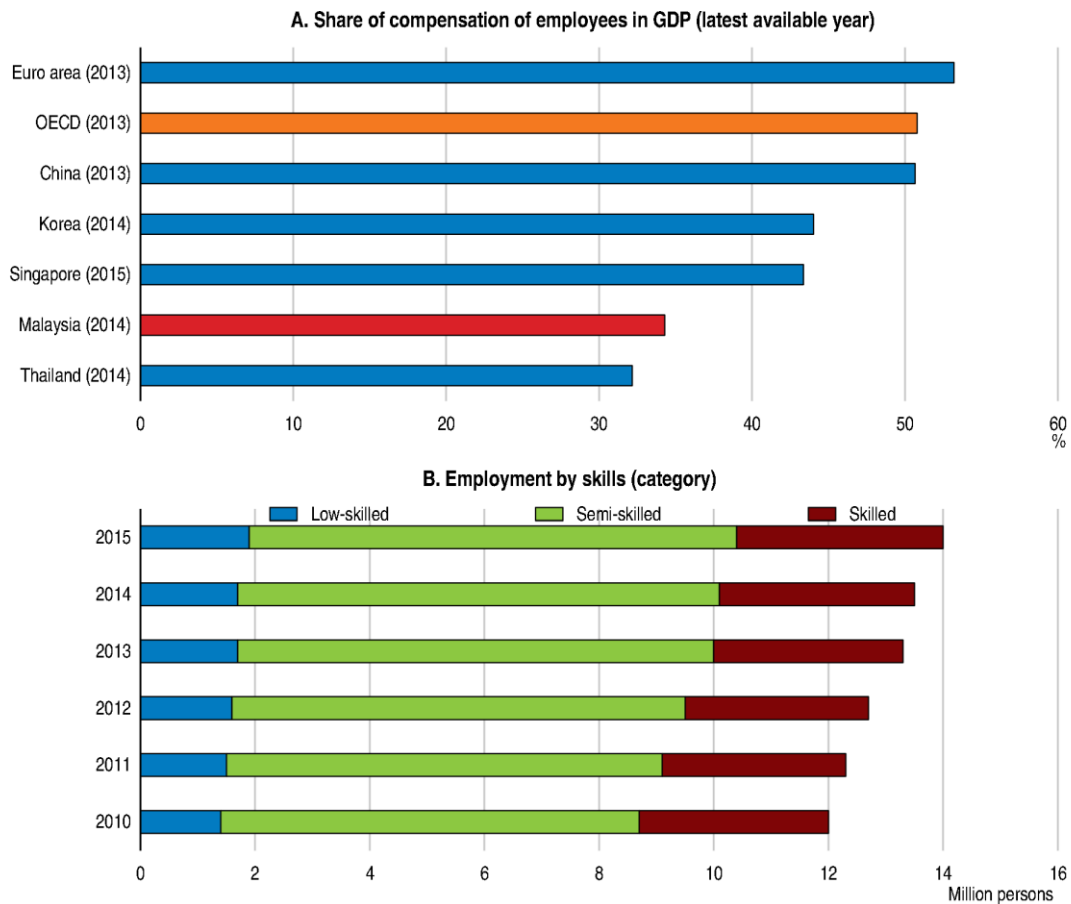
Source: EPU (2013), Malaysian Well-being Report 2013.

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

Addressing labour market imbalances that limit employee returns

Returns to work remain comparatively low in Malaysia, as reflected in a much lower share of employee compensation in GDP than in OECD countries (Figure 5.A). Slow growth of skilled job creation is contributing to this (Figure 5.B). Low relative returns to labour limit the inclusiveness of labour markets by discouraging participation and delivering excessive benefits to capital holders.

A minimum wage was introduced in 2013, applying to both Malaysian national and migrant workers. In 2009, around 34% of private sector workers earned less than MYR 700 (USD 175) per month, below the MYR 800 (USD 200) national poverty line income. The introduction of the minimum wage was estimated to have increased the wages of roughly 3.2 million private sector workers, or approximately 30% of the total workforce, though a systematic assessment of beneficiaries has not been carried out post implementation (UNDP, 2013; BNM 2013). The decline in relative poverty between 2012 and 2014 may reflect a positive impact of the minimum wage (Figure 2.B). Rates are determined every two-three years by a consultative council comprising government, employer association and union representatives. As of 1 July 2016, the monthly rate was raised to MYR 1 000 (USD 250) for Peninsular Malaysia and MYR 920 (USD 240) for the states of Sabah and Sarawak. The minimum for Peninsular Malaysia stood at 57% of the median wage in 2014.

Figure 5. The wage share is relatively low and skilled job creation has lagged

1. Skilled employment includes managers, professionals, technicians and associated professionals.

2. Semi-skilled employment includes clerical support workers, service and sales workers, skilled agricultural, forestry and fishery workers, craft and related trades workers, and plant and machine-operators and assemblers.

3. Low-skilled employment is for the remaining elementary occupations.

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

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

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

Reforms have also sought to reduce labour market skills mismatches through increased tertiary sector cooperation with industry and the creation of TalentCorp. Established in 2011 as an agency under the Prime Minister's Department, TalentCorp co-ordinates labour market and skills-development policies under the Talent Roadmap 2020. Policies aim to facilitate demand-driven, inclusive and productive

labour markets through reskilling programmes to reduce skills gaps, information and job-matching services to reduce youth unemployment, initiatives to enhance female labour participation and the attraction and retention of foreign talent, including Malaysians working abroad. Education sector reforms to address supply-side constraints, such as the shortage of job-ready graduates, are necessary.

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

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

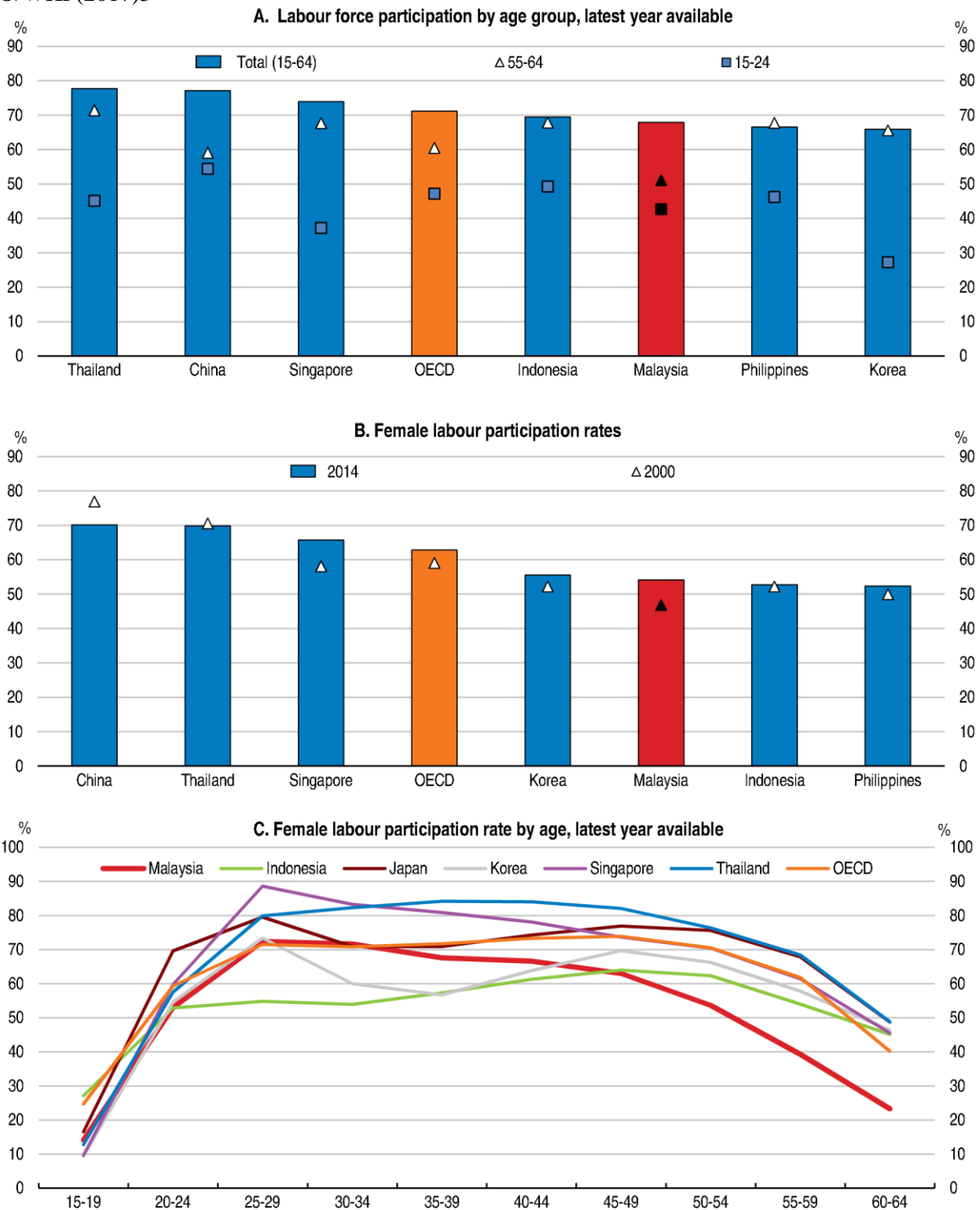
Malaysia's low trade union membership rate at 9.4% in 2013 compared with an average of 17% for OECD countries (ILO data) is also indicative of labour market imbalances that limit returns for workers. Impediments to the formation of unions and their rights to influence remuneration and conditions contribute to this, though implementation of the Trans-Pacific Partnership agreement (TPPA) is expected to require major improvements in this area. Indeed, TPPA signatories are required to ensure compliance with the 1998 ILO Declaration on Fundamental Principles and Rights at Work and its Follow-Up. The principles and rights include the freedom of association in forming labour unions and collective bargaining, and the elimination of employment discrimination. Alongside these expected changes, a modest Trade Union Development Programme has been introduced to increase worker understanding of collective bargaining and encourage union creation. These reforms will improve the balance between the protection of employees and the promotion of a flexible labour market.

Raising labour participation rates of women, youth and older people

Another priority for creating a more inclusive labour market is to raise the labour participation rates of women, youth and older people – groups which have ample room to contribute toward raising the overall participation rate. Across OECD countries, the gender employment gap has narrowed, with increased labour participation of women the result of rising education attainment and increased use of family-friendly policies (OECD, 2015b). In Malaysia, participation rates for these groups remain relatively low compared to other Southeast and East Asian countries and the OECD average (Figure 6.A and B).

The labour participation rate of women decreases with age from 25-29 years old in Malaysia, displaying a single-peak curve. This contrasts with the M-shaped participation profile of countries such as Japan and Korea, where participation rates rise anew after falling at the time of childbirth (Figure 6.C). Prior to 2010, female labour participation rates remained stubbornly low at around 46%. Reforms since then have contributed to it increasing to 54% in 2015, with the 11th Malaysia Plan targeting 59% by 2020. The government is encouraging female labour participation by providing better labour market information, improving access to jobs through the 1Malaysia Support for Housewives and Flexworklife programmes, and supporting entrepreneurship among women through Women Entrepreneurial Incubator (*Azam Niaga*) and 1Nita programmes. Women's participation also benefits from the

Figure 6 Labour participation rates are relatively low



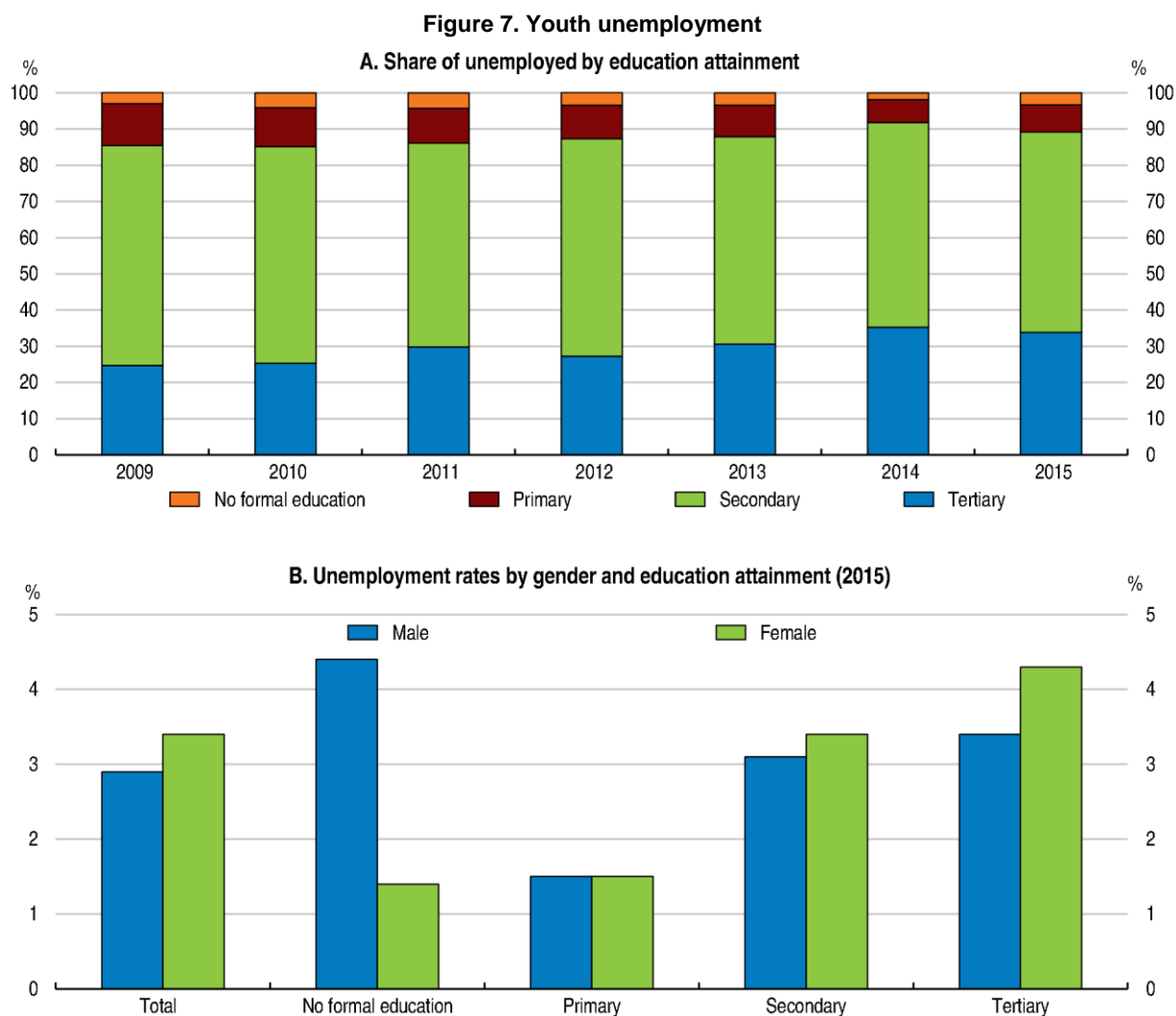
Note: In panel B, data for Malaysia is 2015 and 2014 for all others.

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

Career Comeback programme and Resourcing and Retention grants (which provide financial incentives for employers to hire returning workers) and the flexWorkLife.my portal increasing awareness of flexible working arrangements. To achieve the 59% target rate, the government will be strengthening its family-friendly employment strategy, including better access and affordability to quality

childcare facilities and early childhood education. It will also be undertaking labour market reforms promoting flexible working conditions, including flexible working hours and work-from-home options. Such family-friendly strategies and labour market reforms have proven to be effective in OECD countries. Providing life-long learning and reskilling opportunities would also facilitate women's return to work. Malaysia's particular challenge is to raise the participation rate of middle-aged and older women. Women of these generations have lower average levels of educational attainment, thus programmes that provide re-skilling opportunities and hiring incentives for employers are necessary to facilitate their re-entry.

Although the overall unemployment rate is low, at around 3% in recent years, unemployment of youth aged 15-24 approached 11% in 2015, accounting for 61% of total unemployment. The share of unemployed persons with tertiary degrees has risen steadily to close to 34% in 2015 (Figure 7.A). Unemployed women with a tertiary degree have become one of the largest groups of unemployed (Figure 7.B).



Source: Department of Statistics, Malaysia.

Higher unemployment rates among the highly-educated youth can largely be attributed to skill mismatches and a lack of work experience. To achieve the 11th Malaysia Plan target for youth unemployment of below 8% by 2020, the successful implementation of reforms to improve skills training,

job matching and the industry relevance of tertiary qualifications will be critical. The government also offers a programme, Transit home, aimed at high-risk children and youth to improve their employability including entrepreneurship, education and skills training as well as providing emotional and psychological support to return into society.

Stronger minimum wage enforcement and effective policies for migrant workers

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

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

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

More broadly Malaysia needs to rectify its approach to labour migration policies that for two decades have focussed on immediate business needs rather than longer-term settlement. While business-oriented temporary worker programmes provide flexibility as part of an overall immigration policy mix, the sole focus on temporary workers should be revisited to reduce the business stranglehold on low-skilled labour policy. This would encourage migrants to cooperate with government as legal temporary workers and potential future permanent residents where consistent with long-term labour market needs (ILO, 2016) (Box 1).

Strengthening social protection

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

Box 1. An immigration policy befitting a high-income inclusive country

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

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

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

In contrast, policies regarding low-skilled foreign workers are high volume and politically charged, resulting in migration being more difficult to manage. Registered foreign workers accounted for 17% of total employment in 2014, while the share is estimated to be 27% if undocumented foreign workers are taken into account. Indeed, 2.5 million unregistered foreign workers applied for regularisation in 2011 (OECD, 2012a). A large portion of registered foreign workers were engaged on a short-term basis in the manufacturing (36%), agriculture (23%) and construction (20%) sectors, reflecting restrictions on employment in many services sectors. Approximately one-third of the agricultural, manufacturing and construction workforce are migrants (ILO, 2016). Official planning documents, domestic commentators and to some extent industry see an enduring reliance on informal low-cost and low-skilled foreign workers as contributing to slower than desirable industrial upgrading and lower wage growth, though a causal link is difficult to substantiate. As noted previously, policies to align domestic and foreign worker rights through minimum wages and conditions are welcome but incompletely implemented and enforced (ILO, 2016). In addition to the 15% quota on migrant workers, increasingly high levies on migrant workers have further sought to reduce incentives to hire these workers and provide a financial barrier to prospective employers of migrants. The government attempted to drastically increase levies in early 2016, but has reduced the size of the hike following protests from employers. Malaysia has also bolstered regulations covering the employment and conditions of foreign workers, although the minimum wage does not apply to domestic helpers, who are mostly foreign workers. It has set up a single-window system for employers to apply for worker permits to encourage formalisation and has strengthened laws against the employers of undocumented foreign workers. However, these measures do not appear to have been effective in managing migration patterns or community attitudes to foreign workers.

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

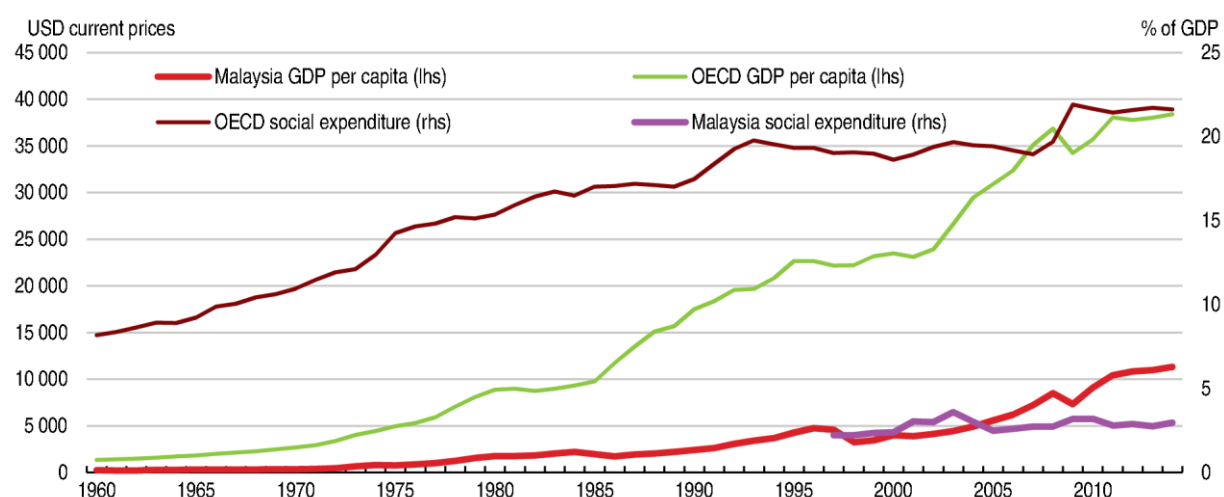
Malaysia's social protection expenditure is low for its development stage

Malaysia's social protection expenditure is lower than in all Southeast Asian countries for which data are available and than in all but a handful of countries in the Asia-Pacific region (ADB, 2015). Public expenditure on social protection as a proportion of GDP typically rises in step with GDP per capita, as has been the case for OECD countries. This has not been the case in Malaysia (Figure 8).

The low level of social protection expenditure is further reflected in the low redistributive power of the tax-and-transfer system: pre and post-tax and transfer Gini coefficients for income barely differ, like in Turkey (OECD, 2012b; Figure 9).

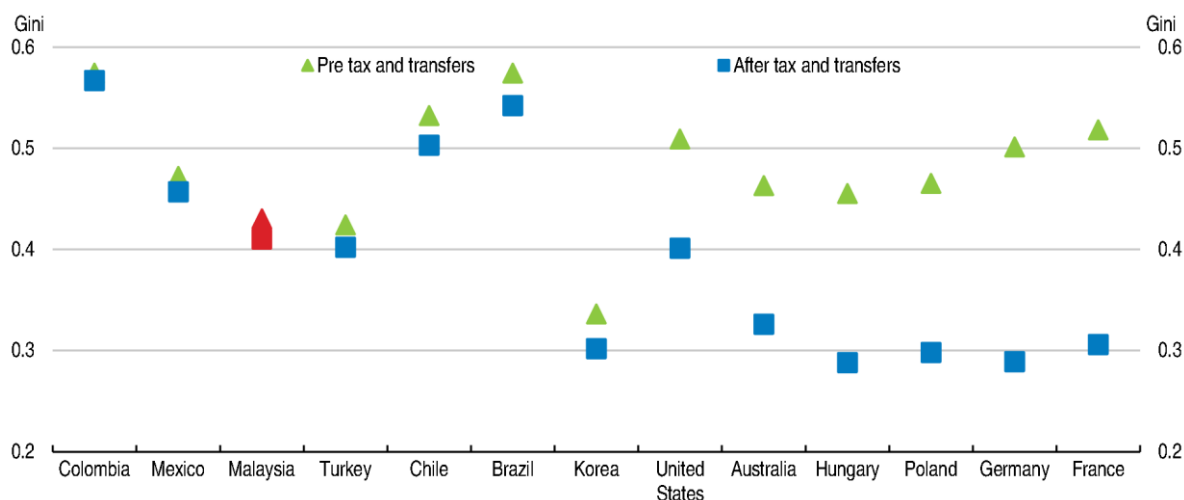
Subsidies that artificially kept down fuel, food and transport prices were by far the largest transfer to households prior to their substantial removal in 2014 (amounting to around MYR 24 billion or 4% of nominal GDP in 2013). Pension payments to retired civil servants are now the largest transfer, benefiting a small set of comparatively well-off households. Neither of these are a transfer that targets social welfare to low-income households.

Figure 8. Social expenditure in Malaysia has not increased in step with GDP per capita



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

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

Figure 9. Malaysia's tax-and-transfer system has little effect on income distribution

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

Fragmentation of programmes and institutions results in poorly targeted support

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

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

needed to improve the consistency of objectives, programme targeting and the overall impact on reducing disadvantage.

Beyond government, civil society makes an important contribution to social expenditure in Malaysia. As the size of this contribution increases, the effectiveness of Islamic institutions supporting the collection and distribution of *Zakat* and collaboration with government will be critical to optimising overall social expenditure (Box 2).

Towards a comprehensive social safety net

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

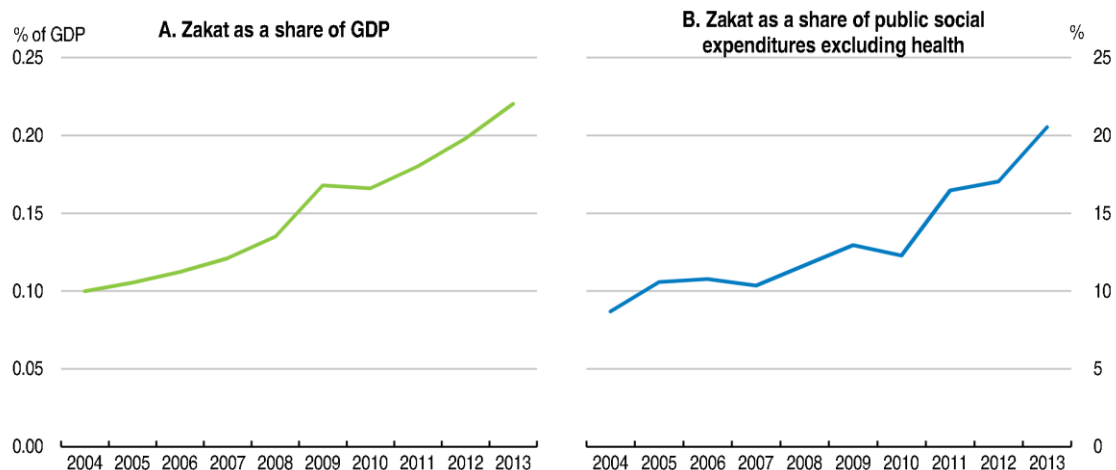
Experience suggests there is no one-size-fits-all approach to social protection systems, which need to be suited to country circumstances. However, a well-designed system would complement the strong incentives to engage in productive employment that exist in Malaysia, while supporting inclusiveness through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

Box 2. The contribution of *Zakat* to social expenditure in Malaysia

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

The contribution of *Zakat* to social expenditure has increased significantly in recent years, in absolute terms and in proportion to GDP (Figure 10). Importantly from the perspective of expenditure consistency and timeliness, the growth in *Zakat* collections is not proportional to GDP but holds up well during times of economic turbulence, when it is most needed. In 2013, *Zakat* represented over 20% of the level of government social spending excluding health, making it a major contributor to Malaysia's overall social expenditure.

Figure 10. Zakat has been expanding rapidly



Note: Social expenditure in Panel B includes central government expenditure on social security and welfare and zakat expenditure.

Source: Department of Awqaf, Zakat and Hajj (JAWHAR); ADB (2016), Statistical Database System.

Recent growth in the size of collections has prompted additional research evaluating the effectiveness of *Zakat* as a social expenditure mechanism (Johari et al., 2015). While effective in alleviating poverty by supplementing the income of benefiting households by as much as 30%, studies have identified numerous ways to increase *Zakat* collections, distributional targeting and the professionalism of institutional governance. Among priority areas for

improvement are delays in the distribution of funds, the need for modern collection methodologies (such as internet banking) and disbursement for income-generation activities (rather than income supplements).

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

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

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

A tax and transfer system that supports inclusive growth

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

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

Reversing the decline in revenue collection

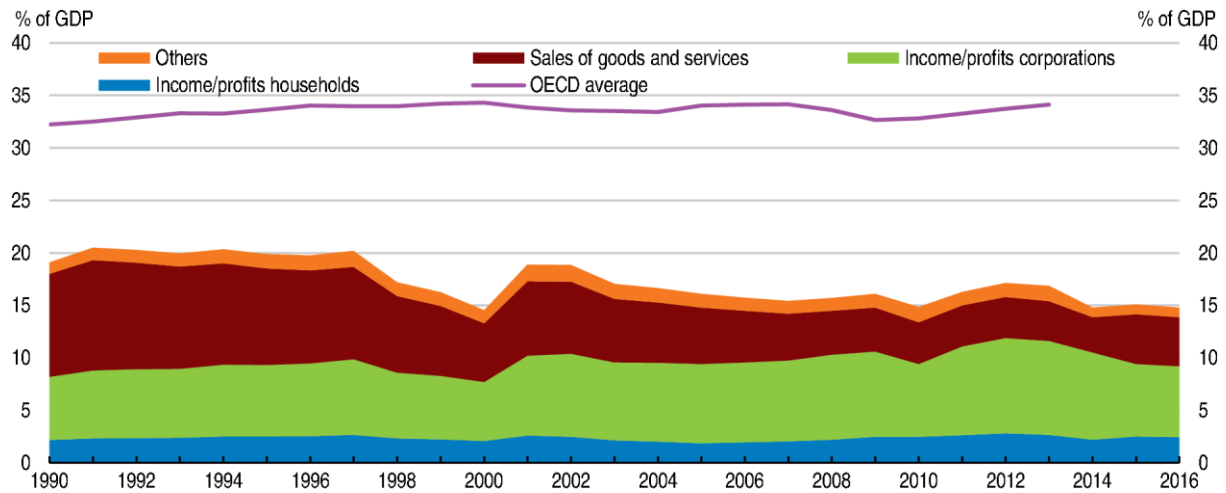
Low global oil prices have seen oil-related revenue decline substantially in recent years, with its share in overall revenue estimated to have halved between 2014 and 2016, to under 15%. Declining oil-related revenue is the latest contribution to a more concerning longer-term structural decline in the overall tax base. From around 20% of GDP prior to the Asian Financial Crisis, tax revenue has fallen throughout the 2000s to around 15% of GDP today (Figure 11). Tax revenue as a share of GDP is less than half the 34% OECD average and trending downwards. This evolution contrasts with the experience of other countries with rising income levels.

Faced with declining oil-related revenue, Malaysia has mainly acted on the spending side to achieve fiscal consolidation. Nonetheless, some difficult tax reforms have been implemented to reduce the rate of

revenue decline, including the introduction of the GST in April 2015 as well as an increase in the top marginal income tax rate from 25% to 28%. Intensifying popular concerns with rising cost-of-living pressures have more recently reversed the momentum for tax reform, prompting an expansion of the number of exempt or zero-rated GST items and a series of new income and corporate tax deductions.

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

Figure 11. The share of tax revenue in GDP is low and declining



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

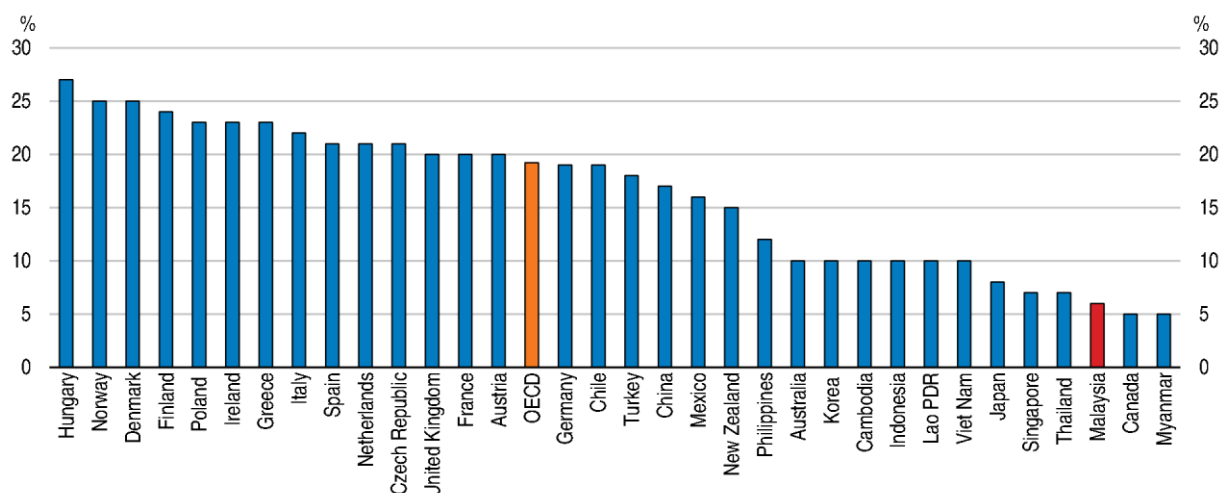
Indirect taxes and the GST in perspective

Indirect tax collections have declined over the past 25 years, with the revenue increase from the recently-introduced GST providing only a partial offset. Sales tax revenue as a proportion of GDP is less than half the early 1990s levels (Figure 11). Malaysia's opening to trade through the gradual reduction of tariffs and duties provide a partial explanation. However, despite an increasing share of consumption in GDP since the late 1990s, a combination of reduced tax rates and rising tax evasion has caused an erosion of the indirect tax intake. Reversing this trend in the context of rising cost-of-living pressures will be difficult but necessary.

Consumption taxes are potentially quite important to the overall tax mix given the size of the informal household sector, which includes an estimated 1.7 million undocumented foreign workers, and to tax around 350 000 Malaysian residents commuting to work in Singapore. Implementation of the GST has been more successful than anticipated, with a high rate of business compliance boosting collections beyond original projections. Recent research on OECD countries also indicates that greater use of simple, broad-based consumption taxes can be beneficial in reducing compliance costs and distortions to consumption decisions arising from differential rate systems, while also being proportional or slightly progressive when measured as a percentage of household expenditure (OECD/Korea Institute of Public Finance, 2014). In fact, there is ample scope for the GST to raise further revenue. The initial rate of 6% is low by regional and broader international standards (Figure 12), while increasingly extensive exemptions have reduced its effectiveness. For some zero-rated goods, the introduction of the GST has actually resulted in a decline in the tax rate with the concurrent repeal of the preceding sales tax. There is ample room for a gradual series of increases to bring Malaysia's GST rate into line with regional peers and OECD countries. Reducing the number of exempt or zero-rated

items and strengthening tax enforcement would help reduce tax leakage in the short term, while consideration could be given to a gradual increase in the rate of the GST over the medium term.

Figure 12. The GST rate is low by international standards



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

A more progressive income tax system with a broader base

Malaysia has traditionally sourced a large proportion of tax revenue from corporate income and profits taxes, in particular through taxes on profitable state-owned oil companies (Figure 11). Declining oil revenue in recent years has rendered this model unsustainable and highlighted the need to diversify the tax base. Opportunities still exist to adjust corporate tax settings where these would support broader industrial and environmental objectives.

Besides, Malaysia's income tax and transfer system does very little to enhance inclusiveness through tax schedule progressivity or redistribution, as evidenced by almost identical before and after tax and transfer Gini coefficients (Figure 9). A more progressive income tax schedule would complement the development of a comprehensive social protection system in reducing income inequality.

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

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

Taxes on capital income as well as on capital gains, in particular in relation to property, contribute little to the current tax base. The high proportion of home ownership, while in some ways supportive of inclusive growth, suggests incentives to invest (including low tax rates) are skewing household investment towards property. Even minor increases in taxes on capital income and gains from property could raise

significant revenue given the size of the potential base, while at the same time improving the progressivity of the tax system. Property taxes are also underutilised, with ongoing taxes based on the value of the property another possible means to achieve similar objectives. Additionally, with constitutional responsibility for property taxes with state governments, reform in this area could support fiscal decentralisation.

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

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

A more sustainable pension system that delivers higher retirement incomes

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

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

A more sustainable approach for public service pensions

Like a number of OECD countries, Malaysia has an increasingly unsustainable public sector pension system that offers more generous retirement incomes than afforded to private sector workers. Workers retiring after 30 or more years of service receive a guaranteed ongoing pension equal to 60% of their

final salary (excluding allowances), a lump-sum worth more than two years' salary and free or subsidised medical benefits for life. This implies a more-than-adequate effective replacement rate of around 80% of final salary. Pensions are financed through general tax revenue – including the anticipated contribution of Retirement Fund Incorporated established in 2007 to invest a portion of government funds set aside for pensions – and employees do not explicitly contribute a portion of their salary to fund the scheme.

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

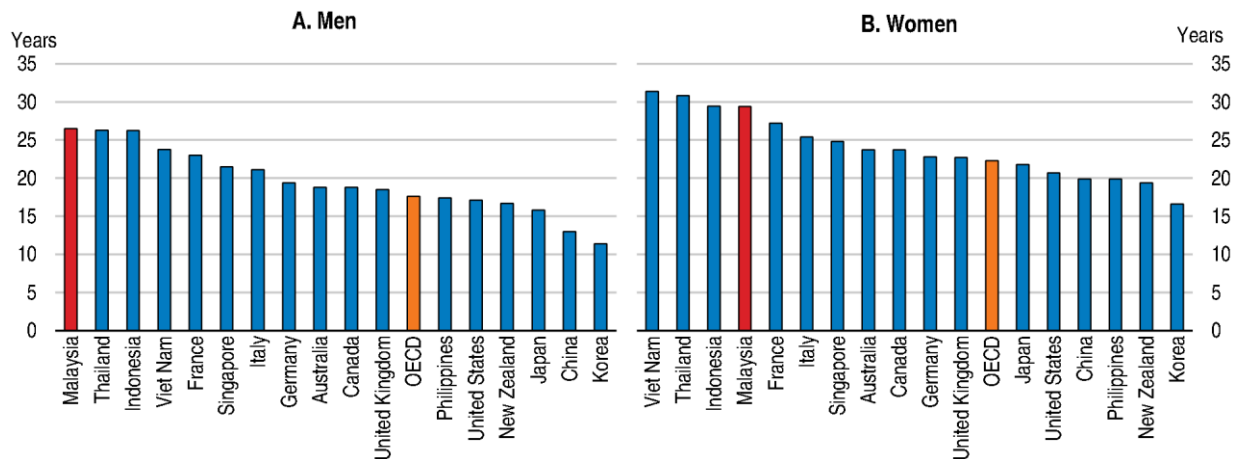
Raising the effective retirement age to account for rapid population ageing

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

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

Malaysians can already expect a long retirement compared to residents of both OECD countries and countries in the region (Figure 13). Despite being raised by five years in 2013, Malaysia's official retirement age of 60 remains below the OECD average of 64 in 2014. Moreover, by not simultaneously adjusting upward the withdrawal age for private sector workers under the EPF, the effective retirement age remains at 55. Malaysia should consider an immediate alignment of the EPF withdrawal age with the retirement age with transitional arrangements for current or imminent retirees, while developing a broader strategy to progressively raise its official retirement age and the EPF withdrawal age in line with expected changes in healthy life expectancy. Consultation between the EPF and its members on withdrawal age increases indicates that changes will need be done cautiously and effectively communicated, as individual awareness of retirement adequacy is low.

Figure 13. Malaysians can expect a lengthy retirement



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

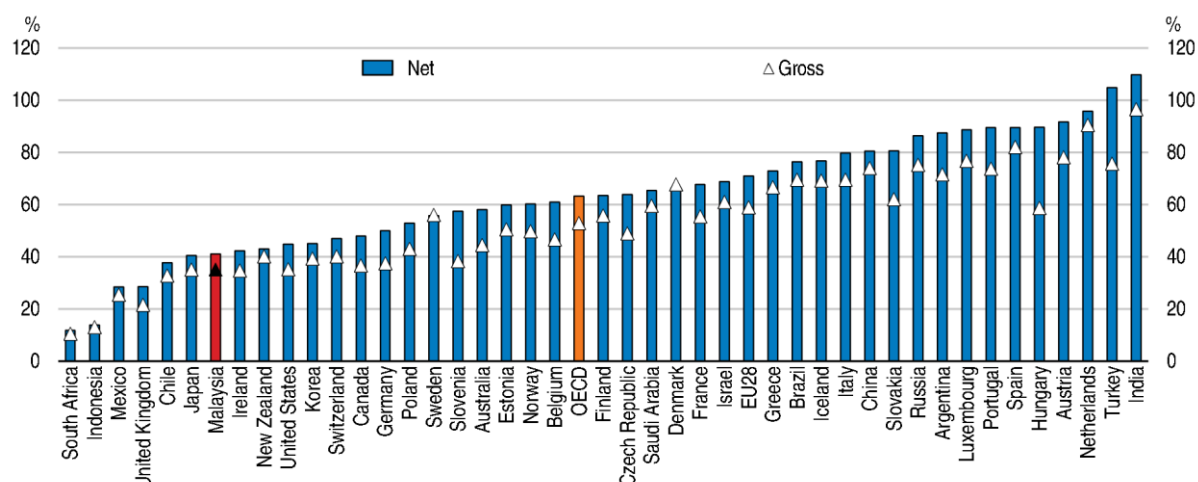
Source: OECD (2013b), Pensions at a Glance Asia-Pacific 2013, http://dx.doi.org/10.1787/pension_asia-2013-en; OECD (2015c), Pensions at a Glance 2015, http://dx.doi.org/10.1787/pension_glance-2015-en.

Options to improve replacement rates

The net replacement rate for a Malaysian male of average income was 41% in 2012, while the net replacement rate for a Malaysian male earning half the level of average income was 40.3% (OECD, 2013b). By comparison, the OECD average for these indicators was 68.3% and 79.5% respectively in 2014, with a replacement rate of around 70% of average income considered a reasonable benchmark for pension system adequacy (OECD, 2015d) (Figure 14). EPF data indicates that 70% of 54-year old members would not have enough savings to meet basic retirement needs if they retired at age 55, while half of all retirees exhaust their savings in just five years. System immaturity is not an issue for Malaysia's longstanding retirement system; it is the system settings that are delivering inadequate retirement incomes, with B40 households especially vulnerable. Replacement rates under the private sector scheme would not be expected to reach OECD levels in the absence of reforms.

The generous provision permitting early withdrawals ahead of the official retirement age and for certain current consumption activities (housing, education, medical and religious reasons), undermines a system designed to provide for retirement income. Compared to lowering mandatory contribution rates by 30% - equivalent to the share of contributions that can be withdrawn before age 55 –the system of early withdrawals adds bureaucracy and limits consumption opportunities for low-income households post-retirement. Tightening the system for early withdrawals would boost system integrity and ultimately improve replacement rates.

Figure 14. Pension replacement rates are low



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

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

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

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

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

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

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

At around 60%, Malaysia's low pension coverage rate as a proportion of its labour force indicates that high contribution rates may be deterring the entrance of workers into the formal sector. Labour force

formalisation would improve the effectiveness of government policies including tax and social welfare, with lower pension contribution rates for low-income workers one way to realign incentives to encourage formalisation. As a benchmark for pension coverage, Malaysia could seek convergence with the OECD average of around 86% in 2014.

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

Maintaining universal access to quality healthcare

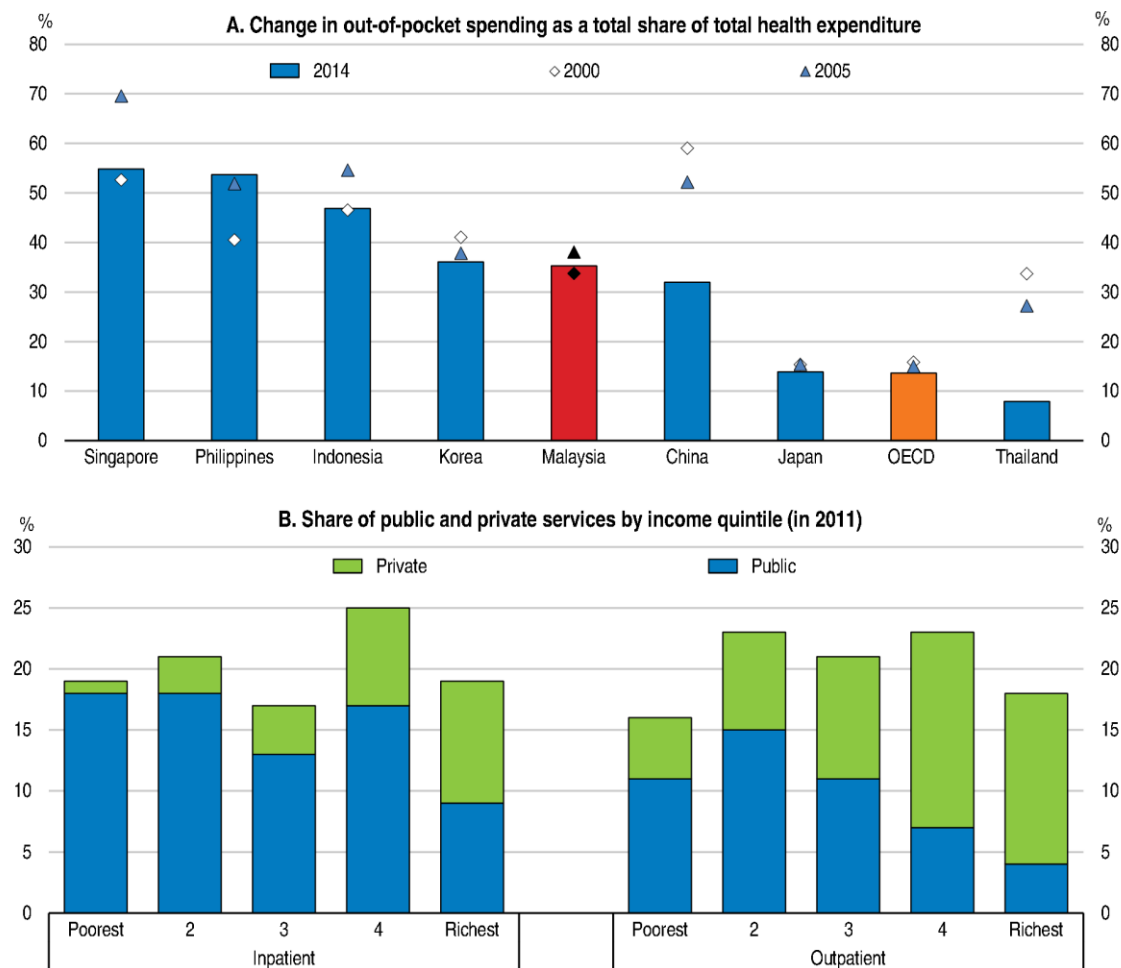
An accessible healthcare system that supports increasing healthy life expectancy is not only integral to well-being and inclusiveness, but is a necessary condition for a productive labour force. Malaysia's significant investment in public healthcare has complemented broader initiatives to alleviate poverty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

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

Addressing the increasing burden on the public system

High out-of-pocket expenditure for healthcare – representing 35% of total healthcare expenditure as of 2014 compared to an OECD average of 14% – is contributing to polarisation in the provision of healthcare services by socio-economic status (Figure 15). Use of private services increases with household income, while dependence on public services increases the poorer the household. This is especially the case for inpatients, who require more intensive care, as opposed to outpatients, who require mainly primary care. Access to highly-subsidised public healthcare ensures low incidences of catastrophic and impoverishing expenditures or deferral of medical treatment for financial reasons; however, it is resulting in an overburdening of the public health system.

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

Figure 15. Poor households are more reliant on public-sector health care services

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

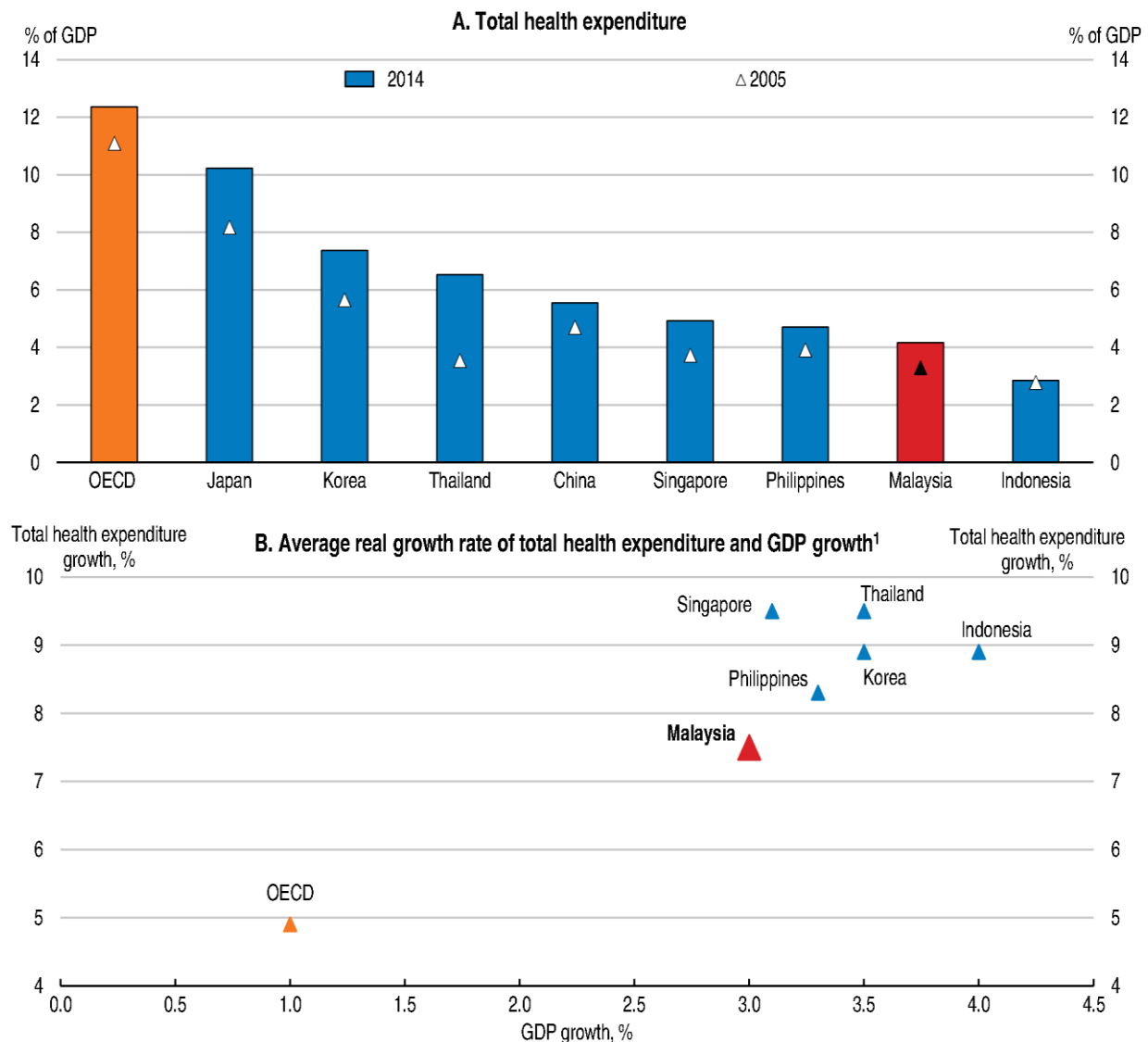
Malaysia has taken steps to ease the burden on the urban public health system and improve access to quality healthcare for low-income urban residents. The operational hours of some public outpatient clinics have been extended to increase access to primary care, catering to the irregular working hours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

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

The private system also suffers from a shortage of qualified professionals, most acutely with respect to qualified nurses. In contrast to the migration of doctors to the private system, many trained nurses have shifted to public hospitals attracted by better compensation packages and training opportunities. Private hospitals find it difficult to send their nurses for post-basic training due to a

shortage in training capacity (MPC, 2015). Despite the shortage of nurses in the private sector, 8 000 nursing graduates mainly from private colleges remained unemployed in 2012 due to a lack of necessary skills, in particular communication skills, and inadequate training. As most government hospitals have their feeder colleges, they are unable to employ graduates from the private nursing colleges. Most private hospitals prefer to hire graduates from public universities, who are perceived to have the necessary academic and employability skills (Nalini, 2014). To narrow skills and job mismatches, an integrated and well-structured programme encompassing universities, the government, and public and private medical institutions is required, as is a long-term view of skills training and a more flexible regulatory framework including with respect to labour conditions. For this purpose, the government and private colleges offer post-basic training course for private-sector nurses.

Figure 16. Healthcare expenditure in Malaysia



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

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

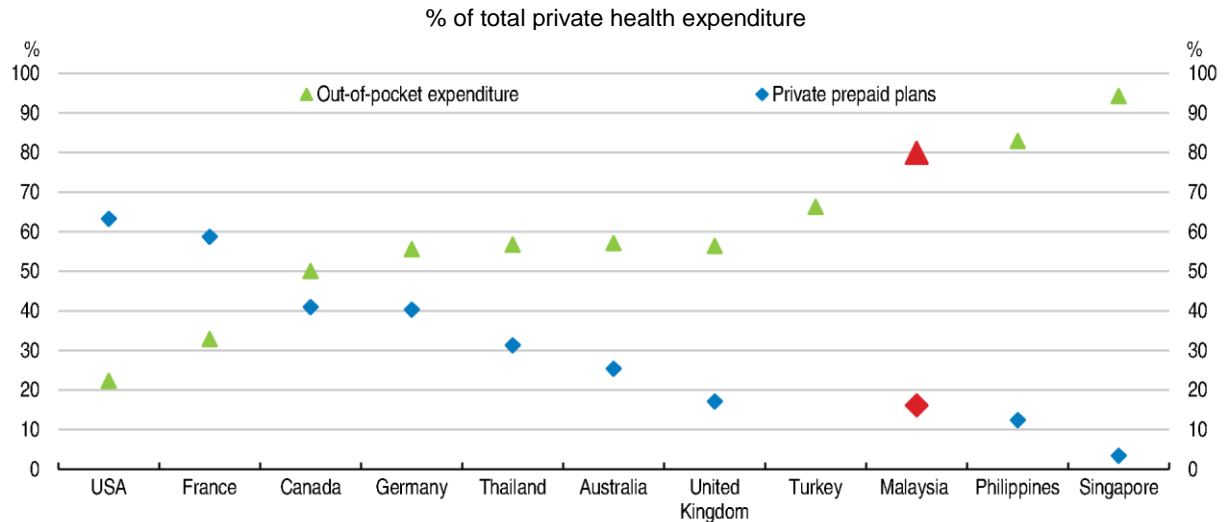
Enhancing the sustainability of the healthcare system

Malaysia's total expenditure on health amounted to 4% of GDP in 2014, below other Southeast Asian countries and the OECD average (Figure 16A). However, healthcare spending has outpaced GDP since 2000 and is expected to increase in line with rising living standards, technological development and the acceleration of population ageing (Figure 16B). Research on OECD and BRIICS countries has shown that while income and ageing effects account for a large share of rising health expenditure, health policies and institutions can help contain costs and provide opportunities to increase efficiency (OECD, 2013c).

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

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

Consistent with the ambitions of the Ministry of Health's ICT Strategic Plan 2016-2020, increased use of information and communications technology (ICT) systems would promote efficiency gains by enabling televisual primary care consultations (tele-primary care) and integrating the management of patients' health-related information (lifetime health records). Utilising the existing National Registration Identity Card (MyKad) system in implementing the lifetime health record system would deliver efficiency gains by exploiting synergies. Reforming the financing structure to ensure sustainability of the healthcare system has long been a government target (OECD, 2015e). Attempts to introduce a public healthcare insurance system have not met with agreement among stakeholders, despite intensive debates regarding cost sharing and the impact on quality and access to the services (Leng and Hong, 2014). Irrespective of whether public healthcare insurance is utilised in the future, rising healthcare costs accompanying population ageing will need to be accounted for in fiscal planning (Lee, 2015). In principle, private health insurance could make a greater contribution to managing rising healthcare costs, reducing the burden on the public healthcare system and driving improvements in preventive care. In practice, private health insurance is voluntary in Malaysia, with a low uptake so far resulting in a modest overall contribution to health expenditure and high out-of-pocket expenses for private healthcare (Figure 17). Tax relief for premiums have sought to raise the contribution of private health insurance with limited success, but as household incomes continue to rise renewed efforts could have more success. The scarcity of net taxpaying households suggests a levy, such as a surcharge on high-income individuals who do not take out private health insurance, would have a stronger incentive effect than tax relief. High-income households would thereby contribute to either private healthcare through insurance or to government revenue to fund the public system. An expanded private insurance market may also help promote preventive care, as insurance providers in countries such as the United States and Australia encourage utilisation of free or subsidised preventive health services to reduce future expenses.

Figure 17. Private insurance could fund a higher share of health expenditure

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

Narrowing the regional development gap

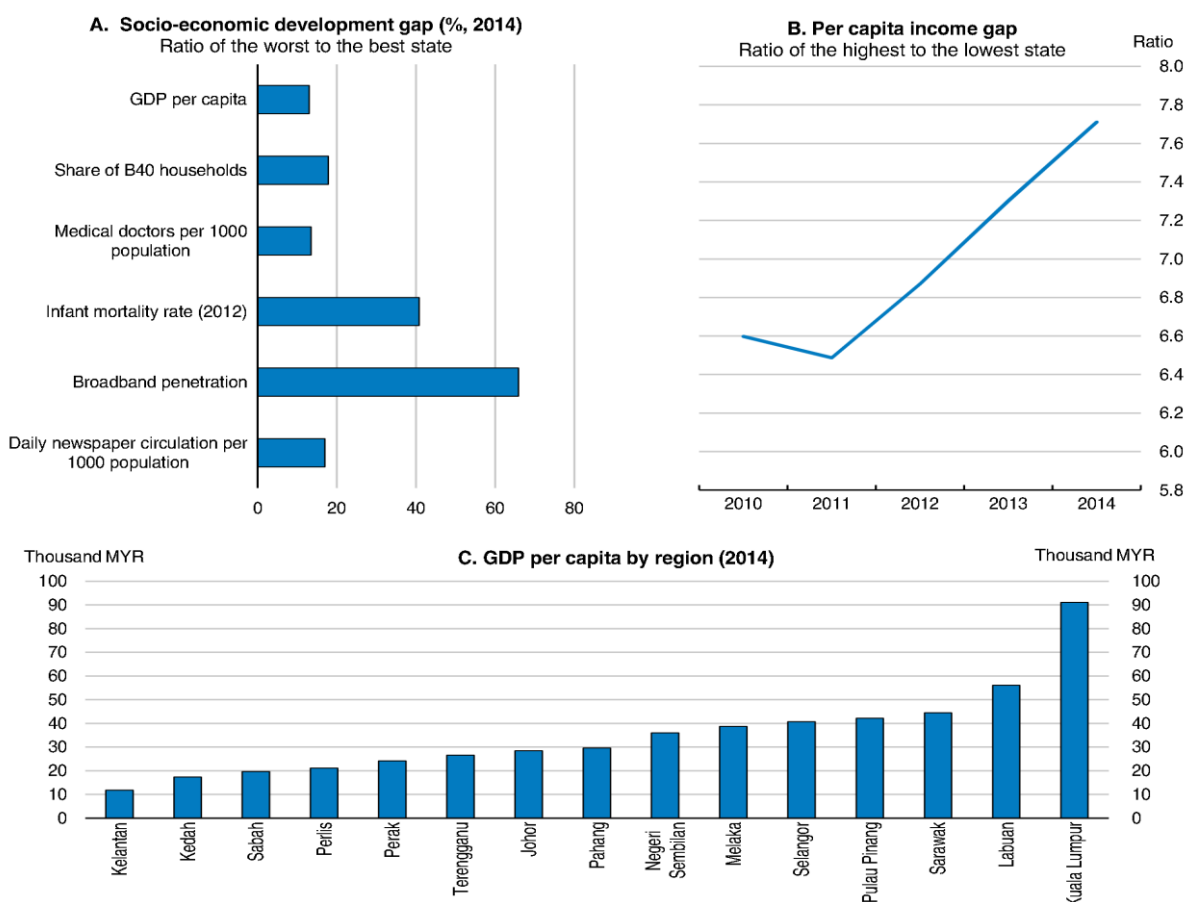
Malaysia's rapid and relatively inclusive development since independence has achieved impressive reductions in overall inequality. However, despite lower regional inequality being a priority of Malaysia's economic and social development strategy, regional differences remain large and have been widening in recent years. In 2014, the per capita GDP of Malaysia's richest state was almost eight times that of the poorest, having widened significantly since 2011 (Figure 18.A). More broadly, the socio-economic development gap is substantial, most notably in terms of relative income inequality, healthcare and access to information (Figure 18.B).

Regional inequality reflects the combination of historical, geographical and socio-economic factors that have favoured the development of western Peninsular Malaysia. These richer states have benefited from their location on global trade routes, with trade and investment facilitating the rapid development of industry and commerce. Growth in eastern Peninsular Malaysia and the Borneo Island states has relied more on primary industries, with slower development of infrastructure and human capital. These states are dominated by mountainous terrain or dense tropical rainforests, with challenging geography and low population density creating impediments to the efficient provision of public services. Despite these challenges, Malaysia has achieved near universal supply of reliable electricity and water supply and is making significant investments in improving transport and telecommunications infrastructure, education and healthcare. Even so, more can be done to further reduce regional differences.

The 9th Malaysia Plan (2006-10) created five regional economic corridors focused on attracting additional investment and creating jobs in target industries based on regional comparative advantages. Federal government financial incentives and streamlined regulatory approvals are offered to fast-track private sector investment and infrastructure improvements. Between 2011 and 2014, the corridors have attracted almost MYR 175 billion in investment and created 427 000 jobs (Table 1). The 11th Malaysia Plan increased the focus on programmes to raise skills training and entrepreneurship, while also improving the targeting of support to the needs of each economic corridor. For example, in the East Coast Economic Region, the entrepreneurship development programme is targeting women and youth to address relatively high unemployment of these persons in the region. The Sabah Development Corridor programme is providing skills training to upgrade agro-based industry and tourism with an aim to exploit rich natural endowments. The Iskandar Economic Development Zone has utilised investment liberalisation to develop target industries, becoming an emerging hub for sectors such as higher education and medical

tourism (attracting patients from neighbouring countries for high-quality, private sector care at competitive prices).

Figure 18. Increasing development gaps between states



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

Recent policy priorities issues include raising rural well-being and stimulating economic activities utilising land and natural resources. Initiatives are ongoing to develop rural infrastructure, increasingly in collaboration with non-government organisations and private companies, and government-linked corporations that provide financial contributions to these projects as contributions to corporate social responsibility. Although income inequality and differences in access to public services such as education, medical services and basic infrastructure between urban and rural areas have narrowed since the 1970s (EPU, 2015d), targeted support to improve education and healthcare services are still required as a basis for improving well-being. Targeted educational support for students from socio-economically disadvantaged backgrounds, who are more numerous in rural areas, would invigorate social mobility and enhance overall education outcomes.

As noted in the preceding section on healthcare, responding to the acceleration of ageing in rural areas, improving access to quality medical care and strengthening preventive and primary care is also necessary to improve well-being in rural communities. This could contribute to narrowing life expectancy gaps vis-à-vis advanced economies.

To narrow the income gap, it is necessary to create a resilient economic structure in rural areas by promoting rural economic activities and decent employment opportunities (EPU, 2015d). Only 8.9% of the rural population attained tertiary education in 2015. The unemployment rate for rural women with a tertiary degree was 7.4% in 2015, substantially higher than the 3.8% rate for their urban counterparts.

Encouraging agro-based processing activities and eco-tourism that utilise regional assets offers business opportunities in rural areas. Enhancing connectivity such as road and broadband internet with urban areas enlarges business opportunities for rural enterprises and should continue to be central to reducing regional inequality. To realise the business potential fully the government needs to implement a programme to support rural entrepreneurs through skills training, in particular for e-commerce, which contributes to linking consumers directly with rural entrepreneurs.

Table 1. Investment and job creation in regional economic corridors in 2011-14

Regional corridor	Committed investment (MYR bn)	Realised investment (MYR bn)	Jobs created
Iskandar Malaysia	90.4	47.1	320 100
Northern Corridor Economic Region	51.7	51.7	63 500
East Coast Economic Region	55.4	22.9	23 000
Sabah Development Corridor	96.7	44.5	15 200
Sarawak Corridor of Renewable Energy	12.9	8.3	5 300
Total	307.1	174.5	427 100

Innovation by rural SMEs will also be critical to boosting regional equality. The Inclusive Innovation programme under the SME Masterplan aims to empower the B40 by promoting the transformation of communities, including through technical financial and management support to microenterprises in rural areas. Harnessing the innovation potential of rural entrepreneurs will help create globally competitive SMEs from all parts of Malaysia and develop creative solutions to regional development problems. Private sector initiatives such as iCube – which provides a dynamic co-working space, financial and expert support for local young entrepreneurs in Kuching (Sarawak state) – also play a critical role in maximising the growth potential of regions.

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ANNEX 1

Malaysian Well-being index values and sub-indicators

Values

Components	Index value in 2012 (base year 2000 = 100)	Index value in 2013	Preliminary index value in 2014
Economic well-being	133.3	130.5	131.0
Transport	136.9	134.3	135.7
Communications	136.2	130.3	132.8
Education	132.9	133.4	135.7
Income and distribution	131.8	131.2	136.5
Working life	128.6	123.1	114.4
Social well-being	121.0	118.9	112.6
Housing	136.9	132.8	144.5
Leisure	131.4	129.9	135.9
Governance	128.1	129.5	132.5
Public safety	125.6	126.2	134.2
Social participation	120.6	111.9	116.3
Culture	120.3	110.6	119.0
Health	114.1	118.6	118.0
Environment	107.3	104.5	103.4
Family	104.6	105.7	100.1
Overall	125.4	123.0	125.6

Sub-indicators

Economic well-being	
Income and distribution	
➤	Real Gross National Product per capita (+)
➤	Gini coefficient for disposable income (-)
➤	Incidence of absolute poverty (-)
Education	
➤	Pre-school participation rate (+)
➤	Primary school participation rate (+)
➤	Secondary school participation rate (+)
➤	Tertiary participation rate (+)
➤	Literacy rate (+)
➤	Percentage of graduate teachers in primary schools (+)
➤	Percentage of graduate teachers in secondary schools (+)
➤	National Average Grade (Malaysian school examinations) (+)
➤	Number of lecturers with PhD (+)
➤	Primary education completion rate (+)
➤	Secondary education completion rate (+)
Transport	
➤	Road Development Index - incorporates the length of the road network, land area and population (+)
➤	Private motorcars & motorcycles (per '000 population) (+)
➤	Road length per capita (km) (+)
➤	Rail ridership (million) (+)
Communications	
➤	Fixed and mobile telephone line subscriptions (per '000 population) (+)
➤	Internet subscribers (per '000 population) (+)
➤	Number of hotspot locations (+)
➤	Number of domain names (per '000 population) (+)
Working life	
➤	Trade disputes (-)
➤	Days lost due to industrial action ('000) (-)
➤	Industrial accidents (-)

➤ Average working hours (-)
Social well-being
Housing
➤ Percentage of low-cost housing units to bottom 40% (+)
➤ Percentage of households with treated water (+)
➤ Percentage of households with electricity (+)
➤ Percentage of households with garbage collection services (-)
➤ Crowdedness (no. of persons per room) (-)
Leisure
➤ No. of households with paid TV subscription ('000) (+)
➤ Domestic hotel guests (per '000 population) (+)
➤ Recreational parks visitors (per '000 population) (+)
➤ Cinema goers (per '000 population) (+)
Governance
➤ Percentage of corruption cases prosecuted out of total arrests by Malaysian Anti-Corruption Commission (+)
➤ Number of e-payment transactions (million) (+)
➤ Percentage of cases solved by the Public Complaints Bureau (+)
➤ Percentage of income tax returns filed electronically (+)
Public safety
➤ Crime rate (per '000 population) (-)
➤ Road accidents (per '000 vehicles) (-)
Social participation
➤ Percentage of registered voters (per population aged 21 years and above) (+)
➤ Number of registered non-profit organisations (per '000 population) (+)
➤ Number of registered residents associations (+)
➤ Membership in RELA (volunteer security organisation) and RakanCop (policy community programme) (per '000 population)(+)
Culture
➤ Membership of public libraries (per '000 population)(+)
➤ Number of Istana Budaya (an entertainment show) visitors (per '000 population) (+)
➤ Number of museum visitors (per '000 population) (+)
➤ Number of Kompleks Kraf (a handicraft attraction) visitors (per '000 population)(+)
Health
➤ Life expectancy at birth (+)
➤ Non-communicable disease cases (per '000 population) (-)
➤ Infant mortality rate (per 1,000 live births) (-)
➤ Maternal mortality rate (per 100,000 live births) (-)
➤ Number of hospital beds (per '000 population) (+)
➤ Doctor to population ratio (-)
➤ Hospital waiting time for out-patients (minutes) (-)
Environment
➤ Air quality (% of station with API<50) (+)
➤ Water quality (% of clean river monitored) (+)
➤ Percentage of forested land (+)
➤ Quantity of scheduled waste generated (tonnes/year)/population (-)
➤ Average maximum temperature per annum (°C) (-)
Family
➤ Divorce rate (% of population aged 18 and above) (-)
➤ Domestic violence cases reported to police (per '000 population) (-)
➤ Juvenile crime cases (% of population aged 10 -18) (-)
➤ Mean monthly household gross income (RM) (+)
➤ Household debt per capita (RM) (+)
➤ Dependency ratio (-)

Source: EPU (2013), Malaysian Well-Being 2013.